

Section 1: 10-K (10-K)

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

FORM 10-K

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2018

OR

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

For transition period from _____ to _____

Commission File Number: 001-37391

SMARTFINANCIAL, INC.
(Exact name of registrant as specified in its charter)

Tennessee
(State or other jurisdiction of
incorporation or organization)

62-1173944
(I.R.S. Employer
Identification No.)

5401 Kingston Pike, Suite 600
Knoxville, Tennessee
(Address of principal executive offices)

37919
(Zip Code)

(865) 437-5700
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:
Common Stock, \$1.00 Par Value

Name of exchange where registered:
The NASDAQ Stock Market, LLC

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, \$1.00 Par Value

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the of the Securities Act.
Yes No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes No

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 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 and post such files).

Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging Growth Company

If emerging growth company, indicate by check market 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 June 30, 2018, the aggregate market value of the registrant's voting and non-voting common stock held by non-affiliates was approximately \$294.2 million. As of March 6, 2019, there were 13,946,283 shares outstanding of the registrant's common stock, \$1.00 par value.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement for the Annual Meeting of Shareholders to be held on May 2, 2019, are incorporated by reference in Part III of this Form 10-K.

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FORWARD-LOOKING STATEMENTS

SmartFinancial, Inc. (“SmartFinancial”) may from time to time make written or oral statements, including statements contained in this report (including, without limitation, certain statements in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in Item 7), that constitute forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 (the “Exchange Act”). Any statements that do not relate to historical or current facts or matters are forward-looking statements. You can identify some of the forward-looking statements by the use of forward-looking words, such as “may,” “will,” “could,” “project,” “believe,” “anticipate,” “expect,” “estimate,” “continue,” “potential,” “plan,” “forecast,” and the like, the negatives of such expressions, or the use of the future tense. Statements concerning current conditions may also be forward-looking if they imply a continuation of a current condition. These forward-looking statements involve known and unknown risks, uncertainties, and other factors that may cause our actual results, levels of activity, performance, financial condition, or achievements to be materially different from any future results, levels of activity, performance, or achievements expressed or implied by such forward-looking statements. Such factors include, but are not limited to:

- weakness or a decline in the U.S. economy, in particular in Tennessee, and other markets in which we operate;
- the possibility that our asset quality would decline or that we experience greater loan losses than anticipated;
- the impact of liquidity needs on our results of operations and financial condition;
- competition from financial institutions and other financial service providers;
- the impact of negative developments in the financial industry and U.S. and global capital and credit markets;
- the impact of recently enacted and future legislation and regulation on our business;
- negative changes in the real estate markets in which we operate and have our primary lending activities, which may result in an unanticipated decline in real estate values in our market area;
- risks associated with our growth strategy, including a failure to implement our growth plans or an inability to manage our growth effectively;
- claims and litigation arising from our business activities and from the companies we acquire, which may relate to contractual issues, environmental laws, fiduciary responsibility, and other matters;
- expected revenue synergies and cost savings from our recently completed acquisition of Foothills Bancorp, Inc. (“*Foothills*”) and the proposed acquisition of Entegra Financial (“*Entegra*”) may not be fully realized or may take longer than anticipated to be realized;
- disruption from these merger with customers, suppliers or employees or other business partners’ relationships;
- the risk of successful integration of the targets’ businesses with our business;
- lower than expected revenue following these mergers;
- SmartFinancial’s ability to manage the combined company’s growth following the mergers;
- the possibility that the Entegra merger may be more expensive to complete than anticipated, including as a result of unexpected factors or events;
- the dilution caused by SmartFinancial’s issuance of additional shares of its common stock in connection with the Foothills merger and the Entegra merger;
- cyber attacks, computer viruses or other malware that may breach the security of our websites or other systems we operate or rely upon for services to obtain unauthorized access to confidential information, destroy data, disable or degrade service, or sabotage our systems and negatively impact our operations and our reputation in the market;
- results of examinations by our primary regulators, the Tennessee Department of Financial Institutions (the “TDFI”), the Board of Governors of the Federal Reserve System (the “Federal Reserve”), and other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require us to increase our allowance for credit losses, write-down assets, require us to reimburse customers, change the way we do business, or limit or eliminate certain other banking activities;
- government intervention in the U.S. financial system and the effects of and changes in trade and monetary and fiscal policies and laws, including the interest rate policies of the Federal Reserve;
- our inability to pay dividends at current levels, or at all, because of inadequate future earnings, regulatory restrictions or limitations, and changes in the composition of qualifying regulatory capital and minimum capital requirements (including those resulting from the U.S. implementation of Basel III requirements);
- the relatively greater credit risk of commercial real estate loans and construction and land development loans in our loan portfolio;
- unanticipated credit deterioration in our loan portfolio or higher than expected loan losses within one or more segments of our loan portfolio;
- unexpected significant declines in the loan portfolio due to the lack of economic expansion, increased competition, large prepayments, changes in regulatory lending guidance or other factors;
- unanticipated loan delinquencies, loss of collateral, decreased service revenues, and other potential negative effects on our business caused by severe weather or other external events;

- changes in expected income tax expense or tax rates, including changes resulting from revisions in tax laws, regulations and case law;
- our ability to retain the services of key personnel; and
- the impact of Tennessee's anti-takeover statutes and certain of our charter provisions on potential acquisitions of us.

For a more detailed discussion of some of the risk factors, see the section entitled "Risk Factors" below. We do not intend to update any factors, except as required by SEC rules, or to publicly announce revisions to any of our forward-looking statements. Any forward-looking statement speaks only as of the date that such statement was made. You should consider any forward looking statements in light of this explanation, and we caution you about relying on forward-looking statements.

PART I

ITEM 1. BUSINESS

OVERVIEW

SmartFinancial, Inc. (“SmartFinancial” or the “Company”) was incorporated on September 19, 1983, under the laws of the State of Tennessee. SmartFinancial is a bank holding company registered under the Bank Holding Company Act of 1956, as amended.

The primary activity of SmartFinancial currently is, and is expected to remain for the foreseeable future, the ownership and operation of SmartBank (the “Bank”). As a bank holding company, SmartFinancial intends to facilitate SmartBank’s ability to serve its customers’ requirements for financial services. The holding company structure also provides flexibility for expansion through the possible acquisition of other financial institutions and the provision of additional banking-related services, as well as certain non-banking services, which a traditional commercial bank may not provide under present laws.

SmartBank

SmartBank is a Tennessee-chartered commercial bank established in 2007 which has its principal office in Pigeon Forge, Tennessee. The principal business of the Bank consists of attracting deposits from the general public and investing those funds, together with funds generated from operations and from principal and interest payments on loans, primarily in commercial loans, commercial and residential real estate loans, consumer loans and residential and commercial construction loans. Funds not invested in the loan portfolio are invested by the Bank primarily in obligations of the U.S. Government, U.S. Government agencies, and various states and their political subdivisions. In addition to deposits, sources of funds for the Bank’s loans and other investments include amortization and prepayment of loans, sales of loans or participations in loans, sales of its investment securities and borrowings from other financial institutions. The principal sources of income for the Bank are interest and fees collected on loans, fees collected on deposit accounts and interest and dividends collected on other investments. The principal expenses of the Bank are interest paid on deposits, employee compensation and benefits, office expenses and other overhead expenses. At December 31, 2018, SmartBank had 29 full-service branches located in Tennessee, Alabama, and Florida, two loan production offices, two mortgage loan production offices, and two service centers.

Foothills Merger

On June 28, 2018, the Company along with the Bank entered into an agreement and plan of merger with Foothills Bancorp, Inc., a Tennessee corporation and Foothills Bank, a Tennessee-chartered commercial bank and wholly owned subsidiary of Foothills Bancorp. The merger was consummated on November 1, 2018, with Foothills Bancorp stockholders receiving stock of the Company. After the merger, original stockholders of SmartFinancial owned approximately 91 percent of the outstanding common stock of the combined entity on a fully diluted basis while the previous Foothills Bancorp stockholders owned approximately 9 percent. The assets and liabilities of Foothills Bancorp, as of the effective date of the merger, were recorded at their respective estimated fair values and combined with those of the Company. The excess of the purchase price over the net estimated fair values of the acquired assets and liabilities was allocated to identifiable intangible assets with the remaining excess allocated to goodwill, which was approximately \$7.5 million. As a result of the merger the Company assets increased approximately \$218 million and liabilities increased approximately \$196 million.

Tennessee Bancshares Merger

On December 12, 2017, the Company along with the Bank entered into an agreement and plan of merger with Tennessee Bancshares, Inc., a Tennessee corporation and Southern Community Bank, a Tennessee-chartered commercial bank and wholly owned subsidiary of Tennessee Bancshares. The merger was consummated on May 1, 2018, with Tennessee Bancshares stockholders receiving stock of the Company. After the merger, original stockholders of SmartFinancial owned approximately 89 percent of the outstanding common stock of the combined entity on a fully diluted basis while the previous Tennessee Bancshares stockholders owned approximately 11 percent. The assets and liabilities of Tennessee Bancshares, as of the effective date of the merger, were recorded at their respective estimated fair values and combined with those of the Company. The excess of the purchase price over the net estimated fair values of the acquired assets and liabilities was allocated to identifiable intangible assets with the remaining excess allocated to goodwill, which was approximately \$16 million. As a result of the merger the Company assets increased approximately \$226 million and liabilities increased approximately \$207 million.

Capstone Merger

On May 22, 2017, the stockholders of the Company approved a merger with Capstone Bancshares, Inc. ("Capstone"), the one bank holding company of Capstone Bank, which was consummated on November 1, 2017. Capstone stockholders received either stock, cash, or a combination of stock and cash. After the merger, stockholders of SmartFinancial owned approximately 74 percent of the outstanding common stock of the combined entity on a fully diluted basis. The assets and liabilities of Capstone, as of the effective date of the merger, were recorded at their respective estimated fair values and combined with those of SmartFinancial. The excess of the purchase price over the net estimated fair values of the acquired assets and liabilities was allocated to identifiable intangible assets with the remaining excess allocated to goodwill, which was approximately \$38 million. As a result of the merger Company assets increased approximately \$536 million and liabilities increased approximately \$466 million. The merger had a significant impact on all aspects of the Company's financial statements, and as a result, financial results after the merger may not be comparable to financial results prior to the merger.

Purchase of Cleveland, Tennessee branch

On December 8, 2016, the Bank entered into a purchase and assumption agreement with Atlantic Capital Bank, N.A. on a branch in Cleveland, Tennessee. The purchase was completed on May 19, 2017 for a total of \$1.2 million in cash. The assets and liabilities as of the effective date of the transaction were recorded at their respective estimated fair values. The excess of the purchase price over the net estimated fair values of the acquired assets and liabilities was allocated to identifiable intangible assets with the remaining excess allocated to goodwill, which was \$660 thousand. In the periods following the acquisition, the financial statements include the results attributable to the Cleveland branch purchase beginning on the date of purchase. As a result of the transaction the Company acquired approximately \$27 million in assets and assumed \$27 million in liabilities.

SBLF Preferred Stock

On March 6, 2017, the Company redeemed its \$12 million of Senior Non-Cumulative Perpetual Preferred Stock, Series A ("SmartFinancial SBLF Stock"), to the United States Secretary of the Treasury and paid \$195 thousand in accrued dividends. More details about the SBLF Preferred Stock can be found in Note 16 in the "Notes to Consolidated Financial Statements."

Employees

As of December 31, 2018, SmartFinancial and SmartBank had 387 full-time equivalent employees. The employees are not represented by a collective bargaining unit. SmartFinancial believes that its relationship with its employees is good.

Merger and Acquisition Strategy

Our strategic plan involves growing a high performing community bank through organic loan and deposit growth as well as disciplined merger and acquisition activity. We are continually evaluating business combination opportunities and may conduct due diligence activities in connection with these opportunities. As a result, business combination discussions and, in some cases, negotiations, may take place, and transactions involving cash, debt or equity securities could be expected. Any future business combinations or series of business combinations that we might undertake may be material in terms of assets acquired, liabilities assumed, or equity issued.

Competition

We compete in the highly competitive banking and financial services industry. Our profitability depends principally on our ability to effectively compete in the markets in which we conduct business. We expect competition in the industry to continue to increase mainly as a result of the improvement in financial technology used by both existing and new banking and financial services firms. Competition may further intensify as additional companies enter the markets where we conduct business and we enter mature markets in accordance with our expansion strategy.

We experience strong competition from both bank and non-bank competitors. Broadly speaking, we compete with national banks, super-regional banks, smaller community banks and non-traditional internet-based banks. In addition, we compete with other financial intermediaries and investment alternatives such as mortgage companies, credit card issuers, leasing companies, finance companies, money market mutual funds, brokerage firms, governmental and corporation bond issuers, and other securities firms. Many of these non-bank competitors are not subject to the same regulatory oversight, affording them a competitive advantage in some instances. In many cases, our competitors have substantially greater resources and offer certain services that we are unable to provide to our customers.

We encounter strong pricing competition in providing our services. Additionally, other banks offer different products or services from those that we provide. The larger national and super-regional banks may have significantly greater lending limits and may offer additional products than we are capable of providing. We attempt to compete successfully with our competitors, regardless of their size, by emphasizing customer service while continuing to provide a wide variety of services.

Supervision and Regulation

General

The U.S. banking industry is highly regulated under federal and state law. The following is a general summary of the material aspects of certain statutes and regulations applicable to SmartFinancial and SmartBank. This supervisory framework could materially impact the conduct and profitability of SmartFinancial's and SmartBank's activities. A change in applicable laws or regulations, or in the manner such laws or regulations are interpreted by regulatory agencies or courts, may have a material effect on SmartFinancial's and SmartBank's business, operations, and earnings.

SmartFinancial is a bank holding company registered under the Bank Holding Company Act of 1956, as amended (which we refer to as the "BHC Act"). As a result, SmartFinancial is subject to supervision, regulation, and examination by the Federal Reserve and is required to file with the Federal Reserve annual reports and such additional information as the Federal Reserve may require pursuant to the BHC Act and applicable regulations. SmartFinancial is also under the jurisdiction of the SEC for matters relating to the offering and sale of SmartFinancial's securities and is subject to the SEC's rules and regulations relating to periodic reporting, reporting to stockholders, proxy solicitations, and insider-trading.

SmartBank is a Tennessee-chartered commercial bank and is a member of the Federal Reserve System. As a Tennessee-chartered bank, SmartBank is subject to supervision, regulation, and examination by the Tennessee Department of Financial Institutions ("TDFI"). As a member of the Federal Reserve System, SmartBank is also subject to supervision, regulation, and examination by the Federal Reserve. In addition, SmartBank's deposit accounts are insured up to applicable limits by the Deposit Insurance Fund of the Federal Deposit Insurance Corporation ("FDIC"), and SmartBank is subject to regulation by the FDIC as the insurer of its deposits.

The bank and bank holding company regulatory scheme has two primary goals: to maintain a safe and sound banking system and to facilitate the conduct of sound monetary policy. This comprehensive system of supervision and regulation is intended primarily for the protection of the FDIC's Deposit Insurance Fund, bank depositors, and the public, rather than SmartFinancial's stockholders or creditors. To this end, federal and state banking laws and regulations control, among other things, the types of activities in which SmartFinancial and SmartBank may engage, permissible investments that SmartFinancial and SmartBank may make, the level of reserves that SmartBank must maintain against deposits, minimum equity capital levels, the nature and amount of collateral required for loans, maximum interest rates that can be charged, the ability of SmartFinancial and SmartBank to pay dividends and the amount of dividends paid, and corporate activities regarding mergers, acquisitions, and the establishment and closing of branch offices. In addition, federal and state laws impose substantial requirements on SmartBank in the areas of consumer protection and detection and reporting of potential or suspected money laundering and terrorist financing activities.

The sections below summarize certain elements of the bank holding company and bank regulatory framework applicable to SmartFinancial and SmartBank. This summary is not, however, intended to describe all laws, regulations, and policies applicable to SmartFinancial and SmartBank, and you should refer to the full text of the referenced statutes, regulations, and corresponding guidance for more information. These statutes and regulations are subject to change, and additional statutes, regulations, and corresponding guidance may be adopted. Proposals to change the laws and regulations governing the banking industry are frequently raised at both the state and federal level. We are unable to predict any such future changes or the effects, if any, that any such changes could have on SmartFinancial's business, revenues, and financial results.

Regulation of SmartFinancial

As a regulated bank holding company, SmartFinancial is subject to various laws and regulations that affect SmartFinancial's business. These laws and regulations, among other things, prescribe minimum capital requirements, limit transactions with affiliates, impose limitations on the business activities in which SmartFinancial can engage, restrict SmartFinancial's ability to pay dividends to its stockholders, restrict the ability of institutions to guarantee its debt, and impose certain specific accounting requirements on SmartFinancial that may be more restrictive and may result in greater or earlier charges to earnings or reductions in its capital than generally accepted accounting principles.

Permitted Activities

Under the BHC Act, a bank holding company that is not a financial holding company (as discussed below) is generally permitted to engage in, or acquire direct or indirect control of more than 5 percent of any class of the voting shares of any company that is not a bank or bank holding company and that is engaged in, the following activities (in each case subject to certain conditions and restrictions and prior approval of the Federal Reserve):

- banking or managing or controlling banks;
- furnishing services to or performing services for its subsidiaries; and
- any activity that the Federal Reserve determines by regulation or order to be so closely related to banking as to be a proper incident to the business of banking, including, for example, factoring accounts receivable, making, acquiring, brokering, or servicing loans and usual related activities, leasing personal or real property, operating a nonbank depository institution, such as a savings association, performing trust company functions, conducting financial and investment advisory activities, underwriting and dealing in government obligations and money market instruments, performing selected insurance underwriting activities, issuing and selling money orders and similar consumer-type payment instruments, and engaging in certain community development activities.

While the Federal Reserve has in the past found these activities acceptable for other bank holding companies, the Federal Reserve may not allow SmartFinancial to conduct any or all of these activities, which are reviewed by the Federal Reserve on a case by case basis upon application by a bank holding company.

Acquisitions Subject to Prior Regulatory Approval

The BHC Act generally requires the prior approval of the Federal Reserve for a bank holding company to acquire substantially all the assets of a bank or to acquire direct or indirect ownership or control of more than 5 percent of any class of the voting shares of any bank, bank holding company, savings and loan holding company, or savings association, or to increase any such non-majority ownership or control of any bank, bank holding company, savings and loan holding company, or savings association, or to merge or consolidate with any bank holding company.

Under the BHC Act, a bank holding company that is located in Tennessee and is “well capitalized” and “well managed”, as such terms are defined under the BHC Act and implementing regulations, may purchase a bank located outside of Tennessee. Conversely, a well-capitalized and well-managed bank holding company located outside of Tennessee may purchase a bank located inside Tennessee. In each case, however, restrictions may be placed on the acquisition of a bank that has only been in existence for a limited amount of time or will result in concentrations of deposits exceeding limits specified by statute.

Federal and state laws, including the BHC Act and the Change in Bank Control Act, impose additional prior notice or approval requirements and ongoing regulatory requirements on any investor that seeks to acquire direct or indirect “control” of an FDIC-insured depository institution or bank holding company. “Control” of a depository institution or bank holding company is a facts and circumstances analysis, but generally an investor is deemed to control a depository institution or bank holding company if the investor owns or controls 25 percent or more of any class of voting securities. Ownership or control of 10 percent or more of any class of voting securities, where either the depository institution or bank holding company is a public company, like SmartFinancial, or no other person will own or control a greater percentage of that class of voting securities after the acquisition, is also presumed to result in the investor controlling the depository institution or bank holding company, although this is subject to rebuttal.

The BHC Act was substantially amended through the Financial Services Modernization Act of 1999, commonly referred to as the Gramm-Leach Bliley Act, or the GLBA. The GLBA eliminated long-standing barriers to affiliations among banks, securities firms, insurance companies, and other financial services providers. A bank holding company whose subsidiary deposit institutions are “well capitalized” and “well managed” may elect to become a “financial holding company” and thereby engage without prior Federal Reserve approval in certain banking and non-banking activities that are deemed to be financial in nature or incidental to financial activity. These “financial in nature” activities include securities underwriting, dealing, and market making; organizing, sponsoring, and managing mutual funds; insurance underwriting and agency; merchant banking activities; and other activities that the Federal Reserve has determined to be closely related to banking. Generally, no regulatory approval is required for a financial holding company to acquire a company, other than a bank or savings association, engaged in activities that are financial in nature or incidental to activities that are financial in nature, as determined by the Federal Reserve. SmartFinancial has not elected to become a financial holding company.

A dominant theme of the GLBA is functional regulation of financial services, with the primary regulator of a company or its subsidiaries being the agency which traditionally regulates the activity in which the company or its subsidiaries wish to engage. For example, the SEC regulates bank holding company securities transactions, and the various banking regulators oversee banking activities.

Bank Holding Company Obligations to Bank Subsidiaries

Under current law and Federal Reserve policy, a bank holding company is expected to act as a source of financial and managerial strength to its depository institution subsidiaries and to maintain resources adequate to support such subsidiaries, which could require SmartFinancial to commit resources to support SmartBank in situations where additional investments may not otherwise be warranted. As a result of these obligations, a bank holding company may be required to contribute additional capital to its subsidiaries.

Bank Holding Company Dividends

The Federal Reserve's policy regarding dividends generally is that a bank holding company should not declare or pay a cash dividend which would impose undue pressure on the capital of any bank subsidiary or would be funded only through borrowing or other arrangements that might adversely affect a bank holding company's financial position. As a general matter, the Federal Reserve has indicated that the board of directors of a bank holding company should consult with the Federal Reserve and eliminate, defer, or significantly reduce the bank holding company's dividends if:

- the company's net income available to stockholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends;
- the company's prospective rate of earnings retention is not consistent with its capital needs and overall current and prospective financial condition; or
- the company will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios.

If an insured member bank controlled by a bank holding company becomes "significantly undercapitalized" under the applicable federal bank capital ratios, or if the bank is "undercapitalized" and has failed to submit an acceptable capital restoration plan or has materially failed to implement such a plan, the Federal Reserve may require prior approval for any capital distribution by the bank holding company. For more information, see "*Capitalization Levels and Prompt Corrective Action*" below.

In addition, because SmartFinancial is a legal entity separate and distinct from SmartBank and does not conduct stand-alone operations, the company's ability to pay dividends largely depends on the ability of SmartBank to pay dividends to SmartFinancial, which is also subject to regulatory restrictions as described below in "*Bank Dividends*."

Under Tennessee law, SmartFinancial is not permitted to pay cash dividends if, after giving effect to the payment of such dividends, the company would not be able to pay its debts as they become due in the usual course of business or its total assets would be less than the sum of its total liabilities plus any amounts needed to satisfy any preferential rights if it were dissolving.

Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (which we refer to as the "Dodd-Frank Act") significantly changed the regulatory structure for financial institutions like SmartBank and their holding companies with respect to lending, deposit, investment, trading, and operating activities. Although the Dodd-Frank Act is primarily aimed at the activities of investment banks and large commercial banks, many of the provisions of the legislation impact the operations of community banks like SmartBank. The following aspects of the Dodd-Frank Act are, or may be, applicable to SmartFinancial's or SmartBank's operations:

- Tier 1 capital treatment for certain "hybrid" capital items such as trust preferred securities was eliminated, subject to various grandfathering and transition rules.
- The deposit insurance assessment base calculation now equals a depository institution's average consolidated total assets minus its average tangible equity during the assessment period. Previously, the deposit insurance assessment was calculated based on the insured deposits held by the institution.
- The ceiling on the size of the Deposit Insurance Fund was removed and the minimum designated reserve ratio of the Deposit Insurance Fund increased 20 basis points to 1.35 percent of estimated annual insured deposits or assessment base. The FDIC also was directed to offset the effect of the increased reserve ratio for insured depository institutions with total consolidated assets of less than \$10 billion.
- Bank holding companies and banks must be "well capitalized" and "well managed" in order to acquire banks located outside of their home state, which codified longstanding Federal Reserve policy. Any bank holding

- company electing to be treated as a financial holding company must be and remain “well capitalized” and “well managed.”
- Capital requirements for insured depository institutions are now countercyclical, such that capital requirements increase in times of economic expansion and decrease in times of economic contraction.
 - The Federal Reserve established interchange transaction fees for electronic debit transactions under a restrictive “reasonable and proportional cost” per transaction standard.
 - The “opt in” provisions of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1997 have been eliminated, which allows a state bank to establish de novo branches in a state other than the bank’s home state if the law of such other state would permit a bank chartered in that state to open a branch at that location.
 - The Durbin Amendment limits interchange fees payable on debit card transactions for financial institutions with more than \$10 billion in assets. While the Durbin Amendment does not directly apply to SmartBank, competitive market forces related to the reduction mandated by the Durbin Amendment may result in a decrease in revenue from interchange fees for smaller financial institutions.
 - The prohibition on the payment of interest on demand deposit accounts was repealed effective one year after enactment, thereby permitting depository institutions to pay interest on business checking and other accounts.
 - A new federal agency was created, the Bureau of Consumer Financial Protection (also known as the Consumer Financial Protection Bureau, or CFPB), which has broad rulemaking, supervisory, and enforcement authority over consumer financial products and services, including deposit products, residential mortgages, home-equity loans, and credit cards. The CFPB is also responsible for examining large financial institutions (i.e., those with more than \$10 billion in assets) for, and enforcing, compliance with federal consumer financial protection laws and regulations.
 - The regulation of consumer protections relative to mortgage originations, addressing loan originator compensation, minimum repayment standards, including restrictions on variable-rate lending by requiring the ability to repay be determined based on the maximum rate that will apply during the first five years of a variable-rate loan term, prepayment considerations, and new disclosures, has been expanded.

Economic Growth, Regulatory Relief, and Consumer Protection Act

On May 24, 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act (which we refer to as the “Regulatory Relief Act”) was enacted to modify or remove certain financial reform rules and regulations, including some of those implemented under the Dodd-Frank Act. While it maintains the majority of the regulatory structure established by the Dodd-Frank Act, the Regulatory Relief Act amends certain aspects for smaller depository institutions with less than \$10 billion in assets, such as SmartBank. Portions of the Regulatory Relief Act address access to mortgage credit; consumer access to credit; protections for veterans, consumers, and homeowners; rules for certain bank holding companies; capital access; and protections for student borrowers. SmartFinancial and SmartBank will focus on the implementing rules, regulations, and guidance for the various provisions of the Regulatory Relief Act that impact their operations and activities.

Among other things, the Regulatory Relief Act simplifies the regulatory capital rules for financial institutions and their holding companies with total consolidated assets of less than \$10 billion. The Regulatory Relief Act requires federal banking agencies to develop a community bank leverage ratio (defined as the ratio of tangible equity capital to average total consolidated assets) for banks and holding companies with total consolidated assets of less than \$10 billion and an appropriate risk profile. The required regulations must specify a minimum community bank leverage ratio of not less than 8 percent and not more than 10 percent, as well as procedures for treatment of a qualifying banking organization that has a community bank leverage ratio that falls below the required minimum. Qualifying banking organizations that exceed the minimum community bank leverage ratio will be deemed to be in compliance with all other capital and leverage requirements. On November 21, 2018, pursuant to the Regulatory Relief Act, the federal banking agencies issued a notice of proposed rulemaking proposing a community bank leverage ratio of 9 percent. The comment period for the proposed rule has since closed, but the regulation is not yet finalized. The final minimum community bank leverage ratio is not known at this time.

The Regulatory Relief Act also expands the universe of holding companies that are permitted to rely on the “Small Bank Holding Company and Savings and Loan Holding Company Policy Statement” (which we refer to as the “Small BHC Policy Statement”). The asset size of a qualifying holding company was increased from \$1 billion to \$3 billion on August 30, 2018, thus excluding holding companies with less than \$3 billion in total consolidated assets from consolidated capital requirements.

Further, the Regulatory Relief Act decreased the burden for community banks in regards to call reports, the Volcker Rule (which generally restricts banks from engaging in certain investment activities and limits involvement with hedge funds and private equity firms), mortgage disclosures, and risk weights for some high-risk commercial real estate loans. On December 28, 2018, the federal banking agencies issued a final rule under the Regulatory Relief Act increasing the asset threshold to qualify for an 18-month on-site examination cycle from \$1 billion to \$3 billion for qualifying institutions that are well capitalized, well managed, and meet certain other requirements.

As of December 31, 2018, SmartFinancial had total consolidated assets of approximately \$2.3 billion, meaning that it could qualify to rely on the Small BHC Policy Statement and qualify for an 18-month on-site examination cycle. However, in the event the Entegra merger is completed, SmartFinancial would have total consolidated assets of more than \$3 billion and would not qualify for these regulatory relief measures.

The Dodd-Frank Act, even despite the regulatory relief afforded by the Regulatory Relief Act, or any number of the provisions of the Regulatory Relief Act itself, may have the effect of increasing SmartFinancial's and SmartBank's expenses, decreasing their revenues, and changing the activities in which they choose to engage. The environment in which banking organizations operate is ever-evolving and any number of changes, whether legal, regulatory, social, economic, or otherwise, may have long-term effects on the profitability of banking organizations that cannot now be foreseen. It is particularly difficult at this time to determine or predict the impact of the Regulatory Relief Act on SmartFinancial and SmartBank, in part because various implementing rules and regulations are required and many of these have not yet been written or finalized.

U.S. Basel III Capital Rules

The U.S. Basel III capital rules, which were effective January 1, 2015, currently apply to all national and state banks and savings associations and certain, generally larger, bank holding companies (which we refer to collectively as "covered banking organizations"). The requirements in the U.S. Basel III capital rules started to phase in on January 1, 2015, for many covered banking organizations, including SmartFinancial and SmartBank, and were fully phased in on January 1, 2019.

In recent years, bank holding companies with less than \$1 billion in total consolidated assets and that are not engaged in significant nonbanking activities, do not conduct significant off-balance sheet activities, and do not have a material amount of debt or equity securities registered with the SEC have been exempt from the Federal Reserve's consolidated capital requirements under the Small BHC Policy Statement. As discussed above, the Regulatory Relief Act increased the asset threshold for bank holding companies to qualify for the Small BHC Policy Statement from \$1 billion to \$3 billion. Accordingly, SmartFinancial currently is not subject to the Federal Reserve's consolidated capital requirements (as of December 31, 2018, SmartFinancial had total consolidated assets of approximately \$2.3 billion), but will become subject to these requirements if and when it reaches \$3 billion in total consolidated assets. Despite SmartFinancial currently being exempt from these requirements, SmartBank remains subject to minimum capital requirements. In the event the Entegra merger is completed, however, SmartFinancial would have total consolidated assets of more than \$3 billion and would become subject to the Federal Reserve's consolidated capital requirements.

The U.S. Basel III capital rules impose the following minimum capital requirements:

- a common equity Tier 1 risk-based capital ratio of 4.5 percent;
- a Tier 1 risk-based capital ratio of 6 percent;
- a total risk-based capital ratio of 8 percent;
- a leverage ratio of 4 percent; and
- for a very small number of the largest financial institutions in the United States, an enhanced supplementary leverage ratio of 3 percent.

Under the U.S. Basel III capital rules, Tier 1 capital is defined to include two components: common equity Tier 1 capital and additional Tier 1 capital. The highest form of capital, common equity Tier 1 capital, or CET1 capital, consists solely of common stock (plus related surplus), retained earnings, accumulated other comprehensive income, and limited amounts of minority interests that are in the form of common stock. Additional Tier 1 capital includes other perpetual instruments historically included in Tier 1 capital, such as non-cumulative perpetual preferred stock.

The rules permit bank holding companies with less than \$15.0 billion in total consolidated assets, such as SmartFinancial, to continue to include trust-preferred securities and cumulative perpetual preferred stock issued before May 19, 2010, in Tier 1 capital, but not in CET1 capital, subject to certain restrictions. Tier 2 capital consists of an institution's allowance for loan and lease losses, up to 1.25 percent of risk-weighted assets; qualifying perpetual preferred stock (and related surplus); certain qualifying hybrid capital instruments, perpetual debt, and mandatory convertible debt; certain qualifying subordinated debt instruments and intermediate-term preferred stock (and related surplus), subject to limitations; and a percentage of pretax net unrealized gains on available-for-sale equity securities with readily determinable fair values.

In addition, in order to avoid restrictions on capital distributions or discretionary bonus payments to executives, a covered banking organization must maintain a capital conservation buffer on top of its minimum risk-based capital requirements. This buffer must consist solely of Tier 1 common equity, but the buffer applies to all three risk-based capital measurements (common equity Tier 1 capital, Tier 1 capital, and total capital). The capital conservation buffer, which was phased in incrementally over time and became fully phased in on January 1, 2019, consists of an additional amount of common equity Tier 1 capital equal to 2.5 percent of risk-weighted assets.

The U.S. Basel III capital standards require certain deductions from or adjustments to capital. Deductions from CET1 capital are required for goodwill (net of associated deferred tax liabilities); intangible assets such as non-mortgage servicing assets and purchased credit card relationships (net of associated deferred tax liabilities); deferred tax assets that arise from net operating loss and tax credit carryforwards (net of any related valuation allowances and net of deferred tax liabilities); any gain on sale in connection with a securitization exposure; any defined benefit pension fund net asset (net of any associated deferred tax liabilities) held by a bank holding company (this provision does not apply to a bank or savings association); the aggregate amount of outstanding equity investments (including retained earnings) in financial subsidiaries; and identified losses. Other deductions are necessary from different levels of capital. The U.S. Basel III capital rules generally also increased the risk weight for certain assets, meaning that more capital must be held against those assets. For example, under Basel III, commercial real estate loans that do not meet certain underwriting requirements must be risk-weighted at 150 percent, rather than at 100 percent which was the case prior to the U.S. Basel III capital rules becoming effective; however, the Regulatory Relief Act has reversed this for community banks with respect to some commercial real estate loans.

Additionally, the U.S. Basel III capital standards provide for the deduction of three categories of assets: (i) deferred tax assets arising from temporary differences that cannot be realized through net operating loss carrybacks (net of related valuation allowances and of deferred tax liabilities), (ii) mortgage servicing assets (net of associated deferred tax liabilities), and (iii) investments in more than 10 percent of the issued and outstanding common stock of unconsolidated financial institutions (net of associated deferred tax liabilities). The amount in each category that exceeds 10 percent of CET1 capital must be deducted from CET1 capital. The remaining, non-deducted amounts are then aggregated, and the amount by which this total amount exceeds 15 percent of CET1 capital must be deducted from CET1 capital. Amounts of minority investments in consolidated subsidiaries that exceed certain limits and investments in unconsolidated financial institutions may also have to be deducted from the category of capital to which such instruments belong.

Accumulated other comprehensive income, or AOCI, is presumptively included in CET1 capital and often would operate to reduce this category of capital. The U.S. Basel III capital rules provided a one-time opportunity at the end of the first quarter of 2015 for covered banking organizations to opt out of much of this treatment of AOCI, and SmartFinancial elected to opt out. The rules also have had the effect of increasing capital requirements by increasing the risk weights on certain assets, including high volatility commercial real estate (as discussed above), mortgage servicing rights not includable in CET1 capital, equity exposures, and claims on securities firms, which are used in the denominator of the three risk-based capital ratios.

As discussed above under "*Economic Growth, Regulatory Relief, and Consumer Protection Act*," pursuant to the Regulatory Relief Act, federal banking agencies have proposed a new minimum community bank leverage ratio (defined as the ratio of tangible equity capital to average total consolidated assets) of 9 percent for banks and holding companies with total consolidated assets of less than \$10 billion and an appropriate risk profile. Qualifying banking organizations that exceed the minimum community bank leverage ratio would be deemed to be in compliance with all other risk-based and leverage capital requirements. At the same time, the agencies proposed corresponding capital adequacy levels. As proposed, a qualifying banking organization with a community bank leverage ratio of greater than 9 percent would be considered "well capitalized"; a qualifying banking organization with a community bank leverage ratio of 7.5 percent or greater would be considered "adequately capitalized"; a qualifying banking organization with a community bank leverage ratio of less than 7.5 percent would be considered "undercapitalized"; and a qualifying banking organization with a community bank leverage ratio of less than 6 percent would be considered "significantly capitalized" and would be required to provide its primary regulator with additional information in order to determine whether such organization would be classified as "critically undercapitalized." The comment period for these proposed rules has closed, but the regulation is not yet finalized.

SmartFinancial management believes that SmartFinancial and SmartBank would meet all capital adequacy requirements under the community bank leverage ratio capital rules if such rules were currently effective.

The Regulatory Relief Act also makes important changes to the “prompt corrective action” framework discussed below in “*Regulation of SmartBank-Capitalization Levels and Prompt Corrective Action.*”

Anti-Tying Restrictions

Bank holding companies and their affiliates are prohibited from tying the provision of certain services, such as extensions of credit, to other nonbanking services offered by a bank holding company or its affiliates.

Executive Compensation and Corporate Governance

The Dodd-Frank Act generally requires public companies to include, at least once every three years, a separate non-binding “say on pay” vote in their proxy statement to allow stockholders the opportunity to vote on the compensation of the company’s named executive officers. In addition, if such public companies are involved in a merger, acquisition, or consolidation, or if they propose to sell or dispose of all or substantially all of their assets, stockholders generally have a right to an advisory vote on any golden parachute arrangements in connection with such transaction (frequently referred to as “say-on-golden parachute” vote). Other provisions of the Dodd-Frank Act may also impact SmartFinancial’s corporate governance. For instance, the Dodd-Frank Act required the SEC to adopt rules directing the national securities exchanges to prohibit the listing of any equity security of a company that does not have an independent compensation committee and requiring all exchange-traded companies to adopt clawback policies for incentive compensation paid to executive officers in the event of accounting restatements based on material non-compliance with financial reporting requirements.

Regulation of SmartBank

As a Tennessee-chartered commercial bank, SmartBank is subject to supervision, regulation, and examination by the TDFI, and, as a member of the Federal Reserve System, SmartBank is also subject to supervision, regulation, and examination by the Federal Reserve. Federal and state laws and regulations affect virtually all aspects of SmartBank’s operations, including its capital requirements, its ability to pay dividends, mergers and acquisitions, limitations on the amount that it can loan to a single borrower and related interests, permissible investments, and geographic and new product expansion, among other things. SmartBank generally must submit an application to, and receive the approval of, the TDFI and Federal Reserve before opening a new branch office or merging with another financial institution. The Commissioner of the TDFI and the Federal Reserve have the authority to enforce laws and regulations by ordering SmartBank, or a director, officer, or employee of SmartBank, to cease and desist from violating a law or regulation or from engaging in unsafe or unsound banking practices and by imposing other sanctions, including civil money penalties.

Tennessee law contains limitations on the interest rates that may be charged on various types of loans and restrictions on the nature and amount of loans that may be granted, and on the type of investments which may be made, by Tennessee-chartered banks. Tennessee-chartered banks are also subject to regulation by the TDFI with regard to capital requirements and the payment of dividends.

Tennessee has adopted the provisions of the Federal Reserve’s Regulation O with respect to restrictions on loans and other extensions of credit to bank “insiders.” Further, under Tennessee law, state banks are prohibited from lending to any one person, firm, or corporation amounts more than 15 percent of the bank’s equity capital accounts, except, (i) in the case of certain loans secured by negotiable title documents covering readily marketable nonperishable staples or (ii) with the prior approval of the bank’s board of directors or finance committee (however titled), the bank may make a loan to any person, firm, or corporation of up to 25 percent of its equity capital accounts.

Various state and federal consumer laws and regulations also affect the operations of SmartBank, including state usury laws, consumer credit and equal credit opportunity laws, and fair credit reporting laws. In addition, the Federal Deposit Insurance Corporation Improvement Act of 1991, generally prohibits insured state-chartered banks from conducting activities as principal that are not permitted for national banks.

SmartBank’s deposits are insured by the FDIC under the Federal Deposit Insurance Act.

Current Expected Credit Loss

A new accounting standard changing the current method for providing allowances for loan losses has been adopted by the Financial Accounting Standards Board. This new standard is referred to as Current Expected Credit Loss (or “CECL”) and becomes effective for SmartBank in 2020. The use of this standard will increase the types of data required to determine the appropriate level of SmartBank’s allowance for loan losses.

The use of this standard may increase SmartBank’s allowance for loan losses. Any increase in SmartBank’s allowance for loan losses or expenses incurred in order to make the determination for such allowance for loan losses could have a material adverse effect on SmartBank’s financial condition and results of operations. The direct effects of CECL on SmartBank are further discussed in Note 1-Summary of Significant Accounting Policies to our audited consolidated financial statements.

Capitalization Levels and Prompt Corrective Action

Federal law and regulations establish a capital-based regulatory framework designed to promote early intervention for troubled banks and require the FDIC to choose the least expensive method of resolution in the event of bank failures. The capital-based regulatory framework contains five categories of regulatory capital requirements, including “well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized,” and “critically undercapitalized.” Generally, to qualify as a “well capitalized” institution, a bank (i) must have a Tier 1 leverage capital ratio of no less than 5 percent, a common equity Tier 1 risk-based capital ratio of no less than 6.5 percent, a Tier 1 risk-based capital ratio of no less than 8 percent, and a total risk-based capital ratio of no less than 10 percent and (ii) must not be subject to any order or written directive to meet and maintain a specific capital level for any capital measure. Generally, a bank is considered “adequately capitalized” if it maintains a Tier 1 leverage capital ratio of at least 4 percent, a common equity Tier 1 risk-based capital ratio of at least 4.5 percent, a Tier 1 risk-based capital ratio of at least 6 percent, and a total risk-based capital ratio of at least 8 percent.

Immediately upon becoming “undercapitalized” (i.e., a Tier 1 leverage capital ratio of less than 4 percent, a common equity Tier 1 risk-based capital ratio of less than 4.5 percent, a Tier 1 risk-based capital ratio of less than 6 percent, or a total risk-based capital ratio of less than 8 percent), a depository institution becomes subject to the provisions of Section 38 of the Federal Deposit Insurance Act, which: (i) restrict payment of capital distributions and management fees; (ii) require that the appropriate federal banking agency monitor the condition of the institution and its efforts to restore its capital; (iii) require submission of a capital restoration plan; (iv) restrict the growth of the institution’s assets; and (v) require prior approval of certain expansion proposals. Additionally, bank holding companies controlling financial institutions can be called upon to boost the institutions’ capital and to partially guarantee the institutions’ performance under their capital restoration plans. The appropriate federal banking agency for an undercapitalized institution also may take any number of discretionary supervisory actions if the agency determines that any of these actions is necessary to resolve the problems of the institution at the least possible long-term cost to the Deposit Insurance Fund, subject in certain cases to specified procedures. These discretionary supervisory actions include: (i) requiring the institution to raise additional capital; (ii) restricting transactions with affiliates; (iii) requiring divestiture of the institution or the sale of the institution to a willing purchaser; (iv) requiring the institution to change and improve its management; (v) prohibiting the acceptance of deposits from correspondent banks; (vi) requiring prior Federal Reserve approval for any capital distribution by a bank holding company controlling the institution; and (vii) any other supervisory action that the agency deems appropriate. These and additional mandatory and permissive supervisory actions may be taken with respect to significantly undercapitalized and critically undercapitalized institutions.

It should be noted that the minimum capital ratios referred to above in this section are merely guidelines, and federal and state bank regulators possess the discretionary authority to require higher capital ratios.

As previously discussed above, the Regulatory Relief Act simplifies the regulatory capital rules for financial institutions and their holding companies with total consolidated assets of less than \$10 billion. The Regulatory Relief Act requires federal banking agencies to develop a community bank leverage ratio (defined as the ratio of tangible equity capital to average total consolidated assets) for banks and holding companies with total consolidated assets of less than \$10 billion and an appropriate risk profile. The required regulations must specify a minimum community bank leverage ratio of not less than 8 percent and not more than 10 percent, as well as procedures for treatment of a qualifying community bank that has a community bank leverage ratio that falls below the required minimum. Qualifying banks that exceed the minimum community bank leverage ratio will be deemed to be in compliance with all other capital and leverage requirements. On November 21, 2018, pursuant to the Regulatory Relief Act, the federal banking agencies issued a notice of proposed rulemaking proposing a community bank leverage ratio of 9 percent. The comment period for the proposed rule has since closed, but the regulation is not yet finalized and, therefore, the final minimum community bank leverage ratio is not known at this time.

Bank Reserves

The Federal Reserve requires all depository institutions, even if not members of the Federal Reserve System, to maintain reserves against some transaction accounts (primarily demand deposit and negotiable order of withdrawal (NOW) accounts). The balances maintained to meet the reserve requirements imposed by the Federal Reserve may be used to satisfy liquidity requirements. An institution may borrow from the Federal Reserve Bank “discount window” as a secondary source of funds, provided that the institution meets the Federal Reserve Bank’s credit standards.

Bank Dividends

Under federal law, an insured depository institution may not pay a dividend if it is undercapitalized or if paying the dividend would cause the institution to become undercapitalized. Tennessee law also places restrictions on the declaration and payment of dividends by state-chartered banks. For example, under Tennessee law, the board of directors of a Tennessee-chartered bank may only declare dividends from the surplus profits arising from the business of the bank and may not declare dividends in any calendar year that exceed the total of the bank’s retained net income of that year combined with its retained net income of the preceding two years without the prior approval of the Commissioner of the TDFI. Tennessee law also requires certain charges against and transfers from an institution’s undivided profits account before undivided profits can be made available for the payment of dividends. Furthermore, the TDFI also has the authority to prohibit the payment of dividends by a Tennessee-chartered bank when it determines payment of those dividends to be an unsafe and unsound banking practice.

Insurance of Accounts and Other Assessments

SmartBank pays deposit insurance assessments to the Deposit Insurance Fund, which are determined through a risk-based assessment system. SmartBank’s deposit accounts are currently insured by the Deposit Insurance Fund, generally up to a maximum of \$250,000 per separately insured depositor. SmartBank pays assessments to the FDIC for such deposit insurance. Under the current assessment system, the FDIC assigns an institution to a risk category based on the institution’s most recent supervisory and capital evaluations, which are designed to measure risk. Under the Federal Deposit Insurance Act, the FDIC may terminate a bank’s deposit insurance upon a finding that the institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order, agreement, or condition imposed by the FDIC.

In addition, all FDIC-insured institutions are required to pay assessments to the FDIC to fund interest payments on bonds issued by the Financing Corporation, or FICO, a federal government corporation established to recapitalize the predecessor to the Savings Association Insurance Fund. These assessments will continue until the last of the FICO bonds mature in 2019.

Restrictions on Transactions with Affiliates

SmartBank is also subject to federal laws that restrict certain transactions between it and its nonbank affiliates. An affiliate of a bank generally is any company or entity that controls, is controlled by, or is under common control with the bank, including, in the case of SmartBank, SmartFinancial. Under Sections 23A and 23B of the Federal Reserve Act (which we refer to as the “FRA”) and the Federal Reserve’s Regulation W, covered transactions by SmartBank with a single nonbank affiliate are generally limited to 10 percent of SmartBank’s capital and surplus and 20 percent of capital and surplus for all covered transactions with all nonbank affiliates. The definition of “covered transactions” includes transactions such as a loan by a bank to an affiliate, an investment by a bank in an affiliate, or a purchase by a bank of assets from an affiliate. A loan by a bank to a nonbank affiliate must be secured by collateral valued at 100 percent to 130 percent of the loan amount, depending on the type of collateral, and certain low quality assets and securities of an affiliate may not serve as collateral.

All such transactions must generally be consistent with safe and sound banking practices and must be on terms that are no less favorable to the bank than those that would be available from nonaffiliated third parties. Moreover, state banking laws impose restrictions on affiliate transactions similar to those imposed by federal law. Federal Reserve policies also prohibit the payment by bank subsidiaries of management fees which are unreasonable in amount or exceed the fair market value of the services rendered or, if no market exists, actual costs plus a reasonable profit.

Loans to Insiders

Loans to executive officers or directors of a bank, or to any person who directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote more than 10 percent of any class of voting securities of a bank, or to any related interest of those persons, including any company controlled by such persons, are subject to Sections 22(g) and 22(h) of the FRA and their corresponding regulations, which are commonly referred to as “Regulation O.” Among other things, these loans must be made on terms substantially the same as those prevailing in transactions made to unaffiliated individuals and certain extensions of credit to these persons must first be approved in advance by a disinterested majority of the bank’s entire board of directors. Regulation O generally prohibits loans to any of these persons where the aggregate amount exceeds an amount equal to 15 percent of an institution’s unimpaired capital and surplus plus an additional 10 percent of unimpaired capital and surplus in the case of loans that are fully secured by certain readily marketable collateral, or when the aggregate amount on all of the extensions of credit outstanding to all of these persons would exceed the bank’s unimpaired capital and unimpaired surplus. Section 22(g) identifies limited circumstances in which a bank is permitted to extend credit to its executive officers.

Community Reinvestment Act

The Community Reinvestment Act (which we refer to as the “CRA”) and its corresponding regulations are intended to encourage banks to help meet the credit needs of their service areas, including low- and moderate-income neighborhoods, consistent with safe and sound operations. The CRA and its regulations provide for regulatory assessment of a bank’s record in meeting the credit needs of its service area. Federal banking agencies are required to make public the rating of a bank’s performance under the CRA. The federal banking agencies consider a bank’s CRA rating when a bank submits an application to establish banking centers, merge, or acquire the assets and assume the liabilities of another bank. In the case of an application by a bank holding company for approval of a merger or acquisition, the CRA performance record of all banks involved in the merger or acquisition are reviewed in connection with the application filing. An unsatisfactory record of CRA compliance can substantially delay, block, or result in the imposition of conditions in connection with expansionary activities. SmartBank’s last CRA performance evaluation was in August 2016, and SmartBank was assigned a rating of “Satisfactory.”

Branching

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (which we refer to as the “Riegle-Neal Act”) provides that adequately capitalized and managed bank holding companies are permitted to acquire banks in any state. Previously, under the Riegle-Neal Act, a bank’s ability to branch into a particular state was largely dependent upon whether that state “opted in” to de novo interstate branching. Many states did not “opt-in,” which resulted in branching restrictions in those states. The Dodd-Frank Act amended the Riegle-Neal Act legal framework for interstate branching to permit national banks and state banks to establish de novo branches in any state if that state would permit the establishment of the branch by a state bank chartered in that state. Under current Tennessee law, SmartBank may open branch offices throughout Tennessee with the prior approval of the TDFI and adherence to applicable legal requirements.

Bank Secrecy Act

The Currency and Foreign Transactions Reporting Act of 1970, better known as the “Bank Secrecy Act,” requires all United States financial institutions to assist United States government agencies to detect and prevent money laundering. Specifically, the Bank Secrecy Act requires financial institutions to keep records of cash purchases of negotiable instruments, file reports of cash transactions exceeding a daily aggregate amount of \$10,000, and to report suspicious activity that might signify money laundering, tax evasion, or other criminal activities, and to obtain and retain information regarding the identify and verification of the beneficial owners of business customers.

Anti-Money Laundering and Economic Sanctions

The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (better known as the “USA PATRIOT Act”) provides the federal government with additional powers to address terrorist threats through enhanced domestic security measures, expanded surveillance powers, increased information sharing, and broadened anti-money laundering requirements. By way of amendments to the Bank Secrecy Act, the USA PATRIOT Act imposed new requirements that obligate financial institutions, such as banks, to take certain steps to control the risks associated with money laundering and terrorist financing.

Among other requirements, the USA PATRIOT Act and its implementing regulations require banks, such as SmartBank, to establish anti-money laundering programs that include, at a minimum:

- internal policies, procedures, and controls designed to implement and maintain the bank's compliance with all of the requirements of the USA PATRIOT Act, the Bank Secrecy Act, and related laws and regulations;
- systems and procedures for monitoring and reporting suspicious transactions and activities;
- a designated compliance officer;
- employee training;
- an independent audit function to test the anti-money laundering program;
- procedures to verify the identity of each customer upon the opening of accounts;
- heightened due diligence policies, procedures, and controls applicable to certain foreign accounts and relationships; and
- ongoing due diligence and monitoring of customer relationships, including the beneficial owners of business customers.

Additionally, the USA PATRIOT Act requires each financial institution to develop a customer identification program, or CIP, as part of the bank's anti-money laundering program. The key components of the CIP are identification, verification, government list comparison, notice, and record retention. The purpose of the CIP is to enable the financial institution to determine the true identity and anticipated account activity of each customer. To make this determination, among other things, the financial institution must collect certain information from customers at the time they enter into the customer relationship with the financial institution. This information must be verified within a reasonable time through documentary and non-documentary methods. Furthermore, all customers must be screened against any CIP-related government lists of known or suspected terrorists. Information regarding the identity and verification of the beneficial owners of business customers must also be obtained and retained. Furthermore, financial institutions are also required to comply with various reporting and recordkeeping requirements. Federal banking regulators consider an applicant's effectiveness in combating money laundering, among other factors, in connection with an application to approve a bank merger or the acquisition of control of a bank or bank holding company.

The U.S. Department of the Treasury's Office of Foreign Assets Control (which we refer to as "OFAC") is responsible for helping to ensure that United States entities do not engage in transactions with the subjects of U.S. sanctions, as defined by various executive orders and acts of Congress. Currently, OFAC administers and enforces comprehensive U.S. economic sanctions programs against certain specified countries/regions. In addition to the country/region-wide sanctions programs, OFAC also administers complete embargoes against individuals and entities identified on OFAC's list of Specially Designated Nationals and Blocked Persons, or "SDN List." The SDN List includes thousands of parties that are located in many jurisdictions throughout the world, including in the United States and Europe. SmartBank is responsible for determining whether any potential and/or existing customers appear on the SDN List or are owned or controlled by a person on the SDN List. If any customer appears on the SDN List or is owned or controlled by a person or entity on the SDN List, such customer's account must be placed on hold and a blocking or rejection report, as appropriate and if required, must be filed within 10 business days with OFAC. In addition, if a customer is a citizen of, has provided an address in, or is organized under the laws of any country or region for which OFAC maintains a comprehensive sanctions program, SmartBank must take certain actions with respect to such customer as dictated under the relevant OFAC sanctions program. SmartBank must maintain compliance with OFAC by implementing appropriate policies and procedures and by establishing a recordkeeping system that is reasonably appropriate to administer SmartBank's compliance program. SmartBank has adopted policies, procedures, and controls to comply with the Bank Secrecy Act, the USA PATRIOT Act, and OFAC regulations.

Privacy and Data Security

Under the GLBA, federal banking regulators adopted rules limiting the ability of banks and other financial institutions to disclose nonpublic information about consumers to nonaffiliated third parties. The rules require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to nonaffiliated third parties. The GLBA also directed federal regulators to prescribe standards for the security of consumer information. SmartBank is subject to these standards, as well as standards for notifying customers in the event of a security breach. Laws, regulations, and guidance related to data protection, consumer privacy, third party vendor management, disaster recovery, and information security continue to develop and change as a result of the rapid increase in and evolution of electronic bank products and services. The federal banking agencies are likely to spend time developing additional rules, regulations, and guidance on the subject of cyber security in response to recent cyber-attacks against financial institutions and continued development of electronic and online banking products and services.

Consumer Laws and Regulations

SmartBank is also subject to other federal and state consumer-related laws and regulations that are designed to protect consumers in transactions with banks. These laws and regulations include, among others, the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Check Clearing for the 21st Century Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Home Mortgage Disclosure Act, the Fair and Accurate Transactions Act, the Servicemembers Civil Relief Act, the Military Lending Act, the Mortgage Disclosure Improvement Act, and the Real Estate Settlement Procedures Act. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with consumers when offering consumer financial products and services.

Rulemaking authority for these and other consumer financial protection laws transferred from the prudential regulators to the CFPB on July 21, 2011. In some cases, regulators such as the Federal Trade Commission, the U.S. Department of Housing and Urban Development, and the U.S. Department of Justice also retain certain rulemaking or enforcement authority. The CFPB also has broad authority to prohibit unfair, deceptive, and abusive acts and practices and to investigate and penalize financial institutions that violate this prohibition. While the statutory language of the Dodd-Frank Act sets forth the standards for acts and practices that violate the prohibition on unfair, deceptive, and abusive acts and practices, certain aspects of these standards are untested and it is currently not possible to predict how the CFPB will exercise this authority. In addition, consumer compliance examination authority remains with the prudential regulators for smaller depository institutions (i.e., those with \$10 billion or less in total assets).

Pursuant to the Dodd-Frank Act, the CFPB established certain minimum standards for the origination of residential mortgages, including a requirement to determine the borrower's ability to repay. The Dodd-Frank Act generally prohibits a financial institution from making a residential mortgage loan unless the institution makes a "reasonable and good faith determination" that the consumer has a "reasonable ability" to repay the loan. The Dodd-Frank Act allows borrowers to raise certain defenses to a foreclosure action if a financial institution has not complied with the ability to repay requirements, but also provides a full or partial safe harbor from such defenses for loans that are "qualified mortgages." The CFPB's implementing rules define a "qualified mortgage" to have certain specified characteristics, and generally prohibit loans with negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years from being qualified mortgages. The rules also establishes general underwriting criteria for qualified mortgages, including that monthly payments be calculated based on the highest payment that will apply in the first five years of the loan and that the borrower have a total debt-to-income ratio that is less than or equal to 43 percent. The Regulatory Relief Act has expanded the qualified mortgage safe harbor for financial institutions with total consolidated assets of less than \$10 billion to generally include loans that the institution retains in portfolio and that comply with existing limits on prepayment penalties, that comply with existing limits on total points and fees of 3 percent of the loan amount, that do not have negative amortization or interest-only features, and for which the institution has considered and documented the consumer's debt, income, and financial resources.

FIRREA and FDICIA

Far-reaching legislation, including the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (which we refer to as "FIRREA") and the Federal Deposit Insurance Corporation Improvement Act of 1991 (which we refer to as "FDICIA"), has impacted the business of banking for years. FIRREA primarily affected the regulation of savings institutions, rather than the regulation of commercial banks and bank holding companies like SmartBank and SmartFinancial, but did include provisions affecting deposit insurance premiums, acquisitions of thrifts by banks and bank holding companies, liability of commonly controlled depository institutions, and receivership and conservatorship rights and procedures, and substantially increased penalties for violations of banking laws, regulations, and orders.

FDICIA resulted in extensive changes to the federal banking laws. The primary purpose of FDICIA was to authorize additional borrowings by the FDIC in order to assist in the resolution of failed and failing financial institutions. However, the law also instituted certain changes to the supervisory process and contained various provisions affecting the operations of banks and bank holding companies.

The additional supervisory powers and regulations mandated by FDICIA include a "prompt corrective action" program based upon five regulatory zones for banks, in which banks are placed largely based on their capital positions. Regulators are permitted to take increasingly harsh action as a bank's financial condition declines. Regulators are also empowered to place a bank in receivership or require the sale of a bank to another depository institution when the bank's ratio of tangible equity to total assets reaches 2 percent. Better capitalized institutions are generally subject to less onerous regulation and supervision than banks with lesser amounts of capital. The Federal Reserve has adopted regulations implementing the prompt corrective action provisions of

FDICIA, which place financial institutions into one of the following five categories based upon capitalization ratios (as these ratios have been revised following the implementation of Basel III):

- a “well capitalized” institution has a total risk-based capital ratio of at least 10 percent, a Tier 1 risk-based capital ratio of at least 8 percent, a common equity Tier 1 risk-based capital ratio of at least 6.5 percent, and a Tier 1 leverage capital ratio of at least 5 percent;
- an “adequately capitalized” institution has a total risk-based capital ratio of at least 8 percent, a Tier 1 risk-based capital ratio of at least 6 percent, a common equity Tier 1 risk-based capital ratio of at least 4.5 percent, and a Tier 1 leverage capital ratio of at least 4 percent;
- an “undercapitalized” institution has a total risk-based capital ratio of less than 8 percent, a Tier 1 risk-based capital ratio of less than 6 percent, a common equity Tier 1 risk-based capital ratio of less than 4.5 percent, or a Tier 1 leverage capital ratio of less than 4 percent;
- a “significantly undercapitalized” institution has a total risk-based capital ratio of less than 6 percent, a Tier 1 risk-based capital ratio of less than 4 percent, a common equity Tier 1 risk-based capital ratio of less than 3 percent, or a Tier 1 leverage capital ratio of less than 3 percent; and
- a “critically undercapitalized” institution has a ratio of tangible equity to total assets of 2 percent or less.

Institutions in any of the three undercapitalized categories would generally be prohibited from declaring dividends or making capital distributions. The regulations also establish procedures for “downgrading” an institution to a lower capital category based on supervisory factors other than capital.

These levels will differ for community banks such as SmartBank who qualify for and elect to use the new community bank leverage ratio pursuant to the requirements of the Regulatory Relief Act. As previously discussed, the Regulatory Relief Act requires federal banking agencies to develop a community bank leverage ratio (defined as the ratio of tangible equity capital to average total consolidated assets) for banks and holding companies with total consolidated assets of less than \$10 billion and an appropriate risk profile. The required regulations must specify a minimum community bank leverage ratio of not less than 8 percent and not more than 10 percent, as well as procedures for treatment of a qualifying banking organization that has a community bank leverage ratio that falls below the required minimum. Qualifying banking organizations that exceed the minimum community bank leverage ratio will be deemed to be in compliance with all other risk-based and leverage capital requirements. On November 21, 2018, the federal banking agencies issued a notice of proposed rulemaking proposing a community bank leverage ratio of 9 percent and corresponding capital adequacy levels. As proposed, a qualifying banking organization with a community bank leverage ratio of greater than 9 percent would be considered “well capitalized”; a qualifying banking organization with a community bank leverage ratio of 7.5 percent or greater would be considered “adequately capitalized”; a qualifying banking organization with a community bank leverage ratio of less than 7.5 percent would be considered “undercapitalized”; and a qualifying banking organization with a community bank leverage ratio of less than 6 percent would be considered “significantly capitalized” and would be required to provide its primary regulator with additional information in order to determine whether such organization would be classified as “critically undercapitalized.” The comment period for the proposed rule has closed, but the regulation is not yet finalized.

SmartFinancial’s management believes that SmartBank and SmartFinancial would meet all capital adequacy requirements under the community bank leverage ratio capital rules if such rules were currently effective.

Various other sections of FDICIA impose substantial audit and reporting requirements and increase the role of independent accountants and outside directors. Set forth below is a list of certain other significant requirements under or provisions of FDICIA:

- annual on-site examinations by regulators (except for smaller, well-capitalized banks with high management ratings, which must be examined every 18 months);
- mandated annual independent audits by independent public accountants and an independent audit committee of outside directors for institutions with more than \$500 million in assets;
- uniform disclosure requirements for interest rates and terms of deposit accounts;
- a requirement that the FDIC establish a risk-based deposit insurance assessment system;
- authorization for the FDIC to impose one or more special assessments on insured banks to recapitalize the bank insurance fund (now called the Deposit Insurance Fund);
- a requirement that each institution submit to its primary regulators an annual report on its financial condition and management, which report is available to the public;
- a ban on the acceptance of brokered deposits except by well capitalized institutions and by adequately capitalized institutions with the permission of the FDIC, and the regulation of the brokered deposit market by the FDIC;
- restrictions on the activities engaged in by state banks and their subsidiaries as principal, including insurance underwriting, to the same activities permissible for national banks and their subsidiaries unless the state bank is

- well capitalized and a determination is made by the FDIC that the activities do not pose a significant risk to the insurance fund;
- a review by each regulatory agency of accounting principles applicable to reports or statements required to be filed with federal banking agencies and a mandate to devise uniform requirements for all such filings;
- the institution by each regulatory agency of noncapital safety and soundness standards for each institution it regulates which cover (i) internal controls, (ii) loan documentation, (iii) credit underwriting, (iv) interest rate exposure, (v) asset growth, (vi) compensation, fees, and benefits paid to employees, officers, and directors, (vii) operational and managerial standards, and (viii) asset quality, earnings, and stock valuation standards for preserving a minimum ratio of market value to book value for publicly traded shares (if feasible);
- uniform regulations regarding real estate lending; and
- a review by each regulatory agency of the risk-based capital rules to ensure they take into account adequate interest rate risk, concentration of credit risk, and the risks of non-traditional activities.

Future Legislative Developments

Legislation that could impact SmartFinancial and/or SmartBank is routinely introduced in Congress and the Tennessee legislature. Any such legislation could change current banking laws and the environment in which SmartFinancial and SmartBank operate in significant and unpredictable ways. SmartFinancial cannot now determine the effects (if any) that any such legislation, if enacted, or the regulations implementing the legislation or interpretations of such legislation or regulations, would have on SmartFinancial's or SmartBank's business, financial condition, or results of operations.

ITEM 1A. RISK FACTORS

Investing in our common stock involves various risks which are particular to SmartFinancial, its industry, and its market area. Several risk factors regarding investing in our securities are discussed below. This listing should not be considered as all-inclusive. If any of the following risks were to occur, we may not be able to conduct our business as currently planned and our financial condition or operating results could be negatively impacted. These matters could cause the trading price of our securities to decline in future periods.

Risks Related to Our Industry

Our net interest income could be negatively affected by interest rate adjustments by the Federal Reserve Board.

As a financial institution, our earnings are dependent upon our net interest income, which is the difference between the interest income that we earn on interest-earning assets, such as investment securities and loans, and the interest expense that we pay on interest-bearing liabilities, such as deposits and borrowings. Therefore, any change in general market interest rates, including changes resulting from changes in the Federal Reserve Board's policies, affects us more than non-financial institutions and can have a significant effect on our net interest income and total income. Our assets and liabilities may react differently to changes in overall market rates or conditions because there may be mismatches between the repricing or maturity characteristics of our assets and liabilities. As a result, an increase or decrease in market interest rates could have a material adverse effect on our net interest margin and results of operations. Actions by monetary and fiscal authorities, including the Federal Reserve Board, could have an adverse effect on our deposit levels, loan demand, business and results of operations.

The Federal Reserve Board raised interest rates by 200 basis points since December 2016 after having held interest rates at almost zero over recent years. However, the consistently low rate environment has negatively impacted our net interest margin, notwithstanding decreases in nonperforming loans and improvements in deposit mix. Any reduction in net interest income will negatively affect our business, financial condition, liquidity, results of operations, and/or cash flows.

Changes in the level of interest rates also may negatively affect our ability to originate loans, the value of our assets, and our ability to realize gains from the sale of our assets, all of which ultimately affect our earnings. A decline in the market value of our assets may limit our ability to borrow additional funds. As a result, we could be required to sell some of our loans and investments under adverse market conditions, upon terms that are not favorable to us, in order to maintain our liquidity. If those sales are made at prices lower than the amortized costs of the investments, we will incur losses.

The primary tool that management uses to measure short-term interest rate risk is a net interest income simulation model prepared by an independent third party provider. As of December 31, 2018, SmartFinancial is considered to be in an asset-sensitive position, meaning income is generally expected to increase with an increase in short-term interest rates and, conversely, to decrease with a decrease in short-term interest rates. Based on the results of this simulation model, which assumed a static environment with no contemplated asset growth or changes in our balance sheet management strategies, if short-term interest rates immediately increased by 200 basis points, we could expect net income to increase by approximately \$2.0 million over a 12-month period. This result is primarily due to the floating rate securities and loans which we anticipate would reprice at a quicker rate than our interest bearing liabilities. The actual amount of any increase or decrease may be higher or lower than predicted by our simulation model.

The final Basel III capital rules generally require insured depository institutions and their holding companies to hold more capital, which could adversely affect our financial condition and operations.

In July 2013, the federal banking agencies published new regulatory capital rules based on the international standards, known as Basel III, that had been developed by the Basel Committee on Banking Supervision. The new rules raised the risk-based capital requirements and revised the methods for calculating risk-weighted assets, usually resulting in higher risk weights. The new rules became effective on January 1, 2015, with a phase in period that generally extends from January 1, 2015 through January 1, 2019.

The Basel III-based rules increase capital requirements and include two new capital measurements that will affect us, a risk-based common equity Tier 1 ratio and a capital conservation buffer. As an example, the Tier 1 capital ratio minimum requirement of 4 percent from January 1, 2015 is increasing to 8.5 percent by 2019. SmartBank has approximately \$235.5 million of Tier 1 capital. Under the previous standard, we could have grown SmartBank's total asset size to approximately \$5.9 billion with our current capital but will be limited to \$2.8 billion in assets under the new Basel III standards to be fully phased in by 2019. In 2018, 89 percent of our average assets were earning assets and over 92 percent of our revenue was generated from net interest income. Therefore, a future reduction of potential earning assets by approximately 53 percent could drastically reduce our future income. More details about the new capital requirements can be found in Note 13-Regulatory Matters to our audited consolidated financial statements.

We are dependent on our information technology and telecommunications systems and third-party servicers, and systems failures, interruptions or breaches of security could have an adverse effect on our financial condition and results of operations.

Our operations rely on the secure processing, storage and transmission of confidential and other information in our computer systems and networks. Although we take protective measures and endeavor to modify these systems as circumstances warrant, the security of our computer systems, software and networks may be vulnerable to breaches, unauthorized access, misuse, computer viruses or other malicious code and other events that could have a security impact. We outsource many of our major systems, such as data processing, loan servicing and deposit processing systems. The failure of these systems, or the termination of a third-party software license or service agreement on which any of these systems is based, could interrupt our operations. Because our information technology and telecommunications systems interface with and depend on third-party systems, we could experience service denials if demand for such services exceeds capacity or such third-party systems fail or experience interruptions. If sustained or repeated, a system failure or service denial could result in a deterioration of our ability to process new and renewal loans, gather deposits and provide customer service, compromise our ability to operate effectively, damage our reputation, result in a loss of customer business and/or subject us to additional regulatory scrutiny and possible financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

In addition, we provide our customers the ability to bank remotely, including over the Internet or through their mobile device. The secure transmission of confidential information is a critical element of remote and mobile banking. Our network could be vulnerable to unauthorized access, computer viruses, phishing schemes, spam attacks, human error, natural disasters, power loss and other security breaches. We may be required to spend significant capital and other resources to protect against the threat of security breaches and computer viruses, or to alleviate problems caused by security breaches or viruses. To the extent that our activities or the activities of our customers involve the storage and transmission of confidential information, security breaches (including breaches of security of customer systems and networks) and viruses could expose us to claims, litigation and other possible liabilities. Any inability to prevent security breaches or computer viruses could also cause existing customers to lose confidence in our systems and could adversely affect our reputation, results of operations and ability to attract and maintain customers and businesses. In addition, a security breach could also subject us to additional regulatory scrutiny, expose us to civil litigation and possible financial liability and cause reputational damage.

Risks Related to Our Company

If our allowance for loan losses and fair value adjustments with respect to acquired loans is not sufficient to cover actual loan losses, our earnings will be adversely affected.

Our success depends significantly on the quality of our assets, particularly loans. Like other financial institutions, we are exposed to the risk that our borrowers may not repay their loans according to their terms, and the collateral securing the payment of these loans may be insufficient to fully compensate us for the outstanding balance of the loan plus the costs to dispose of the collateral. As a result, we may experience significant loan losses that may have a material adverse effect on our operating results and financial condition.

We maintain an allowance for loan losses with respect to our loan portfolio, in an attempt to cover loan losses inherent in our loan portfolio. In determining the size of the allowance, we rely on an analysis of our loan portfolio, our experience and our evaluation of general economic conditions. We also make various assumptions and judgments about the collectability of our loan portfolio, including the diversification in our loan portfolio, the effect of changes in the economy on real estate and other collateral values, the results of recent regulatory examinations, the effects on the loan portfolio of current economic conditions and their probable impact on borrowers, the amount of charge-offs for the period and the amount of nonperforming loans and related collateral security.

The application of the acquisition method of accounting in our acquisitions has impacted our allowance for loan losses. Under the acquisition method of accounting, all acquired loans were recorded in our consolidated financial statements at their fair values at the time of acquisition and the related allowance for loan losses was eliminated because credit quality, among other factors, was considered in the determination of fair value. To the extent that our estimates of fair values are too high, we will incur losses associated with the acquired loans. The allowance, if any, associated with our purchased credit impaired loans reflects deterioration in cash flows since acquisition resulting from our quarterly re-estimation of cash flows which involves complex cash flow projections and significant judgment on timing of loan resolution.

If our analysis or assumptions prove to be incorrect, our current allowance may not be sufficient, and adjustments may be necessary to allow for different economic conditions or adverse developments in our loan portfolio. Material additions to the allowance for loan losses would materially decrease our net income and adversely affect our general financial condition. As an example, an increase in the amount of the reserve to organic loans of 0.05 percent in 2018 would have resulted in a reduction of approximately 3 percent to pre-tax income.

In addition, federal and state regulators periodically review our allowance for loan losses and may require us to increase our allowance for loan losses or recognize further loan charge-offs, based on judgments different than those of our management. Any increase in our allowance for loan losses or loan charge-offs required by these regulatory agencies could have a material adverse effect on our operating results and financial condition.

Our success depends significantly on economic conditions in our market areas.

Unlike larger organizations that are more geographically diversified, our branches are currently concentrated in Eastern Tennessee and the Florida Panhandle. As a result of this geographic concentration, our financial results will depend largely upon economic conditions in these market areas. If the communities in which we operate do not grow or if prevailing economic conditions, locally or nationally, deteriorate, this may have a significant impact on the amount of loans that we originate, the ability of our borrowers to repay these loans and the value of the collateral securing these loans. A return to economic downturn conditions caused by inflation, recession, unemployment, government action, natural disasters or other factors beyond our control would likely contribute to the deterioration of the quality of our loan portfolio and reduce our level of deposits, which in turn would have an adverse effect on our business. As an example, the Florida Panhandle area has been and will continue to be susceptible to major hurricanes, floods, and tropical storms including Hurricane Michael in 2018. In 2016, certain of our markets in Eastern Tennessee were disrupted by wildfires which damaged homes and businesses. In addition, some portions of our target market are in areas which a substantial portion of the economy is dependent upon tourism. The tourism industry tends to be more sensitive than the economy as a whole to changes in unemployment, inflation, wage growth, and other factors which affect consumer's financial condition and sentiment.

Our organic loan growth may be limited by regulatory constraints

During 2018 many of the regulatory agencies, including ours, increased their focus on the application of an interagency guidance issued in 2006, titled "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices." The 2006 interagency guidance focuses on the risks of high levels of concentration in CRE lending at banking institutions, and specifically addresses two supervisory criteria:

- Construction concentration criterion: Loans for construction, land, and land development (CLD or "construction") represent 100 percent or more of a banking institution's total risk-based capital, commonly referred to as the "100 ratio"
- Total CRE concentration criterion: Total nonowner-occupied CRE loans (including CLD loans), as defined in the 2006 guidance ("total CRE"), represent 300 percent or more of the institution's total risk-based capital, and growth in total CRE lending has increased by 50 percent or more during the previous 36 months, commonly referred to as the "300 ratio"

The guidance states that banking institutions exceeding the concentration levels mentioned in the two supervisory criteria should have in place enhanced credit risk controls, including stress testing of CRE portfolios. The guidance also states that institutions with CRE concentration levels above those specified in the two supervisory criteria may be identified for further supervisory analysis. Under the guidance for every \$1 in increased capital only \$1 can be leveraged to construction lending and only \$3 can be lent to total CRE lending. In comparison \$1 of capital can be leveraged into about \$10 other types of lending. At the end of 2018 our loan portfolio was below both the 100 and 300 ratio as laid out in the guidance, but given the guidance our ability to grow those loan types could well be constrained by the amount we are also able to grow capital.

To the extent that we are unable to identify and consummate attractive acquisitions, or increase loans through organic loan growth, we may be unable to successfully implement our growth strategy, which could materially and adversely affect us.

A substantial part of our historical growth has been a result of acquisitions and we intend to continue to grow our business through strategic acquisitions of banking franchises coupled with organic loan growth. Previous availability of attractive acquisition targets may not be indicative of future acquisition opportunities, and we may be unable to identify any acquisition targets that meet our investment objectives. To the extent that we are unable to find suitable acquisition candidates, an important component of our strategy may be lost. If we are able to identify attractive acquisition opportunities, we must generally satisfy a number of conditions prior to completing any such transaction, including certain bank regulatory approvals, which have become substantially more difficult, time-consuming and unpredictable as a result of the recent financial crisis. Additionally, any future acquisitions may not produce the revenue, earnings or synergies that we anticipated. As our purchased credit impaired loan portfolio, which produces substantially higher yields than our organic and purchased non-credit impaired loan portfolios, is paid down, we expect downward pressure on our income. If we are unable to replace our purchased credit impaired loans and the related accretion with a significantly higher level of new performing loans and other earning assets due to our inability to identify attractive acquisition opportunities, a decline in loan demand, competition from other financial institutions in our markets, stagnation or continued deterioration of economic conditions, or other conditions, our financial condition and earnings may be adversely affected.

Our strategic growth plan contemplates additional acquisitions, which could expose us to additional risks.

We periodically evaluate opportunities to acquire additional financial institutions. As a result, we may engage in negotiations or discussions that, if they were to result in a transaction, could have a material effect on our operating results and financial condition, including short and long-term liquidity. Our acquisition activities could be material and could require us to use a substantial amount of common stock, cash, other liquid assets, and/or incur debt.

Our acquisition activities could involve a number of additional risks, including the risks of:

- incurring time and expense associated with identifying and evaluating potential acquisitions and negotiating potential transactions, resulting in management's attention being diverted from the operation of our existing business;
- using inaccurate estimates and judgments to evaluate credit, operations, management and market risks with respect to the target institution or assets;
- incurring time and expense required to integrate the operations and personnel of the combined businesses, creating an adverse short-term effect on results of operations; and
- losing key employees and customers as a result of an acquisition that is poorly received.

Our recent acquisition and future expansion may result in additional risks.

Over the last two years we have completed the acquisitions of Capstone, Tennessee Bancshares, and Foothills Bancorp and we anticipate consummating our proposed merger with Entegra Financial in mid-2019, subject to customary closing conditions. We expect to continue to expand in our current markets and in other select markets through additional branches or through additional acquisitions of all or part of other financial institutions. These types of expansions involve various risks, including the risks detailed below.

Growth. As a result of our merger activity, we may be unable to successfully:

- maintain loan quality in the context of significant loan growth;
- obtain regulatory and other approvals;
- attract sufficient deposits and capital to fund anticipated loan growth;
- maintain adequate common equity and regulatory capital;
- avoid diversion or disruption of our existing operations or management as well as those of the acquired institution;
- maintain adequate management personnel and systems to oversee and support such growth;
- maintain adequate internal audit, loan review and compliance functions; and
- implement additional policies, procedures and operating systems required to support such growth.

Results of Operations. There is no assurance that existing offices or future offices will maintain or achieve deposit levels, loan balances or other operating results necessary to avoid losses or produce profits. Our growth strategy necessarily entails growth in overhead expenses as we routinely add new offices and staff. Our historical results may not be indicative of future results or results that may be achieved as we continue to increase the number and concentration of our branch offices in our newer markets.

Development of offices. There are considerable costs involved in opening branches, and new branches generally do not generate sufficient revenues to offset their costs until they have been in operation for at least a year or more. Accordingly, any new branches we establish can be expected to negatively impact our earnings for some period of time until they reach certain economies of scale. The same is true for our efforts to expand in these markets with the hiring of additional seasoned professionals with significant experience in that market. Our expenses could be further increased if we encounter delays in opening any of our new branches. We may be unable to accomplish future branch expansion plans due to a lack of available satisfactory sites, difficulties in acquiring such sites, failure to receive any required regulatory approvals, increased expenses or loss of potential sites due to complexities associated with zoning and permitting processes, higher than anticipated merger and acquisition costs or other factors. Finally, we have no assurance any branch will be successful even after it has been established or acquired, as the case may be.

Regulatory and economic factors. Our growth and expansion plans may be adversely affected by a number of regulatory and economic developments or other events. Failure to obtain required regulatory approvals, changes in laws and regulations or other regulatory developments and changes in prevailing economic conditions or other unanticipated events may prevent or adversely affect our continued growth and expansion. Such factors may cause us to alter our growth and expansion plans or slow or halt the growth and expansion process, which may prevent us from entering into or expanding in our targeted markets or allow competitors to gain or retain market share in our existing markets.

Failure to successfully address these and other issues related to our expansion could have a material adverse effect on our financial condition and results of operations, and could adversely affect our ability to successfully implement our business strategy. Also, if our growth occurs more slowly than anticipated or declines, our results of operations and financial condition could be materially adversely affected.

Integrating Foothills Bank and, if our pending merger with Entegra Financial is completed, Entegra Bank into SmartBank's may be more difficult, costly, or time-consuming than anticipated.

We are still in the process of integrating Foothills Bank's business with that of SmartBank, and if the merger with Entegra Financial is completed as planned, we will begin the process of integrating Entegra Bank with that of SmartBank as well. A successful integration of these businesses with ours will depend substantially on our ability to consolidate operations, corporate cultures, systems and procedures and to eliminate redundancies and costs. We may not be able to combine our business with one or both of the targets' businesses without encountering difficulties, such as:

- the loss of key employees;
- disruption of operations and business;
- inability to maintain and increase competitive presence;

- loan and deposit attrition, customer loss and revenue loss, including as a result of any decision we may make to close one or more locations;
- possible inconsistencies in standards, control procedures and policies;
- unexpected problems with costs, operations, personnel, technology and credit; and/or
- problems with the assimilation of new operations, sites or personnel, which could divert resources from regular banking operations.

Additionally, general market and economic conditions or governmental actions affecting the financial industry generally may inhibit our successful integration of one or both of the targets' businesses. Further, we acquired Foothills and intend to acquire Entegra Financial with the expectation that the acquisitions will result in various benefits including, among other things, benefits relating to enhanced revenues, a strengthened market position for the combined company, cross selling opportunities, technological efficiencies, cost savings and operating efficiencies. Achieving the anticipated benefits of this acquisition is subject to a number of uncertainties, including whether we integrate Foothill's and/or Entegra Bank's businesses, including its organizational culture, operations, technologies, services and products, in an efficient and effective manner, our ability to achieve the estimated noninterest expense savings we believe we can achieve, and general competitive factors in the marketplace. Failure to achieve these anticipated benefits on the anticipated timeframe, or at all, could result in a reduction in the price of our shares as well as in increased costs, decreases in the amount of expected revenues and diversion of management's time and energy and could materially and adversely affect our business, results of operations and financial condition. Additionally, we made fair value estimates of certain assets and liabilities in recording our acquisition of Foothills and will make fair value estimates of certain assets and liabilities in recording our acquisition of Entegra Bank. Actual values of these assets and liabilities could differ from our estimates, which could result in our not achieving the anticipated benefits of the acquisition. Finally, any cost savings that are realized may be offset by losses in revenues or other charges to earnings.

We may face risks with respect to future acquisitions.

When we attempt to expand our business through mergers and acquisitions (as we have done over the last three years), we seek targets that are culturally similar to us, have experienced management and possess either market presence or have potential for improved profitability through economies of scale or expanded services. In addition to the general risks associated with our growth plans which are highlighted above, in general acquiring other banks, businesses or branches, particularly those in markets with which we are less familiar, involves various risks commonly associated with acquisitions, including, among other things:

- the time and costs associated with identifying and evaluating potential acquisition and merger targets;
- inaccuracies in the estimates and judgments used to evaluate credit, operations, management and market risks with respect to the target institution;
- the time and costs of evaluating new markets, hiring experienced local management, including as a result of de novo expansion into a market, and opening new bank locations, and the time lags between these activities and the generation of sufficient assets and deposits to support the significant costs of the expansion that we may incur, particularly in the first 12 to 24 months of operations;
- our ability to finance an acquisition and possible dilution to our existing shareholders;
- the diversion of our management's attention to the negotiation of a transaction and integration of an acquired company's operations with ours;
- the incurrence of an impairment of goodwill associated with an acquisition and adverse effects on our results of operations;
- entry into new markets where we have limited or no direct prior experience;
- closing delays and increased expenses related to the resolution of lawsuits filed by our shareholders or shareholders of companies we may seek to acquire;
- the inability to receive regulatory approvals timely or at all, including as a result of community objections, or such approvals being restrictively conditional; and
- risks associated with integrating the operations, technologies and personnel of the acquired business.

We expect to continue to evaluate merger and acquisition opportunities that are presented to us in our current markets, as well as other markets, throughout the region and conduct due diligence activities related to possible transactions with other financial institutions. As a result, merger or acquisition discussions and, in some cases, negotiations may take place and future mergers or acquisitions involving cash or equity securities and related capital raising transactions may occur at any time. Generally, acquisitions of financial institutions involve the payment of a premium over book and market values, and, therefore, some dilution of our book value and fully diluted earnings per share may occur in connection with any future transaction. Failure to realize the expected revenue increases, cost savings, increases in product presence and/or other projected benefits from an acquisition could have a material adverse effect on our financial condition and results of operations.

In addition, we may face significant competition from numerous other financial services institutions, many of which may have greater financial resources than we do, when considering acquisition opportunities. Accordingly, attractive acquisition opportunities may not be available to us. There can be no assurance that we will be successful in identifying or completing any potential future acquisitions.

Our concentration in loans secured by real estate, particularly commercial real estate and construction and development, is subject to risks that could adversely affect our results of operations and financial condition.

We offer a variety of secured loans, including commercial lines of credit, commercial term loans, real estate, construction, home equity, consumer and other loans. Many of our loans are secured by real estate (both residential and commercial) in our market areas. Consequently, declines in economic conditions in these market areas may have a greater effect on our earnings and capital than on the earnings and capital of larger financial institutions whose real estate loan portfolios are more geographically diverse.

At December 31, 2018, approximately 82 percent of our loans had real estate as a primary or secondary component of collateral, which includes 11 percent of our loans secured by construction and development collateral. The real estate collateral in each case provides an alternate source of repayment in the event of default by the borrower and may deteriorate in value during the time the credit is extended. If we are required to liquidate the collateral securing a loan to satisfy the debt during a period of reduced real estate values, our earnings and capital could be adversely affected. Real estate values declined significantly during the recent economic crisis and may decline similarly in future periods. Although real estate prices in most of our markets have stabilized or are improving, a renewed decline in real estate values would expose us to further deterioration in the value of the collateral for all loans secured by real estate and may adversely affect our results of operations and financial condition.

Commercial real estate loans are generally viewed as having more risk of default than residential real estate loans, particularly when there is a downturn in the business cycle. They are also typically larger than residential real estate loans and consumer loans and depend on cash flows from the owner's business or the property to service the debt. Cash flows may be affected significantly by general economic conditions and a downturn in the local economy or in occupancy rates in the local economy where the property is located, each of which could increase the likelihood of default on the loan. Because our loan portfolio contains a number of commercial real estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in the percentage of nonperforming loans. An increase in nonperforming loans could result in a loss of earnings from these loans, an increase in the provision for loan losses and an increase in charge-offs, all of which could have a material adverse effect on our results of operations and financial condition, which could negatively affect our stock price.

If a commercial real estate loan did default there would be legal expenses associated with obtaining the real estate which is typically collateral for the loan. In the last several years the amount of these legal expenses has been low, compared to periods when the defaults of commercial real estate loans have been higher. Once we obtain the collateral for the commercial real estate loan it is put into foreclosed assets. Foreclosed assets generally do not produce income but do have the costs associated with the ownership of real estate, principally real estate taxes and maintenance costs. Since these assets have a cost to maintain our goal is to keep costs at a minimum by liquidating the assets as soon as possible. Generally, in spite of our best efforts and intentions, foreclosed assets are sold at a loss. Among other reasons the rate of loan defaults increase as the economy worsens and declining economic environment and political turmoil generally results in downward pressure on foreclosed asset values and increased marketing periods. In simple terms for banks like ours who have a large amount of commercial real estate loans a worsening economy will typically lead to higher loan delinquencies, followed by increases in loan defaults and greater legal expenses, leading to higher foreclosed asset levels with an increased expense to maintain the properties, ending in a sale of the foreclosed assets - most likely at a loss.

Our largest loan relationships currently make up a significant percentage of our total loan portfolio.

As of December 31, 2018, our 10 largest borrowing relationships totaled approximately \$180 million in commitments (including unfunded commitments), or approximately 10 percent of our total loan portfolio. The concentration risk associated with having a small number of relatively large loan relationships is that, if one or more of these relationships were to become delinquent or suffer default, we could be at risk of material losses. The allowance for loan losses may not be adequate to cover losses associated with any of these relationships, and any loss or increase in the allowance could have a material adverse effect on our business, financial condition, results of operations and prospects.

Our corporate structure provides for decision-making authority by our regional presidents and banking teams. Our business, financial condition, results of operations and prospects could be negatively affected if our employees do not follow our internal policies or are negligent in their decision-making.

We attract and retain our management talent by empowering them to make certain business decisions on a local level. Lending authorities are assigned to relationship managers, regional and presidents and regional credit officers to make credit decisions based on their experience. Additionally, all loans not in full compliance with the bank's loan policy must be approved by an additional level of authority with adequate credit authority for the exposure and any exposure in excess of \$2.8 million in Total Relationship Exposure with some sample loans below this amount are reviewed by our Chief Credit Officer in Knoxville, Tennessee. Moreover, for decisions that fall outside of the assigned individual authorities at every level, our teams are required to obtain approval from our Officer Loan Committee and/or Directors Loan Committee. Our local bankers may not follow our internal procedures or otherwise act in our best interests with respect to their decision-making. A failure of our employees to follow our internal policies, or actions taken by our employees that are negligent could have a material adverse effect on our business, financial condition, results of operations and prospects.

Declines in the businesses or industries of our customers could cause increased credit losses and decreased loan balances, which could adversely affect our financial results.

The small to medium-sized businesses that we lend to may have fewer resources to weather adverse business developments, which may impair a borrower's ability to repay a loan, and such impairment could have an adverse effect on our business, financial condition and results of operations. A substantial focus of our marketing and business strategy is to serve small to medium-sized businesses in our market areas. As a result, a relatively high percentage of our loan portfolio consists of commercial loans to such businesses. We further anticipate an increase in the amount of loans to small to medium-sized businesses during 2018.

Small to medium-sized businesses frequently have smaller market shares than their competition, may be more vulnerable to economic downturns, often need substantial additional capital to expand or compete and may experience substantial volatility in operating results, any of which may impair a borrower's ability to repay a loan. In addition, the success of a small and medium-sized business often depends on the management skills, talents and efforts of one or two people or a small group of people, and the death, disability or resignation of one or more of these people could have an adverse impact on the business and its ability to repay its loan. If general economic conditions negatively impact the markets in which we operate and small to medium-sized businesses are adversely affected or our borrowers are otherwise harmed by adverse business developments, this, in turn, could have an adverse effect on our business, financial condition and results of operations.

Certain of our deposits and other funding sources may be volatile and impact our liquidity.

We bank several large depository clients including three customers totaling approximately \$160.6 million in deposits at December 31, 2018. Should those clients reduce their balances we would be forced to find other funding sources. In addition to the traditional core deposits, such as demand deposit accounts, interest checking, money market savings and certificates of deposits less than \$250,000, we utilize or in the past have utilized several noncore funding sources, such as brokered certificates of deposit, Federal Home Loan Bank (FHLB) of Cincinnati advances, federal funds purchased and other sources. We utilize these noncore funding sources to fund the ongoing operations and growth of SmartBank. The availability of these noncore funding sources is subject to broad economic conditions and to investor assessment of our financial strength and, as such, the cost of funds may fluctuate significantly and/or be restricted, thus impacting our net interest income, our immediate liquidity and/or our access to additional liquidity. We have somewhat similar risks to the extent high balance core deposits exceed the amount of deposit insurance coverage available.

We impose certain internal limits as to the absolute level of noncore funding we will incur at any point in time. Should we exceed those limitations, we may need to modify our growth plans, liquidate certain assets, participate loans to correspondents or execute other actions to allow for us to return to an acceptable level of noncore funding within a reasonable amount of time.

We face additional risks due to our increase in mortgage banking activities that have and could negatively impact our net income and profitability.

We have established mortgage banking operations which expose us to risks that are different from our retail and commercial banking operations. During higher and rising interest rate environments, the demand for mortgage loans and the level of refinancing activity tends to decline, which can lead to reduced volumes of business and lower revenues, which could negatively impact our earnings. While we have been experiencing historically low interest rates, the low interest rate environment likely will not continue indefinitely. Because we sell a substantial portion of the mortgage loans we originate, the profitability of our mortgage banking operations also depends in large part on our ability to aggregate a high volume of loans and sell them in the secondary market at a gain. Thus, in addition to our dependence on the interest rate environment, we are dependent upon (a) the existence of an active secondary market and (b) our ability to profitably sell loans into that market. Our mortgage banking operations incurred additional expenses over \$3.0 million in 2018 and generated noninterest income of \$1.4 million. Profitability of our mortgage operations will depend upon our ability to increase production and thus income while holding or reducing costs. In addition, mortgages sold to third-party investors are typically subject to certain repurchase provisions related to borrower refinancing, defaults, fraud or other reasons stipulated in the applicable third-party investor agreements. If the fair value of a loan when repurchased is less than the fair value when sold, we may be required to charge such shortfall to earnings.

Any expansion into new lines of business might not be successful.

As part of our ongoing strategic plan, we will continue to consider expansion into new lines of business through the acquisition of third parties, or through organic growth and development. There are substantial risks associated with such efforts, including risks that (a) revenues from such activities might not be sufficient to offset the development, compliance, and other implementation costs, (b) competing products and services and shifting market preferences might affect the profitability of such activities, and (c) our internal controls might be inadequate to manage the risks associated with new activities. Furthermore, it is possible that our unfamiliarity with new lines of business might adversely affect the success of such actions. If any such expansions into new product markets are not successful, there could be an adverse effect on our financial condition and results of operations.

We may need additional access to capital, which we may be unable to obtain on attractive terms or at all.

We may need to incur additional debt or equity financing in the future to make strategic acquisitions or investments, for future growth or to fund losses or additional provision for loan losses in the future. Our ability to raise additional capital, if needed, will depend in part on conditions in the capital markets at that time, which are outside our control, and on our financial performance. Accordingly, we may be unable to raise additional capital, if and when needed, on terms acceptable to us, or at all. If we cannot raise additional capital when needed, our ability to further expand our operations through internal growth and acquisitions could be materially impaired and our stock price negatively affected.

Any deficiencies in our financial reporting or internal controls could materially and adversely affect us, including resulting in material misstatements in our financial statements, and could materially and adversely affect the market price of our common stock.

If we fail to maintain effective internal controls over financial reporting, our operating results could be harmed and it could result in a material misstatement in our financial statements in the future. Inferior controls and procedures or the identification of accounting errors could cause our investors to lose confidence in our internal controls and question our reported financial information, which, among other things, could have a negative impact on the trading price of our common stock. Additionally, we could become subject to increased regulatory scrutiny and a higher risk of shareholder litigation, which could result in significant additional expenses and require additional financial and management resources.

We incur increased costs as a result of being a public company.

As a public company, we incur significant legal, accounting and other expenses, including costs associated with public company reporting requirements. We also incur costs associated with the Sarbanes-Oxley Act, the Dodd-Frank Act and related rules implemented or to be implemented by the SEC and the NASDAQ Stock Market. In addition, changing laws, regulations and standards relating to corporate governance and public disclosure are creating uncertainty for public companies, increasing legal and financial compliance costs and making some activities more time consuming. These laws, regulations and standards are subject to varying interpretations, in many cases due to their lack of specificity, and, as a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies. This could result in continuing uncertainty regarding compliance matters and higher costs necessitated by ongoing revisions to disclosure and governance practices. We intend to continue to invest resources to comply with evolving laws, regulations and standards and this continued investment may result in increased general and administrative expenses and a diversion of management's time and attention from revenue-generating

activities to compliance activities. If our efforts to comply with new laws, regulations and standards differ from the activities intended by regulatory or governing bodies due to ambiguities related to their application and practice, regulatory authorities may initiate legal proceedings against us and our business may be adversely affected. In 2018, we incurred over \$840 thousand in direct external costs associated with being a public company, which does not include the increased internal costs of the personnel needed to comply with being a public company.

Inability to retain senior management and key employees or to attract new experienced financial services professionals could impair our relationship with our customers, reduce growth and adversely affect our business.

We have assembled a senior management team which has substantial background and experience in banking and financial services. Moreover, much of historical loan growth was the result of our ability to attract experienced financial services professionals who have been able to attract customers from other financial institutions. Inability to retain these key personnel or to continue to attract experienced lenders with established books of business could negatively impact our growth because of the loss of these individuals' skills and customer relationships and/or the potential difficulty of promptly replacing them.

We may be subject to losses due to fraudulent and negligent conduct of our loan customers, deposit customers, third party service providers and employees.

When we make loans to individuals or entities, we rely upon information supplied by borrowers and other third parties, including information contained in the applicant's loan application, property appraisal reports, title information and the borrower's net worth, liquidity and cash flow information. While we attempt to verify information provided through available sources, we cannot be certain all such information is correct or complete. Our reliance on incorrect or incomplete information could have a material adverse effect on our financial condition or results of operations.

The value of our goodwill and other intangible assets may decline in the future.

As of December 31, 2018, we had \$79.0 million of goodwill and other intangible assets. A significant decline in our financial condition, a significant adverse change in the business climate, slower growth rates or a significant and sustained decline in the price of our common stock may necessitate taking charges in the future related to the impairment of our goodwill and other intangible assets. If we were to conclude that a future write-down of goodwill and other intangible assets is necessary, we would record the appropriate charge, which could have a material adverse effect on our financial condition and results of operations. Future acquisitions could result in additional goodwill.

Risks Related to Our Stock

Our ability to declare and pay dividends is limited.

There can be no assurance of whether or when we may pay dividends on our common stock in the future. Future dividends, if any, will be declared and paid at the discretion of our board of directors and will depend on a number of factors. Our principal source of funds used to pay cash dividends on our common stock will be dividends that we receive from SmartBank. Although the Bank's asset quality, earnings performance, liquidity and capital requirements will be taken into account before we declare or pay any future dividends on our common stock, our board of directors will also consider our liquidity and capital requirements and our board of directors could determine to declare and pay dividends without relying on dividend payments from the Bank.

Federal and state banking laws and regulations and state corporate laws restrict the amount of dividends we may declare and pay. For example, Federal Reserve Board regulations implementing the capital rules required under Basel III do not permit dividends unless capital levels exceed certain higher levels applying capital conservation buffers that began to apply on January 1, 2016 and are being phased in over three years.

Even though our common stock is currently traded on the Nasdaq Capital Market, it has less liquidity than many other stocks quoted on a national securities exchange.

The trading volume in our common stock on the Nasdaq Capital Market has been relatively low when compared with larger companies listed on the Nasdaq Capital Market or other stock exchanges. Although we have experienced increased liquidity in our stock, we cannot say with any certainty that a more active and liquid trading market for our common stock will continue to develop. Because of this, it may be more difficult for stockholders to sell a substantial number of shares for the same price at which stockholders could sell a smaller number of shares.

We cannot predict the effect, if any, that future sales of our common stock in the market, or the availability of shares of common stock for sale in the market, will have on the market price of our common stock. We can give no assurance that sales of substantial amounts of common stock in the market, or the potential for large amounts of sales in the market, would not cause the price of our common stock to decline or impair our future ability to raise capital through sales of our common stock.

The market price of our common stock has fluctuated significantly, and may fluctuate in the future. These fluctuations may be unrelated to our performance. General market or industry price declines or overall market volatility in the future could adversely affect the price of our common stock, and the current market price may not be indicative of future market prices.

We may issue additional shares of stock or equity derivative securities, including awards to current and future executive officers, directors and employees, which could result in the dilution of shareholders' investment.

Our authorized capital includes 40,000,000 shares of common stock and 2,000,000 shares of preferred stock. As of December 31, 2018, we had 13,933,504 shares of common stock and no shares of preferred stock outstanding, and had reserved or otherwise set aside for issuance 170,625 shares underlying outstanding options and 2,479,055 shares that are available for future grants of stock options, restricted stock or other equity-based awards pursuant to our equity incentive plans. Subject to NASDAQ rules, our board of directors generally has the authority to issue all or part of any authorized but unissued shares of common stock or preferred stock for any corporate purpose. We anticipate that we will issue additional equity in connection with the acquisition of other strategic partners and that in the future we likely will seek additional equity capital as we develop our business and expand our operations, depending on the timing and magnitude of any particular future acquisition. These issuances would dilute the ownership interests of existing shareholders and may dilute the per share book value of the common stock. New investors also may have rights, preferences and privileges that are senior to, and that adversely affect, our then existing shareholders.

In addition, the issuance of shares under our equity compensation plans will result in dilution of our shareholders' ownership of our Common Stock. The exercise price of stock options could also adversely affect the terms on which we can obtain additional capital. Option holders are most likely to exercise their options when the exercise price is less than the market price for our Common Stock. They may profit from any increase in the stock price without assuming the risks of ownership of the underlying shares of Common Stock by exercising their options and selling the stock immediately.

We are subject to Tennessee's anti-takeover statutes and certain charter provisions that could decrease our chances of being acquired even if the acquisition is in the best interest of our shareholders.

As a Tennessee corporation, we are subject to various legislative acts that impose restrictions on and require compliance with procedures designed to protect shareholders against unfair or coercive mergers and acquisitions. These statutes may delay or prevent offers to acquire us and increase the difficulty of consummating any such offers, even if the acquisition would be in our shareholders' best interests. Our charter also contains provisions which may make it difficult for another entity to acquire us without the approval of a majority of the disinterested directors on our board of directors. Secondly, the amount of common stock owned by, and other compensation arrangements with, certain of our officers and directors may make it more difficult to obtain shareholder approval of potential takeovers that they oppose. Agreements with our senior management also provide for significant payments under certain circumstances following a change in control. These compensation arrangements, together with the common stock and option ownership of our board of directors and management, could make it difficult or expensive to obtain majority support for shareholder proposals or potential acquisition proposals that the board of directors and officers oppose.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

As of December 31, 2018, the principal offices of SmartFinancial are located at 5401 Kingston Pike, #600, Knoxville, Tennessee 37919. This property is owned by SmartBank and also serves as a branch location for the Bank's customers. The Bank provides services or performs operational functions at 35 locations, of which 23 are owned and 12 that are leased. Although the properties owned and leased are generally considered adequate, we have a continuing program of modernization, expansion, and when necessary, occasional replacement of facilities. For additional information relating to the Company's premises, equipment and lease commitments, see Note 5—Premises and Equipment to our audited consolidated financial statements.

ITEM 3. LEGAL PROCEEDINGS

As of the end of 2018, neither SmartFinancial nor SmartBank was involved in any material litigation. SmartBank is periodically involved as a plaintiff or defendant in various legal actions in the ordinary course of its business. Management believes that any claims pending against SmartFinancial or its subsidiary are without merit or that the ultimate liability, if any, resulting from them will not materially affect SmartBank's financial condition or SmartFinancial's consolidated financial position.

ITEM 4. MINE SAFETY DICLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

On December 31, 2018, SmartFinancial had 13,933,504 shares of common stock outstanding. SmartFinancial's common stock is listed on NASDAQ under the symbol "SMBK".

There were approximately 3,338 holders of record of the common stock as of March 6, 2019.

During the fourth quarter of 2018 the Board of Directors of SmartFinancial approved a common stock repurchase program. There were no shares purchased under this program in 2018.

For information relating to compensation plans under which our equity securities are authorized for issuance, see Part III Items 11 and 12.

ITEM 6. SELECTED FINANCIAL DATA

This item is not applicable to smaller reporting companies.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion of our financial condition at December 31, 2018 and 2017 and our results of operations for each of the years in the three-year period ended December 31, 2018. The purpose of this discussion is to focus on information about our financial condition and results of operations which is not otherwise apparent from our consolidated financial statements. The following discussion and analysis should be read along with our consolidated financial statements and the related notes included

Business Overview

The Company's business model consists of leveraging capital into assets funded by liabilities. As a general rule capital can be leveraged approximately ten times. The primary source of revenue is interest income from earning assets, namely loans and securities. These liabilities used to fund the assets are primarily deposits. The Company seeks to maximize net interest income, the difference between interest received on earning assets and the amount of interest paid on liabilities. Net interest income to average assets is a key ratio that measures the profitability of the earning assets of the company. Noninterest income is the second source of revenue and primarily consists of customer service fees, gains on the sales of securities and loans, and other noninterest income. Noninterest income to average assets is a ratio that reflects our effectiveness in generating these other forms of revenue. The Company incurs noninterest expenses as result of the operations of its business. Primary expenses are those of employees, occupancy and equipment, professional services, and data processing. The Company seeks to minimize the amount of noninterest expense relative to the amount of total assets; noninterest expense to assets is a key ratio that measures the efficiency of the costs incurred to operate the business.

Executive Summary

The following is a summary of the Company's financial highlights and significant events during 2018:

- Completed two acquisitions during the year which increased assets by approximately \$444 million : Tennessee Bancshares the second quarter and Foothills Bancorp in the fourth quarter.
- Earnings available to common shareholders increased to \$18.1 million and earnings per share increased to \$1.46.
- Ended 2018 with record high total assets of \$2.3 billion, net loans of \$1.8 billion, and deposits of \$1.9 billion.
- Net interest margin, taxable equivalent, increased to 4.43 percent 2018 compared to 4.29 percent in 2017.
- Efficiency ratio, which is equal to noninterest expense divided by the sum of net interest income and noninterest income, decreased to 70.7 percent in 2018, compared to 76.0 percent in 2017.

Analysis of Results of Operations

2018 compared to 2017

Net income was \$18.1 million in 2018, compared to \$5.0 million in 2017. Net income available to common shareholders was \$18.1 million, or \$1.45 per diluted common share, in 2018, compared to \$4.8 million, or \$0.55 per diluted common share, in 2017. Net interest income to average assets of 3.90 percent in 2018 held steady from in 2017. Noninterest income to average assets of 0.34 percent decreased from 0.42 percent in 2017 as growth in assets exceeded increases in noninterest income. Noninterest expense to average assets decreased from 3.29 percent in 2017 to 3.00 percent in 2018 as the company continued to capture economies of scale following the mergers. The resulting pretax income to average assets was 1.19 percent in 2018 compared to 1.00 percent in 2017. Finally, in 2018 the effective tax rate was 15.2 percent, which was lower than normal due to a tax benefit from options exercised while the rate of 56.2 percent in 2017 was elevated due to a \$2.4 million after-tax charge to write down the Company's deferred tax assets as a result of the Tax Cuts and Jobs Act of 2017.

2017 compared to 2016

Net income was \$5.0 million in 2017 a decrease from \$5.8 million in 2016 primarily due to a \$2.4 million after-tax charge to write down the Company's deferred tax assets as a result of the Tax Cuts and Jobs Act of 2017. Net income available to common shareholders was \$4.8 million, or \$0.55 per diluted common share, in 2017 compared to \$4.8 million, or \$0.78 per diluted common share, in 2016. Net interest income to average assets of 3.90 percent in 2017 increased from 3.77 percent in 2016 as a result of a higher percentage of average earning assets to average total assets. Noninterest income to average assets of 0.42 percent in 2017 increased slightly from 0.41 percent in 2016 due to higher customer service fees, higher interchange and debit cards fees, and higher other noninterest income. Noninterest expense to average assets increased from 3.20 percent in 2016 to 3.29 percent in 2017 primarily due to \$2.4 million in merger expenses. The resulting pretax income to average assets was 1.00 percent in 2017 compared to 0.95 percent in 2016. Finally, the effective tax rate of 56.2 percent in 2017 was elevated due to a \$2.4 million after-tax charge to write down the Company's deferred tax assets as a result of the Tax Cuts and Jobs Act of 2017 while in 2016 the effective tax rate was 36.70 percent..

Net Interest Income and Yield Analysis

2018 compared to 2017

Net interest income, taxable equivalent, increased to \$76.8 million in 2018 from \$46.4 million in 2017. The increase in net interest income, taxable equivalent, was the result of a significant increase in earning assets primarily from the mergers but also from organic business activity. Average earning assets increased from \$1.1 billion in 2017 to \$1.7 billion in 2018. Over this period, average loan balances increased by \$592.1 million and average securities balances increased by \$33.0 million. In addition, total average interest-bearing deposits increased by \$543.1 million. Net interest income to average assets of 3.90 percent in 2018 was unchanged from 3.90 percent in 2017. Net interest margin, taxable equivalent, was 4.43 percent in 2018, compared to 4.29 percent in 2017, with the increase due to higher yields on earning assets. Net interest margin, taxable equivalent, was slightly negatively impacted by an increase in the cost of interest bearing liabilities from 0.66 percent in 2017 to 1.10 percent in 2018. In 2019 we expect net interest income to average assets and net interest margin, taxable equivalent, to experience pressure as there is the potential for pressure to increase deposit rates as short term rates have continued to increase but do anticipate the effect of rate increases will be mitigated on the income side by increases in yields of our floating rate earning assets.

2017 compared to 2016

Net interest income, taxable equivalent, increased to \$46.4 million in 2017 from \$38.3 million in 2016. The increase in net interest income, taxable equivalent, was the result of a significant increase in earning assets primarily from the merger but also from organic business activity. Average earning assets increased from \$944.6 million in 2016 to \$1.1 billion in 2017 . Over this period, average loan balances increased by \$149.6 million and average securities and interest bearing balances decreased by \$17.3 million. In addition, total average interest-bearing deposits increased by \$113.8 million. Net interest income to average assets of 3.90 percent in 2017 increased from 3.77 percent in 2016 . Net interest margin, taxable equivalent, was 4.29 percent in 2017 4.06 percent in 2016, with the increase due to higher yields on earning assets.. Net interest margin, taxable equivalent, was slightly negatively impacted by an increase in the cost of interest bearing liabilities from 0.56 percent in 2016 to 0.66 percent in 2017.

The following table summarizes the major components of net interest income and the related yields and costs for the periods presented.

(Dollars in thousands)	2018			2017			2016		
	Average Balance	Interest *	Yield/ Cost*	Average Balance	Interest *	Yield/ Cost*	Average Balance	Interest *	Yield/ Cost*
Assets									
Loans (1)	\$1,511,724	\$ 86,479	5.72%	\$ 919,603	\$ 48,834	5.31%	\$ 769,990	\$ 39,779	5.18%
Taxable Securities	143,281	3,512	2.46%	123,741	2,369	1.92%	142,271	2,358	1.66%
Tax-exempt securities (2)	19,734	767	3.90%	6,260	214	3.43%	4,996	162	3.25%
Federal funds and other earning assets	65,244	1,642	2.52%	36,754	723	1.97%	25,828	336	1.30%
Total interest-earning assets	<u>1,739,983</u>	<u>92,400</u>	<u>5.32%</u>	<u>1,086,358</u>	<u>52,140</u>	<u>4.81%</u>	<u>943,085</u>	<u>42,635</u>	<u>4.53%</u>
Noninterest-earning assets	<u>222,734</u>			<u>102,231</u>			<u>69,147</u>		
Total assets	<u>\$1,962,717</u>			<u>\$1,188,589</u>			<u>\$1,012,232</u>		
Liabilities and Stockholders' Equity									
Interest-bearing demand deposits	\$ 242,859	1,290	0.53%	\$ 166,382	539	0.32%	\$ 150,649	286	0.19%
Money market and savings deposits	601,808	5,579	0.93%	342,637	1,759	0.51%	258,092	1,172	0.46%
Time deposits	536,964	7,419	1.39%	329,524	3,221	0.98%	316,046	2,647	0.84%
Total interest-bearing deposits	<u>1,381,631</u>	<u>14,288</u>	<u>1.04%</u>	<u>838,543</u>	<u>5,519</u>	<u>0.66%</u>	<u>724,787</u>	<u>4,105</u>	<u>0.57%</u>
Federal funds purchased and other borrowings	16,940	155	0.92%	20,771	90	0.43%	23,015	84	0.37%
Federal Home Loan Bank advances	6,939	118	1.71%	2,260	16	0.71%	15,360	93	0.61%
Long-term debt	18,855	1,005	5.34%	1,699	68	4.01%	448	17	3.81%
Total interest-bearing liabilities	<u>1,424,365</u>	<u>15,566</u>	<u>1.10%</u>	<u>863,273</u>	<u>5,693</u>	<u>0.66%</u>	<u>763,610</u>	<u>4,299</u>	<u>0.56%</u>
Noninterest-bearing deposits	285,729			172,842			139,652		
Other liabilities	10,172			6,670			5,492		
Total liabilities	<u>1,720,266</u>			<u>1,042,785</u>			<u>908,754</u>		
Stockholders' equity	<u>242,451</u>			<u>145,804</u>			<u>103,478</u>		
Total liabilities and stockholders' equity	<u>\$1,962,717</u>			<u>\$1,188,589</u>			<u>\$1,012,232</u>		
Net interest income, taxable equivalent		<u>\$ 76,834</u>			<u>\$ 46,447</u>			<u>\$ 38,336</u>	
Interest rate spread (3)			<u>4.22%</u>			<u>4.15%</u>			<u>3.95%</u>
Tax equivalent net interest margin (4)			<u>4.43%</u>			<u>4.29%</u>			<u>4.06%</u>
Percentage of average interest-earning assets to average interest-bearing liabilities			<u>122.2%</u>			<u>125.8%</u>			<u>123.7%</u>
Percentage of average equity to average assets			<u>12.4%</u>			<u>12.3%</u>			<u>10.2%</u>

* Taxable equivalent basis

- (1) Loans include nonaccrual loans. Yields related to loans exempt from income taxes are stated on a taxable-equivalent basis assuming a federal income tax rate of 21.0 percent in 2018 and 34.0 percent in 2017 and 2016. The taxable-equivalent adjustment was \$10 thousand for 2018, \$28 thousand for 2017 and \$16 thousand for 2016. Loan fees included in loan income was \$2.7 million, \$2.5 million, and \$2.6 million for 2018, 2017 and 2016, respectively.
- (2) Yields related to investment securities exempt from income taxes are stated on a taxable-equivalent basis assuming a federal income tax rate of 21.0 percent in 2018 and 34.0 percent in 2017 and 2016. The taxable-equivalent adjustment was \$180 thousand, \$90 thousand and \$55 thousand for 2018, 2017 and 2016, respectively.
- (3) Net interest spread represents the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities.
- (4) Net interest margin represents net interest income divided by average interest-earning assets.

Rate and Volume Analysis

Net interest income, taxable equivalent, increased by \$30.4 million between the years ended December 31, 2018 and 2017 and by \$8.1 million between the years ended December 31, 2017 and 2016. The following is an analysis of the changes in net interest income comparing the changes attributable to rates and those attributable to volumes (in thousands):

	2018 Compared to 2017 Increase (decrease) due to			2017 Compared to 2016 Increase (decrease) due to		
	Rate	Volume	Net	Rate	Volume	Net
Interest-earning assets:						
Loans (1)	\$ 6,203	\$ 31,442	\$ 37,645	\$ 1,284	\$ 7,771	\$ 9,055
Taxable Securities	768	375	1,143	319	(308)	11
Tax-exempt securities (2)	91	462	553	11	41	52
Federal funds and other earning assets	358	561	919	245	142	387
Total interest-earning assets	7,420	32,840	40,260	1,859	7,646	9,505
Interest-bearing liabilities:						
Interest-bearing demand deposits	506	245	751	223	30	253
Money market and savings deposits	2,498	1,322	3,820	197	390	587
Time deposits	2,165	2,033	4,198	460	114	574
Total interest-bearing deposits	5,169	3,600	8,769	880	534	1,414
Federal funds purchased and other borrowings	81	(16)	65	14	(8)	6
Federal Home Loan Bank advances	69	33	102	3	(80)	(77)
Long-term debt	249	688	937	3	48	51
Total interest-bearing liabilities	5,568	4,305	9,873	948	446	1,394
Net interest income	\$ 1,852	\$ 28,535	\$ 30,387	\$ 911	\$ 7,200	\$ 8,111

(1) Loans include nonaccrual loans. Yields related to loans exempt from income taxes are stated on a taxable-equivalent basis assuming a federal income tax rate of 21.0 percent in 2018 and 34.0 percent in 2017 and 2016. The taxable-equivalent adjustment was \$10 thousand for 2018, \$28 thousand for 2017 and \$16 thousand for 2016. Loan fees included in loan income was \$2.7 million, \$2.5 million, and \$2.6 million for 2018, 2017 and 2016, respectively.

(2) Yields related to investment securities exempt from income taxes are stated on a taxable-equivalent basis assuming a federal income tax rate of 21.0 percent in 2018 and 34.0 percent in 2017 and 2016. The taxable-equivalent adjustment was \$180 thousand, \$90 thousand and \$55 thousand for 2018, 2017 and 2016, respectively.

Changes in net interest income are attributed to either changes in average balances (volume change) or changes in average rates (rate change) for earning assets and sources of funds on which interest is received or paid. Volume change is calculated as change in volume times the previous rate while rate change is change in rate times the previous volume. The change attributed to rates and volumes (change in rate times change in volume) is considered above as a change in volume.

Noninterest Income

The following table provides a summary of noninterest income for the periods presented.

(Dollars in thousands)	Year ended December 31,		
	2018	2017	2016
Customer service fees	\$ 2,416	\$ 1,374	\$ 1,128
Interchange and debit card transaction fees	573	952	732
Gain on sale of securities	1	144	199
Gain on sale of loans and other assets	1,433	1,276	1,139
Other noninterest income	2,161	1,281	986
Total noninterest income	<u>\$ 6,584</u>	<u>\$ 5,027</u>	<u>\$ 4,183</u>

2018 compared to 2017

Noninterest income totaled \$6.6 million in 2018, which was an increase from \$5.0 million in 2017. Noninterest income to average assets of 0.34 percent decreased from 0.42 percent in 2017. Primary drivers of the decrease were a change in the accounting treatment form interchange and debit card transaction fees, which starting in 2018 are shown net of direct costs. In 2018, there were gains of \$1.4 million on the sale of mortgage loans, SBA loans and other assets compared to \$1.3 million in 2017. Other noninterest income of \$2.2 million in 2018 increased from \$1.3 million in 2017 primarily due to higher income from bank owned life insurance and higher income from investment operations. In 2018, we expect noninterest income to average assets to increase as a result of increased loan sales from the mortgage unit, higher service charges on deposit accounts, increases in income from investment services, and greater other noninterest income.

2017 compared to 2016

Noninterest income totaled \$5.0 million in 2017, which was an increase from \$4.2 million in 2016. Noninterest income to average assets of 0.42 percent in 2017 increased slightly from 0.41 percent in 2016. Primary drivers of the increase were higher gains higher customer service fees, higher interchange and debit cards fees, and higher other noninterest income. In 2017, there were \$1.4 million in customer service fees compared to \$1.1 million in 2016 due to higher volumes. Interchange an debit card fees increased from \$732 thousand in 2016 to \$952 thousand in 2017 due to higher volumes. Other noninterest income of \$1.3 million in 2017 increased from \$986 thousand in 2016 primarily due to increased revenue as a result of the merger.

Noninterest Expense

The following table provides a summary of noninterest expense for the periods presented.

(Dollars in thousands)	Year ended December 31,		
	2018	2017	2016
Salaries and employee benefits	\$ 30,630	\$ 20,743	\$ 17,715
Net occupancy and equipment expense	6,303	4,271	3,996
FDIC insurance	786	466	606
Foreclosed assets	776	132	236
Advertising	873	638	616
Data processing	1,906	1,875	1,893
Professional services	3,647	2,085	2,123
Amortization of other intangible assets	976	346	305
Software as services contracts	2,054	1,398	1,154
Merger expenses	3,781	2,417	—
Other operating expenses	7,224	4,758	3,856
Total noninterest expense	<u>\$ 58,956</u>	<u>\$ 39,130</u>	<u>\$ 32,500</u>

2018 compared to 2017

Noninterest expense totaled \$59.0 million in 2018 compared to \$39.1 million in 2017. Noninterest expense to average assets decreased from 3.29 percent in 2017 to 3.00 percent in 2018. Salaries and employee benefits, occupancy and equipment, and other noninterest expense categories in 2018 were all higher as a result of post-merger expenses including ten additional months of Capstone expenses, seven additional months of Tennessee Bancshares expenses, and two additional months of Foothills expenses. In 2019, we expect noninterest expense to average assets to increase as anticipated increases in merger expenses offset reductions in core operating expenses.

2017 compared to 2016

Noninterest expense totaled \$39.1 million in 2017 compared to \$32.5 million in 2016. Noninterest expense to average assets increased from 3.20 percent in 2016 to 3.29 percent in 2017. Salaries and employee benefits, occupancy and equipment, data processing, and other noninterest expense categories in 2017 were all higher as a result of two full months of post-merger expense. In 2017 noninterest expense was also elevated by \$2.4 million of merger expenses, compared to none in 2016.

Income Taxes

2018 compared to 2017

In 2018, income tax expense totaled \$3.2 million compared to \$6.4 million in 2017. In 2018 the effective tax rate was 15.2 percent, which was lower than normal due to a tax benefit from options exercised in the prior period while the rate of 56.2 percent in 2017 was elevated due to a \$2.4 million after-tax charge to write down the Company's deferred tax assets as a result of the Tax Cuts and Jobs Act of 2017. In 2019, we expect our effective tax rate to be in the range of 25 percent.

2017 compared to 2016

In 2017, income tax expense totaled \$6.4 million compared to \$3.4 million in 2016. The effective tax rate of 56.2 percent in 2017 was elevated due to a \$2.4 million after-tax charge to reduce the value of the Company's deferred tax assets as a result of the tax law signed in December compared to 36.7 percent in 2016.

Loan Portfolio Composition

The Company had total net loans outstanding, including organic and purchased loans, of approximately \$1.8 billion at December 31, 2018 and \$1.3 billion at December 31, 2017. Loans secured by real estate, consisting of commercial or residential property, are the principal component of our loan portfolio. We do not generally originate traditional long-term residential mortgages for our portfolio but we do originate and hold traditional second mortgage residential real estate loans, adjustable rate mortgages and home equity lines of credit. Even if the principal purpose of the loan is not to finance real estate, when reasonable, we attempt to obtain a security interest in the real estate in addition to any other available collateral to increase the likelihood of ultimate repayment or collection of the loan.

Organic Loans

Our net organic loans increased \$356.6 million, or 44.9 percent to \$1.2 billion at December 31, 2018, from December 31, 2017, primarily as a result of the mergers. Our goal of streamlining the credit process has improved our efficiency and is a competitive advantage in many of our markets. In addition, continued training and recruiting of experienced loan officers has provided us with the opportunity to close larger and more complex deals than we historically have. Finally, the overall business environment continues to rebound from recessionary conditions. Organic loans include loans which were originally purchased non-credit impaired loans but have been renewed.

Purchased Loans

Purchased non-credit impaired loans of \$584.5 million at December 31, 2018 increased by \$93.6 million from December 31, 2017 as a result of the mergers. Also during 2018, our purchased credit impaired ("PCI") loans increased by \$1.4 million to \$34.2 million at December 31, 2018. The activity within the purchased credit impaired loans will be impacted by how quickly these loans are resolved and/or our future acquisition activity.

The following tables summarize the composition of our loan portfolio for the periods presented (dollars in thousands):

	2018				
	Organic Loans	Purchased Non-Credit Impaired Loans	Purchased Credit Impaired Loans	Total Amount	% of Gross Total
Commercial real estate-mortgage	\$ 555,915	\$ 286,430	\$ 17,682	\$ 860,027	48.4%
Consumer real estate-mortgage	224,958	173,584	8,712	407,254	22.9%
Construction and land development	134,232	49,061	4,602	187,895	10.6%
Commercial and industrial	234,877	70,820	2,557	308,254	17.3%
Consumer and other	8,627	4,577	605	13,809	0.8%
Total gross loans receivable, net of deferred fees	1,158,609	584,472	34,158	1,777,239	100.0%
Allowance for loan losses	(8,275)	—	—	(8,275)	
Total loans, net	\$ 1,150,333	\$ 584,473	\$ 34,158	\$ 1,768,964	

	2017				
	Organic Loans	Purchased Non-Credit Impaired Loans	Purchased Credit Impaired Loans	Total Amount	% of Gross Total
Commercial real estate-mortgage	\$ 387,313	\$ 237,772	\$ 17,903	\$ 642,988	48.6%
Consumer real estate-mortgage	173,988	112,019	7,450	293,457	22.2%
Construction and land development	97,116	33,173	5,120	135,409	10.2%
Commercial and industrial	135,271	101,958	858	238,087	18.0%
Consumer and other	5,925	5,929	1,463	13,317	1.0%
Total gross loans receivable, net of deferred fees	799,613	490,851	32,794	1,323,258	100.0%
Allowance for loan losses	(5,844)	—	(16)	(5,860)	
Total loans, net	\$ 793,769	\$ 490,851	\$ 32,778	\$ 1,317,398	

	2016				
	Organic Loans	Purchased Non-Credit Impaired Loans	Purchased Credit Impaired Loans	Total Amount	% of Gross Total
Commercial real estate-mortgage	\$ 297,689	\$ 102,576	\$ 14,943	\$ 415,208	51.0%
Consumer real estate-mortgage	135,923	42,875	9,004	187,802	23.1%
Construction and land development	108,390	7,801	1,678	117,869	14.5%
Commercial and industrial	68,235	15,219	1,568	85,022	10.5%
Consumer and other	6,786	689	—	7,475	0.9%
Total gross loans receivable, net of deferred fees	617,023	169,160	27,193	813,376	100.0%
Allowance for loan losses	(5,105)	—	—	(5,105)	
Total loans, net	\$ 611,918	\$ 169,160	\$ 27,193	\$ 808,271	

2015					
	Organic Loans	Purchased Non-Credit Impaired Loans	Purchased Credit Impaired Loans	Total Amount	% of Gross Total
Commercial real estate-mortgage	\$ 229,203	\$ 120,524	\$ 20,050	\$ 369,777	50.8%
Consumer real estate-mortgage	95,233	53,697	12,764	161,694	22.2%
Construction and land development	73,028	29,755	2,695	105,478	14.5%
Commercial and industrial	53,761	28,422	2,768	84,951	11.7%
Consumer and other	4,692	1,123	—	5,815	0.8%
Total gross loans receivable, net of deferred fees	455,917	233,521	38,277	727,715	100.0%
Allowance for loan losses	(4,354)	—	—	(4,354)	
Total loans, net	\$ 451,563	\$ 233,521	\$ 38,277	\$ 723,361	

2014					
	Organic Loans	Purchased Non-Credit Impaired Loans	Purchased Credit Impaired Loans	Total Amount	% of Gross Total
Commercial real estate-mortgage	\$ 186,444	\$ 3,905	\$ 3,102	\$ 193,451	53.2%
Consumer real estate-mortgage	75,066	1,968	4,380	81,414	22.4%
Construction and land development	52,421	48	36	52,505	14.5%
Commercial and industrial	33,716	—	3	33,719	9.3%
Consumer and other	2,314	—	—	2,314	0.6%
Total gross loans receivable, net of deferred fees	349,961	5,921	7,521	363,403	100.0%
Allowance for loan losses	(3,880)	—	—	(3,880)	
Total loans, net	\$ 346,081	\$ 5,921	\$ 7,521	\$ 359,523	

Loan Portfolio Maturities

The following table sets forth the maturity distribution of our loans, including the interest rate sensitivity for loans maturing after one year (dollars in thousands).

	One Year or Less	One through Five Years	Over Five Years	Total	Rate Structure for Loans Maturing Over One Year	
					Fixed Rate	Floating Rate
Commercial real estate-mortgage	\$ 119,165	\$ 430,911	\$ 309,951	\$ 860,027	\$ 484,199	\$ 256,663
Consumer real estate-mortgage	46,742	172,854	187,658	407,254	133,332	227,180
Construction and land development	84,855	70,949	32,091	187,895	43,704	59,336
Commercial and industrial	107,826	127,006	73,422	308,254	164,744	35,684
Consumer and other	6,286	6,314	1,209	13,809	6,308	1,215
Total Loans	\$ 364,874	\$ 808,034	\$ 604,331	\$ 1,777,239	\$ 832,287	\$ 580,078

Nonaccrual, Past Due, and Restructured Loans

Loans are considered past due when the contractual amounts due with respect to principal and interest are not received within 30 days of the contractual due date. Loans are generally classified as nonaccrual if they are past due for a period of 90 days or more, unless such loans are well secured and in the process of collection. If a loan or a portion of a loan is classified as doubtful or as partially charged off, the loan is generally classified as nonaccrual. Loans that are on a current payment status or past due less than 90 days may also be classified as nonaccrual if repayment in full of principal and interest is in doubt. Loans may be returned to accrual status when all principal and interest amounts contractually due are reasonably assured of repayment within an acceptable period of time, and there is a sustained period of repayment performance of interest and principal by the borrower in accordance with the contractual terms.

PCI loans with common risk characteristics are grouped in pools at acquisition. These loans are evaluated for accrual status at the pool level rather than the individual loan level and performance is based on our ability to reasonably estimate the amount and timing of future cash flows rather than a borrower's ability to repay contractual loan amounts. Since we are able to reasonably estimate the amount and timing of future cash flows on the Company's PCI loan pools, none of these loans have been identified as nonaccrual. However, PCI loans included in pools are identified as nonperforming if they are past due 90 days or more at acquisition or become 90 days or more past due after acquisition. The past due status is determined based on the contractual terms of the individual loans.

While a loan is classified as nonaccrual and the future collectability of the recorded loan balance is doubtful, collections of interest and principal are generally applied as a reduction to the principal outstanding, except in the case of loans with scheduled amortizations where the payment is generally applied to the oldest payment due. When the future collectability of the recorded loan balance is expected, interest income may be recognized on a cash basis. In the case where a nonaccrual loan had been partially charged off, recognition of interest on a cash basis is limited to that which would have been recognized on the recorded loan balance at the contractual interest rate. Receipts in excess of that amount are recorded as recoveries to the allowance for loan losses until prior charge-offs have been fully recovered.

Assets acquired as a result of foreclosure are recorded at estimated fair value in foreclosed assets. Any excess of cost over estimated fair value at the time of foreclosure is charged to the allowance for loan losses. Valuations are periodically performed on these properties, and any subsequent write-downs are charged to earnings. Routine maintenance and other holding costs are included in noninterest expense.

Loans, excluding pooled PCI loans, are classified as troubled debt restructurings (“TDR”) by the Company when certain modifications are made to the loan terms and concessions are granted to the borrowers due to financial difficulty experienced by those borrowers. The Company grants concessions by (1) reduction of the stated interest rate for the remaining original life of the debt or (2) extension of the maturity date at a stated interest rate lower than the current market rate for new debt with similar risk. The Company does not generally grant concessions through forgiveness of principal or accrued interest. The Company’s policy with respect to accrual of interest on loans restructured in a TDR follows relevant supervisory guidance. That is, if a borrower has demonstrated performance under the previous loan terms and shows capacity to perform under the restructured loan terms, continued accrual of interest at the restructured interest rate is likely. If a borrower was materially delinquent on payments prior to the restructuring but shows the capacity to meet the restructured loan terms, the loan will likely continue as nonaccrual until there is demonstrated performance under new terms. Lastly, if the borrower does not perform under the restructured terms, the loan is placed on nonaccrual status. The Company closely monitors these loans and ceases accruing interest on them if we believe that the borrowers may not continue performing based on the restructured note terms.

PCI loans that were classified as TDRs prior to acquisition are not classified as TDRs by the Company after the acquisition date. Subsequent modification of a PCI loan accounted for in a pool that would otherwise meet the definition of a TDR is not reported, or accounted for, as a TDR since pooled PCI loans are excluded from the scope of TDR accounting. A PCI loan not accounted for in a pool would be reported, and accounted for, as a TDR if modified in a manner that meets the definition of a TDR after the acquisition date.

Nonperforming loans as a percentage of gross loans, net of deferred fees, was 0.18 percent as of December 31, 2018, compared to 0.25 percent as of December 31, 2017. Total nonperforming assets as a percentage of total assets as of December 31, 2018 totaled 0.25 percent compared to 0.34 percent as of December 31, 2017. Acquired PCI loans that are included in loan pools are reclassified at acquisition to accrual status and thus are not included as nonperforming assets unless they are 90 days or greater past due. In 2018, there was \$124 thousand in interest income recognized on nonaccrual and restructured loans compared to the \$222 thousand in gross interest income that would have been recognized if the loans had been current in accordance with their original terms.

The following table summarizes the Company's nonperforming assets as of December 31 for the periods presented.

(Dollars in thousands)	2018	2017	2016	2015	2014
Nonaccrual loans	\$ 2,696	\$ 1,764	\$ 1,415	\$ 2,252	\$ 5,067
Accruing loans past due 90 days or more (1)	584	1,509	699	502	—
Total nonperforming loans	3,280	3,273	2,114	2,754	5,067
Foreclosed assets	2,495	3,254	2,386	5,358	4,983
Total nonperforming assets	\$ 5,775	\$ 6,527	\$ 4,500	\$ 8,112	\$ 10,050
Restructured loans not included above	\$ 116	\$ 41	\$ 166	\$ 3,693	\$ 1,937

(1) Balances include PCI loans past due 90 days or more that are grouped in pools which accrue interest based on pool yields.

Potential Problem Loans

At December 31, 2018 problem loans amounted to approximately \$784.0 thousand or 0.04 percent of total loans outstanding. Potential problem loans, which are not included in nonperforming loans, represent those loans with a well-defined weakness and where information about possible credit problems of borrowers has caused management to have doubts about the borrower's ability to comply with present repayment terms. This definition is believed to be substantially consistent with the standards established by the Bank's primary regulators, for loans classified as substandard or worse, but not considered nonperforming loans.

Allocation of the Allowance for Loan Losses

We maintain the allowance at a level that we deem appropriate to adequately cover the probable losses inherent in the loan portfolio. As of December 31, 2018 and December 31, 2017, our allowance for loan losses was \$8.3 million and \$5.9 million, respectively, which we deemed to be adequate at each of the respective dates. The increase in the allowance for loan losses in 2018 as compared to 2017 is primarily the result of increases in organic loan growth offset slightly by improving overall credit metrics within our portfolio. Our allowance for loan loss as a percentage of total loans has increased from 0.44 percent at December 31, 2017 to 0.47 percent at December 31, 2018. As a percentage of organic loans the allowance for loan losses decreased slightly from 0.73 percent at December 31, 2017 to 0.71 percent at December 31, 2018. In 2019, we expect the allowance to organic loans to remain in the range of 0.70 to 0.80 percent.

Our purchased loans were recorded at fair value upon acquisition. The fair value adjustments on the performing purchased loans will be accreted into income over the life of the loans. At December 31, 2018, the remaining accretable yield was approximately \$7.1 million. Also at the end of 2018, the balance on PCI loans was \$48.4 million and the carrying value was \$34.2 million, for a net difference of \$14.2 million in discounts. These loans are subject to the same allowance methodology as our legacy portfolio. The calculated allowance is compared to the remaining fair value discount to determine if additional provisioning should be recognized. At December 31, 2018, there was no allowance on PCI loans. The judgments and estimates associated with our allowance determination are described in Note 1 in the "Notes to Consolidated Financial Statements."

The following table sets forth, based on our best estimate, the allocation of the allowance to types of loans as well as the unallocated portion as of December 31 for each of the past five years and the percentage of loans in each category to total loans (in thousands):

	December 31,									
	2018		2017		2016		2015		2014	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Commercial real estate-mortgage	\$ 3,639	44.0%	\$ 2,465	42.1%	\$ 2,369	46.4%	\$ 1,906	43.8%	\$ 1,734	44.7%
Consumer real estate-mortgage	1,789	21.6%	1,596	27.2%	1,382	27.1%	1,015	23.3%	906	23.3%
Construction and land development	795	9.6%	521	8.9%	717	14.0%	627	14.4%	690	17.8%
Commercial and industrial	1,746	21.1%	1,062	18.1%	520	10.2%	777	17.8%	524	13.5%
Consumer and other	306	3.7%	216	3.7%	117	2.3%	29	0.7%	26	0.7%
Total allowance for loan losses	<u>\$ 8,275</u>	<u>100.0%</u>	<u>\$ 5,860</u>	<u>100.0%</u>	<u>\$ 5,105</u>	<u>100.0%</u>	<u>\$ 4,354</u>	<u>100.0%</u>	<u>\$ 3,880</u>	<u>100.0%</u>

The increase in the overall allowance for loan losses is due to the increased balance of organic loans offset by improvements of our loan portfolio and the reduction of nonperforming loans and net charge-offs, which is largely influenced by the overall improvement in the economies in our market areas. The allocation by category is determined based on the assigned risk rating, if applicable, and environmental factors applicable to each category of loans. For impaired loans, those loans are reviewed for a specific allowance allocation. Specific valuation allowances related to impaired loans were approximately \$534 thousand at December 31, 2018, compared to \$445 thousand at December 31, 2017. Additional information on the allocation of the allowance between performing and impaired loans is provided in Note 4-Loans and Allowance for Loan Losses to our audited consolidated financial statements.

Analysis of the Allowance for Loan Losses

The following is a summary of changes in the allowance for loan losses for each of the years in the five-year period ended December 31, 2018 and the ratio of the allowance for loan losses to total loans as of the end of each period (in thousands):

	2018	2017	2016	2015	2014
Balance at beginning of period	\$ 5,860	\$ 5,105	\$ 4,354	\$ 3,880	\$ 4,136
Provision for loan losses	2,936	783	788	923	432
Charged-off loans:					
Commercial real estate	(38)	—	—	(95)	—
Consumer real estate	(275)	(111)	(102)	(247)	(623)
Construction and land development	—	—	(14)	(50)	(7)
Commercial and industrial	(177)	(24)	(35)	—	(118)
Consumer and other	(370)	(141)	(155)	(114)	(65)
Total charged-off loans	(860)	(276)	(306)	(506)	(813)
Recoveries of previously charged-off loans:					
Commercial real estate	2	8	45	—	2
Consumer real estate	100	99	76	—	—
Construction and land development	9	13	22	26	—
Commercial and industrial	72	67	58	19	—
Consumer and other	156	61	68	12	123
Total recoveries of previously charged-off loans	339	248	269	57	125
Net charge-offs	(521)	(28)	(37)	(449)	(688)
Balance at end of period	\$ 8,275	\$ 5,860	\$ 5,105	\$ 4,354	\$ 3,880
Ratio of allowance for loan losses to total loans outstanding at end of period	0.47 %	0.44 %	0.63 %	0.60 %	1.07 %
Ratio of net charge-offs to average loans outstanding for the period	(0.03)%	— %	— %	(0.09)%	(0.20)%

We assess the adequacy of the allowance at the end of each calendar quarter. This assessment includes procedures to estimate the allowance and test the adequacy and appropriateness of the resulting balance. The level of the allowance is based upon our evaluation of the loan portfolios, past loan loss experience, known and inherent risks in the portfolio, the views of the Bank's regulators, adverse situations that may affect the borrower's ability to repay (including the timing of future payments), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan quality indications and other pertinent factors. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change.

Investment Portfolio

Our investment portfolio which is carried at fair market value, consisting primarily of Federal agency bonds, mortgage-backed securities, state and municipal securities and other debt securities amounted to \$201.7 million and \$151.9 million at December 31, 2018 and 2017, respectively. This increase was a result of purchasing additional investments from liquidity received through the sale of the investment portfolios after the two mergers. In 2016, the investment portfolio amounted to \$131.0 million and it increased in 2017 to \$151.9 million as a result purchasing additional investments from liquidity received through the sale of the investment portfolios after the Capstone merger. Our investment to asset ratio has decreased from 12.1 percent at December 31, 2016, to 8.8 percent at December 31, 2017, and then increased slightly to 8.9 percent at December 31, 2018. Over the last several years we have reduced the ratio of investments to total assets and the absolute level of investment securities on our balance sheet as we have allocated more funding to loans. Our investment portfolio serves many purposes including serving as a potential liquidity source, collateral for public funds, and as a stable source of income.

The following table shows the amortized cost of the Company's investment securities. In 2018, 2017, and 2016, all investment securities were classified as available for sale.

Investment Securities
(in thousands)

	2018	2017	2016
U.S. Government-sponsored enterprises (GSEs)	\$ 44,117	\$ 26,207	\$ 18,279
Municipal securities	55,248	9,122	8,182
Other debt securities	977	974	—
Mortgage-backed securities	103,875	117,263	104,585
Total securities	\$ 204,217	\$ 153,566	\$ 131,046

The following table presents the contractual maturity of investment securities by contractual maturity date and average yields based on amortized cost (for all obligations on a fully taxable basis). The composition and maturity / repricing distribution of the securities portfolio is subject to change depending on rate sensitivity, capital and liquidity needs.

Expected Maturity of Investment Securities
As of December 31, 2018
(in thousands)

	Maturity By Years				
	1 or Less	1 to 5	5 to 10	Over 10	Total
U.S. Government-sponsored enterprises (GSEs)	\$ 3,000	\$ 33,000	\$ 8,117	\$ —	\$ 44,117
Municipal securities	112	—	5,494	49,642	55,248
Other debt securities	—	—	977	—	977
Mortgage-backed securities	—	9,820	18,944	75,111	103,875
Total securities available for sale	\$ 3,112	\$ 42,820	\$ 33,532	\$ 124,753	\$ 204,217
Weighted average yield (1)	1.45%	2.39%	2.23%	3.33%	2.95%

(1) Based on amortized cost, taxable equivalent basis

Deposits

Deposits are the primary source of funds for the Company's lending and investing activities. The Company provides a range of deposit services to businesses and individuals, including noninterest-bearing checking accounts, interest-bearing checking accounts, savings accounts, money market accounts, Individual Retirement Accounts ("IRAs") and certificates of deposit ("CDs"). These accounts generally earn interest at rates the Company establishes based on market factors and the anticipated amount and timing of funding needs. The establishment or continuity of a core deposit relationship can be a factor in loan pricing decisions. While the Company's primary focus is on establishing customer relationships to attract core deposits, at times, the Company uses brokered deposits and other wholesale deposits to supplement its funding sources. As of December 31, 2018, brokered deposits represented approximately 12.6 percent of total deposits.

The composition of the deposit portfolio, by category, as of December 31, 2018 was as follows: 33.8 percent in time deposits, 33.4 percent in money market and savings, 16.2 percent in interest-bearing demand deposit, and 16.6 percent in noninterest-bearing demand deposits. The composition of the deposit portfolio, by category, as of December 31, 2017 was as follows: 30.8 percent in time deposits, 37.8 percent in money market and savings, 16.1 percent in interest-bearing demand deposit, and 15.3 percent in noninterest-bearing demand deposits.

The following table summarizes the average balances outstanding and average interest rates for each major category of deposits for 2018 and 2017.

(Dollars in thousands)	2018			2017		
	Average Balance	% of Total	Average Rate	Average Balance	% of Total	Average Rate
Noninterest-bearing demand	\$ 285,729	17.1%	—	\$ 172,842	17.1%	—
Interest-bearing demand	242,859	14.6%	0.53%	166,382	16.5%	0.32%
Money market and savings	601,808	36.1%	0.93%	342,637	33.9%	0.51%
Time deposits	536,964	32.2%	1.39%	329,524	32.5%	0.98%
Total average deposits	\$ 1,667,360	100.0%	0.86%	\$ 1,011,385	100.0%	0.54%

During 2018 the overall mix of average deposits has shifted to a higher percentage of noninterest-bearing demand deposits, interest-bearing demand accounts, and time deposits with a reduction in the percentage of deposits held in money market and savings deposits. The Company believes its deposit product offerings are properly structured to attract and retain core low-cost deposit relationships. The average cost of deposits was 0.86 percent in 2018 compared to 0.54 percent in 2017 as deposit costs increased with rising interest rates.

Total deposits as of December 31, 2018 were \$1,922.0 million, which was an increase of \$483.4 million from December 31, 2017. As of December 31, 2018, the Company had outstanding time deposits under \$100,000 of \$309.3 million, time deposits over \$100,000 of \$605.3 million, and a time deposit fair value adjustment of \$759 thousand. The following table summarizes the maturities of time deposits \$100,000 or more as of December 31, 2018.

(Dollars in thousands)	December 31, 2018
Remaining maturity:	
Three months or less	\$ 97,907
Three to six months	99,517
Six to twelve months	217,597
More than twelve months	190,282
Total	\$ 605,303

Borrowings

The Company uses short-term borrowings and long-term debt to provide both funding and, to a lesser extent, regulatory capital for debt at the Company level which can be downstreamed as Tier 1 capital to the Bank. Short-term borrowings totaled \$11.2 million December 31, 2018, and consisted primarily of federal funds purchased. Short-term borrowings totaled \$33.6 million at December 31, 2017, and consisted entirely of federal funds purchased. Short-term borrowings totaled \$18.5 million at December 31, 2016, and consisted of \$5.0 million in FHLB advances maturing within twelve months and \$13.5 million federal funds purchased. Long-term debt totaled \$39.2 million at December 31, 2018 and consisted of subordinated debt. Long-term debt totaled \$10 million at December 31, 2017 and consisted of one line of credit that matures in 2022. There was no long-term debt outstanding at December 31, 2016.

Capital Resources

The Company uses leverage analysis to examine the potential of the institution to increase assets and liabilities using the current capital base. The key measurements included in this analysis are the Banks' Common Equity Tier 1 capital, Tier 1 capital, leverage and total capital ratios. At December 31, 2018 and 2017, our capital ratios, including our Banks' capital ratios, exceeded regulatory minimum capital requirements. From time to time we may be required to support the capital needs of our bank subsidiary. We believe we have various capital raising techniques available to us to provide for the capital needs of our Bank, if necessary. Additional information on capital is provided in Note 14-Regulatory Matters to our audited consolidated financial statements.

Off-Balance Sheet Arrangements

At December 31, 2018, we had \$333.9 million of pre-approved but unused lines of credit and \$12.2 million of standby letters of credit. These commitments generally have fixed expiration dates and many will expire without being drawn upon. The total commitment level does not necessarily represent future cash requirements. If needed to fund these outstanding commitments, the Bank has the ability to liquidate Federal funds sold or securities available-for-sale, or on a short-term basis to borrow and purchase Federal funds from other financial institutions. Additional information about our off-balance sheet risk exposure is presented in Note 13—Commitments and Contingencies to our audited consolidated financial statements.

Market Risk and Liquidity Risk Management

The Bank's Asset Liability Management Committee ("ALCO") is responsible for making decisions regarding liquidity and funding solutions based upon approved liquidity, loan, capital and investment policies. The ALCO must consider interest rate sensitivity and liquidity risk management when rendering a decision on funding solutions and loan pricing. To assist in this process the Bank has contracted with an independent third party to prepare quarterly reports that summarize several key asset-liability measurements. In addition, the third party will also provide recommendations to the Bank's ALCO regarding future balance sheet structure, earnings and liquidity strategies. Two critical areas of focus for ALCO are interest rate sensitivity and liquidity risk management.

Interest Rate Sensitivity

Interest rate sensitivity refers to the responsiveness of interest-earning assets and interest-bearing liabilities to changes in market interest rates. In the normal course of business, we are exposed to market risk arising from fluctuations in interest rates. ALCO measures and evaluates the interest rate risk so that we can meet customer demands for various types of loans and deposits. ALCO determines the most appropriate amounts of on-balance sheet and off-balance sheet items. The primary measurements we use to help us manage interest rate sensitivity are an earnings simulation model and an economic value of equity model. These measurements are used in conjunction with competitive pricing analysis and are further described below.

Earnings Simulation Model We believe interest rate risk is effectively measured by our earnings simulation modeling. Earning assets, interest-bearing liabilities and off-balance sheet financial instruments are combined with simulated forecasts of interest rates for the next 12 months and 24 months. To limit interest rate risk, we have guidelines for our earnings at risk which seek to limit the variance of net interest income in instantaneous changes to interest rates. We also periodically monitor simulations based on various rate scenarios such as non-parallel shifts in market interest rates over time. For changes up or down in rates from our flat interest rate forecast over the next 12 and 24 months, limits in the decline in net interest income are as follows:

	Maximum Percentage Decline in Net Interest Income from the Budgeted or Base Case Projection of Net Interest Income	
	Next 12 Months	Next 24 Months
An instantaneous, parallel rate increase or decrease of the following at the beginning of the first quarter:		
± 100 basis points	9%	9%
± 200 basis points	14%	14%
± 300 basis points	20%	20%
± 400 basis points	25%	25%

We were in compliance with our earnings simulation model policies as of December 31, 2018, indicating what we believe to be a slightly asset sensitive profile.

Economic Value of Equity Our economic value of equity model measures the extent that estimated economic values of our assets, liabilities and off-balance sheet items will change as a result of interest rate changes. Economic values are determined by discounting expected cash flows from assets, liabilities and off-balance sheet items, which establishes a base case economic value of equity.

To help monitor our related risk, we've established the following policy limits regarding simulated changes in our economic value of equity:

Instantaneous, Parallel Change in Prevailing Interest Rates Equal to	Maximum Percentage Decline in Economic Value of Equity from the Economic Value of Equity at Currently Prevailing Interest Rates
±100 basis points	20%
±200 basis points	25%
±300 basis points	30%
±400 basis points	35%

At December 31, 2018, our model results indicated that we were within these policy limits.

Each of the above analyses may not, on its own, be an accurate indicator of how our net interest income will be affected by changes in interest rates. Income associated with interest-earning assets and costs associated with interest-bearing liabilities may not be affected uniformly by changes in interest rates. In addition, the magnitude and duration of changes in interest rates may have a significant impact on net interest income. For example, although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market interest rates. Interest rates on certain types of assets and liabilities fluctuate in advance of changes in general market rates, while interest rates on other types may lag behind changes in general market rates.

In addition, certain assets, such as adjustable rate mortgage loans, have features (generally referred to as interest rate caps and floors) which limit changes in interest rates. Prepayment and early withdrawal levels also could deviate significantly from those assumed in calculating the maturity of certain instruments. The ability of many borrowers to service their debts also may decrease during periods of rising interest rates. Our ALCO reviews each of the above interest rate sensitivity analyses along with several different interest rate scenarios as part of its responsibility to provide a satisfactory, consistent level of profitability within the framework of established liquidity, loan, investment, borrowing, and capital policies.

Liquidity Risk Management

The purpose of liquidity risk management is to ensure that there are sufficient cash flows to satisfy loan demand, deposit withdrawals, and our other needs. Traditional sources of liquidity for a bank include asset maturities and growth in core deposits. A bank may achieve its desired liquidity objectives from the management of its assets and liabilities and by internally generated funding through its operations. Funds invested in marketable instruments that can be readily sold and the continuous maturing of other earning assets are sources of liquidity from an asset perspective. The liability base provides sources of liquidity through attraction of increased deposits and borrowing funds from various other institutions.

Changes in interest rates also affect our liquidity position. We currently price deposits in response to market rates and intend to continue this policy. If deposits are not priced in response to market rates, a loss of deposits could occur which would negatively affect our liquidity position.

Scheduled loan payments are a relatively stable source of funds, but loan payoffs and deposit flows fluctuate significantly, being influenced by interest rates, general economic conditions and competition. Additionally, debt security investments are subject to prepayment and call provisions that could accelerate their payoff prior to stated maturity. We attempt to price our deposit products to meet our asset/liability objectives consistent with local market conditions. Our ALCO is responsible for monitoring our ongoing liquidity needs. Our regulators also monitor our liquidity and capital resources on a periodic basis.

Impact of Inflation and Changing Prices

As a financial institution, we have an asset and liability make-up that is distinctly different from that of an entity with substantial investments in plant and inventory, because the major portions of a commercial bank's assets are monetary in nature. As a result, our performance may be significantly influenced by changes in interest rates. Although we, and the banking industry, are more affected by changes in interest rates than by inflation in the prices of goods and services, inflation is a factor that may influence interest rates. However, the frequency and magnitude of interest rate fluctuations do not necessarily coincide with changes in the general inflation rate. Inflation does affect operating expenses in that personnel expenses and the cost of supplies and outside services tend to increase more during periods of high inflation.

Critical Accounting Policies

The Company has identified accounting policies that are the most critical to fully understand and evaluate its reported financial results and require management's most difficult, subjective or complex judgments. Management has reviewed the following critical accounting policies and related disclosures with the Audit Committee of the Board of Directors. These policies along with a brief discussion of the material implications of the uncertainties of each policy are below. For a full description of these critical accounting policies, see Note 1 in the "Notes to Consolidated Financial Statements."

Allowance for loan losses – In establishing the allowance we take into account reserves required for impaired loans, historical charge-offs for loan types, and a variety of qualitative factors including economic outlook, portfolio concentrations, and changes in portfolio credit quality. Many of the qualitative factors are measurable but there is also a level of subjective assumptions. If those assumptions change it could have a material impact on the level of the allowance required and as a result the earnings of the Company. As an example an increase in the amount of the reserve to organic loans of 0.05 percent in 2018 would have resulted in a reduction of approximately 3 percent in pre-tax income.

Fair values for acquired assets and assumed liabilities- Assets and liabilities acquired are recorded at their respective fair values as of the date of the acquisition. The excess of the purchase price over the net estimated fair values of the acquired assets and liabilities is allocated to identifiable intangible assets with the remaining excess allocated to goodwill. Goodwill has an indefinite useful life and is evaluated for impairment annually, or more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. As of December 31, 2018 there was approximately \$66.1 million in goodwill. The Company has not identified any triggering events that would indicate potential impairment of goodwill.

Cash flow estimates on purchased credit-impaired loans- Purchase credit impaired loans do not have traditional loan yields and interest income; instead they have accretible yield and accretion. Any excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretible discount and is recognized in interest income as accretion over the remaining life of the loan when there is reasonable expectation about the amount and timing of such cash flows. The amount expected to be accreted divided by the accretible discount is the accretible yield. Cash flow estimates are re-evaluated quarterly. If the estimated cash flows increase then the accretible yield over the life of the loan increases. If, however, the estimated cash flows decrease then impairment is generally recognized immediately. As an example a loan with a fair value of \$200,000 with estimated cash flows of \$300,000 over five years would have an accretible yield of approximately 8.2 percent and would have accretion of approximately \$16,400 a year. If the cash flow estimate changed to \$350,000 the accretible yield would increase to approximately 10.1 percent and the yearly accretion recognized into income would be approximately \$20,300. If, however, the cash flow estimate changed to \$250,000 the Company would generally recognize an impairment of \$50,000 immediately, instead of reducing the accretion over the life of the loan.

Valuation of foreclosed assets - Foreclosed assets are initially recorded at fair value less selling costs. If the fair value decreases the assets are written down. As of December 31, 2018, there was approximately \$2.5 million in foreclosed assets carried at a 23.3 percent discount to appraisal values.

Valuation of deferred tax assets- Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not that the tax position will be realized or sustained upon examination. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment. Deferred tax assets may be reduced by deferred tax liabilities and a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized. As of December 31, 2018, there were approximately \$5.6 million in net deferred tax assets.

Evaluation of investment securities for other than temporary impairment- We evaluate investment securities for other than temporary impairment taking into account if we do not have the intent to sell a debt security prior to recovery and it is more likely than not that we will not have to sell the debt security prior to recovery, the security would not be considered other than temporarily impaired unless a credit loss has occurred in the security. Temporary impairments are recognized on the balance sheet in other comprehensive income / loss. If a security becomes permanently impaired the impairment expense would be recognized and reduce earnings. As of December 31, 2018, there was approximately \$3.0 million in gross unrealized losses on investment securities that were classified as temporarily impaired.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

This Item is not applicable to smaller reporting companies.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

SMARTFINANCIAL, INC. AND SUBSIDIARY

Report on Consolidated Financial Statements

For the years ended December 31, 2018 and 2017

SmartFinancial, Inc. and Subsidiary

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MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of SmartFinancial, Inc. (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934. The Company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation and fair presentation of the Company's financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

Because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Accordingly, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2018. In making this assessment, management used the criteria set forth in Internal Control – Integrated Framework (2013 edition) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). As permitted by SEC guidance, management excluded from its assessment the operations of the Southern Community Bank acquisition made during 2018, which is described in Note 2 of the Consolidated Financial Statements. The total assets of Southern Community Bank acquired represented approximately 10 percent of the Company's total consolidated assets as of December 31, 2018 and 8 percent of consolidated revenue for the year then ended. Based on this assessment, management has determined that the Company's internal control over financial reporting as of December 31, 2018 is effective based on the specified criteria. As permitted by SEC guidance, management excluded from its assessment the operations of the Foothills Bank & Trust acquisition made during 2018, which is described in Note 2 of the Consolidated Financial Statements. The total assets of Foothills Bank & Trust acquired represented approximately 10 percent of the Company's total consolidated assets as of December 31, 2018 and 1 percent of consolidated revenue for the year then ended. Based on this assessment, management has determined that the Company's internal control over financial reporting as of December 31, 2018 is effective based on the specified criteria.

Dixon Hughes Goodman LLP, the independent registered public accounting firm that audited the consolidated financial statements of the Company included in this Annual Report on Form 10-K, has issued an attestation report on the effectiveness of the Company's internal control over financial reporting as of December 31, 2018. The report, which expresses an unqualified opinion on the effectiveness of the Company's internal control over financial reporting as of December 31, 2018, is included herein.



Report of Independent Registered Public Accounting Firm

To the Stockholders and the Board of Directors of SmartFinancial, Inc.

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheet of SmartFinancial, Inc. and Subsidiary (the "Company") as of December 31, 2018, the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows, for the year ended December 31, 2018, and the related notes (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2018, and the results of their operations and their cash flows for the year ended December 31, 2018, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the Company's internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control - Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 18, 2019 expressed an unqualified opinion thereon.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Dixon Hughes Goodman LLP

We have served as the Company's auditor since 2018.

Atlanta, Georgia
March 18, 2019

Report of Independent Registered Public Accounting Firm

To the Stockholders and the Board of Directors of SmartFinancial, Inc.

Opinion on Internal Control Over Financial Reporting

We have audited SmartFinancial, Inc. and Subsidiary (the “Company”)’s internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control-Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission. In our opinion, SmartFinancial, Inc. and Subsidiary maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control-Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (“PCAOB”), the consolidated balance sheet of the Company as of December 31, 2018 and the related consolidated statements of income, comprehensive income, changes in stockholders’ equity and cash flows for the year then ended and our report dated March 18, 2019, expressed an unqualified opinion thereon.

Basis for Opinion

The Company’s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management’s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company’s internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

As described in Management’s Report on Internal Control over Financial Reporting, the scope of management’s assessment of internal control over financial reporting as of December 31, 2018 has excluded Southern Community Bank (“Southern”) acquired on May 1, 2018 and Foothills Bank & Trust (“Foothills”) acquired on November 1, 2018. We have also excluded Southern and Foothills from the scope of our audit of internal control over financial reporting. Southern and Foothills represented 8 percent and 1 percent of consolidated revenues (total interest income and total noninterest income) for the year ended December 31, 2018, and 10 percent and 10 percent of consolidated total assets as of December 31, 2018, respectively.

Definition and Limitations of Internal Control Over Financial Reporting

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ Dixon Hughes Goodman LLP

Atlanta, Georgia
March 18, 2019

SmartFinancial, Inc. and Subsidiary**Consolidated Financial Statements****Consolidated Balance Sheets**

December 31, 2018 and 2017

	2018	2017
ASSETS		
Cash and due from banks	\$ 40,015,438	\$ 64,097,287
Interest-bearing deposits at other financial institutions	75,807,021	41,965,597
Federal funds sold	—	6,964,000
Total cash and cash equivalents	115,822,459	113,026,884
Securities available-for-sale	201,687,683	151,944,567
Restricted investments, at cost	11,499,000	6,430,700
Loans, net of allowance for loan losses of \$8,275,055 in 2018 and \$5,860,291 in 2017	1,768,963,569	1,317,397,909
Bank premises and equipment, net	56,012,184	43,000,249
Foreclosed assets	2,495,458	3,254,392
Goodwill and core deposit intangible, net	79,033,607	50,836,840
Cash surrender value of life insurance	24,381,485	21,646,894
Other assets	14,513,890	13,232,247
Total assets	\$ 2,274,409,335	\$ 1,720,770,682
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand deposits	\$ 319,861,237	\$ 220,520,287
Interest-bearing demand deposits	311,482,434	231,643,508
Money market and savings deposits	641,944,880	543,644,830
Time deposits	648,675,440	442,774,094
Total deposits	1,921,963,991	1,438,582,719
Securities sold under agreement to repurchase	11,755,923	24,054,730
Federal funds purchased and other borrowings	11,242,533	43,600,000
Subordinated debt	39,176,947	—
Accrued expenses and other liabilities	7,258,460	8,681,393
Total liabilities	1,991,397,854	1,514,918,842
Stockholders' equity:		
Preferred stock - \$1 par value; 2,000,000 shares authorized; None issued and outstanding as of December 31, 2018 and 2017	—	—
Common stock - \$1 par value; 40,000,000 shares authorized; 13,933,504 and 11,152,561 shares issued and outstanding in 2018 and 2017, respectively	13,933,504	11,152,561
Additional paid-in capital	231,851,730	174,008,753
Retained earnings	39,990,990	21,888,575
Accumulated other comprehensive loss	(2,764,743)	(1,198,049)
Total stockholders' equity	283,011,481	205,851,840

Total liabilities and stockholders' equity

\$ 2,274,409,335 \$ 1,720,770,682

See Notes to Consolidated Financial Statements

SmartFinancial, Inc. and Subsidiary**Consolidated Statements of Income**

For the years ended December 31, 2018 and 2017

	2018	2017
INTEREST INCOME		
Loans, including fees	\$ 86,469,051	\$ 48,805,647
Securities and interest-bearing deposits at other financial institutions	5,147,002	2,862,825
Federal funds sold and other earning assets	594,093	353,924
Total interest income	<u>92,210,146</u>	<u>52,022,396</u>
INTEREST EXPENSE		
Deposits	14,288,090	5,518,350
Securities sold under agreements to repurchase	44,509	61,933
Subordinated debt	603,045	—
Federal funds purchased and other borrowings	630,533	113,070
Total interest expense	<u>15,566,177</u>	<u>5,693,353</u>
Net interest income before provision for loan losses	76,643,969	46,329,043
Provision for loan losses	2,936,472	782,687
Net interest income after provision for loan losses	<u>73,707,497</u>	<u>45,546,356</u>
NONINTEREST INCOME		
Customer service fees	2,416,126	1,374,068
Interchange and debit card transaction fees	573,194	952,294
Gain on sale of securities	1,255	143,508
Gain on sale of loans and other assets	1,432,652	1,275,925
Other noninterest income	2,160,888	1,281,493
Total noninterest income	<u>6,584,115</u>	<u>5,027,288</u>
NONINTEREST EXPENSES		
Salaries and employee benefits	30,629,961	20,743,153
Net occupancy and equipment expense	6,303,466	4,271,289
FDIC insurance	786,105	465,844
Foreclosed assets	775,535	131,703
Advertising	872,547	637,600
Data processing	1,905,777	1,875,462
Professional services	3,647,164	2,084,735
Amortization of intangible assets	976,195	346,435
Software as services contracts	2,054,411	1,398,018
Merger expenses	3,780,785	2,417,070
Other operating expenses	7,223,848	4,758,480
Total noninterest expenses	<u>58,955,794</u>	<u>39,129,789</u>
Income before income tax expense	21,335,818	11,443,855
Income tax expense	3,233,403	6,428,791
Net income	<u>18,102,415</u>	<u>5,015,064</u>
Preferred stock dividends	—	195,000
Net income available to common stockholders	<u>\$ 18,102,415</u>	<u>\$ 4,820,064</u>
EARNINGS PER COMMON SHARE		
Basic	<u>\$ 1.46</u>	<u>\$ 0.56</u>
Diluted	<u>1.45</u>	<u>0.55</u>
Weighted average common shares outstanding		
Basic	<u>12,423,618</u>	<u>8,639,212</u>

Diluted	12,517,640	8,793,527
Dividends per common share	<u>N/A</u>	<u>N/A</u>

See Notes to Consolidated Financial Statements

SmartFinancial, Inc. and Subsidiary
Consolidated Statements of Comprehensive Income

For the years ended December 31, 2018 and 2017

	2018	2017
Net income	\$ 18,102,415	\$ 5,015,064
Other comprehensive income (loss), net of tax:		
Unrealized holding gains (losses) arising during the year, net of tax (benefit) expense of \$(514,287) and \$55,405 in 2018 and 2017, respectively	(1,565,719)	90,381
Reclassification adjustment for gains included in net income, net of tax expense of \$280 and \$54,533 in 2018 and 2017, respectively	(975)	(88,975)
	<u>(1,566,694)</u>	<u>1,406</u>
Effect of tax rate change on unrealized gains (losses) on available-for-sale securities	—	(197,215)
Total other comprehensive loss	<u>(1,566,694)</u>	<u>(195,809)</u>
Comprehensive income	<u>\$ 16,535,721</u>	<u>\$ 4,819,255</u>

See Notes to Consolidated Financial Statements

SmartFinancial, Inc. and Subsidiary
Consolidated Statements of Changes in Stockholders' Equity
For the years ended December 31, 2018 and 2017

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
BALANCE, December 31, 2016	\$ 12,000	\$ 5,896,033	\$ 83,463,051	\$ 16,871,296	\$ (1,002,240)	\$ 105,240,140
Net income	—	—	—	5,015,064	—	5,015,064
Other comprehensive gain	—	—	—	—	1,406	1,406
Reclassification adjustment for tax rate change	—	—	—	197,215	(197,215)	—
Issuance of common stock	—	1,840,000	31,094,676	—	—	32,934,676
Issuance of stock grants	—	1,511	30,280	—	—	31,791
Shares issued to shareholders of Capstone Bancshares, Inc.	—	2,908,094	66,875,727	—	—	69,783,821
Redemption of preferred stock	(12,000)	—	(11,988,000)	—	—	(12,000,000)
Exercise of stock options	—	506,923	4,378,723	—	—	4,885,646
Dividends on preferred stock	—	—	—	(195,000)	—	(195,000)
Stock compensation expense	—	—	154,296	—	—	154,296
BALANCE, December 31, 2017	—	11,152,561	174,008,753	21,888,575	(1,198,049)	205,851,840
Net income	—	—	—	18,102,415	—	18,102,415
Other comprehensive loss	—	—	—	—	(1,566,694)	(1,566,694)
Shares issued to shareholders of FootHills BancCorp, net	—	1,183,232	22,783,563	—	—	23,966,795
Issuance of stock grants and restricted stock	—	5,947	3,115	—	—	9,062
Shares issued to shareholders of TN Bancshares Inc, net	—	1,458,981	33,272,941	—	—	34,731,922
Exercise of stock options	—	132,783	1,386,461	—	—	1,519,244
Stock compensation expense	—	—	396,897	—	—	396,897
BALANCE, December 31, 2018	\$ —	\$ 13,933,504	\$ 231,851,730	\$ 39,990,990	\$ (2,764,743)	\$ 283,011,481

See Notes to Consolidated Financial Statements.

SmartFinancial, Inc. and Subsidiary**Consolidated Statements of Cash Flows**

For the years ended December 31, 2018 and 2017

	2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 18,102,415	\$ 5,015,064
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization, and accretion	(3,717,501)	(1,691,396)
Provision for loan losses	2,936,472	782,687
Stock compensation expense	396,897	154,296
Gains from redemption and sale of securities available-for-sale	(1,255)	(143,508)
Deferred income tax expense	2,431,705	1,599,000
Income on bank owned life insurance, net	(595,718)	(295,040)
Loss on disposal of fixed assets	41,215	—
Net gains from sale of loans and other assets	(1,432,652)	(1,275,925)
Net losses from sale of foreclosed assets	643,215	47,795
Loans originated for sale	(52,070,349)	(35,547,322)
Proceeds from sale of loans originated for sale	55,761,398	35,576,882
Changes in other assets and liabilities:		
Accrued interest receivable	(377,666)	(331,347)
Accrued interest payable	816,740	31,488
Other assets and liabilities	(2,110,950)	(2,682,548)
Net cash provided by operating activities	20,823,966	1,240,126
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of securities available-for-sale	(72,149,260)	(53,998,043)
Proceeds from sales, maturities, and paydowns of securities available-for-sale	93,478,332	82,636,066
(Purchase) redemption of restricted investments	(4,053,000)	246,350
Purchase of bank owned life insurance	—	(10,000,000)
Loan originations and principal collections, net	(117,642,156)	(66,724,124)
Purchase of bank premises and equipment	(3,846,490)	(2,798,898)
Proceeds from sale of foreclosed assets	4,972,526	82,864
Net cash and cash equivalents paid (received) in business combinations	4,365,193	(178,312)
Net cash used in investing activities	(94,874,855)	(50,734,097)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	95,073,483	50,474,866
Net decrease in securities sold under agreements to repurchase	(12,599,642)	(2,567,254)
Issuance of common stock	1,528,306	37,852,113
Payment of dividends on preferred stock	—	(195,000)
Redemption of preferred stock	—	(12,000,000)
Net proceeds from subordinated debt	39,158,444	—
Repayment of Federal Home Loan Bank advances and other borrowings	(221,691,352)	(119,196,383)
Proceeds from Federal Home Loan Bank advances and other borrowings	175,377,225	139,404,205
Net cash provided by financing activities	76,846,464	93,772,547
	2018	2017
NET INCREASE IN CASH AND CASH EQUIVALENTS	2,795,575	44,278,576

CASH AND CASH EQUIVALENTS, beginning of year	113,026,884	68,748,308
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CASH AND CASH EQUIVALENTS, end of year	\$ 115,822,459	\$ 113,026,884
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SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION

Cash paid during the period for interest	\$ 14,749,437	\$ 5,399,749
Cash paid during the period for income taxes	856,756	3,531,984

NONCASH INVESTING AND FINANCING ACTIVITIES

Change in unrealized losses on securities available-for-sale	\$ 2,081,261	\$ (2,276)
Acquisition of real estate through foreclosure	4,439,866	588,775
Transfer from Bank premises to foreclosed assets	(1,289,102)	—
Change in goodwill due to acquisitions	23,212,962	38,707,620
Financed sales of foreclosed assets	1,601,471	—

See Notes to Consolidated Financial Statements

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies

Nature of Business:

SmartFinancial, Inc. (the "Company") is a bank holding company whose principal activity is the ownership and management of its wholly-owned subsidiary, SmartBank (the "Bank"). The Company provides a variety of financial services to individuals and corporate customers through its offices in Tennessee, Alabama, Florida, and Georgia. The Company's primary deposit products are interest-bearing demand deposits, savings and money market deposits, and time deposits. Its primary lending products are commercial, residential, and consumer loans.

Basis of Presentation and Accounting Estimates:

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary. All significant intercompany balances and transactions have been eliminated in consolidation.

In preparing the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet, and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of foreclosed assets and deferred taxes, other than temporary impairments of securities, the fair value of financial instruments, goodwill, and business combination elements (Day 1 and Day 2 Valuation).

The Company has evaluated subsequent events for potential recognition and/or disclosure in the consolidated financial statements and accompanying notes included in this Annual Report through the date of the issued consolidated financial statements.

Cash and Cash Equivalents:

For purposes of reporting consolidated cash flows, cash and due from banks includes cash on hand, cash items in process of collection and amounts due from banks. Cash and cash equivalents also includes interest-bearing deposits in banks and federal funds sold. Cash flows from loans, federal funds sold, securities sold under agreements to repurchase and deposits are reported net.

The Bank is required to maintain average balances in cash or on deposit with the Federal Reserve Bank. The reserve requirement was \$36.7 million and \$16.5 million at December 31, 2018 and 2017, respectively.

The Company places its cash and cash equivalents with other financial institutions and limits the amount of credit exposure to any one financial institution. From time to time, the balances at these financial institutions exceed the amount insured by the Federal Deposit Insurance Corporation. The Company has not experienced any losses on these accounts and management considers this to be a normal business risk.

Securities:

Management has classified all securities as available-for-sale. Securities available-for-sale are recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive loss. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

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

Note 1. Summary of Significant Accounting Policies, Continued

Securities (continued):

Securities borrowed or purchased under agreements to resell and securities loaned or sold under agreements to repurchase are treated as collateralized financial transactions. These agreements are recorded at the amount at which the securities were acquired or sold plus accrued interest. It is the Company's policy to take possession of securities purchased under resale agreements. The market value of these securities is monitored, and additional securities are obtained when deemed appropriate to ensure such transactions are adequately collateralized. The Company also monitors its exposure with respect to securities sold under repurchase agreements, and a request for the return of excess securities held by the counterparty is made when deemed appropriate.

Restricted Investments:

The Company is required to maintain an investment in capital stock of various entities. Based on redemption provisions of these entities, the stock has no quoted market value and is carried at cost. At their discretion, these entities may declare dividends on the stock. Management reviews restricted investments for impairment based on the ultimate recoverability of the cost basis in these stocks.

Loans:

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding principal balances less deferred fees and costs on originated loans and the allowance for loan losses. Interest income is accrued on the outstanding principal balance. Loan origination fees, net of certain direct origination costs of consumer and installment loans are recognized at the time the loan is placed on the books. Loan origination fees for all other loans are deferred and recognized as an adjustment of the yield over the life of the loan using the straight-line method without anticipating prepayments.

The accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due, or at the time the loan is 90 days past due, unless the loan is well-secured and in the process of collection. Unsecured loans are typically charged off no later than 120 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal and interest is considered doubtful. All interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income or charged to the allowance, unless management believes that the accrual of interest is recoverable through the liquidation of collateral. Interest income on nonaccrual loans is recognized on the cash basis, until the loans are returned to accrual status. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and the loan has been performing according to the contractual terms for a period of not less than six months.

Loans Held for Sale:

Loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value. When a loan is placed in the held-for-sale category, we stop amortizing the related deferred fees and costs. The remaining unamortized fees and costs are recognized as part of the cost basis of the loan at the time it is sold. Loans held for sale primarily represent mortgage loans on one-to-four family dwellings ("Mortgage") and to a lesser extent the portion of Small Business Administration ("SBA") loans intended to be sold. Realized gains and losses for Mortgage loans are recognized when legal title to the loans has been transferred to the purchaser and sales proceeds have been received and are reflected in the accompanying consolidated statement of income in gains on sale of loans and other assets. We generally sell the guaranteed portion of SBA loans in the secondary market and retain the unguaranteed portion in our portfolio. Upon sale of the guaranteed portion of an SBA loan, we recognize a portion of the gain on sale into income and defer a portion of the gain related to the relative fair value of the unguaranteed loan balance we retain. The deferred gain is amortized into income over the remaining life of the loan. Gains and losses on sales of loans held for sale are included in the Consolidated Statements of Operations in gains on sale of loans and other assets.

Note 1. Summary of Significant Accounting Policies, Continued

Acquired Loans:

Acquired loans are those acquired in business combinations by the Company or Bank. The fair values of acquired loans with evidence of credit deterioration, Purchased Credit Impaired loans (“PCI loans”), are recorded net of a nonaccretable discount and accretable discount. Any excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretable discount and is recognized in interest income over the remaining life of the loan when there is reasonable expectation about the amount and timing of such cash flows. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is the nonaccretable discount, which is included in the carrying amount of acquired loans. Subsequent decreases to the expected cash flows will generally result in a provision for loan losses. Subsequent significant increases in cash flows result in a reversal of the provision for loan losses to the extent of prior charges or a reclassification of the difference from nonaccretable to accretable with a positive impact on the accretable discount. Acquired loans are initially recorded at fair value at acquisition date. Accretable discounts related to certain fair value adjustments are accreted into income over the estimated lives of the loans.

The Company accounts for PCI loans acquired in the acquisition using the expected cash flows method of recognizing discount accretion based on the acquired loans' expected cash flows. Management recasts the estimate of cash flows expected to be collected on each acquired impaired loan pool periodically. If the present value of expected cash flows for a pool is less than its carrying value, an impairment is recognized by an increase in the allowance for loan losses and a charge to the provision for loan losses. If the present value of expected cash flows for a pool is greater than its carrying value, any previously established allowance for loan losses is reversed and any remaining difference increases the accretable yield which will be taken into interest income over the remaining life of the loan pool. Acquired impaired loans are generally not subject to individual evaluation for impairment and are not reported with impaired loans, even if they would otherwise qualify for such treatment. Purchased performing loans are recorded at fair value, including a credit discount. Credit losses on acquired performing loans are estimated based on analysis of the performing portfolio. Such estimated credit losses are recorded as nonaccretable discounts in a manner similar to purchased impaired loans. The fair value discount other than for credit loss is accreted as an adjustment to yield over the estimated lives of the loans. A provision for loan losses is recorded for any deterioration in these loans subsequent to the acquisition.

Allowance for Loan Losses:

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to expense. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Confirmed losses are charged off immediately. Subsequent recoveries, if any, are credited to the allowance.

The allowance is an amount that management believes will be adequate to absorb estimated losses relating to specifically identified loans, as well as probable credit losses inherent in the balance of the loan portfolio. The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the uncollectibility of loans in light of historical experience, the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, current economic conditions that may affect the borrower's ability to pay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. This evaluation does not include the effects of expected losses on specific loans or groups of loans that are related to future events or expected changes in economic conditions. While management uses the best information available to make its evaluation, future adjustments to the allowance may be necessary if there are significant changes in economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses, and may require the Company to make additions to the allowance based on their judgment about information available to them at the time of their examinations.

The allowance consists of specific and general components. The specific component relates to loans that are classified as impaired. For impaired loans, an allowance is established when the discounted cash flows, collateral value, or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers non-impaired loans and is based on the Company's historical loss experience adjusted for other qualitative factors. Other adjustments may be made to the allowance for pools of loans after an assessment of internal or external influences on credit quality that are not fully reflected in the historical loss or risk rating data.

Note 1. Summary of Significant Accounting Policies, Continued

Allowance for Loan Losses (continued):

An unallocated component may be maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio. As part of the risk management program, an independent review is performed on the loan portfolio, which supplements management's assessment of the loan portfolio and the allowance for loan losses. The result of the independent review is reported directly to the Audit Committee of the Board of Directors. Loans, for which the terms have been modified at the borrower's request, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

A loan is considered impaired when it is probable, based on current information and events, the Company will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest when due. Loans that experience insignificant payment delays and payment shortfalls are not classified as impaired. Impaired loans are measured by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Interest on accruing impaired loans is recognized as long as such loans do not meet the criteria for nonaccrual status. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment.

The Company's homogeneous loan pools include consumer real estate loans, commercial real estate loans, construction and land development loans, commercial and industrial loans, and consumer and other loans. The general allocations to these loan pools are based on the historical loss rates for specific loan types and the internal risk grade, if applicable, adjusted for both internal and external qualitative risk factors. The qualitative factors considered by management include, among other factors, (1) changes in local and national economic conditions; (2) changes in asset quality; (3) changes in loan portfolio volume; (4) the composition and concentrations of credit; (5) the impact of competition on loan structuring and pricing; (6) the impact of interest rate changes on portfolio risk and (7) effectiveness of the Company's loan policies, procedures and internal controls. The total allowance established for each homogeneous loan pool represents the product of the historical loss ratio adjusted for qualitative factors and the total dollar amount of the loans in the pool.

Troubled Debt Restructurings:

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

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

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

Note 1. Summary of Significant Accounting Policies, Continued

Foreclosed Assets:

Foreclosed assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less selling costs. Any write-down to fair value at the time of transfer to foreclosed assets is charged to the allowance for loan losses. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less costs to sell. Costs of improvements are capitalized, whereas costs relating to holding foreclosed assets and subsequent write-downs to the value are expensed. The amount of residential real estate where physical possession had been obtained included within foreclosed assets at December 31, 2018 and 2017 was \$400 thousand and \$546 thousand, respectively. There was no residential real estate in process of foreclosure at December 31, 2018 and December 31, 2017.

Premises and Equipment:

Land is carried at cost. Premises and equipment are carried at cost less accumulated depreciation computed on the straight-line method over the estimated useful lives of the assets or the expected terms of the leases, if shorter. Expected terms include lease option periods to the extent that the exercise of such options is reasonably assured. Maintenance and repairs are expensed as incurred while major additions and improvements are capitalized. Gains and losses on dispositions are included in current operations.

Buildings and leasehold improvements	15 - 40 years
Furniture and equipment	3-7 years

Goodwill and Intangible Assets:

Goodwill represents the cost in excess of the fair value of net assets acquired (including identifiable intangibles) in transactions accounted for as business combinations. Goodwill has an indefinite useful life and is evaluated for impairment annually, or more frequently if events and circumstances indicate that the asset might be impaired. FASB ASC 350, *Goodwill and Other*, regarding testing goodwill for impairment provides an entity the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity does a qualitative assessment and determines that this is the case, or if a qualitative assessment is not performed, it is required to perform additional goodwill impairment testing to identify potential goodwill impairment and measure the amount of goodwill impairment loss to be recognized for that reporting unit (if any). Based on a qualitative assessment, if an entity determines that the fair value of a reporting unit is more than its carrying amount, the two-step goodwill impairment test is not required. The Company performs its annual goodwill impairment test as of December 31 of each year. For 2018, the results of the qualitative assessment provided no indication of potential impairment. Goodwill will continue to be monitored for triggering events that may indicate impairment prior to the next scheduled annual impairment test.

Intangible assets consist of core deposit premiums created as a result of Business Combinations by the Company or Bank where deposits are assumed. The core deposit premium is initially recognized based on a valuation performed as of the consummation date. The core deposit premium is amortized over the average remaining life of the acquired customer deposits. Amortization expense relating to these intangible assets was \$976 thousand and \$346 thousand for the years ended December 31, 2018 and 2017, respectively. The intangible assets were evaluated for impairment as of December 31, 2018, and based on that evaluation it was determined that there was no impairment.

Transfer of Financial Assets:

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

Note 1. Summary of Significant Accounting Policies, Continued

Derivative Instruments:

In accordance with ASC Topic 815, Derivatives and Hedging, all derivative instruments are recorded on the accompanying consolidated balance sheet at their respective fair values. The accounting for changes in fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship. If the derivative instrument is not designated as a hedge, changes in the fair value of the derivative instrument are recognized in earnings in the period of change.

For derivative instruments that are designated and qualify as a fair value hedge, the gain or loss on the derivative instrument as well as the offsetting loss or gain on the hedged asset or liability attributable to the hedged risk are recognized in current earnings. The gain or loss on the derivative instrument is presented on the same income statement line item as the earnings effect of the hedged item.

Advertising Costs:

The Company expenses all advertising costs as incurred. Advertising expense was \$873 thousand and \$638 thousand for the years ended December 31, 2018 and 2017, respectively.

Income Taxes:

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

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

On December 22, 2017, the Tax Cuts and Jobs Act (TCJA) was signed into law by the President of the United States. TCJA is a tax reform act that among other things, reduced corporate tax rates to 21 percent effective January 1, 2018. FASB ASC 740, *Income Taxes*, requires deferred tax assets and liabilities to be adjusted for the effect of a change in tax laws or rates in the year of enactment, which is the year in which the change was signed into law. Accordingly, the Company adjusted its deferred tax assets and liabilities at December 31, 2017, using the new corporate tax rate of 21 percent. See Note 8.

Stock Compensation Plans:

At December 31, 2018, the Company had options outstanding under stock-based compensation plans, which are described in more detail in Note 11. The plans have been accounted for under the accounting guidance (FASB ASC 718, *Compensation - Stock Compensation*) which requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the grant date fair value of the equity or liability instruments issued. The stock compensation accounting guidance covers a wide range of share-based compensation arrangements including stock options, restricted share plans, performance-based awards, share appreciation rights, and stock or other stock based awards.

Note 1. Summary of Significant Accounting Policies, Continued

Stock Compensation Plans(continued):

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

Employee Benefit Plan:

Employee benefit plan costs are based on the percentage of individual employee's salary, not to exceed the amount that can be deducted for federal income tax purposes.

Variable Interest Entities:

An entity is referred to as a variable interest entity (VIE) if it meets the criteria outlined in ASC Topic 810, which are: (1) the entity has equity that is insufficient to permit the entity to finance its activities without additional subordinated financial support from other parties or (2) the entity has equity investors that cannot make significant decisions about the entity's operations or that do not absorb the expected losses or receive the expected returns of the entity. A VIE must be consolidated by the Company if it is deemed to be the primary beneficiary of the VIE, which is the party involved with the VIE that has a majority of the expected losses, expected residual returns, or both. At December 31, 2017, the Company had an investment in Community Advantage Fund, LLC that qualified as an unconsolidated VIE.

The Company's investment in a partnership consists of an equity interest in a lending partnership for the purposes of loaning funds to an unrelated entity. This entity will use the funds to make loans through the SBA Community Advantage Loan Initiative.

The Company uses the equity method when it owns an interest in a partnership and can exert significant influence over the partnership's operations. Under the equity method, the Company's ownership interest in the partnership's capital is reported as an investment on its consolidated balance sheets in other assets and the Company's allocable share of the income or loss from the partnership is reported in noninterest income or expense in the consolidated statements of income. The Company ceases recording losses on an investment in partnership when the cumulative losses and distributions from the partnership exceed the carrying amount of the investment and any advances made by the Company. After the Company's investment in such partnership reaches zero, cash distributions received from these investments are recorded as income.

Comprehensive Income:

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

Fair Value of Financial Instruments:

Fair values of financial instruments are estimates using relevant market information and other assumptions, as more fully disclosed in Note 16. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

Note 1. Summary of Significant Accounting Policies, Continued

Business Combinations:

Business combinations are accounted for using the acquisition method of accounting. Under the acquisition method of accounting, acquired assets and assumed liabilities are included with the acquirer's accounts as of the date of acquisition at estimated fair value, with any excess of purchase price over the fair value of the net assets acquired (including identifiable intangible assets) capitalized as goodwill. In the event that the fair value of the net assets acquired exceeds the purchase price, an acquisition gain is recorded for the difference in consolidated statements of income for the period in which the acquisition occurred. An intangible asset is recognized as an asset apart from goodwill when it arises from contractual or other legal rights or if it is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented or exchanged. In addition, acquisition-related costs and restructuring costs are recognized as period expenses as incurred. Estimates of fair value are subject to refinement for a period not to exceed one year from acquisition date as information relative to acquisition date fair values becomes available.

Earnings Per Common Share:

Basic earnings per common share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company relate to restricted stock and outstanding stock options and are determined using the treasury stock method.

Segment Reporting:

ASC Topic 280, Segment Reporting, provides for the identification of reportable segments on the basis of distinct business units and their financial information to the extent such units are reviewed by an entity's chief decision maker (which can be an individual or group of management persons). ASC Topic 280 permits aggregation or combination of segments that have similar characteristics. In the Company's operations, each bank branch is viewed by management as being a separately identifiable business or segment from the perspective of monitoring performance and allocation of financial resources. Although the branches operate independently and are managed and monitored separately, each is substantially similar in terms of business focus, type of customers, products, and services. Accordingly, the Company's consolidated financial statements reflect the presentation of segment information on an aggregated basis in one reportable segment.

Recently Issued Not Yet Effective Accounting Pronouncements:

The following is a summary of recent authoritative pronouncements not yet in effect that could impact the accounting, reporting, and/or disclosure of financial information by the Company.

In February 2016, the FASB issued guidance that requires lessees to recognize almost all leases on their balance sheet as a right-of-use asset and a lease liability in *ASU 2016-2: Leases (Topic 842)*. For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. Classification will be based on criteria that are largely similar to those applied in current lease accounting, but without explicit bright lines. Lessor accounting is similar to the current model, but updated to align with certain changes to the lessee model and the new revenue recognition standard. Existing sale-leaseback guidance, including guidance for real estate, is replaced with a new model applicable to both lessees and lessors. The new guidance will be effective for public business entities for annual periods beginning after December 15, 2018 including interim periods within those fiscal years. The Company has several lease agreements, such as branch locations, which are currently considered operating leases, and therefore, not recognized on the Company's consolidated statements of condition. The Company expects the new guidance will require these lease agreements to be recognized on the consolidated statements of condition as a right-of-use asset and a corresponding lease liability. Therefore, the Company's preliminary evaluation indicates the provisions of ASU No. 2016-02 are expected to impact the Company's consolidated balance sheets, along with our regulatory capital ratios.

Note 1. Summary of Significant Accounting Policies, Continued

Recently Issued Not Yet Effective Accounting Pronouncements (continued):

In January 2018, the FASB issued *ASU 2018-01, Leases (Topic 842) Land Easement Practical Expedient Transition to Topic 842*, an amendment to *ASU 2016-2: Leases*. The amendments in this Update permit an entity to elect an optional transition practical expedient to not evaluate under Topic 842 land easements that exist or expired before the entity's adoption of Topic 842 and that were not previously accounted for as leases under Topic 840. An entity that elects this practical expedient should apply the practical expedient consistently to all of its existing or expired land easements that were not previously accounted for as leases under Topic 840. Once an entity adopts Topic 842, it should apply that Topic prospectively to all new (or modified) land easements to determine whether the arrangement should be accounted for as a lease. An entity that does not elect this practical expedient should evaluate all existing or expired land easements in connection with the adoption of the new lease requirements in Topic 842 to assess whether they meet the definition of a lease. An entity should continue to apply its current accounting policy for accounting for land easements that existed before the entity's adoption of Topic 842. For example, if an entity currently accounts for certain land easements as leases under Topic 840, it should continue to account for those land easements as leases before its adoption of Topic 842. The effective date and transition requirements for the amendments are the same as the effective date and transition requirements in Update 2016-02.

In July 2018, the FASB issued *ASU No. 2018-11, Leases - Targeted Improvements* to provide entities with relief from the costs of implementing certain aspects of the new leasing standard, ASU No. 2016-02. Specifically, under the amendments in ASU 2018-11: (1) entities may elect not to recast the comparative periods presented when transitioning to the new leasing standard, and (2) lessors may elect not to separate lease and non-lease components when certain conditions are met. The amendments have the same effective date as ASU 2016-02 (January 1, 2019 for the Company). The Company expects to elect both transition options.

In December 2018, the FASB also issued *ASU 2018-20, Leases (Topic 842) - Narrow-Scope Improvements for Lessors*, which provides for certain policy elections and changes lessor accounting for sales and similar taxes and certain lessor costs. Upon adoption of ASU 2016-2, ASU 2018-11 and ASU 2018-20 on January 1, 2019, the Company expects to recognize right-of-use assets and related lease liabilities totaling \$2.6 million and \$2.7 million, respectively. The Company expects to elect to apply certain practical expedients provided under ASU 2016-02 whereby the Company will not reassess (i) whether any expired or existing contracts are or contain leases, (ii) the lease classification for any expired or existing leases and (iii) initial direct costs for any existing leases. The Company also do not expect to apply the recognition requirements of ASU 2016-02 to any short-term leases (as defined by related accounting guidance). The Company expect to account for lease and non-lease components separately because such amounts are readily determinable under our lease contracts and because we expect this election will result in a lower impact on our balance sheet. The Company expect to utilize the modified-retrospective transition approach prescribed by ASU 2018-11.

In June 2016, FASB issued *ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The ASU changed the credit loss model on financial instruments measured at amortized cost, available for sale securities and certain purchased financial instruments. Credit losses on financial instruments measured at amortized cost will be determined using a current expected credit loss model which requires the Company to measure all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions, and reasonable supportable forecasts. This replaces the existing incurred loss model and is applicable to the measurement of credit losses on financial assets measured at amortized cost and applies to some off-balance sheet credit exposures. Purchased financial assets with more-than insignificant credit deterioration since origination ("PCD assets" which are currently named "PCI Loans") measured at amortized cost will have an allowance for credit losses established at acquisition as part of the purchase price. Subsequent increases or decreases to the allowance for credit losses on PCD assets will be recognized in the income statement. Interest income should be recognized on PCD assets based on the effective interest rate, determined excluding the discount attributed to credit losses at acquisition. Credit losses relating to available-for-sale debt securities will be recognized through an allowance for credit losses. The amount of the credit loss is limited to the amount by which fair value is below amortized cost of the available-for-sale debt security. The amendments in this update are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years for the Company and other SEC filers. Early adoption is permitted and if early adopted, all provisions must be adopted in the same period. The amendments should be applied through a cumulative-effect adjustment to retained earnings as of the beginning of the period adopted. A prospective approach is required for securities with other than temporary impairment recognized prior to adoption.

Note 1. Summary of Significant Accounting Policies, Continued

Recently Issued Not Yet Effective Accounting Pronouncements (continued):

The Company is continuing its implementation efforts through its company-wide implementation team. The implementation team meets periodically to discuss the latest developments and ensure progress is being made. The team also keeps current on evolving interpretations and industry practices related to ASU 2016-13 via webcasts, publications, conferences, and peer bank meetings. The team continues to evaluate and validate data resources and different loss methodologies. The Company's preliminary evaluation indicates the provisions of ASU No. 2016-13 are expected to impact the Company's consolidated financial statements, in particular an increase to the level of the reserve for credit losses. However, the Company continues to evaluate the extent of the potential impact.

The guidance of ASU 2016-13 was recently amended by *ASU 2018-19, Codification Improvements to Topic 326, Financial Instruments - Credit Losses*, which changed the effective date for non-public companies and clarified that operating lease receivables are not within the scope of the standard.

In January 2017, FASB issued ASU No. 2017-04, *Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. The ASU simplifies the subsequent measurement of goodwill and eliminates Step 2 from the goodwill impairment test. The Company should perform its goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value. The impairment charge is limited to the amount of goodwill allocated to that reporting unit. The amendments in this update are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for goodwill impairment tests performed on testing dates after January 1, 2017. The Company does not expect these amendments to have a material effect on its financial statements.

In March 2017, FASB issued ASU No. 2017-08, *Receivables - Nonrefundable Fees and Other Costs (Topic 310-20): Premium Amortization on Purchased Callable Debt Securities*. The ASU shortens the amortization period for certain callable debt securities held at a premium. The premium on individual callable debt securities shall be amortized to the earliest call date. This guidance does not apply to securities for which prepayments are estimated on a large number of similar loans where prepayments are probable and reasonably estimable. The amendments in this update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. This update should be adopted on a modified retrospective basis with a cumulative-effect adjustment to retained earnings on the date of adoption. The Company does not expect these amendments to have a material effect on its financial statements.

As part of its Simplification Initiative, the FASB has issued *ASU 2018-07, Compensation-Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*. ASU No. 2018-07 expands the scope of Topic 718, *Compensation-Stock Compensation* (which previously only included payments to employees), to include share-based payment transactions for acquiring goods and services from non-employees. This required entities to apply the requirements of Topic 718 to non-employee awards, except for specific guidance on inputs to an option pricing model and the attribution of cost (i.e., the period of time over which share-based payment awards vest and the pattern of cost recognition over that period). Additionally, the amendments specify that Topic 718 applies to all share-based payment transactions in which a grantor acquires goods or services to be used or consumed in the grantor's own operations by issuing share-based payment awards, and clarify that Topic 718 does not apply to share-based payments used to effectively provide (1) financing to the issuer, or (2) awards granted in conjunction with selling goods or services to customers as part of a contract accounted for under Topic 606, *Revenue from Contracts with Customers*. The amendments are effective for fiscal years beginning after December 15, 2018, and for the interim periods within those years. The Company does not expect these amendments to have a material effect on its consolidated financial statements.

Note 1. Summary of Significant Accounting Policies, Continued

Recently Issued Not Yet Effective Accounting Pronouncements (continued):

In August 2018, the FASB issued *ASU No. 2018-13, Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement*. This ASU eliminates, adds and modifies certain disclosure requirements for fair value measurements. Among the changes, entities will no longer be required to disclose the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy, but will be required to disclose the range and weighted average used to develop significant unobservable inputs for Level 3 fair value measurements. ASU No. 2018-13 is effective for interim and annual reporting periods beginning after December 15, 2019; early adoption is permitted. Entities are also allowed to elect early adoption of the eliminated or modified disclosure requirements and delay adoption of the new disclosure requirements until their effective date. As ASU No. 2018-13 only revises disclosure requirements, it will not have a material impact on the Company's consolidated financial statements.

ASU 2018-15, Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40) - Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract. ASU 2018-15 clarifies certain aspects of ASU 2015-05, "Customer's Accounting for Fees Paid in a Cloud Computing Arrangement," which was issued in April 2015. Specifically, ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). ASU 2018-15 does not affect the accounting for the service element of a hosting arrangement that is a service contract. ASU 2018-15 will be effective for us on January 1, 2020, with early adoption permitted, and is not expected to have a significant impact on our financial statements.

ASU 2018-16, "Derivatives and Hedging (Topic 815) - Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes." The amendments in this update permit use of the OIS rate based on SOFR as a U.S. benchmark interest rate for hedge accounting purposes under Topic 815 in addition to the interest rates on direct U.S. Treasury obligations, the LIBOR swap rate, the OIS rate based on the Fed Funds Effective Rate and the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate. ASU 2018-16 will be effective for the Company on January 1, 2019 and is not expected to have a significant impact on our financial statements.

Recently Issued and Adopted Accounting Pronouncements:

We adopted *ASU 2014-09, Revenue from Contracts with Customers (Topic 606)* and its related amendments as of January 1, 2018 utilizing the modified retrospective approach. The implementation of the new standard did not have a material impact on the measurement or recognition of revenue; as such, a cumulative effect adjustment to opening retained earnings was not deemed necessary. Since the guidance does not apply to revenue associated with financial instruments, including loans and securities that are accounted for under other GAAP, the new guidance did not have a material impact on revenue most closely associated with financial instruments, including interest income and expense. The Company completed its overall assessment of revenue streams and review of related contracts potentially affected by the ASU, including, deposit related fees, interchange fees, merchant income, and insurance and brokerage commissions. Based on this assessment, the Company concluded that ASU 2014-09 did not materially change the method in which the Company currently recognizes revenue for these revenue streams.

Under ASU 2014-09, we adopted new policies related to revenue recognition. In general, for revenue not associated with financial instruments, guarantees and lease contracts, we apply the following steps when recognizing revenue from contracts with customers: (i) identify the contract, (ii) identify the performance obligations, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations and (v) recognize revenue when performance obligation is satisfied. Our contracts with customers are generally short term in nature, typically due within one year or less or cancellable by us or our customer upon a short notice period. Performance obligations for our customer contracts are generally satisfied at a single point in time, typically when the transaction is complete, or over time. For performance obligations satisfied over time, we primarily use the output method, directly measuring the value of the products/services transferred to the customer, to determine when performance obligations have been satisfied. We typically receive payment from customers and recognize revenue concurrent with the satisfaction of our performance obligations. In most cases, this occurs within a single financial reporting period. For payments received in advance of the satisfaction of performance obligations, revenue recognition is deferred until such time the performance obligations have been satisfied. In cases where we have not received payment despite satisfaction of our performance obligations, we accrue an estimate of the amount due in the period our performance obligations have been satisfied. For contracts with variable components, only amounts for which collection is probable are accrued. We generally act in a principal capacity, on our own behalf, in most of

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Note 1. Summary of Significant Accounting Policies, Continued

Recently Issued and Adopted Accounting Pronouncements (continued):

our contracts with customers. In such transactions, we recognize revenue and the related costs to provide our services on a gross basis in our financial statements. In some cases, we act in an agent capacity, deriving revenue through assisting other entities in transactions with our customers. In such transactions, we recognized revenue and the related costs to provide our services on a net basis in our financial statements. These transactions relate to our customers' use of various interchange and ATM/debit card networks.

Based on our underlying contracts, ASU 2014-09 requires us to report network costs associated with debit card and ATM transactions netted against the related fees from such transactions. Previously, such network costs were reported as a component of other noninterest expense. For the twelve months period ended December 31, 2018, gross interchange and debit card transaction fees totaled \$1.6 million while related network costs totaled \$1.0 million. On a net basis, we reported \$573 thousand as interchange and debit card transaction fees in the accompanying Consolidated Statement of Income for the twelve months period ended December 31, 2018.

For the twelve months period ended December 31, 2017 we reported interchange and debit card transaction fees totaling \$952 thousand on a gross basis in the accompanying Consolidated Statement of Income while related network costs totaling \$595 thousand were reported in other operating expenses included as a component of other noninterest expense.

ASU 2016-01 Financial Instruments - Overall (Subtopic 825-10): Recognition of Financial Assets and Financial Liabilities, makes targeted amendments to the guidance for recognition, measurement, presentation and disclosure of financial instruments. ASU 2016-01 requires equity investments, other than equity method investments, to be measured at fair value with changes in fair value recognized in net income. The ASU requires a cumulative-effect adjustment to retained earnings as of the beginning of the reporting period of adoption to reclassify the cumulative change in fair value of equity securities previously recognized in Accumulated Other Comprehensive Income. ASU 2016-01 became effective for the Company on January 1, 2018 and there was no adjustment to retained earnings. ASU 2016-01 also emphasizes the existing requirement to use exit prices to measure fair value for disclosure purposes and clarifies that entities should not make use of a practicability exception in determining the fair value of loans. Accordingly, we refined the calculation used to determine the disclosed fair value of our loans held for investment portfolio as part of adopting this standard. The refined calculation is disclosed Note 16 - Fair Value Disclosures.

ASU 2017-09, Compensation - Stock Compensation (Topic 718) - Scope of Modification Accounting. ASU 2017-09 clarifies when changes to the terms or conditions of a share-based payment award must be accounted for as modifications. Under ASU 2017-09, an entity will not apply modification accounting to a share-based payment award if all of the following are the same immediately before and after the change: (i) the award's fair value, (ii) the award's vesting conditions and (iii) the award's classification as an equity or liability instrument. ASU 2017-09 became effective for us on January 1, 2018 and did not have a significant impact on our financial statements.

ASU 2017-12, Derivatives and Hedging (Topic 815) - Targeted Improvements to Accounting for Hedging Activities. ASU 2017-12 amends the hedge accounting recognition and presentation requirements in ASC 815 to improve the transparency and understandability of information conveyed to financial statement users about an entity's risk management activities to better align the entity's financial reporting for hedging relationships with those risk management activities and to reduce the complexity of and simplify the application of hedge accounting. The Company early adopted the standard and it does not have a significant impact on our financial statements.

Reclassifications:

Certain captions and amounts in the 2017 consolidated financial statements were reclassified to conform to the 2018 presentation. Such reclassifications had no effect on net income and shareholders' equity.

Pending Merger with Entegra Financial, Corp.

On January 15, 2019, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") with Entegra Financial, Corp., a North Carolina corporation ("Entegra"). The Merger Agreement was approved and adopted by the board of directors of SmartFinancial and the board of directors of Entegra. Under the terms and subject to the conditions of the Merger Agreement each outstanding share of Entegra common stock (other than certain excluded) will be converted into the right to receive 1.215 shares of SmartFinancial common stock. As of January 15, 2019, Entegra had 6,917,703 (unaudited) shares of common stock outstanding.

Acquisition of Foothills Bancorp, Inc.

On November 1, 2018, the Company completed its merger with Foothills Bancorp, Inc., a Tennessee corporation ("Foothills Bancorp"), pursuant to an Agreement and Plan of Merger dated June 27, 2018 (the "Foothills Bancorp merger agreement"), by and among SmartFinancial, FootHills Bancorp, and Foothills Bank, a Tennessee-chartered commercial bank and wholly owned subsidiary of Foothills Bancorp. Foothills Bancorp merged with and into SmartFinancial, with SmartFinancial continuing as the surviving corporation. Immediately following the merger, Foothills Bank merged

with and into the Bank continuing as the surviving banking corporation.

Pursuant to the Foothills Bancorp merger agreement, each outstanding share of Foothills Bancorp common stock was converted into and cancelled in exchange to the right to receive \$1.75 in cash and 0.666 shares of SmartFinancial common stock. SmartFinancial issued 1,183,232 shares of SmartFinancial common stock and paid \$3.1 million in cash as consideration for the merger plus \$3.0 million in consideration for Foothills Bancorp Director and management stock options. SmartFinancial did not issue fractional shares of its common stock in connection with the merger, but instead paid cash in lieu of fractional shares based on the volume weighted average closing price of SmartFinancial common stock on the Nasdaq Capital Market for the 10 consecutive trading days ending on (and including) October 31, 2018 (calculated as \$22.46).

After the merger, shareholders of SmartFinancial owned approximately 91 percent of the outstanding common stock of the combined entity on a fully diluted basis, after taking into account the exchange ratio.

The merger was effected by the issuance of shares of SmartFinancial stock along with cash consideration to the shareholders of Foothills Bancorp. The assets and liabilities of Foothills Bancorp as of the effective date of the merger were recorded at their respective estimated fair values and combined with those of SmartFinancial. The excess of the purchase price over the net estimated fair values of the acquired assets and liabilities was allocated to identifiable intangible assets with the remaining excess allocated to goodwill. Goodwill from the transaction was \$7.5 million, none of which is deductible for income tax purposes.

In periods following the Foothills Bancorp merger, the financial statements of the combined entity will include the results attributable to Foothills Bank beginning on the date the merger was completed. In the twelve months period ended December 31, 2018, the revenues and net income attributable to Foothills Bank were approximately \$1.5 million and \$876 thousand, respectively.

The pro-forma impact to 2018 revenues and net income if the merger had occurred on January 1, 2018 would have been \$11.0 million and \$1.6 million for the twelve months period ending December 31, 2018, respectively. While certain adjustments were made for the estimated impact of certain fair value adjustments, they are not indicative of what would have occurred had the merger taken place on the indicated date nor are they intended to represent or be indicative of future results of operations. In particular, no adjustments have been made to eliminate the amount of Foothills Bank's provision for credit losses or any adjustments to estimate any additional income that would have been recorded as a result of fair value adjustments for 2018 that may have occurred had the acquired loans been recorded at fair value as of the beginning of 2018. In addition there are no adjustments to reflect any expenses that potentially could have been reduced for 2018 had the merger occurred on January 1, 2018. There were \$2.3 million nonrecurring pro forma adjustments to expense included in the reported proforma earnings for twelve month period ending December 31, 2018.

The fair value estimates of Foothills Bancorp assets and liabilities recorded are preliminary and subject to refinement as additional information becomes available. Under current accounting principles, the Company's estimates of fair values may be adjusted for a period of up to one year from the acquisition date. As of December 31, 2018 there were no adjustments initially recorded as part of the business combination.

SmartFinancial, Inc. and Subsidiary

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Note 2. Business Combinations

The following table details the financial impact of the merger, including the calculation of the purchase price, the allocation of the purchase price to the fair values of net assets assumed, and goodwill recognized:

Calculation of Purchase Price

Shares of SMBK common stock issued to Foothills Bancorp shareholders as of November 1, 2018	1,183,232
Market price of SMBK common stock on November 1, 2018	\$ 20.34
Estimated fair value of SMBK common stock issued (in thousands)	24,067
Cash consideration paid (in thousands)	6,069
Total consideration (in thousands)	\$ 30,136

Allocation of Purchase Price (in thousands)

Total consideration above	\$ 30,136
Fair value of assets acquired and liabilities assumed:	
Cash and cash equivalents	4,882
Investment securities available-for-sale	48,091
Restricted investments	551
Loans	153,692
Premises and equipment	3,622
Core deposit intangible	3,670
Prepaid and other assets	3,944
Deposits	(185,259)
FHLB advances and other borrowings	(10,257)
Payables and other liabilities	(276)
Total fair value of net assets acquired	22,660
Goodwill	\$ 7,476

Acquisition of Tennessee Bancshares, Inc.

On May 1, 2018, the Company completed its merger with Tennessee Bancshares, Inc., a Tennessee corporation (“Tennessee Bancshares”), pursuant to an Agreement and Plan of Merger dated December 12, 2017 (the “Tennessee Bancshares merger agreement”), by and among SmartFinancial, Tennessee Bancshares, and Southern Community Bank, a Tennessee-chartered commercial bank. Tennessee Bancshares merged with and into SmartFinancial, with SmartFinancial continuing as the surviving corporation. Immediately following the merger, Southern Community Bank merged with and into the Bank continuing as the surviving banking corporation.

Pursuant to the Tennessee Bancshares merger agreement, each outstanding share of Tennessee Bancshares common stock was converted into and cancelled in exchange for 0.8065 shares of SmartFinancial common stock. SmartFinancial issued 1,458,981 shares of SmartFinancial common stock as consideration for the merger. SmartFinancial did not issue fractional shares of its common stock in connection with the merger, but instead paid cash in lieu of fractional shares based on the volume weighted average closing price of SmartFinancial common stock on the Nasdaq Capital Market for the 10 consecutive trading days ending on (and including) April 27, 2018 (calculated as \$23.92).

After the merger, shareholders of SmartFinancial owned approximately 89 percent of the outstanding common stock of the combined entity on a fully diluted basis, after taking into account the exchange ratio.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 2. Business Combination, Continued

The merger was effected by the issuance of shares of SmartFinancial stock along with cash consideration to the fractional shareholders of Tennessee Bancshares, Inc. The assets and liabilities of Tennessee Bancshares as of the effective date of the merger were recorded at their respective estimated fair values and combined with those of SmartFinancial. The excess of the purchase price over the net estimated fair values of the acquired assets and liabilities was allocated to identifiable intangible assets with the remaining excess allocated to goodwill. Goodwill from the transaction was \$15.8 million, none of which is deductible for income tax purposes.

In periods following the Tennessee Bancshares merger, the financial statements of the combined entity will include the results attributable to Southern Community Bank beginning on the date the merger was completed. In the twelve months period ended December 31, 2018, the revenues and net income attributable to Southern Community Bank were approximately \$8.4 million million and \$3.5 million million, respectively.

The pro-forma impact to 2018 revenues and net income if the merger had occurred on January 1, 2018 would have been \$14.7 million and \$3.6 million for the twelve months period ending December 31, 2018, respectively. While certain adjustments were made for the estimated impact of certain fair value adjustments, they are not indicative of what would have occurred had the merger taken place on the indicated date nor are they intended to represent or be indicative of future results of operations. In particular, no adjustments have been made to eliminate the amount of Southern Community Bank's provision for credit losses or any adjustments to estimate any additional income that would have been recorded as a result of fair value adjustments for 2018 that may have occurred had the acquired loans been recorded at fair value as of the beginning of 2018. In addition there are no adjustments to reflect any expenses that potentially could have been reduced for 2018 had the merger occurred on January 1, 2018. There were \$2.0 million nonrecurring pro forma adjustments to expense included in the reported proforma earnings for the twelve months period ending December 31, 2018.

The fair value estimates of Tennessee Bancshares assets and liabilities recorded are preliminary and subject to refinement as additional information becomes available. Under current accounting principles, the Company's estimates of fair values may be adjusted for a period of up to one year from the acquisition date. As of December 31, 2018 there was one adjustment for approximately \$51 thousand to fair values initially recorded as part of the business combination.

The following table details the financial impact of the merger, including the calculation of the purchase price, the allocation of the purchase price to the fair values of net assets assumed, and goodwill recognized:

Calculation of Purchase Price

Shares of SMBK common stock issued to TN Bancshares shareholders as of May 1, 2018		1,458,981
Market price of SMBK common stock on May 1, 2018	\$	23.85
Estimated fair value of SMBK common stock issued (in thousands)		34,797
Cash consideration paid (in thousands)		5
Total consideration (in thousands)	\$	34,802

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Note 2. Business Combination, Continued

Allocation of Purchase Price (in thousands)	
Total consideration above	\$ 34,802
Fair value of assets acquired and liabilities assumed:	
Cash and cash equivalents	5,723
Investment securities available-for-sale	24,563
Restricted investments	464
Loans	180,490
Premises and equipment	9,470
Core deposit intangible	2,290
Other real estate owned	674
Prepaid and other assets	2,207
Deposits	(202,272)
FHLB advances and other borrowings	(4,000)
Payables and other liabilities	(586)
Total fair value of net assets acquired	19,023
Goodwill	\$ 15,779

Acquisition of Capstone Bancshares, Inc.

On May 22, 2017, the shareholders of the Company approved a merger with Capstone Bancshares, Inc. ("Capstone"), the one bank holding company of Capstone Bank, which became effective November 1, 2017. Capstone shareholders received either: (a) 0.85 shares of SmartFinancial common stock, (b) \$18.50 in cash, or (c) a combination of 80 percent SmartFinancial common stock and 20 percent cash. Elections were limited by the requirement that 80 percent of the total shares of Capstone common stock be exchanged for SmartFinancial common stock and 20 percent be exchanged for cash. Therefore, the allocation of SmartFinancial common stock and cash that a Capstone shareholder received depended on the elections of other Capstone shareholders, and were allocated in accordance with the procedures set forth in the merger agreement. Capstone shareholders also received cash instead of any fractional shares they would have otherwise received in the merger.

After the merger, shareholders of SmartFinancial owned approximately 74 percent of the outstanding common stock of the combined entity on a fully diluted basis, after taking into account the exchange ratio.

The assets and liabilities of Capstone as of the effective date of the merger were recorded at their respective estimated fair values and combined with those of SmartFinancial. The excess of the purchase price over the net estimated fair values of the acquired assets and liabilities was allocated to identifiable intangible assets with the remaining excess allocated to goodwill. Goodwill from the transaction was \$38.0 million, none of which is deductible for income tax purposes.

In periods following the merger, the financial statements of the combined entity will include the results attributable to Capstone beginning on the date the merger was completed. In the period ended December 31, 2017, the revenues and net income attributable to Capstone were \$5.0 million and \$186 thousand, respectively. The pro-forma impact to 2017 revenues and net income if the merger had occurred on December 31, 2016 would have been \$24.9 million and \$947 thousand, respectively.

While certain adjustments were made for the estimated impact of certain fair value adjustments, they are not indicative of what would have occurred had the merger taken place on the indicated date nor are they intended to represent or be indicative of future results of operations. In particular, no adjustments have been made to eliminate the amount of Capstone's provision for credit losses or any adjustments to estimate any additional income that would have been recorded as a result of fair value adjustments for the twelve months of 2017 that may have occurred had the acquired loans been recorded at fair value as of the beginning of 2017. In addition there are no adjustments to reflect any expenses that potentially could have been reduced for the twelve months of 2017 had the merger occurred on January 1, 2017. There were \$4.6 million in nonrecurring pro forma adjustments to expense included in the reported proforma revenue and earnings. For the twelve months period ended December 31, 2018, the revenues and net income attributable to Capstone were \$27.8 million and \$13.5 million, respectively. For the twelve months period ended December 31, 2018, there was an \$11 thousand adjustment to reduce fair values initially recorded as part of the business combination.

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 2. Business Combination, Continued

The following table details the financial impact of the merger, including the calculation of the purchase price, the allocation of the purchase price to the fair values of net assets assumed, and goodwill recognized:

Calculation of Purchase Price	
Shares of SMBK common stock issued to Capstone shareholders as of November 1, 2017	2,908,094
Market price of SMBK common stock on November 1, 2017	\$ 23.49
Estimated fair value of SMBK common stock issued (in thousands)	68,311
Estimated fair value of Capstone stock options (in thousands)	1,585
Cash consideration paid (in thousands)	15,826
Total consideration (in thousands)	<u>\$ 85,722</u>

Allocation of Purchase Price (in thousands)	
Total consideration above	<u>\$ 85,722</u>
Fair value of assets acquired and liabilities assumed:	
Cash and cash equivalents	16,810
Investment securities available for sale	51,638
Restricted investments	1,049
Loans	413,012
Premises and equipment	8,668
Bank owned life insurance	10,031
Core deposit intangible	5,530
Other real estate owned	410
Prepaid and other assets	6,360
Deposits	(454,154)
FHLB advances and other borrowings	(4,887)
Payables and other liabilities	(6,803)
Total fair value of net assets acquired	<u>47,664</u>
Goodwill	<u>\$ 38,058</u>

Acquisition of branch from Atlantic Capital Bank, N.A.

On December 8, 2016, the Bank entered into a purchase and assumption agreement with Atlantic Capital Bank, N.A. that provided for the acquisition and assumption by the Bank of certain assets and liabilities associated with Atlantic Capital Bank's branch office located at 3200 Keith Street NW, Cleveland, Tennessee 37312. The purchase was completed on May 19, 2017 for total cash consideration of \$1.2 million. The assets and liabilities as of the effective date of the transaction were recorded at their respective estimated fair values. The excess of the purchase price over the net estimated fair values of the acquired assets and liabilities was allocated to identifiable intangible assets with the remaining excess allocated to goodwill. In the periods following the acquisition, the financial statements will include the results attributable to the Cleveland branch purchase beginning on the date of purchase. For the twelve months period ended December 31, 2018, the revenues and net income attributable to the Cleveland branch were \$1.6 million and \$546 thousand, respectively. For the twelve months period ended December 31, 2017, the revenues and net income attributable to the Cleveland branch were \$903 thousand and \$63 thousand, respectively. It is impracticable to determine the pro-forma impact to the 2017 revenues and net income if the acquisition had occurred on January 1, 2017 as the Company does not have access to those records for a single branch. The following table details the financial impact of the transaction, including the allocation of the purchase price to the fair values of net assets assumed and goodwill recognized:

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 2. Business Combination, Continued

Allocation of Purchase Price (in thousands)

Total consideration in cash	\$ 1,183
Fair value of assets acquired and liabilities assumed:	
Cash and cash equivalents	133
Loans	24,073
Premises and equipment	2,839
Core deposit intangible	310
Prepaid and other assets	77
Deposits	(26,888)
Payables and other liabilities	(21)
Total fair value of net assets acquired	523
Goodwill	\$ 660

As of December 31, 2018 there have not been any changes to the initial fair values recorded as part of the business combination.

Note 3. Securities

The amortized cost and fair value of securities available-for-sale at December 31, 2018 and 2017 are summarized as follow (in thousands):

	December 31, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government-sponsored enterprises (GSEs)	\$ 44,117	\$ 12	\$ (626)	\$ 43,503
Municipal securities	55,248	276	(363)	55,161
Other debt securities	977	—	(67)	910
Mortgage-backed securities	103,875	153	(1,914)	102,114
Total	\$ 204,217	\$ 441	\$ (2,970)	\$ 201,688

	December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government-sponsored enterprises (GSEs)	\$ 26,207	\$ 1	\$ (432)	\$ 25,776
Municipal securities	9,122	28	(147)	9,003
Other debt securities	974	—	(24)	950
Mortgage-backed securities	117,263	136	(1,184)	116,215
Total	\$ 153,566	\$ 165	\$ (1,787)	\$ 151,944

The amortized cost and estimated market value of securities at December 31, 2018, by contractual maturity, are shown below (in thousands). Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 3. Securities, Continued

	Amortized Cost	Fair Value
Due in one year or less	\$ —	\$ —
Due from one year to five years	36,112	35,780
Due from five years to ten years	14,588	14,145
Due after ten years	49,642	49,649
	<u>100,342</u>	<u>99,574</u>
Mortgage-backed securities	103,875	102,114
Total	\$ 204,217	\$ 201,688

The following tables present the gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities available-for-sale have been in a continuous unrealized loss position, as of December 31, 2018 and 2017 (in thousands):

	As of December 31, 2018					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Government- sponsored enterprises (GSEs)	\$ 14,763	\$ (237)	\$ 13,728	\$ (389)	\$ 28,491	\$ (626)
Municipal securities	16,455	(150)	4,767	(213)	21,222	(363)
Other debt securities	—	—	910	(67)	910	(67)
Mortgage-backed securities	10,516	(155)	69,884	(1,759)	80,400	(1,914)
Total	\$ 41,734	\$ (542)	\$ 89,289	\$ (2,428)	\$ 131,023	\$ (2,970)

	As of December 31, 2017					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Government- sponsored enterprises (GSEs)	\$ 1,358	\$ (1)	\$ 13,420	\$ (431)	\$ 14,778	\$ (432)
Municipal securities	3,418	(43)	2,112	(104)	5,530	(147)
Other debt securities	950	(24)	—	—	950	(24)
Mortgage-backed securities	61,332	(407)	35,048	(777)	96,380	(1,184)
Total	\$ 67,058	\$ (475)	\$ 50,580	\$ (1,312)	\$ 117,638	\$ (1,787)

At December 31, 2018, the categories of temporarily impaired securities, and management's evaluation of those securities, are as follows:

U.S. Government-sponsored enterprises: At December 31, 2018, eight investments in U.S. GSE securities had unrealized losses. These unrealized losses related principally to changes in market interest rates. The contractual terms of the investments does not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Bank does not intend to sell the investments and it is more likely than not that the Bank will not be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Bank does not consider these investments to be other-than temporarily impaired at December 31, 2018.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 3. Securities, Continued

Municipal securities: At December 31, 2018, twenty two investments in obligations of municipal securities had unrealized losses. The Bank believes the unrealized losses on those investments were caused by the interest rate environment and do not relate to the underlying credit quality of the issuers. Because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Bank does not consider these investments to be other than temporarily impaired at December 31, 2018.

Other debt securities: At December 31, 2018, one investment in other debt securities had unrealized losses. The Bank believes the unrealized losses on this investment was caused by the interest rate environment and does not relate to the underlying credit quality of the issuers. Because the Bank does not intend to sell the investment and it is not more likely than not that the Bank will be required to sell the investment before recovery of their amortized cost basis, which may be maturity, the Bank does not consider this investment to be other than temporarily impaired at December 31, 2018.

Mortgage-backed securities: At December 31, 2018, sixty six investments in residential mortgage-backed securities had unrealized losses. This impairment is believed to be caused by the current interest rate environment. The contractual cash flows of those investments are guaranteed by an agency of the U.S. Government. Because the decline in market value is attributable to the current interest rate environment and not credit quality, and because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Bank does not consider these investments to be other than temporarily impaired at December 31, 2018.

Sales of available-for-sale securities for the years ended December 31, 2018 and 2017, were as follows (in thousands):

	<u>2018</u>	<u>2017</u>
Proceeds	\$ 2,970	\$ 12,614
Gains realized	1	145
Losses realized	—	2

Securities with a carrying value of \$103.7 million and \$97.2 million at December 31, 2018 and 2017, respectively, were pledged to secure various deposits, securities sold under agreements to repurchase, as collateral for federal funds purchased from other financial institutions and serve as collateral for borrowings at the Federal Home Loan Bank.

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses

Portfolio Segmentation:

At December 31, 2018 and 2017, loans consisted of the following (in thousands):

	December 31, 2018			December 31, 2017		
	PCI Loans	All Other Loans	Total	PCI Loans	All Other Loans	Total
Commercial real estate	\$ 17,682	\$ 842,345	\$ 860,027	\$ 17,903	\$ 625,085	\$ 642,988
Consumer real estate	8,712	398,542	407,254	7,450	286,007	293,457
Construction and land development	4,602	183,293	187,895	5,120	130,289	135,409
Commercial and industrial	2,557	305,697	308,254	858	237,229	238,087
Consumer and other	605	13,204	13,809	1,463	11,854	13,317
Total loans	34,158	1,743,081	1,777,239	32,794	1,290,464	1,323,258
Less: Allowance for loan losses	—	(8,275)	(8,275)	(16)	(5,844)	(5,860)
Loans, net	\$ 34,158	\$ 1,734,806	\$ 1,768,964	\$ 32,778	\$ 1,284,620	\$ 1,317,398

For purposes of the disclosures required pursuant to the adoption of ASC 310, the loan portfolio was disaggregated into segments. A portfolio segment is defined as the level at which an entity develops and documents a systematic method for determining its allowance for credit losses. There are five loan portfolio segments that include commercial real estate, consumer real estate, construction and land development, commercial and industrial, and consumer and other.

The following describe risk characteristics relevant to each of the portfolio segments:

Commercial Real Estate: Commercial real estate loans include owner-occupied commercial real estate loans and loans secured by income-producing properties. Owner-occupied commercial real estate loans to operating businesses are long-term financing of land and buildings. These loans are repaid by cash flow generated from the business operation. Real estate loans for income-producing properties such as apartment buildings, office and industrial buildings, and retail shopping centers are repaid from rent income derived from the properties. Loans within this portfolio segment are particularly sensitive to the valuation of real estate.

Consumer Real Estate: Consumer real estate loans include real estate loans secured by first liens, second liens, or open end real estate loans, such as home equity lines. These are repaid by various means such as a borrower's income, sale of the property, or rental income derived from the property. One to four family first mortgage loans are repaid by various means such as a borrower's income, sale of the property, or rental income derived from the property. Loans within this portfolio segment are particularly sensitive to the valuation of real estate.

Construction and Land Development: Loans for real estate construction and development are repaid through cash flow related to the operations, sale or refinance of the underlying property. This portfolio segment includes extensions of credit to real estate developers or investors where repayment is dependent on the sale of the real estate or income generated from the real estate collateral. Loans within this portfolio segment are particularly sensitive to the valuation of real estate.

Commercial and Industrial: The commercial and industrial loan portfolio segment includes commercial, financial, and agricultural loans. These loans include those loans to commercial customers for use in normal business operations to finance working capital needs, equipment purchases, or expansion projects. Loans are repaid by business cash flows. Collection risk in this portfolio is driven by the creditworthiness of the underlying borrower, particularly cash flows from the customers' business operations.

Consumer and Other: The consumer loan portfolio segment includes direct consumer installment loans, overdrafts and other revolving credit loans, and educational loans. Loans in this portfolio are sensitive to unemployment and other key consumer economic measures.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued

Credit Risk Management:

The Company employs a credit risk management process with defined policies, accountability and routine reporting to manage credit risk in the loan portfolio segments. Credit risk management is guided by credit policies that provide for a consistent and prudent approach to underwriting and approvals of credits. Within the Credit Policy, procedures exist that elevate the approval requirements as credits become larger and more complex. All loans are individually underwritten, risk-rated, approved, and monitored.

Responsibility and accountability for adherence to underwriting policies and accurate risk ratings lies in each portfolio segment. For the consumer real estate and consumer and other portfolio segments, the risk management process focuses on managing customers who become delinquent in their payments. For the other portfolio segments, the risk management process focuses on underwriting new business and, on an ongoing basis, monitoring the credit of the portfolios, including a third party review of the largest credits on an annual basis or more frequently as needed. To ensure problem credits are identified on a timely basis, several specific portfolio reviews occur periodically to assess the larger adversely rated credits for proper risk rating and accrual status.

Credit quality and trends in the loan portfolio segments are measured and monitored regularly. Detailed reports, by product, collateral, accrual status, etc., are reviewed by the Senior Credit Officer and the Directors Loan Committee.

The allowance for loan losses is a valuation reserve allowance established through provisions for loan losses charged against income. The allowance for loan losses, which is evaluated quarterly, is maintained at a level that management deems sufficient to absorb probable losses inherent in the loan portfolio. Loans deemed to be uncollectible are charged against the allowance for loan losses, while recoveries of previously charged-off amounts are credited to the allowance for loan losses. The allowance for loan losses is comprised of specific valuation allowances for loans evaluated individually for impairment and general allocations for pools of homogeneous loans with similar risk characteristics and trends.

The allowance for loan losses related to specific loans is based on management's estimate of potential losses on impaired loans as determined by (1) the present value of expected future cash flows; (2) the fair value of collateral if the loan is determined to be collateral dependent or (3) the loan's observable market price. The Company's homogeneous loan pools include commercial real estate loans, consumer real estate loans, construction and land development loans, commercial and industrial loans, and consumer and other loans. The general allocations to these loan pools are based on the historical loss rates for specific loan types and the internal risk grade, if applicable, adjusted for both internal and external qualitative risk factors.

The qualitative factors considered by management include, among other factors, (1) changes in local and national economic conditions; (2) changes in asset quality; (3) changes in loan portfolio volume; (4) the composition and concentrations of credit; (5) the impact of competition on loan structuring and pricing; (6) the impact of interest rate changes on portfolio risk and (7) effectiveness of the Company's loan policies, procedures and internal controls. The total allowance established for each homogeneous loan pool represents the product of the historical loss ratio adjusted for qualitative factors and the total dollar amount of the loans in the pool.

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

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

While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the estimated losses on loans. Such agencies may require the Company to recognize additional losses based on their judgments about information available to them at the time of their examination. Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near term.

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued
Credit Risk Management (continued):

The composition of loans by loan classification for impaired and performing loan status at December 31, 2018 and 2017, is summarized in the tables below (amounts in thousands):

	December 31, 2018					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	\$ 841,709	\$ 397,306	\$ 182,746	\$ 304,673	\$ 13,088	\$ 1,739,522
Impaired loans	636	1,236	547	1,024	116	3,559
	<u>842,345</u>	<u>398,542</u>	<u>183,293</u>	<u>305,697</u>	<u>13,204</u>	<u>1,743,081</u>
PCI loans	17,682	8,712	4,602	2,557	605	34,158
Total	<u>\$ 860,027</u>	<u>\$ 407,254</u>	<u>\$ 187,895</u>	<u>\$ 308,254</u>	<u>\$ 13,809</u>	<u>\$ 1,777,239</u>

	December 31, 2017					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	\$ 624,638	\$ 284,585	\$ 129,742	\$ 237,016	\$ 11,842	\$ 1,287,823
Impaired loans	447	1,422	547	213	12	2,641
	<u>625,085</u>	<u>286,007</u>	<u>130,289</u>	<u>237,229</u>	<u>11,854</u>	<u>1,290,464</u>
PCI loans	17,903	7,450	5,120	858	1,463	32,794
Total loans	<u>\$ 642,988</u>	<u>\$ 293,457</u>	<u>\$ 135,409</u>	<u>\$ 238,087</u>	<u>\$ 13,317</u>	<u>\$ 1,323,258</u>

The following tables show the allowance for loan losses allocation by loan classification for impaired and performing loans as of December 31, 2018 and 2017 (amounts in thousands):

	December 31, 2018					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	\$ 3,639	\$ 1,763	\$ 795	\$ 1,304	\$ 240	\$ 7,741
PCI loans	—	—	—	—	—	—
Impaired loans	—	26	—	442	66	534
Total	<u>\$ 3,639</u>	<u>\$ 1,789</u>	<u>\$ 795</u>	<u>\$ 1,746</u>	<u>\$ 306</u>	<u>\$ 8,275</u>

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued

Credit Risk Management (continued):

	December 31, 2017					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	\$ 2,444	\$ 1,340	\$ 521	\$ 890	\$ 204	\$ 5,399
PCI Loans	16	—	—	—	—	16
Impaired loans	5	256	—	172	12	445
Total	<u>\$ 2,465</u>	<u>\$ 1,596</u>	<u>\$ 521</u>	<u>\$ 1,062</u>	<u>\$ 216</u>	<u>\$ 5,860</u>

The following tables detail the changes in the allowance for loan losses for the year ending December 31, 2018 and December 31, 2017, by loan classification (amounts in thousands):

	December 31, 2018					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Beginning balance	\$ 2,465	\$ 1,596	\$ 521	\$ 1,062	\$ 216	\$ 5,860
Loans charged off	(38)	(275)	—	(177)	(370)	(860)
Recoveries of loans charged off	2	100	9	72	156	339
Provision (reallocation) charged to operating expense	1,210	368	265	789	304	2,936
Ending balance	<u>\$ 3,639</u>	<u>\$ 1,789</u>	<u>\$ 795</u>	<u>\$ 1,746</u>	<u>\$ 306</u>	<u>\$ 8,275</u>

	December 31, 2017					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Beginning balance	\$ 2,369	\$ 1,382	\$ 717	\$ 520	\$ 117	\$ 5,105
Loans charged off	—	(111)	—	(24)	(141)	(276)
Recoveries of loans charged off	8	99	13	67	61	248
Provision (reallocation) charged to operating expense	88	226	(209)	499	179	783
Ending balance	<u>\$ 2,465</u>	<u>\$ 1,596</u>	<u>\$ 521</u>	<u>\$ 1,062</u>	<u>\$ 216</u>	<u>\$ 5,860</u>

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued

Credit Risk Management (continued):

A description of the general characteristics of the risk grades used by the Company is as follows:

Pass: Loans in this risk category involve borrowers of acceptable-to-strong credit quality and risk who have the apparent ability to satisfy their loan obligations. Loans in this risk grade would possess sufficient mitigating factors, such as adequate collateral or strong guarantors possessing the capacity to repay the debt if required, for any weakness that may exist.

Watch: Loans in this risk category involve borrowers that exhibit characteristics, or are operating under conditions that, if not successfully mitigated as planned, have a reasonable risk of resulting in a downgrade within the next six to twelve months. Loans may remain in this risk category for six months and then are either upgraded or downgraded upon subsequent evaluation.

Special Mention: Loans in this risk grade are the equivalent of the regulatory definition of "Other Assets Especially Mentioned" classification. Loans in this category possess some credit deficiency or potential weakness, which requires a high level of management attention. Potential weaknesses include declining trends in operating earnings and cash flows and /or reliance on the secondary source of repayment. If left uncorrected, these potential weaknesses may result in noticeable deterioration of the repayment prospects for the asset or in the Company's credit position.

Substandard: Loans in this risk grade are inadequately protected by the borrower's current financial condition and payment capability or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the orderly repayment of debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful: Loans in this risk grade have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or orderly repayment in full, on the basis of current existing facts, conditions and values, highly questionable and improbable. Possibility of loss is extremely high, but because of certain important and reasonably specific factors that may work to the advantage and strengthening of the exposure, its classification as an estimated loss is deferred until its more exact status may be determined.

Uncollectible: Loans in this risk grade are considered to be non-collectible and of such little value that their continuance as bankable assets is not warranted. This does not mean the loan has absolutely no recovery value, but rather it is neither practical nor desirable to defer writing off the loan, even though partial recovery may be obtained in the future. Charge-offs against the allowance for loan losses are taken in the period in which the loan becomes uncollectible. Consequently, the Company typically does not maintain a recorded investment in loans within this category.

The following tables outline the amount of each loan classification and the amount categorized into each risk rating as of December 31, 2018 and 2017 (amounts in thousands):

Non PCI Loans

	December 31, 2018					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$ 834,912	\$ 394,728	\$ 182,524	\$ 303,805	\$ 12,927	\$ 1,728,896
Watch	6,791	2,678	64	1,090	135	10,758
Special mention	—	14	158	137	—	309
Substandard	642	1,122	547	462	142	2,915
Doubtful	—	—	—	203	—	203
Total	\$ 842,345	\$ 398,542	\$ 183,293	\$ 305,697	\$ 13,204	\$ 1,743,081

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued
Credit Risk Management (continued):
PCI Loans

	December 31, 2018					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$ 14,050	\$ 5,617	\$ 4,033	\$ 2,382	\$ 541	\$ 26,623
Watch	1,805	756	569	—	17	3,147
Special mention	1,030	446	—	50	10	1,536
Substandard	797	1,893	—	125	37	2,852
Doubtful	—	—	—	—	—	—
Total	<u>\$ 17,682</u>	<u>\$ 8,712</u>	<u>\$ 4,602</u>	<u>\$ 2,557</u>	<u>\$ 605</u>	<u>\$ 34,158</u>
Total loans	<u>\$ 860,027</u>	<u>\$ 407,254</u>	<u>\$ 187,895</u>	<u>\$ 308,254</u>	<u>\$ 13,809</u>	<u>\$ 1,777,239</u>

Non PCI Loans

	December 31, 2017					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$ 616,028	\$ 279,464	\$ 129,359	\$ 233,942	\$ 11,624	\$ 1,270,417
Watch	7,673	2,543	383	3,007	62	13,668
Special mention	1,006	2,627	—	64	155	3,852
Substandard	378	1,159	547	157	—	2,241
Doubtful	—	214	—	59	13	286
Total	<u>\$ 625,085</u>	<u>\$ 286,007</u>	<u>\$ 130,289</u>	<u>\$ 237,229</u>	<u>\$ 11,854</u>	<u>\$ 1,290,464</u>

PCI Loans

	December 31, 2017					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$ 14,386	\$ 4,151	\$ 4,134	\$ 68	\$ 819	\$ 23,558
Watch	261	1,345	649	120	262	2,637
Special mention	—	456	—	58	24	538
Substandard	3,084	1,192	337	588	107	5,308
Doubtful	172	306	—	24	251	753
Total	<u>\$ 17,903</u>	<u>\$ 7,450</u>	<u>\$ 5,120</u>	<u>\$ 858</u>	<u>\$ 1,463</u>	<u>\$ 32,794</u>
Total loans	<u>\$ 642,988</u>	<u>\$ 293,457</u>	<u>\$ 135,409</u>	<u>\$ 238,087</u>	<u>\$ 13,317</u>	<u>\$ 1,323,258</u>

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued

Past Due Loans:

A loan is considered past due if any required principal and interest payments have not been received as of the date such payments were required to be made under the terms of the loan agreement. Generally, management places a loan on nonaccrual when there is a clear indication that the borrower's cash flow may not be sufficient to meet payments as they become due, which is generally when a loan is 90 days past due.

The following tables present the aging of the recorded investment in loans and leases as of December 31, 2018 and 2017 (amounts in thousands):

December 31, 2018								
	30-59 Days Past Due and Accruing	60-89 Days Past Due and Accruing	Past Due 90 Days or More and Accruing	Nonaccrual	Total Past Due	PCI Loans	Current Loans	Total Loans
Commercial real estate	\$ 377	\$ 19	\$ —	\$ 272	\$ 668	\$ 17,682	\$ 841,677	\$ 860,027
Consumer real estate	1,168	462	454	844	2,928	8,712	395,614	407,254
Construction and land development	343	—	—	547	890	4,602	182,403	187,895
Commercial and industrial	155	—	101	909	1,165	2,557	304,532	308,254
Consumer and other	117	—	29	124	270	605	12,934	13,809
Total	\$ 2,160	\$ 481	\$ 584	\$ 2,696	\$ 5,921	\$ 34,158	\$ 1,737,160	\$ 1,777,239

December 31, 2017								
	30-59 Days Past Due and Accruing	60-89 Days Past Due and Accruing	Past Due 90 Days or More and Accruing	Nonaccrual	Total Past Due	PCI Loans	Current Loans	Total Loans
Commercial real estate	\$ 517	\$ —	\$ 728	\$ 128	\$ 1,373	\$ 17,903	\$ 623,712	\$ 642,988
Consumer real estate	769	194	33	991	1,987	7,450	284,020	293,457
Construction and land development	65	—	326	547	938	5,120	129,351	135,409
Commercial and industrial	86	200	131	85	502	858	236,727	238,087
Consumer and other	109	56	291	13	469	1,463	11,385	13,317
Total	\$ 1,546	\$ 450	\$ 1,509	\$ 1,764	\$ 5,269	\$ 32,794	\$ 1,285,195	\$ 1,323,258

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued
Impaired Loans:

A loan held for investment is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due (both principal and interest) according to the terms of the loan agreement.

The following is an analysis of the impaired loan portfolio detailing the related allowance recorded as of and for the years ended December 31, 2018 and 2017 (amounts in thousands):

	At December 31, 2018			For the year ended December 31, 2018	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Non PCI Loans:					
Commercial real estate	\$ 636	\$ 648	\$ —	\$ 855	\$ 33
Consumer real estate	1,073	1,089	—	934	29
Construction and land development	547	547	—	547	—
Commercial and industrial	69	70	—	69	6
Consumer and other	29	33	—	15	3
	<u>2,354</u>	<u>2,387</u>	<u>—</u>	<u>2,420</u>	<u>71</u>
PCI loans: None in 2018					
Impaired loans with a valuation allowance:					
Non PCI Loans:					
Commercial real estate	—	—	—	—	—
Consumer real estate	163	205	26	365	—
Construction and land development	—	—	—	—	—
Commercial and industrial	955	973	442	476	37
Consumer and other	87	87	66	86	3
	<u>1,205</u>	<u>1,265</u>	<u>534</u>	<u>927</u>	<u>40</u>
PCI loans:					
Commercial real estate	—	—	—	11	—
	<u>—</u>	<u>—</u>	<u>—</u>	<u>11</u>	<u>—</u>
Total impaired loans	<u>\$ 3,559</u>	<u>\$ 3,652</u>	<u>\$ 534</u>	<u>\$ 3,358</u>	<u>\$ 111</u>

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued

Impaired Loans (continued):

	At December 31, 2017			For the year ended December 31, 2017	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Non PCI Loans:					
Commercial real estate	\$ 424	\$ 454	\$ —	\$ 204	\$ 44
Consumer real estate	415	420	—	401	16
Construction and land development	547	547	—	628	—
Commercial and industrial	41	41	—	44	3
Consumer and other	—	—	—	—	—
	<u>1,427</u>	<u>1,462</u>	<u>—</u>	<u>1,277</u>	<u>63</u>
PCI loans: None in 2017					
Impaired loans with a valuation allowance:					
Non PCI Loans:					
Commercial real estate	23	23	5	5	1
Consumer real estate	1,007	1,033	256	601	38
Construction and land development	—	—	—	—	—
Commercial and industrial	172	172	172	117	10
Consumer and other	12	13	12	2	1
	<u>1,214</u>	<u>1,241</u>	<u>445</u>	<u>725</u>	<u>50</u>
PCI loans:					
Commercial real estate	<u>16</u>	<u>123</u>	<u>16</u>	<u>3</u>	<u>16</u>
Total impaired loans	<u>\$ 2,657</u>	<u>\$ 2,826</u>	<u>\$ 461</u>	<u>\$ 2,005</u>	<u>\$ 129</u>

Troubled Debt Restructurings:

At December 31, 2018 and 2017, impaired loans included loans that were classified as Troubled Debt Restructurings ("TDRs"). The restructuring of a loan is considered a TDR if both (i) the borrower is experiencing financial difficulties and (ii) the creditor has granted a concession.

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

The Company considers all aspects of the modification to loan terms to determine whether or not a concession has been granted to the borrower. Key factors considered by the Company include the debtor's ability to access funds at a market rate for debt with similar risk characteristics, the significance of the modification relative to unpaid principal balance or collateral value of the debt, and the significance of a delay in the timing of payments relative to the original contractual terms of the loan.

SmartFinancial, Inc. and Subsidiary**Notes to Consolidated Financial Statements**

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, ContinuedTroubled Debt Restructurings (continued):

The most common concessions granted by the Company generally include one or more modifications to the terms of the debt, such as (i) a reduction in the interest rate for the remaining life of the debt; (ii) an extension of the maturity date at an interest rate lower than the current market rate for new debt with similar risk; (iii) a temporary period of interest-only payments; and (iv) a reduction in the contractual payment amount for either a short period or remaining term of the loan. As of December 31, 2018 and 2017, management had approximately \$116 thousand and \$41 thousand, respectively, in loans that met the criteria for restructured. No restructured loans were on nonaccrual as of December 31, 2018 and 2017. A loan is placed back on accrual status when both principal and interest are current and it is probable that management will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement.

The following table presents a summary of loans that were modified as troubled debt restructurings during the year ended December 31, 2018 (amounts in thousands):

December 31, 2018	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial real estate	1	\$ 62	\$ 62
Commercial and industrial	1	18	18

There were no loans modified as troubled debt restructurings during the year ended December 31, 2017.

There were no loans that were modified as troubled debt restructurings during the past twelve months and for which there was a subsequent payment default.

Purchased Credit Impaired Loans:

The Company has acquired loans which there was, at acquisition, evidence of deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. The carrying amount of those loans at for the years ended December 31, 2018 and 2017 is as follows (in thousands):

	2018	2017
Commercial real estate	\$ 24,849	\$ 23,366
Consumer real estate	11,108	10,764
Construction and land development	5,731	6,285
Commercial and industrial	5,824	1,452
Consumer and other	892	1,710
Total loans	\$ 48,404	\$ 43,577
Less remaining purchase discount	(14,246)	(10,783)
Total, gross	34,158	32,794
Less: Allowance for loan losses	—	(16)
Carrying amount, net of allowance	\$ 34,158	\$ 32,778

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued

Purchased Credit Impaired Loans (continued):

The following is a summary of the accretable discount on acquired loans for the years ended December 31, 2018 and 2017 (in thousands):

	2018	2017
Accretable yield, beginning of period	\$ 9,287	\$ 8,950
Additions	2,416	2,581
Accretion income	(5,368)	(4,217)
Reclassification from nonaccretable	1,494	926
Other changes, net	(777)	1,047
Accretable yield, end of period	<u>\$ 7,052</u>	<u>\$ 9,287</u>

The Company increased the allowance for loan losses on purchase credit impaired loans in the amount of approximately \$16 thousand during the year ended December 31, 2017. There were no allowance for loan losses on purchase credit impaired loans at the year ended December 31, 2018.

Purchased credit impaired loans acquired from TN Bancshares during the year ended December 31, 2018 for which it was probable at acquisition that all contractually required payments would not be collected are as follows (in thousands):

	2018
Contractual principal and interest at acquisition	\$ 15,133
Nonaccretable difference	5,302
Expected cash flows at acquisition	9,831
Accretable yield	1,292
Basis in PCI loans at acquisition-estimated fair value	<u>\$ 8,539</u>

Purchased credit impaired loans acquired from Foothills Bancorp during the year ended December 31, 2018 for which it was probable at acquisition that all contractually required payments would not be collected are as follows (in thousands):

	2018
Contractual principal and interest at acquisition	\$ 12,125
Nonaccretable difference	2,748
Expected cash flows at acquisition	9,377
Accretable yield	1,124
Basis in PCI loans at acquisition-estimated fair value	<u>\$ 8,253</u>

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued

Related Party Loans:

In the ordinary course of business, the Company has granted loans to certain related parties, including directors, executive officers, and their affiliates. The interest rates on these loans were substantially the same as rates prevailing at the time of the transaction and repayment terms are customary for the type of loan. A summary of activity in loans to related parties is as follows (in thousands):

	2018	2017
Balance, beginning of year	\$ 18,330	\$ 12,999
Disbursements	34,639	14,533
Repayments	(21,723)	(9,202)
Balance, end of year	<u>\$ 31,246</u>	<u>\$ 18,330</u>

At December 31, 2018, the Company had pre-approved but unused lines of credit totaling approximately \$4.5 million to related parties.

Note 5. Premises and Equipment

A summary of premises and equipment at December 31, 2018 and 2017, is as follows (in thousands):

	2018	2017
Land and land improvements	\$ 14,712	\$ 10,854
Building and leasehold improvements	36,640	28,576
Furniture, fixtures and equipment	12,318	10,073
Construction in progress	2,875	1,495
Total, gross	66,545	50,998
Accumulated depreciation	(10,533)	(7,998)
Total, net	<u>\$ 56,012</u>	<u>\$ 43,000</u>

At December 31, 2018 management estimates the cost necessary to complete the construction in progress will be approximately \$542 thousand.

The Company leases several branch locations and also has two ground leases under non-cancelable operating lease agreements. The leases expire between May 2019 and May 2033. Lease expense under the leases was \$795 thousand and \$722 thousand in 2018 and 2017, respectively. At December 31, 2018, the remaining minimum lease payments relating to these leases were as follows (in thousands):

2019	\$ 644
2020	622
2021	462
2022	259
2023	121
Thereafter	864
Total	<u>\$ 2,972</u>

Depreciation expense was \$2.6 million and \$1.8 million for the years ended December 31, 2018 and 2017, respectively.

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 6. Deposits

The aggregate amount of time deposits in denominations of \$250,000 or more was approximately \$165.1 million and \$171.3 million at December 31, 2018 and 2017, respectively. At December 31, 2018, the scheduled maturities of time deposits are as follows (in thousands):

2019	\$	449,948
2020		120,376
2021		28,094
2022		20,446
2023		29,053
Thereafter		—
Total	\$	647,917

As of December 31, 2018 and 2017, there was a fair value adjustment of \$759.1 thousand and \$1.1 million, respectively, to time deposits as a result of business combinations.

At December 31, 2018 and 2017, the Company had \$747 thousand and \$155 thousand, respectively, of deposit accounts in overdraft status that have been reclassified to loans on the accompanying consolidated balance sheets. From time to time, the Company engages in deposit transactions with its directors, executive officers and their related interests (collectively referred to as "related parties"). Such deposits are made in the ordinary course of business and on substantially the same terms as those for comparable transactions prevailing at the time and do not present other unfavorable features. The total amount of related party deposits was \$24.3 million and \$16.7 million at December 31, 2018 and 2017, respectively.

Note 7. Goodwill and Intangible Assets

Goodwill and intangible assets:

Past business combinations have created \$66.1 million in goodwill for the Company. Finite lived intangible assets of the Company represent a core deposit premium recorded upon the purchase of certain assets and liabilities from other financial institutions.

The following table presents information about our core deposit premium intangible asset at December 31 (in thousands):

	2018		2017	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortized intangible asset:				
Core deposit intangible	\$ 14,549	\$ 1,602	\$ 8,589	\$ 626

The following table presents information about aggregate amortization expense for 2018 and 2017 and for the succeeding fiscal years as follows (in thousands):

	2018	2017
Aggregate amortization expense of core deposit premium intangible	\$ 976	\$ 346

Note 7. Goodwill and Intangible Assets, Continued

Goodwill and intangible assets (continued):

Estimated aggregate amortization expense of the core deposit premium intangible for the year ending December 31 (in thousands):

2019	\$	1,368
2020		1,351
2021		1,334
2022		1,317
2023		1,301
Thereafter		6,276
Total	\$	12,947

Note 8. Income Taxes

Income tax expense in the consolidated statements of income for the years ended December 31, 2018 and 2017, includes the following (in thousands):

	<u>2018</u>	<u>2017</u>
Current tax expense		
Federal	\$ 661	\$ 1,962
State	141	428
Deferred tax expense (benefit) related to:		
Federal	1,992	1,441
State	439	158
Change in tax rate	—	2,440
Total income tax expense	\$ 3,233	\$ 6,429

The income tax expense is different from the expected tax expense computed by multiplying income before income tax expense by the statutory income tax rate of 21 percent in 2018 and 34 percent in 2017. The reasons for this difference are as follows (in thousands):

	<u>2018</u>	<u>2017</u>
Federal income tax expense computed at the statutory rate	\$ 4,481	\$ 3,891
State income taxes, net of federal tax benefit	551	491
Nondeductible acquisition expenses	138	364
Tax benefit from stock options	(1,786)	—
Change in tax rate	—	2,440
Other	(151)	(757)
Total income tax expense	\$ 3,233	\$ 6,429

During 2018, the Company identified an error in the computation and disclosure of deferred taxes for 2017. The error resulted from exclusion of a tax benefit from non-qualified options exercised in 2017. The Company has elected to correct the error in its current year financial statements which reduced tax provision by approximately \$1.6 million for the year ended December 31, 2018.

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 8. Income Taxes, Continued

The components of the net deferred tax asset as of December 31, 2018 and 2017, were as follows (in thousands):

	2018	2017
Deferred tax assets:		
Allowance for loan losses	\$ 2,172	\$ 1,561
Fair value adjustments	6,086	4,829
Unrealized losses on investment securities	659	424
Unrealized losses on hedges	280	—
Foreclosed real estate	271	301
Deferred compensation	833	849
Federal net operating loss carryforward	350	—
Other	440	849
Total deferred tax assets	<u>11,091</u>	<u>8,813</u>
Deferred tax liabilities:		
Accumulated depreciation	1,875	1,194
Core deposit intangible	3,332	1,945
Other	286	223
Total deferred tax liabilities	<u>5,493</u>	<u>3,362</u>
Net deferred tax asset	<u>\$ 5,598</u>	<u>\$ 5,451</u>

The Company has a Federal net operating loss carryforward of \$1.7 million acquired with the acquisition of Foothills Bancorp. This federal net operating loss does not expire. The income tax returns of the Company for 2017, 2016, and 2015 are subject to examination by the federal and state taxing authorities, generally for three years after they were filed.

Note 9. Federal Home Loan Bank Advances and Other Borrowings

Line of Credit:

On October 31, 2017, the Company entered into a loan agreement (the “Loan Agreement”) with CapStar Bank (the “Lender”) providing for a revolving line of credit of up to \$15 million. The Company may borrow and reborrow under the revolving line of credit until the line of credit termination date of January 15, 2019, after which no advances under the revolving line of credit may be reborrowed. The balance of the line on January 15, 2019 when it converted to a term loan was \$0 and there may be no further borrowings. The term loan commencement date would have begun on January 16, 2019. Line of Credit borrowings and the term loan will accrue interest at the Lender’s prime rate minus 0.25 percent, subject to a 3.50 percent floor.

Beginning 90 days after the effective date of the revolving line of credit, the Company is required to pay quarterly payments of interest. In addition, commencing on January 15, 2019, the Company must pay quarterly principal amortization payments of \$262.5 thousand for each fiscal quarter in 2019, \$287.5 thousand for each fiscal quarter in 2020, \$312.5 thousand for each fiscal quarter in 2021 and \$337.5 thousand for each fiscal quarter in 2022 until and including the maturity date. The scheduled principal amortization payments are based upon the assumption that the revolving line of credit is fully drawn, and the required payments will be reduced on a pro-rata basis relative to the amount borrowed if the revolving line of credit is not fully drawn. The loan will mature on October 15, 2022, at which time all outstanding amounts under the loan agreement will become due and payable. In connection with entering into the Loan Agreement, the Company issued to the Lender a line of credit note dated as of October 31, 2017.

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 9. Federal Home Loan Bank Advances and Other Borrowings, Continued

Line of Credit (continued):

The Loan Agreement contains typical representations, warranties and covenants for a revolving line of credit, and the loan agreement has certain financial covenants and capital ratio requirements. Pursuant to the Loan Agreement, the Bank may not permit non-performing assets to be greater than 3.25 percent of total assets. The Bank must not permit its Texas ratio (nonperforming assets divided by the sum of tangible equity plus the allowance for loan and lease losses) to be greater than 35.00 percent, and must not permit its liquidity ratio to be less than 9.00 percent (or less than 10.00 percent for two consecutive quarters). The Bank shall not permit, at the end of each quarter, its returns on average assets to be less than 0.45 percent from December 31, 2017 through and including September 30, 2018 and 0.50 percent at December 31, 2018 and thereafter. The Bank shall not permit the debt service coverage ratio, as of June 30 and December 31 of each fiscal year, commencing on December 31, 2017, to be less than 1.25:1.00.

The regulatory covenant states the Company will be "well capitalized," or such other successor term with a similar meaning, for all applicable state and federal regulatory purposes at all times, and will not be subject to any written agreement, order, capital directive or prompt corrective action directive by any Governmental Authority having regulatory authority over the Company, except where such order, capital directive or prompt corrective action directive does not result in, nor could reasonably be expected to result in, a Material Adverse Effect, or if required by any Governmental Authority having regulatory authority over the Borrower in order to remain "well capitalized" and in compliance with all applicable regulatory requirements, will have such higher amounts of Total Risk-based Capital and Tier 1 Risk-based Capital and/or such greater Tier 1 Leverage Ratio as specified by such Governmental Authority. Each Financial Institution Subsidiary of the Company will be "well capitalized," or such other successor term with a similar meaning, for all applicable state and federal regulatory purposes at all times, and such Financial Institution Subsidiary (i) will have a Total Risk-based Capital Ratio of 10.50 percent or greater, a Tier 1 Risk based Capital Ratio of 9.50 percent or greater, and a Tier 1 Leverage Ratio of 8.00 percent or greater (each as defined by applicable federal and state regulations or orders) and not be subject to any written agreement, order, capital directive or prompt corrective action directive by any Governmental Authority having regulatory authority over such Financial Institution Subsidiary, except where such order, capital directive or prompt corrective action directive does not result in, nor could reasonably be expected to result in, a Material Adverse Effect, or (ii) if required by any Governmental Authority having regulatory authority over such Financial Institution Subsidiary in order to remain "well capitalized" and in compliance with all applicable regulatory requirements, will have such higher amounts of Total Risk-based Capital and Tier 1 Risk-based Capital and/or such greater Tier 1 Leverage Ratio as specified by such Governmental Authority. Notwithstanding the foregoing, if at any time any such Governmental Authority changes the definition of "well capitalized" either by amending such ratios or otherwise, such amended definition, and any such amended or new ratios, shall automatically, and in lieu of the existing definitions and ratios set forth in this Section, be incorporated by reference into this Agreement as the minimum standard for the Company or any Financial Institution Subsidiary, as the case may be, on and as of the date that any such amendment becomes effective by applicable statute, regulation, order or otherwise.

The interest coverage ratio covenant states the Company shall not permit, as of June 30 and December 31 of each fiscal year, commencing December 31, 2017, its interest coverage ratio to be less than 2.50:1.00.

As of December 31, 2018, the Company and the Bank were in compliance with all of the loan covenants. As of December 31, 2017, the Company and the Bank were in compliance with all loan covenants except for the return on assets. The return on assets covenant was not met due to the tax law enacted in December 2017 which caused the Company to write down the deferred tax asset to the new tax rate. Capstar waived the covenant for December 2017 since the non-compliance was due to the tax law change and not caused by operations of the Company or Bank.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 9. Federal Home Loan Bank Advances and Other Borrowings, Continued

Line of Credit (continued):

The Loan Agreement has standard and commercially reasonable events of default, such as non-payment, failure to perform any covenant or agreement, breach of any representation or warranty, failure to pay other material indebtedness, bankruptcy, insolvency, any ERISA event, any material judgment, any material adverse effect, any change in control, any failure to be insured by the FDIC or any action by a governmental or regulatory authority, etc. The Lender has the right to accelerate the indebtedness upon an event of default.

The obligations of the Company under the Loan Agreement are secured by a pledge of all of the capital stock of the Bank pursuant to stock pledge and security agreements. In the event of a default by the Company under the loan Agreement, the lender may terminate the commitments made under the loan agreement, declare all amounts outstanding to be payable immediately, and exercise or pursue any other remedy permitted under the loan agreement or the pledge agreements, or conferred to the lender by operation of law.

As of December 31, 2017, the outstanding borrowings under the line of credit were \$10 million and the rate was 4.25 percent. The Loan Agreement was paid in full on September 28, 2018 and no borrowings were outstanding as of December 31, 2018.

The primary source of liquidity for the Company is the payment of dividends from the Bank. As of December 31, 2018 and 2017, the Bank was under no dividend restrictions that requires regulatory approval prior to the payment of a dividend from the Bank to the Company.

FHLB borrowings:

The Bank has agreements with the Federal Home Loan Bank of Cincinnati (FHLB) that can provide advances to the Bank in an amount up to \$59.4 million. All of the loans are secured by first mortgages on 1-4 family residential, multi-family properties and commercial properties and are pledged as collateral for these advances. Additionally, the Bank pledged securities to FHLB with a carrying amount of \$16.3 million at December 31, 2017. There were no securities pledged to FHLB at December 31, 2018.

At December 31, 2018 and 2017, there were no advances from the FHLB.

Borrowings:

On May 1, 2018, the Company entered into a loan agreement with Waters & Waters, LLC in the amount of \$500 thousand at a rate of 4.75 percent with semi-annual payments of principal plus accrued interest over an amortization period of ten years. The outstanding principal balance and accrued interest will be due and payable on April 30, 2028.

Scheduled maturities:

At December 31, 2018, scheduled maturities of the federal funds purchased of \$10.8 million, and other borrowings of \$480.3 thousand are as follows (amounts in thousands):

2019	\$	10,803
2020		43
2021		45
2022		47
2023		50
Thereafter		254
Total	\$	<u>11,242</u>

Note 10. Subordinated debt

On September 28, 2018, the Company completed an offering of \$40 million in aggregate principal amount of fixed-to-floating rate subordinated notes due 2028 (the “Notes”) to certain institutional accredited investors. The Company used the net proceeds of the offering to repay the outstanding balance on the Company’s existing revolving line of credit to Capstar Bank in the amount of \$15 million. The additional proceeds were used to pay the cash consideration to holders of Foothills Bancorp, Inc. common stock and holders of options to purchase Foothills Bancorp, Inc. common stock in connection with the Company’s acquisition of Foothills Bancorp, Inc., and for other general corporate purposes, including improving the Company’s and the Bank’s liquidity position. As a result \$12 million was downstreamed to the Bank.

The Notes initially bears interest at a rate of 5.625 percent per annum from and including September 28, 2018, to but excluding October 2, 2023, with interest during this period payable semi-annually in arrears. From and including October 2, 2023, to but excluding the maturity date or early redemption date, the interest rate will reset quarterly to an annual floating rate equal to three-month LIBOR, or an alternative rate determined in accordance with the terms of the Notes if three-month LIBOR cannot be determined, plus 255 basis points, with interest during this period payable quarterly in arrears. The Notes are redeemable by the Company, in whole or in part, on or after October 2, 2023, and at any time, in whole but not in part, upon the occurrence of certain events. The Notes have been structured to qualify initially as Tier 2 capital for the Company for regulatory capital purposes.

The Notes debt issuance costs totaled \$842 thousand and will be amortized through the Notes' maturity date. Amortization expense totaled \$19 thousand during the twelve month period December 31, 2018.

As of December 31, 2018, the principal balance was \$40 million and debt issuance cost balance was \$823 thousand.

Note 11. Employee Benefit Plans

401(k) Plan:

The Company provides a deferred salary reduction plan (“Plan”) under Section 401 (k) of the Internal Revenue Code covering substantially all employees. After one year of service the Company matches 100 percent of employee contributions up to 3 percent of compensation and 50 percent of employee contributions on the next 2 percent of compensation. The Company's contribution to the Plan was \$715,698 in 2018 and \$427,975 in 2017.

Stock Option Plans:

The Company has one currently active equity incentive plan administered by the Board of Directors, the 2015 Stock Incentive plan, and four plans or programs, pursuant to which the Company has outstanding prior grants. These plans are described below:

Legacy Cornerstone Bancshares, Inc. 2002 Long Term Incentive Plan – The plan provided Cornerstone Bancshares, Inc. officers and employees incentive stock options or non-qualified stock options to purchase shares of common stock. The exercise price for incentive stock options was not less than 100 percent of the fair market value of the common stock on the date of the grant. The exercise price of the non-qualified stock options was equal to or more or less than the fair market value of the common stock on the date of the grant. This plan expired in 2012.

Legacy Cornerstone Non-Qualified Plan Options — During 2013 and 2014, Cornerstone issued non-qualified options to employees and directors. The options were originally documented in 2013 as being issued out of the Cornerstone Bancshares, Inc. 2002 Long Term Incentive Plan but that plan expired in 2012. The non-qualified options are governed by the grant document issued to the holders which incorporate the terms of the plan by reference.

2015 Stock Incentive Plan – This plan provides for incentive stock options, nonqualified stock options, and restricted stock. The maximum number of shares of common stock that can be sold or optioned under the plan is 2,000,000 shares. The term of each option shall be no more than ten years from the date of grant. In the case of an incentive stock option granted to a participant who, at the time the option is granted, owns stock representing more than ten percent of the voting power of all classes of stock of the Company or any parent or subsidiary thereof, the term of the option shall be five years from the date of grant or such shorter term as may be provided in the award agreement.

SmartFinancial, Inc. and Subsidiary
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Note 11. Employee Benefit Plans, Continued

Stock Option Plans (continued):

The per share exercise price for the shares to be issued upon exercise of an option shall be such price as is determined by the plan administrator, subject to the following: In the case of an incentive stock option: (1) granted to an employee who, at the time of grant of such option, owns stock representing more than ten percent of the voting power of all classes of stock of the company or any parent or subsidiary thereof, the exercise price shall be no less than one hundred and ten percent of the fair market value per share on the date of grant; or (2) granted to any other employee, the per share exercise price shall be no less than one hundred percent of the fair market value per share on the date of grant. In the case of a nonstatutory stock option, the per share exercise price shall be no less than one hundred percent of the fair market value per share on the date of grant, unless otherwise determined by the Administrator.

The incentive stock options vest 30 percent on the second anniversary of the grant date, 30 percent on the third anniversary of the grant date and 40 percent on the fourth anniversary of the grant date. Director non-qualified stock options vest 50 percent on the first anniversary of the grant date and 50 percent on the second anniversary of the grant date.

Legacy Capstone Stock Option Plan - This plan was assumed by the Company on November 3, 2017 and subsequently closed. The plan provided for incentive stock options and nonqualified stock options. Under the plan, the exercise price of each option could not be less than 100 percent of the fair market value of the common stock on the date of grant.

A summary of the status of these stock option plans is presented in the following table:

	Number	Weighted Average Exercisable Price
Outstanding at December 31, 2017	316,574	\$ 11.82
Granted	—	—
Exercised	(132,783)	11.39
Forfeited	(13,166)	31.96
Outstanding at December 31, 2018	<u>170,625</u>	<u>\$ 10.61</u>

	Number	Weighted Average Exercisable Price
Outstanding at December 31, 2016	717,524	\$ 10.57
Granted	—	—
Exercised	(506,923)	9.64
Forfeited	(24,496)	19.90
Capstone options assumed in business combination	130,469	11.76
Outstanding at December 31, 2017	<u>316,574</u>	<u>\$ 11.82</u>

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
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Note 11. Employee Benefit Plans, Continued

Stock Option Plans (continued):

Information pertaining to options outstanding at December 31, 2018, is as follows:

Exercise Prices	Options Outstanding			Options Exercisable		
	Number Outstanding	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price	
6.60	30,000	3.2 years	6.60	30,000	6.60	
6.80	14,250	2.2 years	6.80	14,250	6.80	
9.48	25,625	4.2 years	9.48	25,625	9.48	
9.60	35,125	5.2 years	9.60	35,125	9.60	
11.76	13,599	2.4 years	11.76	13,599	11.76	
14.40	11,792	0.2 years	14.40	11,792	14.40	
15.05	40,234	6.8 years	15.05	26,827	15.05	
Outstanding, end of year	<u>170,625</u>	4.2 years	10.61	<u>157,218</u>	10.23	

The Company recognized stock option compensation expense of \$133,884 and \$97,966 for the periods ended December 31, 2018 and 2017, respectively. Stock appreciation rights compensation expense of \$33,916 and \$21,829 was recognized for the period ended December 31, 2018 and 2017, respectively. Direct stock grant expense issued to local advisory board members of \$9,062 and \$31,791 was included in salary and benefit expense for the period ended December 31, 2018 and 2017, respectively. The total fair value of shares underlying the options which vested during the periods ended December 31, 2018 and 2017, was \$243,831 and \$313,977, respectively. The income tax benefit recognized for the exercise of options for the periods ended December 31, 2018 and 2017 was \$318,826 and \$1,331,689 respectively.

The intrinsic value of options exercised during the periods ended December 31, 2018 and 2017 was \$1,523,014 and \$5,468,780, respectively. The aggregate intrinsic value of total options outstanding and exercisable options at December 31, 2018 was \$1,307,043 and \$1,263,872, respectively. Cash received from options exercised under all share-based payment arrangements for the period ended December 31, 2018 was \$1,519,244.

Information related to non-vested options for the period ended December 31, 2018, is as follows:

	Number	Weighted Average Grant-Date Fair Value
Nonvested at December 31, 2017	23,455	\$ 12.31
Granted	—	—
Vested	(13,346)	15.05
Forfeited/expired	3,298	15.05
Nonvested at December 31, 2018	<u>13,407</u>	<u>\$ 15.05</u>

As of December 31, 2018, there was approximately \$124,450 of total unrecognized compensation cost related to nonvested stock-based compensation arrangements granted under the Plans. The cost is expected to be recognized over a weighted-average period of 1.0 year. There were no stock options granted during the twelve months period ended December 31, 2018 and December 31, 2017.

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
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Note 11. Employee Benefit Plans, Continued

Restricted Stock Awards:

On August 4, 2017, the Board of Directors of the Company made grants of 27,500 shares of restricted stock under the Company's 2015 Stock Incentive Plan to certain executives of the Company. The restricted shares of stock, which are subject to the terms of a Restricted Stock Grant Agreement between the Company and each recipient, will fully vest on the fifth anniversary of the grant date. Prior to vesting, the recipient will be entitled to vote the shares and receive dividends, if any, declared by the Company with respect to its common stock. Compensation expense for restricted stock is based on the fair value of the restricted stock awards at the time of the grant, which is equal to the market value of the Company's common stock on the date of grant. The value of the restricted stock grants that are expected to vest is amortized monthly into compensation expense over the five year vesting period. The restricted shares had a fair value of \$24.58 per share on the date of issuance.

On January 25, 2018, the Board of Directors of the Company made grants of 7,553 shares of restricted stock under the Company's 2015 Stock Incentive Plan to certain executives and directors of the Company. Restricted shares of stock are subject to the terms of a Restricted Stock Grant Agreement between the Company and each recipient. Two thousand (2000) shares will fully vest on the fifth anniversary of the grant date, 4627 shares vested within six months, and 926 shares vested upon two directors' retirement. Prior to vesting, the recipient will be entitled to vote the shares and receive dividends, if any, declared by the Company with respect to its common stock. Compensation expense for restricted stock is based on the fair value of the restricted stock awards at the time of the grant, which is equal to the market value of the Company's common stock on the date of grant. The value of the restricted stock grants that are expected to vest is amortized monthly into compensation expense over the five year and six month vesting periods. The restricted shares had a fair value of \$21.61 per share on the date of issuance.

For the period ended December 31, 2018 and 2017, compensation expense of \$263,013 and \$56,330, respectively, was recognized related to restricted stock awards. As of December 31, 2018, there was \$519,727 of unrecognized compensation cost related to non-vested restricted stock awards granted under the plan.

The following table summarizes activity relating to non-vested restricted stock awards:

	Number
Nonvested at December 31, 2017	27,500
Granted	7,553
Vested	(5,553)
Forfeited/expired	—
Nonvested at December 31, 2018	<u>29,500</u>

Note 12. Securities Sold Under Agreements to Repurchase

Securities sold under repurchase agreements, which are secured borrowings, generally mature within one to four days from the transaction date. Securities sold under repurchase agreements are reflected at the amount of cash received in connection with the transaction. The Company may be required to provide additional collateral based on the fair value of the underlying securities. The Company monitors the fair value of the underlying securities on a daily basis.

At December 31, 2018 and 2017, the Company had securities sold under agreements to repurchase of \$11.8 million and \$24.1 million, respectively, with commercial checking customers which were secured by \$11.8 million and \$24.1 million of agency and of mortgage-backed securities, respectively.

Note 13. Commitments and Contingencies

Loan Commitments:

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing and depository needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Such commitments involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amount recognized in the balance sheets. The majority of all commitments to extend credit are variable rate instruments while the standby letters of credit are primarily fixed rate instruments.

The Company's exposure to credit loss is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments as it does for on-balance sheet instruments.

A summary of the Company's total contractual amount for all off-balance sheet commitments at December 31, 2018 is as follows:

Commitments to extend credit	\$	333.9 million
Standby letters of credit		12.2 million

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 drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the customer. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate, and income-producing commercial properties.

Standby letters of credit issued by the Company are conditional commitments to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. Collateral held varies and is required in instances which the Company deems necessary.

At December 31, 2018 and 2017, the carrying amount of liabilities related to the Company's obligation to perform under standby letters of credit was insignificant. The Company has not been required to perform on any standby letters of credit, and the Company has not incurred any losses on standby letters of credit for the years ended December 31, 2018 and 2017.

Contingencies:

In the normal course of business, the Company may become involved in various legal proceedings. In the opinion of management, any liability resulting from such proceedings would not have a material effect on the Company's consolidated financial statements.

Note 14. Regulatory Matters

Regulatory Capital Requirements:

The Company and the Bank are subject to regulatory capital requirements administered by 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 judgements by regulators. Failure to meet capital requirements can initiate regulatory action. The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Company on January 1, 2015, with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. Under Basel III rules, the Company must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer is being phased in at the rate of 0.625 percent per year from 0.0 percent in 2015 to 2.50 percent on January 1, 2019. The capital conservation buffer for 2017 is 1.2

SmartFinancial, Inc. and Subsidiary
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December 31, 2018 and 2017

Note 14. Regulatory Matters, Continued

5 percent and for 2018 is 1.875 percent. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital. Management believes as of December 31, 2018, the Company and Bank meet all capital adequacy requirements to which they are subject.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 14. Regulatory Matters, Continued

Regulatory Capital Requirements (continued):

Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. At year end 2018 and 2017, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category. Management currently believes, based on internal capital analysis and earnings projections, the Bank's capital position is adequate to meet current and future regulatory minimum capital requirements.

Regulatory Restrictions on Dividends:

Pursuant to Tennessee banking law, the Bank may not, without the prior consent of the Commissioner of the Tennessee Department of Financial Institutions (TDFI), pay any dividends to the Company in a calendar year in excess of the total of the Bank's retained net income for that year plus the retained net income for the preceding two years. During the year ended December 31, 2018, SmartBank paid no dividends to the Company. As of December 31, 2018, the Bank could pay approximately \$33.4 million of additional dividends to the Company without prior approval of the Commissioner of the TDFI.

Regulatory Capital Levels:

Actual and required capital levels at December 31, 2018 and 2017 are presented below (dollars in thousands):
are

	Actual		Minimum for capital adequacy purposes		Minimum to be well capitalized under prompt corrective action provisions (1)	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2018						
SmartFinancial, Inc. (2)						
SmartBank						
Total Capital (to Risk-Weighted Assets)	\$ 243,774	12.74%	\$ 153,017	8.00%	\$ 191,271	10.00%
Tier 1 Capital (to Risk-Weighted Assets)	235,499	12.31%	114,763	6.00%	153,017	8.00%
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	235,499	12.31%	86,072	4.50%	124,326	6.50%
Tier 1 Capital (to Average Assets)	235,499	11.17%	84,300	4.00%	105,375	5.00%

(1) The prompt corrective action provisions are applicable at the Bank level only.

(2) Reporting regulations were revised during 2018 the capital ratios reported for SmartFinancial Inc. at December 31, 2017 were not required to be reported at December 31, 2018.

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 14. Regulatory Matters, Continued

Regulatory Capital Levels (continued):

	Actual		Minimum for capital adequacy purposes		Minimum to be well capitalized under prompt corrective action provisions (1)	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2017						
SmartFinancial, Inc.						
Total Capital (to Risk-Weighted Assets)	\$ 163,683	10.98%	\$ 119,257	8.00%		
Tier 1 Capital (to Risk-Weighted Assets)	157,823	10.59%	89,442	6.00%		
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	157,823	10.59%	67,082	4.50%		
Tier 1 Capital (to Average Assets)	157,823	10.78%	58,562	4.00%		
SmartBank						
Total Capital (to Risk-Weighted Assets)	\$ 168,148	11.29%	\$ 119,111	8.00%	\$ 148,889	10.00%
Tier 1 Capital (to Risk-Weighted Assets)	162,288	10.90%	89,333	6.00%	119,111	8.00%
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	162,288	10.90%	67,000	4.50%	96,778	6.50%
Tier 1 Capital (to Average Assets)	162,288	11.26%	57,656	4.00%	72,070	5.00%

(1) The prompt corrective action provisions are applicable at the Bank level only.

Note 15. Concentrations of Credit Risk

The Company originates primarily commercial, residential, and consumer loans to customers in Tennessee, Florida, Georgia and Alabama. The ability of the majority of the Company's customers to honor their contractual loan obligations is dependent on the economy in these areas.

Eighty-two percent of the Company's loan portfolio is concentrated in loans secured by real estate, of which a substantial portion is secured by real estate in the Company's primary market areas. Commercial real estate, including commercial construction loans, represented 55 percent of the loan portfolio at December 31, 2018, and 56 percent of the loan portfolio at December 31, 2017. Accordingly, the ultimate collectability of the loan portfolio and recovery of the carrying amount of foreclosed assets is susceptible to changes in real estate conditions in the Company's primary market areas. The other concentrations of credit by type of loan are set forth in Note 4.

The Bank, as a matter of policy, does not generally extend credit to any single borrower or group of related borrowers in excess of 25 percent of statutory capital, or approximately \$77.8 million.

Note 16. Fair Value of Assets and Liabilities

Determination of Fair Value:

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the “Fair Value Measurements and Disclosures” ASC Topic 820, the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

ASC Topic 820 provides a consistent definition of fair value, which focuses on exit price in an orderly transaction between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

Fair Value Hierarchy:

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

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

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

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

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

The following methods and assumptions were used by the Company in estimating fair value disclosures for financial instruments:

Cash and Cash Equivalents: For cash and due from banks, interest-bearing deposits, and federal funds sold, the carrying amount is a reasonable estimate of fair value based on the short-term nature of the assets and are considered Level 1 inputs.

Securities Available-for-Sale: Where quoted prices are available in an active market, management classifies the securities within Level 1 of the valuation hierarchy. If quoted market prices are not available, management estimates fair values using pricing models that use observable inputs or quoted prices at securities with similar characteristics. Examples of such instruments, which would generally be classified within Level 2 of the valuation hierarchy, including GSE obligations, corporate bonds, and other securities. Mortgage-backed securities are included in Level 2 if observable inputs are available. In certain cases where there is limited activity or less transparency around inputs to the valuation, management classifies those securities in Level 3.

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
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Note 16. Fair Value of Assets and Liabilities, Continued

Fair Value Hierarchy (continued):

Restricted Investments: It is not practicable to determine the fair value of restricted investments due the restrictions placed on its transferability.

Loans: With the adoption of ASU 2016-01 on January 1, 2018, we refined our methodology to estimate the fair value of our loan portfolio to use the exit price notion as required by the ASU. The guidance was applied on a prospective approach resulting in prior-periods no longer being comparable. See “Note 1 – Presentation of Financial Information” for further information. For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair value for fixed rate loans are estimated using discounted cash flow analyses, using market interest rates for comparable loans. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable. These methods are considered Level 3 inputs.

Deposits: The fair values disclosed for demand deposits (for example, interest and noninterest checking, savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts) and are considered Level 2 inputs. Fair values for fixed-rate time deposits are estimated using a discounted cash flow calculation that applies market interest rates on comparable instruments to a schedule of aggregated expected monthly maturities on time deposits, and are considered Level 2 inputs.

Securities Sold Under Agreement to Repurchase: The carrying value of these liabilities approximates their fair value, and are considered Level 1 inputs.

Federal Home Loan Bank (“FHLB”) Advances, Subordinated Debt and Other Borrowings: The fair value of the FHLB fixed rate borrowings are estimated using discounted cash flows, based on the current incremental borrowing rates for similar types of borrowing arrangements, and are considered Level 2 inputs. The carrying value of FHLB floating rate borrowings and floating rate other borrowings and subordinated debt approximates their fair value and are considered Level 1 inputs. The fair value of the subordinated debt borrowings are estimated using discounted cash flows and are considered Level 3 inputs

Derivative Financial Instruments - Fair value is estimated using pricing models of derivatives with similar characteristics or discounted cash flow models where future floating cash flows are projected and discounted back; and accordingly, these derivatives are classified within Level 2 of the fair value hierarchy. See Note 21—Derivative Financial Instruments for additional information.

Commitments to Extend Credit and Standby Letters of Credit: Because commitments to extend credit and standby letters of credit are made using variable rates and have short maturities, the carrying value and the fair value are immaterial for disclosure.

Measurements of Fair Value:

Assets recorded at fair value on a recurring basis are as follows, in thousands

	Balance as of December 31, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Securities available-for-sale:				
U.S. Government-sponsored enterprises (GSEs)	\$ 43,503	\$ —	\$ 43,503	\$ —
Municipal securities	55,161	—	55,161	—
Other debt securities	910	—	910	—
Mortgage-backed securities	102,114	—	102,114	—
Total securities available-for-sale	\$ 201,688	\$ —	\$ 201,688	\$ —
Derivative financial instruments	\$ 1,174	\$ —	\$ 1,174	

SmartFinancial, Inc. and Subsidiary
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December 31, 2018 and 2017

Note 16. Fair Value of Assets and Liabilities, Continued

	Balance as of December 31, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Securities available-for-sale:				
U.S. Government-sponsored enterprises (GSEs)	\$ 25,776	\$ —	\$ 25,776	\$ —
Municipal securities	9,003	—	9,003	—
Other debt securities	950	—	950	—
Mortgage-backed securities	116,215	—	116,215	—
Total securities available-for-sale	\$ 151,944	\$ —	\$ 151,944	\$ —

The Company has no assets or liabilities whose fair values are measured on a recurring basis using Level 3 inputs. Additionally, there were no transfers between Level 1 and Level 2 in the fair value hierarchy.

Assets Measured at Fair Value on a Nonrecurring Basis:

Under certain circumstances management makes adjustments to fair value for assets and liabilities although they are not measured at fair value on an ongoing basis. The following tables present the financial instruments carried on the consolidated balance sheets by caption and by level in the fair value hierarchy, for which a nonrecurring change in fair value has been recorded (in thousands):

	Balance as of December 31, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans	\$ 671	\$ —	\$ —	\$ 671
Foreclosed assets	2,495	—	—	2,495

	Balance as of December 31, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans	\$ 769	\$ —	\$ —	\$ 769
Foreclosed assets	3,254	—	—	3,254

For Level 3 assets measured at fair value on a non-recurring basis as of December 31, 2018 and 2017, the significant unobservable inputs used in the fair value measurements are presented below.

	Balance as of December 31, 2018 (in thousands)	Valuation Technique	Significant Other Unobservable Input	Weighted Average of Input
Impaired loans	\$ 671	Third Party Appraisal	Appraisal Discounts	44.3%
Foreclosed assets	2,495	Third Party Appraisal	Appraisal Discounts	23.3%

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Note 16. Fair Value of Assets and Liabilities, Continued

	Balance as of December 31, 2017 (in thousands)	Valuation Technique	Significant Other Unobservable Input	Weighted Average of Input
Impaired loans	\$ 769	Cash Flow	Discounted Cash Flow / Appraisal Discounts	35.5%
Foreclosed assets	3,254	Appraisal	Appraisal Discounts	17.8%

Impaired Loans: Loans considered impaired under ASC 310-10-35, *Receivables*, are loans for which, based on current information and events, it is probable that the Company will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement. Impaired loans can be measured based on the present value of expected payments using the loan's original effective rate as the discount rate, the loan's observable market price, or the fair value of the collateral less selling costs if the loan is collateral dependent. The fair value of impaired loans were measured based on the value of the collateral securing these loans or the discounted cash flows of the loans, as applicable. Impaired loans are classified within Level 3 of the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory, and/or accounts receivable. The Company determines the value of the collateral based on independent appraisals performed by qualified licensed appraisers. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraised values are discounted for costs to sell and may be discounted further based on management's historical knowledge, changes in market conditions from the date of the most recent appraisal, and/or management's expertise and knowledge of the customer and the customer's business. Such discounts by management are subjective and are typically significant unobservable inputs for determining fair value. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors discussed above.

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

SmartFinancial, Inc. and Subsidiary
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Note 16. Fair Value of Assets and Liabilities, Continued
Carrying value and estimated fair value:

The carrying amount and estimated fair value of the Company's financial instruments at December 31, 2018 and December 31, 2017 are as follows (in thousands):

	December 31, 2018				
	Fair Value Measurements Using				Estimated Fair Value
	Carrying Amount	Level 1	Level 2	Level 3	
Assets:					
Cash and cash equivalents	\$ 115,822	115,822	—	—	\$ 115,822
Securities available-for-sale	201,688	—	201,688	—	201,688
Restricted investments	11,499	N/A	N/A	N/A	N/A
Loans, net	1,768,964	—	—	1,766,838	1,766,838
Liabilities:					
Noninterest-bearing demand deposits	319,861	—	319,861	—	319,861
Interest-bearing demand deposits	311,482	—	311,482	—	311,482
Money Market and Savings deposits	641,945	—	641,945	—	641,945
Time deposits	648,675	—	649,169	—	649,169
Securities sold under agreements to repurchase	11,756	—	11,756	—	11,756
Federal Home Loan Bank advances and other borrowings	11,243	—	11,243	—	11,243
Subordinated debt	39,177	—	—	39,190	39,158
Derivative financial instruments	1,174	—	1,174	—	1,174
December 31, 2017					
	Fair Value Measurements Using				Estimated Fair Value
	Carrying Amount	Level 1	Level 2	Level 3	
Assets:					
Cash and cash equivalents	\$ 113,027	113,027	—	—	\$ 113,027
Securities available-for-sale	151,944	—	151,944	—	151,944
Restricted investments	6,431	N/A	N/A	N/A	N/A
Loans, net	1,317,398	—	—	1,292,303	1,292,303
Liabilities:					
Noninterest-bearing demand deposits	220,520	—	220,520	—	220,520
Interest-bearing demand deposits	231,644	—	231,644	—	231,644
Money Market and Savings deposits	543,645	—	543,645	—	543,645
Time deposits	442,774	—	443,547	—	443,547
Securities sold under agreements to repurchase	24,055	—	24,055	—	24,055
Federal Home Loan Bank advances and other borrowings	43,600	—	43,600	—	43,600

Note 16. Fair Value of Assets and Liabilities, Continued

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on many judgments. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial instruments include deferred income taxes and premises and equipment. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

Note 17. Small Business Lending Fund

In connection with the Company's merger with Legacy SmartFinancial, Inc. in 2015, the Company assumed Legacy SmartFinancial's obligations under a stock purchase agreement with the U.S. Department of the Treasury and issued 12,000 shares of preferred stock at \$1,000 per share under the Small Business Lending Fund Program (the "SBLF Program"). The Company paid cash dividends at a one percent rate or \$120 thousand for the year ended December 31, 2015 on the preferred shares. On February 4, 2016 the dividend rate for the preferred shares increased to nine percent and as a result the Company incurred preferred stock dividends of \$1.0 million for the year ended December 31, 2016 .

On January 30, 2017, the Company completed a public offering of 2,010,084 shares of its common stock, par value \$1.00 per share, with the gross proceeds to the Company of approximately \$33.2 million. On March 6, 2017, the Company used proceeds from the offering to redeem the \$12 million of preferred stock and pay the \$195 thousand accrued dividend.

Note 18. Concentration in Deposits

The Company had a concentration in its deposits of three customers totaling approximately \$116.1 million at December 31, 2017 and three customers totaling approximately \$160.6 million concentration of deposits at December 31, 2018.

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 19. Earnings Per Share

Basic earnings per share is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding. Diluted earnings per share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding and dilutive common share equivalents using the treasury stock method. Dilutive common share equivalents include common shares issuable upon exercise of outstanding stock options and restricted stock. The effect from the stock options and restricted stock on incremental shares from the assumed conversions for net income per share-basic and net income per share-diluted are presented below. There were antidilutive shares of 13,166 for the year ended December 31, 2017. There were no antidilutive shares at December 31, 2018.

(Dollars in thousands, except share amounts)

	2018	2017
Basic earnings per share computation:		
Net income available to common stockholders	\$ 18,102	\$ 4,820
Average common shares outstanding – basic	12,423,618	8,639,212
Basic earnings per share	\$ 1.46	\$ 0.56
Diluted earnings per share computation:		
Net income available to common stockholders	\$ 18,102	\$ 4,820
Average common shares outstanding – basic	12,423,618	8,639,212
Incremental shares from assumed conversions:		
Stock options and restricted stock	94,022	154,315
Average common shares outstanding - diluted	12,517,640	8,793,527
Diluted earnings per share	\$ 1.45	\$ 0.55

SmartFinancial, Inc. and Subsidiary*Notes to Consolidated Financial Statements*

December 31, 2018 and 2017

Note 20. Condensed Parent Information

(Dollars in thousands)

CONDENSED BALANCE SHEETS

	December 31, 2018	December 31, 2017
ASSETS		
Cash	\$ 13,684	\$ 3,936
Investment in subsidiaries	308,422	168,104
Other assets	99	42,766
Total assets	<u>\$ 322,205</u>	<u>\$ 214,806</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Other liabilities	\$ 17	\$ (1,046)
Other borrowings	39,177	10,000
Total liabilities	39,194	8,954
Stockholders' equity	283,011	205,852
Total liabilities and stockholders' equity	<u>\$ 322,205</u>	<u>\$ 214,806</u>

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 20. Condensed Parent Information, Continued

CONDENSED STATEMENTS OF INCOME

	Years Ended December 31,	
	2018	2017
INCOME		
Interest income	\$ 21	\$ —
EXPENSES		
Interest expense	1,005	69
Other operating expenses	2,822	2,657
(Loss) before equity in undistributed earnings of subsidiaries and income tax benefit	(3,806)	(2,726)
Equity in undistributed earnings of subsidiaries	22,741	7,134
Income tax (benefit) expense	(833)	607
Net income	18,102	5,015
Preferred stock dividend requirements	—	195
Net income available to common stockholders	\$ 18,102	\$ 4,820

STATEMENTS OF CASH FLOWS

	Years Ended December 31,	
	2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 18,102	\$ 5,015
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Equity in undistributed income of subsidiary	(22,741)	(7,134)
Other	1,631	(2,449)
Net cash used in operating activities	(3,008)	(4,568)

SmartFinancial, Inc. and Subsidiary*Notes to Consolidated Financial Statements*

December 31, 2018 and 2017

Note 20. Condensed Parent Information, Continued

CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from issuance of note payable	—	10,000
Repayment of note payable	(10,000)	—
Redemption of preferred stock	—	(12,000)
Issuance of subordination debt	39,158	—
Proceeds from issuance of common stock	1,528	37,853
Payment of dividends on preferred stock	—	(195)
	<u>30,686</u>	<u>35,658</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Net cash paid for business combinations	(5,930)	(14,222)
Equity contribution to subsidiary	(12,000)	(15,000)
	<u>(17,930)</u>	<u>(29,222)</u>
NET INCREASE IN CASH AND CASH EQUIVALENTS	9,748	1,868
CASH AND CASH EQUIVALENTS, beginning of year	<u>3,936</u>	<u>2,068</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 13,684</u>	<u>\$ 3,936</u>

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 21. Derivatives

Financial derivatives are reported at fair value in other assets or other liabilities. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as hedges, the gain or loss is recognized in current period earnings.

Derivatives designated as fair value hedges:

For derivative instruments that are designated and qualify as a fair value hedge, the gain or loss on the derivative instrument as well as the offsetting loss or gain on the hedged asset or liability attributable to the hedged risk are recognized in current earnings. The gain or loss on the derivative instrument is presented on the same income statement line item as the earnings effect of the hedged item. The Company utilizes interest rate swaps designated as fair value hedges to mitigate the effect of changing interest rates on the fair values of fixed rate callable securities available-for-sale. The hedging strategy on securities converts the fixed interest rates to LIBOR-based variable interest rates. These derivatives are designated as partial term hedges of selected cash flows covering specified periods of time prior to the call dates of the hedged securities. The Company has elected early adoption of FASB ASU 2017-12, which allows such partial term hedge designations.

On September 14, 2018 and December 4, 2018, the Company entered into fifteen swap transactions with a notional amount of \$35 million designated as fair value hedges. These derivatives are intended to protect against the effects of changing interest rates on the fair values of fixed rate securities.

A summary of the Company's fair value hedge relationships as of December 31, 2018 are as follows (in thousands):

						December 31, 2018
	Balance Sheet Location	Weighted Average Remaining Maturity (In Years)	Weighted Average Pay Rate	Receive Rate	Notional Amount	Estimated Fair Value
Liability derivatives						
Interest rate swap agreements - securities	Other liabilities	9.23	3.10%	3 month LIBOR	\$35,000	-\$1,174

There were no fair value hedge relationships as of December 31, 2017.

Note 21. Derivatives, Continued

Derivatives designated as fair value hedges (continued):

The effects of the Company's fair value hedge relationships on the income statement during the twelve months ended December 31, 2018 were as follows (in thousands):

	Twelve Months Ended December 31, 2018
	Interest Income
Total amount of income and expense line items presented in the consolidated statements of income	\$92,210
Gain (loss) on fair value hedging relationship	
Interest rate swap agreements - securities:	
Hedged items	(1,174)
Derivative designated as hedging instruments	1,174

The following amounts were recorded on the balance sheet related to cumulative basis adjustments for fair value hedges at December 31, 2018:

Line item on the balance sheet	Carrying Amount of the Hedged Assets (in thousands)	Cumulative Amount of Fair Value Hedging Adjustment Included in the Carrying Amount of the Hedged Assets
	December 31, 2018	December 31, 2018
Securities available-for-sale	\$39,730	\$1,174

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

SmartFinancial maintains disclosure controls and procedures, as defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934 (the "Exchange Act"), that are designed to ensure that information required to be disclosed by it in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms and that such information is accumulated and communicated to SmartFinancial's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. SmartFinancial 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 as of the end of December 31, 2018. Based on the evaluation of these disclosure controls and procedures,

the Chief Executive Officer and Chief Financial Officer have concluded that as of December 31, 2018, SmartFinancial's disclosure controls and procedures were effective.

Management's Report on Internal Control over Financial Reporting

The report of SmartFinancial's management on internal control over financial reporting is set forth in Item 8 of this Annual Report on Form 10-K and incorporated herein by reference.

Changes in Internal Controls

There were no changes in SmartFinancial's internal control over financial reporting during SmartFinancial's fiscal quarter ended December 31, 2018 that have materially affected, or are reasonably likely to materially affect, SmartFinancial's internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The response to this Item is incorporated by reference to SmartFinancial's proxy statement for the annual meeting of stockholders to be held May 2, 2019 under the headings "Proposal One Election of Directors," "Security Ownership of Certain Beneficial Owners and Management," "Corporate Governance and Board of Directors," "Compensation of Directors and Executive Officers," and "Section 16(a) Beneficial Ownership Reporting Compliance."

ITEM 11. EXECUTIVE COMPENSATION

The response to this Item is incorporated by reference to SmartFinancial's proxy statement for the annual meeting of stockholders to be held May 2, 2019 under the headings, "Proposal One Election of the Directors" and "Compensation of Directors and Executive Officers."

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The responses to this Item will be included in SmartFinancial's proxy statement for the annual meeting of stockholders to be held May 2, 2019 under the heading, "Security Ownership of Certain Beneficial Owners and Management."

The following table summarizes information concerning SmartFinancial's equity compensation plans at December 31, 2018:

Plan category	Number of securities to be issued upon exercise of outstanding options	Weighted average exercise price of outstanding options	Number of securities remaining available for future issuance
Equity compensation plans approved by security holders:			
2002 Long-Term Incentive Plan	56,042	\$ 8.29	—
SmartFinancial 2010 Incentive Plan	—	11.67	519,750
2015 Stock Incentive Plan	40,234	15.05	1,959,305
Capstone Stock Option Plan	13,599	11.76	—
Equity compensation plans not approved by shareholders	60,750	9.55	—
Total	170,625	\$ 10.61	2,479,055

Equity Compensation Plans not Approved by Shareholders

During 2013 and 2014, Cornerstone issued non-qualified options to employees and directors. These non-qualified options are governed by the grant document issued to the holders. The non-qualified stock options for employees were issued at the market value of the common stock on the grant date and vest 30% on the second anniversary of the grant date, 60% on the third anniversary of the grant date and 100% on the fourth anniversary of the grant date. The non-qualified stock options for directors are issued at the market value of the common stock on the grant date and vest 50% on the first anniversary of the grant date and 100% on the second anniversary of the grant date. The term of all grants were determined by the compensation committee, not to exceed ten years. As of December 31, 2018, a total of 128,500 non-qualified stock options had been issued to Company employees and directors, of which 60,750 remained outstanding and exercisable.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The response to this Item is incorporated by reference to SmartFinancial's proxy statement for the annual meeting of stockholders to be held May 2, 2019 under the heading, "Proposal One Election of Directors."

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The response to this Item is incorporated by reference to SmartFinancial's proxy statement for the annual meeting of stockholders to be held May 2, 2019 under the heading, "Proposal Three Ratification of Independent Registered Public Accountants."

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

The following documents are filed as part of this report:

- (1) Financial Statements

The following report and consolidated financial statements of SmartFinancial and Subsidiary are included in Item 8:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2018 and 2017

Consolidated Statements of Income for the years ended December 31, 2018 and 2017

Consolidated Statements of Comprehensive Income for the years ended December 31, 2018 and 2017

Consolidated Statements of Changes in Stockholders' Equity for the years ended December 31, 2018 and 2017

Consolidated Statements of Cash Flows for the years ended December 31, 2018 and 2017

Notes to Consolidated Financial Statements

- (2) Financial Statement Schedules:

Schedule II: Valuation and Qualifying Accounts

All other schedules for which provision is made in the applicable accounting regulation of the Securities and Exchange Commission are not required under the related instructions or are inapplicable and therefore have been omitted.

- (3) The following documents are filed, furnished or incorporated by reference as exhibits to this report:

Exhibit Index

<u>Exhibit No.</u>	<u>Description</u>	<u>Location</u>
2.1	Agreement and Plan of Merger, dated as of May 22, 2017, by and among SmartFinancial, Inc., SmartBank, Capstone Bancshares, Inc. and Capstone Bank†	Incorporated by reference to Exhibit 2.1 to Form 8-K filed November 7, 2017
2.2	Agreement and Plan of Merger, dated as of December 12, 2017, by and among SmartFinancial, Inc., Tennessee Bancshares, Inc., and Southern Community Bank†	Incorporated by reference to Exhibit 2.1 to Form 8-K filed December 13, 2017
2.3	Agreement and Plan of Merger, dated as of June 27, 2018, by and among SmartFinancial, Inc., Foothills Bancorp, Inc., and Foothills Bank & Trust†	Incorporated by reference to Exhibit 2.1 to Form 8-K filed June 27, 2018
3.1	Second Amended and Restated Charter of SmartFinancial, Inc.	Incorporated by reference to Exhibit 3.3 to Form 8-K filed September 2, 2015
3.2	Second Amended and Restated Bylaws of SmartFinancial, Inc.	Incorporated by reference to Exhibit 3.1 to Form 8-K filed October 26, 2015
4.1	The right of securities holders are defined in the Charter and Bylaws provided in exhibits 3.1 and 3.2	

4.2	Specimen Common Stock Certificate	Incorporated by reference to Exhibit 4.2 to Form 10-K filed March 30, 2016
4.3	Form of Fixed-to-Floating Rate Subordinated Note due October 2, 2028	Incorporated by reference to Exhibit 4.1 to Form 8-K filed October 1, 2018
10.1**	SmartFinancial, Inc. 2015 Stock Incentive Plan	Incorporated by reference to Exhibit H to the Form S-4 filed April 16, 2015
10.2**	Form of 2015 Stock Incentive Agreement	Incorporated by reference to Exhibit 10.2 to Form 10-K filed March 30, 2016
10.3**	SmartFinancial, Inc. 2010 Incentive Plan	Incorporated by reference to Exhibit 10.6 to Form 8-K filed September 2, 2015
10.4**	Form of Incentive Stock Option Certificate under SmartFinancial, Inc. 2010 Incentive Plan	Incorporated by reference to Exhibit 10.7 to Form 8-K filed September 2, 2015
10.5**	SmartBank Stock Option Plan	Incorporated by reference to Exhibit 10.5 to Form 8-K filed September 2, 2015
10.6**	Form of Management Incentive Stock Option Agreement under SmartBank Stock Option Plan	Incorporated by reference to Exhibit 10.8 to Form 8-K filed September 2, 2015
10.7**	Employment Agreement, dated as of February 1, 2015, by and among William Y. Carroll, Jr., SmartFinancial, Inc. and SmartBank	Incorporated by reference to Exhibit 10.2 to Form 8-K filed September 2, 2015
10.8**	Employment Agreement, dated as of February 1, 2015, by and among William Y. Carroll, Sr., SmartFinancial, Inc. and SmartBank	Incorporated by reference to Exhibit 10.3 to Form 8-K filed September 2, 2015
10.9**	Employment Agreement, dated as of April 15, 2015, by and among C. Bryan Johnson, SmartFinancial, Inc. and SmartBank	Incorporated by reference to Exhibit 10.4 to Form 8-K filed September 2, 2015
10.10**	Employment Agreement with Gary W. Petty, Jr. dated as of December 5, 2014, by and between Cornerstone Bancshares, Inc., Cornerstone Community Bank, and Gary W. Petty, Jr.	Incorporated by reference to Exhibit 10.3 to Form 8-K filed December 10, 2014
10.11**	First Amendment to Employment Agreement by and among Gary W. Petty, Jr., SmartFinancial, Inc. and Cornerstone Community Bank dated December 8, 2015	Incorporated by reference to Exhibit 10.2 to Form 8-K filed December 9, 2015
10.12	Form of Subscription Agreement for 2015 Equity Financing	Incorporated by reference to Exhibit 10.1 to Form 8-K filed August 20, 2015
10.13	Form of Registration Rights Agreement for 2015 Equity Financing	Incorporated by reference to Exhibit 10.2 to Form 8-K filed August 20, 2015

10.14**	Employment Agreement with Nathaniel F. Hughes, dated as of December 5, 2014, by and between Cornerstone Bancshares, Inc. and Nathaniel F. Hughes	Incorporated by reference to Exhibit 10.2 to Form 8-K filed December 10, 2014
10.15**	Cornerstone Bancshares, Inc. 2002 Long-Term Incentive Plan	Incorporated by reference to Exhibit 99.1 to Form S-8 filed on March 5, 2004
10.16**	Form of Unqualified Stock Option Award Agreement under 2002 Long-Term Incentive Plan	Incorporated by reference to Exhibit 10.22 to Form 10-K filed March 30, 2016
10.17**	Form of Stock Appreciation Rights Agreement	Incorporated by reference to Exhibit 10.1 to Form 8-K filed August 8, 2017
10.18**	Form of Restricted Stock Award Agreement	Incorporated by reference to Exhibit 10.2 to Form 8-K filed August 8, 2017
10.19**	Employment Agreement, dated as of February 1, 2015, by and among Rhett Jordan, SmartFinancial, Inc. and SmartBank	Incorporated by Reference to Exhibit 10.21 to Form 10-K filed March 16, 2018
10.20**	Employment Agreement, dated as of February 1, 2015, by and among Greg L. Davis and SmartBank	Incorporated by Reference to Exhibit 10.21 to Form 10-K filed March 16, 2018
10.21**	Employment Agreement, dated as of May 22, 2017, by and between SmartBank and Robert Kuhn	Incorporated by reference to Exhibit 10.1 to Form 10-Q filed November 7, 2017
10.22*	Capstone Bancshares, Inc. 2008 Long-Term Equity Incentive Plan	Incorporated by reference to Exhibit 10.2 to Form 10-Q filed November 7, 2017
10.23*	Form of Award Agreement under Capstone Bancshares, Inc. 2008 Long-Term Incentive Plan	Incorporated by reference to Exhibit 10.3 to Form 8-K filed November 7, 2017
10.24*	Salary Continuation Agreement, dated August 11, 2010, by and between Capstone Bank and Robert W. Kuhn	Incorporated by reference to Exhibit 10.4 to Form 8-K filed November 7, 2017
10.25	Loan Agreement, dated as of October 31, 2017, by and between SmartFinancial, Inc. and CapStar Bank	Incorporated by reference to Exhibit 2.2 to Form 10-Q filed November, 14, 2017
10.26	Stock Pledge and Security Agreement, dated as of October 31, 2017, by and between SmartFinancial, Inc. and CapStar Bank	Incorporated by reference to Exhibit 2.3 to Form 10-Q filed November, 14, 2017

Line of Credit Note, dated as of October 31, 2017, executed by SmartFinancial, Inc. in favor of CapStar Bank

Incorporated by reference to Exhibit 2.4 to Form 10-Q filed November, 14, 2017

[10.27](#)

Form of Subordinated Note Purchase Agreement dated September 28, 2018, for SmartFinancial, Inc. Fixed-to-Floating Rate Subordinate Notes due October 2, 2028

Incorporated by reference to Exhibit 10.1 to Form 8-K filed October 1, 2018

[10.28](#)

16.1	Letter to the Securities and Exchange Commission from Mauldin & Jenkins, LLC	Incorporated by reference to Exhibit 16.1 to Form 8-K filed March 27, 2018
21.1	SmartFinancial, Inc. List of Subsidiaries	Filed herewith
23.1	Consent of Dixon Hughes Goodman LLP	Filed herewith
23.2	Consent of Mauldin & Jenkins, LLC	Filed herewith
31.1	Certification of Principal Executive Officer	Filed herewith
31.2	Certification of Principal Financial Officer	Filed herewith
32.0	Section 906 certifications of Principal Executive Officer and Principal Financial Officer	Filed herewith
101.INS*	XBRL Instance Document	Filed herewith
101.SCH*	XBRL Taxonomy Extension Schema	Filed herewith
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase	Filed herewith
101.DEF*	XBRL Taxonomy Extension Definition Linkbase	Filed herewith
101.LAB*	XBRL Taxonomy Extension Label Linkbase	Filed herewith
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase	Filed herewith

† Schedules and exhibits to which have been omitted pursuant to Items 601(b)(2) of Regulations S-K. SmartFinancial agrees to furnish supplementally a copy of any omitted schedule to the Securities and Exchange Commission.

* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, or Section 18 of the Securities and Exchange Act of 1934, as amended and otherwise are not subject to liability under those sections.

** Indicates management contract or compensatory plan or arrangement

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

SMARTFINANCIAL, INC.

Date: March 18, 2019 By: /s/ William Y. Carroll, Jr.
William Y. Carroll, Jr.
President and Chief Executive Officer and Director
(principal executive officer)

By: /s/ C. Bryan Johnson
C. Bryan Johnson
Executive Vice President and Chief Financial Officer
(principal financial officer and accounting officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
<u>/s/ William Y. Carroll, Jr.</u> William Y. Carroll, Jr. (Principal Executive Officer)	President and Chief Executive Officer and Director	March 18, 2019
<u>/s/ C. Bryan Johnson</u> C. Bryan Johnson (Principal Financial Officer and Principal Accounting Officer)	Executive Vice President and Chief Financial Officer	March 18, 2019
<u>/s/ Victor L. Barrett</u> Victor L. Barrett	Director	March 18, 2019
<u>/s/ Monique P. Berke</u> Monique P. Berke	Director	March 18, 2019
<u>/s/ William Y. Carroll, Sr.</u> William Y. Carroll, Sr.	Director	March 18, 2019
<u>/s/ Frank S. McDonald</u> Frank S. McDonald	Director	March 16, 2018
<u>/s/ Ted C. Miller</u> Ted C. Miller	Director	March 18, 2019
<u>/s/ David A. Ogle</u> David A. Ogle	Director	March 18, 2019

<u>/s/ Doyce Payne</u> Doyce Payne	Director	March 18, 2019
<u>/s/ Miller Welborn</u> Miller Welborn	Director	March 18, 2019
<u>/s/ Keith E. Whaley</u> Keith E. Whaley	Director	March 18, 2019
<u>/s/ Geoffrey A. Wolpert</u> Geoffrey A. Wolpert	Director	March 18, 2019
<u>/s/ Steven B. Tucker</u> Steven B. Tucker	Director	March 18, 2019
<u>/s/ J. Beau Wicks</u> J. Beau Wicks	Director	March 18, 2019
<u>/s/ Clifton Miller</u> Clifton Miller	Director	March 18, 2019

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Section 2: EX-21.1 (EXHIBIT 21.1)

EXHIBIT 21.1

SMARTFINANCIAL, INC.

LIST OF SUBSIDIARIES

<u>Name of Subsidiary</u>	<u>State of Incorporation</u>
SmartBank	Tennessee
Smart Investment Management	Tennessee
Smartholdings I, LLC	Tennessee
Smartholdings II, LLC	Tennessee
CT Merger Sub	North Carolina

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Section 3: EX-23.1 (EXHIBIT 23.1)

Exhibit 23.1

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors
SmartFinancial, Inc.:

We consent to the incorporation by reference in the registration statements on Form S-8 (Nos. 333-219159, 333-203449, 333-208819, 333-131006, and 333-113314) and Form S-3 (Nos. 333-214802, 333-208700) of SmartFinancial, Inc., of our reports dated March 18, 2019, with respect to the 2018 consolidated financial statements of SmartFinancial, Inc. and Subsidiary and the effectiveness of internal control over financial reporting, which reports appear in SmartFinancial, Inc.'s 2018 Annual Report on Form 10-K.

/s/ Dixon Hughes Goodman LLP

Atlanta, Georgia
March 18, 2019

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Section 4: EX-23.2 (EXHIBIT 23.2)

Exhibit 23.1

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors
SmartFinancial, Inc.:

We consent to the incorporation by reference in the registration statements on Form S-8 (Nos. 333-219159, 333-203449, 333-208819, 333-131006, and 333-113314) and Form S-3 (Nos. 333-214802, 333-208700) of SmartFinancial, Inc., of our reports dated March 16, 2018, with respect to the 2017 consolidated financial statements of SmartFinancial, Inc. and Subsidiary and the effectiveness of internal control over financial reporting, which reports appear in SmartFinancial, Inc.'s 2018 Annual Report on Form 10-K.

/s/ Mauldin & Jenkins, LLC
Chattanooga, Tennessee
March 18, 2019

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Section 5: EX-31.1 (EXHIBIT 31.1)

EXHIBIT 31.1

CERTIFICATIONS

I, William Y. (Billy) Carroll, Jr., certify that:

1. I have reviewed this report on Form 10-K of SmartFinancial, Inc. (the “Issuer”) for the fiscal year ended December 31, 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 Issuer as of, and for, the periods presented in this period report.
4. The Issuer’s other certifying officers 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 internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the Issuer 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 Issuer, including its consolidated subsidiary, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) designed such internal controls over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) evaluated the effectiveness of the Issuer’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
 - (d) disclosed in this report any change in the Issuer’s internal control over financial reporting that occurred during the Issuer’s fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Issuer’s internal control over financial reporting.
5. The Issuer’s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Issuer’s auditors and the audit committee of Issuer’s board of directors:
 - (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 Issuer’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 Issuer’s internal control over financial reporting.

Date: March 18, 2019

/s/ William Y. Carroll, Jr.

William Y. Carroll, Jr., President and Chief Executive Officer
and Director
(principal executive officer)

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Section 6: EX-31.2 (EXHIBIT 31.2)

EXHIBIT 31.2

CERTIFICATIONS

I, C. Bryan Johnson, certify that:

1. I have reviewed this report on Form 10-K of SmartFinancial, Inc. (the “Issuer”) for the fiscal year ended December 31, 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 Issuer as of, and for, the periods presented in this period report.

4. The Issuer's other certifying officers 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 internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the Issuer 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 Issuer, including its consolidated subsidiary, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) designed such internal controls over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) evaluated the effectiveness of the Issuer'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

(d) disclosed in this report any change in the Issuer's internal control over financial reporting that occurred during the Issuer's fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Issuer's internal control over financial reporting.

5. The Issuer's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Issuer's auditors and the audit committee of Issuer's board of directors:

(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 Issuer'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 Issuer's internal control over financial reporting.

Date: March 18, 2019

/s/ C. Bryan Johnson

C. Bryan Johnson, Executive Vice President and
Chief Financial Officer

(principal financial officer and accounting officer)

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Section 7: EX-32 (EXHIBIT 32)

EXHIBIT 32

CERTIFICATIONS OF CEO AND CFO PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT

CERTIFICATIONS PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002 (18 U.S.C. SECTION 1350)

In connection with the Annual Report of SmartFinancial, Inc., a Tennessee corporation (the "Company"), on Form 10-K for the fiscal year ended December 31, 2018, as filed with the Securities and Exchange Commission (the "Report"), each of William Y. Carroll, Jr., President & Chief Executive Officer of the Company, and C. Bryan Johnson, Executive Vice President and Chief Financial Officer of the Company, do hereby certify, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to his knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/ s/ William Y. Carroll, Jr.

William Y. Carroll, Jr.

President & Chief Executive Officer & Director
(principal executive officer)

Date: March 18, 2019

/ s/ C. Bryan Johnson

C. Bryan Johnson

Executive Vice President and Chief Financial Officer
(principal financial officer and accounting officer)

Date: March 18, 2019

[A signed original of this written statement required by Section 906 has been provided to SmartFinancial, Inc. and will be retained by SmartFinancial, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.]

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