

Section 1: 10-Q (10-Q)

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United States Securities and Exchange Commission
Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2020

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

For the transition period from _____ to _____

Commission File Number: **001-37661**



SmartFinancial, Inc.

(Exact name of registrant as specified in its charter)

Tennessee

(State or other jurisdiction of incorporation or organization)

5401 Kingston Pike, Suite 600 Knoxville, Tennessee

(Address of principal executive offices)

865-437-5700

(Registrant's telephone number, including area code)

62-1173944

(I.R.S. Employer Identification No.)

37919

(Zip Code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Trading symbol(s)	Name of Exchange on which Registered
Common Stock, par value \$1.00	SMBK	The Nasdaq Stock Market

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such period that the registrant was required to submit such files).

Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company Emerging growth company

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of November 06, 2020, there were 15,235,227 shares of common stock, \$1.00 par value per share, issued and outstanding.

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PART I – FINANCIAL INFORMATION
ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

SMARTFINANCIAL, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except for share data)

	(Unaudited) September 30, 2020	
ASSETS:		
Cash and due from banks	\$	63,884
Interest-bearing deposits with banks		411,625
Federal funds sold		66,306
Total cash and cash equivalents		541,815
Securities available-for-sale, at fair value		214,634
Other investments		14,829
Loans held for sale		11,292
Loans		2,404,057
Less: Allowance for loan losses		(18,817)
Loans, net		2,385,240
Premises and equipment, net		73,934
Other real estate owned		3,932
Goodwill and core deposit intangible, net		86,710
Bank owned life insurance		31,034
Other assets		24,168
Total assets	\$	<u>3,387,588</u>
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Deposits:		
Noninterest-bearing demand	\$	669,733
Interest-bearing demand		534,128
Money market and savings		871,098
Time deposits		577,064
Total deposits		2,652,023
Borrowings		319,391
Subordinated debt		39,325
Other liabilities		27,060
Total liabilities		3,037,799
Shareholders' equity:		
Preferred stock, \$1 par value; 2,000,000 shares authorized; No shares issued and outstanding		—
Common stock, \$1 par value; 40,000,000 shares authorized; 15,233,227 and 14,008,233 shares issued and outstanding, respectively		15,233
Additional paid-in capital		254,626
Retained earnings		78,918
Accumulated other comprehensive income		1,012
Total shareholders' equity		349,789
Total liabilities and shareholders' equity	\$	<u>3,387,588</u>

The accompanying notes are an integral part of the financial statements.

SMARTFINANCIAL, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)
(Dollars in thousands, except share and per share data)

	Three Months Ended		Nine Month
	2020	September 30, 2019	2020
Interest income:			
Loans, including fees	\$ 28,621	\$ 25,515	\$ 83,718
Securities available-for-sale:			
Taxable	546	748	1,813
Tax-exempt	364	338	1,064
Federal funds sold and other earning assets	327	743	1,206
Total interest income	<u>29,858</u>	<u>27,344</u>	<u>87,801</u>
Interest expense:			
Deposits	2,897	5,605	11,016
Borrowings	334	15	674
Subordinated debt	584	584	1,751
Total interest expense	<u>3,815</u>	<u>6,204</u>	<u>13,441</u>
Net interest income	<u>26,043</u>	<u>21,140</u>	<u>74,360</u>
Provision for loan losses	2,634	724	8,683
Net interest income after provision for loan losses	<u>23,409</u>	<u>20,416</u>	<u>65,677</u>
Noninterest income:			
Service charges on deposit accounts	892	767	2,370
Gain (loss) on sale of securities	(9)	1	6
Mortgage banking	1,029	518	2,544
Investment services	359	260	1,159
Insurance commissions	560	—	1,302
Interchange and debit card transaction fees	868	148	1,652
Merger termination fee	—	—	—
Other	422	502	1,417
Total noninterest income	<u>4,121</u>	<u>2,196</u>	<u>10,450</u>
Noninterest expense:			
Salaries and employee benefits	11,032	9,072	31,395
Occupancy and equipment	2,186	1,635	6,093
FDIC insurance	534	(219)	894
Other real estate and loan related expense	643	335	1,535
Advertising and marketing	253	263	653
Data processing	558	273	1,689
Professional services	594	573	2,172
Amortization of intangibles	402	341	1,169
Software as service contracts	573	560	1,604
Merger related and restructuring expenses	290	73	3,863
Other	2,102	1,802	5,699
Total noninterest expense	<u>19,167</u>	<u>14,708</u>	<u>56,766</u>
Income before income tax expense	<u>8,363</u>	<u>7,904</u>	<u>19,361</u>
Income tax expense	1,968	1,941	4,059
Net income	<u>\$ 6,395</u>	<u>\$ 5,963</u>	<u>\$ 15,302</u>
Earnings per common share:			
Basic	<u>\$ 0.42</u>	<u>\$ 0.43</u>	<u>\$ 1.03</u>
Diluted	<u>0.42</u>	<u>0.42</u>	<u>1.02</u>
Weighted average common shares outstanding:			
Basic	15,160,579	13,955,859	14,903,757
Diluted	15,210,611	14,053,432	14,965,455

The accompanying notes are an integral part of the financial statements.

SMARTFINANCIAL, INC. AND SUBSIDIARY
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
 (Unaudited)
 (Dollars in thousands)

	Three Months Ended		20
	September 30,		
	2020	2019	
Net income	\$ 6,395	\$ 5,963	\$
Other comprehensive income:			
Unrealized holding gains (losses) and hedge effects on securities available-for-sale arising during the period	77	(2,078)	
Tax effect	(142)	543	
Reclassification adjustment for realized gains (losses) included in net income	(9)	1	
Tax effect	2	—	
Unrealized gains (losses) on securities available-for-sale arising during the period, net of tax	(72)	(1,534)	
Unrealized gains (losses) on fair value municipal security hedges	538	2,451	
Tax effect	(46)	(643)	
Unrealized gains (losses) on fair value municipal security hedge instruments arising during the period, net of tax	492	1,808	
Total other comprehensive income	420	274	
Comprehensive income	<u>\$ 6,815</u>	<u>\$ 6,237</u>	<u>\$</u>

The accompanying notes are an integral part of the financial statements.



SMARTFINANCIAL, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY - (Unaudited)
For the Three and Nine Months Ended September 30, 2020 and 2019
(Dollars in thousands, except for share data)

	Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive (Loss) Income
	Shares	Amount			
Balance, December 31, 2018	13,933,504	\$ 13,933	\$ 231,852	\$ 39,991	\$ (2,765)
Net income	—	—	—	19,815	—
Other comprehensive gain	—	—	—	—	2,468
Common stock issued pursuant to:					
Stock awards	3,298	3	61	—	—
Exercise of stock options	21,171	22	228	—	—
Stock compensation expense	—	—	432	—	—
Balance, September 30, 2019	<u>13,957,973</u>	<u>\$ 13,958</u>	<u>\$ 232,573</u>	<u>\$ 59,806</u>	<u>\$ (297)</u>
Balance, December 31, 2019	14,008,233	\$ 14,008	\$ 232,732	\$ 65,839	\$ 168
Net income	—	—	—	15,302	—
Other comprehensive gain	—	—	—	—	844
Common stock issued pursuant to:					
Exercise of stock options	27,858	28	254	—	—
Restricted stock, net of forfeitures	36,113	36	(36)	—	—
Shareholders of Progressive Financial Group, Inc.	1,292,578	1,293	23,254	—	—
Stock compensation expense	—	—	365	—	—
Common stock dividend (\$0.15 per share)	—	—	—	(2,223)	—
Repurchase of common stock	(131,555)	(132)	(1,943)	—	—
Balance, September 30, 2020	<u>15,233,227</u>	<u>\$ 15,233</u>	<u>\$ 254,626</u>	<u>\$ 78,918</u>	<u>\$ 1,012</u>
Balance, June 30, 2019	13,953,209	\$ 13,953	\$ 232,386	\$ 53,843	\$ (571)
Net income	—	—	—	5,963	—
Other comprehensive gain	—	—	—	—	274
Common stock issued pursuant to:					
Exercise of stock options	4,764	5	33	—	—
Restricted stock	—	—	—	—	—
Stock compensation expense	—	—	154	—	—
Balance, September 30, 2019	<u>13,957,973</u>	<u>\$ 13,958</u>	<u>\$ 232,573</u>	<u>\$ 59,806</u>	<u>\$ (297)</u>
Balance, June 30, 2020	15,216,932	\$ 15,217	\$ 254,396	\$ 73,283	\$ 592
Net income	—	—	—	6,395	—
Other comprehensive gain	—	—	—	—	420
Common stock issued pursuant to:					
Exercise of stock options	12,500	12	92	—	—
Restricted stock	3,795	4	(4)	—	—
Stock compensation expense	—	—	142	—	—
Common stock dividends (\$0.05 per share)	—	—	—	(760)	—
Repurchase of common stock	—	—	—	—	—
Balance, September 30, 2020	<u>15,233,227</u>	<u>\$ 15,233</u>	<u>\$ 254,626</u>	<u>\$ 78,918</u>	<u>\$ 1,012</u>

The accompanying notes are an integral part of the financial statements.

SMARTFINANCIAL, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(Dollars in thousands)

	Nine Months Ended Sept	
	2020	
	\$	\$
Cash flows from operating activities:		
Net income	15,302	
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,437	
Accretion of fair value purchase accounting adjustments, net	(3,689)	
Provision for loan losses	8,683	
Stock compensation expense	365	
Gain from redemption and sale of securities available-for-sale	(6)	
Deferred income tax expense	(37)	
Increase in cash surrender value of bank owned life insurance	(526)	
Loss on disposal of fixed assets	—	
Net (gains) losses from sale of other real estate owned	142	
Net gains from sale of loans	(2,544)	
Origination of loans held for sale	(99,223)	
Proceeds from sales of loans held for sale	96,330	
Net change in:		
Accrued interest receivable	(3,221)	
Accrued interest payable	807	
Other assets	1,850	
Other liabilities	3,556	
Net cash provided by operating activities	22,226	
Cash flows from investing activities:		
Proceeds from sales of securities available-for-sale	11,759	
Proceeds from maturities and calls of securities available-for-sale	45,800	
Proceeds from paydowns of securities available-for-sale	18,622	
Purchases of securities available-for-sale	(81,893)	
Purchases of other investments	(1,223)	
Net increase in loans	(316,075)	
Purchases of premises and equipment	(4,450)	
Proceeds from sale of other real estate owned	875	
Net cash and cash equivalents received from business combination	46,132	
Net cash used in investing activities	(280,453)	
Cash flows from financing activities:		
Net increase in deposits	332,319	
Net increase (decrease) in securities sold under agreements to repurchase	9	
Proceeds from borrowings	338,340	
Repayment borrowings	(50,581)	
Cash dividends paid	(2,223)	
Issuance of common stock	282	
Purchase of common stock	(2,075)	
Net cash provided by financing activities	616,071	
Net change in cash and cash equivalents	357,844	
Cash and cash equivalents, beginning of period	183,971	
Cash and cash equivalents, end of period	\$ 541,815	\$
Supplemental disclosures of cash flow information:		
Cash paid during the period for interest	12,633	
Cash paid during the period for income taxes	5,778	
Noncash investing and financing activities:		
Acquisition of real estate through foreclosure	971	
Change in goodwill due to acquisitions	9,316	
Initial recognition of operating lease right-of-use assets	484	
Initial recognition of operating lease liabilities	484	

The accompanying notes are an integral part of the financial statements.

SMARTFINANCIAL, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 1. Presentation of Financial Information

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 East and Middle Tennessee, Alabama, and the Florida Panhandle. The Bank's primary deposit products are noninterest-bearing and 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 accounting and financial reporting policies of the Company and its wholly-owned subsidiary conform to U.S. generally accepted accounting principles ("GAAP") and reporting guidelines of banking regulatory authorities and regulators. The accompanying interim consolidated financial statements for the Company and its wholly-owned subsidiary have not been audited. All material intercompany balances and transactions have been eliminated.

In management's opinion, all accounting adjustments necessary to accurately reflect the financial position and results of operations on the accompanying financial statements have been made. These adjustments are normal and recurring accruals considered necessary for a fair and accurate presentation. 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 the fair value of assets acquired and liabilities assumed in acquisitions. The results for interim periods are not necessarily indicative of results for the full year or any other interim periods. The accompanying unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes appearing in the Company's annual report on Form 10-K for the year ended December 31, 2019.

Recently Issued and Adopted Accounting Pronouncements:

As of January 1, 2020, the Company adopted ASU 2019-01, *Leases: Codification Improvements* ("ASU 2019-01"). ASU 2019-01 provides clarification to increase transparency and comparability among organizations by recognizing lease assets and liabilities on the balance sheet and disclosing essential information about leasing transactions. Specifically, ASU 2019-01 (i) allows the fair value of the underlying asset reported by lessors that are not manufacturers or dealers to continue to be its cost and not fair value as measured under the fair value definition, (ii) allows for the cash flows received for sales-type and direct financing leases to continue to be presented as results from investing, and (iii) clarifies that entities do not have to disclose the effect of the lease standard on adoption year interim amounts. The adoption of ASU 2019-01 did not have a material impact on the Company's consolidated financial statements.

Recently Issued Not Yet Effective Accounting Pronouncements:

During interim periods, the Company follows the accounting policies set forth in its annual audited financial statements for the year ended December 31, 2019 as filed in its Annual Report on Form 10-K with the Securities and Exchange Commission ("SEC"). The following is a summary of recent authoritative pronouncements issued but not yet effective that could impact the accounting, reporting, and/or disclosure of financial information by the Company.

In October 2019, the Financial Accounting Standards Board approved a delay for the implementation of ASU 2016-13, *Financial Instruments - Credit Losses* (Topic 326). The Board decided that CECL will be effective for larger Public Business Entities ("PBEs") that are SEC filers, excluding Smaller Reporting Companies ("SRCs") as currently defined by the SEC, for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. For calendar-year-end companies, this will be January 1, 2020. The determination of whether an entity is an SRC will be based on an entity's most recent assessment in accordance with SEC regulations and the Company meets the regulations as an SRC.



SMARTFINANCIAL, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

For all other entities, the Board decided that CECL will be effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For all entities, early adoption will continue to be permitted; that is, early adoption is allowed for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years (that is, effective January 1, 2019, for calendar-year-end companies). The Company does not plan to adopt this standard early and being that the Company is an SRC, adoption is required for fiscal years beginning after December 15, 2022.

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*. The amendments in this update simplify various aspects of the current guidance to promote consistent application of the standard among reporting entities by moving certain exceptions to the general principles. The amendments are effective for fiscal years beginning after December 15, 2020, with early adoption permitted. The Company does not plan to adopt this standard early and adoption should not have a material impact on the Company's consolidated financial statements.

In March 2020, the FASB issued ASU 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting*, which provides temporary optional guidance to ease the potential burden in accounting for reference rate reform. The ASU provides optional expedients and exceptions for applying generally accepted accounting principles to contract modifications and hedging relationships, subject to meeting certain criteria, that reference London Interbank Offered Rate ("LIBOR"). It is intended to help stakeholders during the global market-wide reference rate transition period. The guidance is effective for all entities as of March 12, 2020 through December 31, 2022. The Company is implementing a transition plan to identify and modify its loans and other financial instruments, including certain indebtedness, with attributes that are either directly or indirectly influenced by LIBOR. The Company is assessing ASU 2020-04 and its impact on the transition away from LIBOR for its loan and other financial instruments.

In August 2020, the SEC issued amendments to its disclosure rules to modernize the requirements in Regulation S-K, Item 101 on description of a business, Item 103 on legal proceedings, and Item 105 on risk factors. These amendments are intended to improve the readability of disclosures, reduce repetition, and eliminate immaterial information, thereby simplifying compliance for registrants and making disclosures more meaningful for investors. The amendments to the disclosure requirements related to a registrant's description of its business and risk factors are intended to expand the use of a principles-based approach that gives registrants more flexibility to tailor disclosures. The amendments to the disclosure requirements related to legal proceedings continue to reflect the current, more prescriptive approach because those requirements depend less on a registrant's specific characteristics. Further, additional human capital disclosures are required as part of the amendments to the description of the business. The final rule is effective on November 9, 2020, and the Company will incorporate these changes as part of our annual filing on Form 10-K.

Operating, Accounting and Reporting Considerations related to COVID-19:

The COVID-19 pandemic has negatively impacted the global economy. In response to this crisis, the Coronavirus Aid, Relief, and Economic Security ("CARES") Act was passed by Congress and signed into law on March 27, 2020. The CARES Act provides an estimated \$2.2 trillion to fight the COVID-19 pandemic and stimulate the economy by supporting individuals and businesses through loans, grants, tax changes, and other types of relief. Some of the provisions applicable to the Company include, but are not limited to:

- *Accounting for Loan Modifications* – Section 4013 of the CARES Act provides that a financial institution may elect to suspend (1) the requirements under GAAP for certain loan modifications otherwise be categorized as a TDR and (2) any determination that such loan modifications would be considered a TDR, including the related impairment for accounting purposes. See *Allowance for Loan Losses* for more information.
- *Paycheck Protection Program* - The CARES Act established the Paycheck Protection Program ("PPP"), an expansion of the Small Business Administration's ("SBA") 7(a) loan program for businesses.



SMARTFINANCIAL, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Loan Program ("EIDL"), administered directly by the SBA. The Company is a participant in the PPP. See Note 5 *Loans and Allowance for Loan Losses* for more information.

- *Mortgage Forbearance* - Under the CARES Act, through the earlier of December 31, 2020, or the termination date of the COVID-19 national emergency, a borrower with a federally backed experiencing financial hardship due to COVID-19 may request a forbearance. A multifamily borrower with a federally backed multifamily mortgage loan that was current as of February 29, 2020, and experiencing financial hardship due to COVID-19 may request forbearance on the loan for up to 30 days, with up to two additional 30-day periods at the borrower's request.

Also in response to the COVID-19 pandemic, the Board of Governors of the Federal Reserve System ("FRB"), the Federal Deposit Insurance Corporation ("FDIC"), the National Credit Union Administration ("NCUA"), the Office of the Comptroller of the Currency ("OCC"), and the Consumer Financial Protection Bureau ("CFPB"), in consultation with the state financial regulators (collectively, the "agencies") issued a joint interagency statement (issued March 22, 2020; revised statement issued April 7, 2020). Some of the provisions applicable to the Company include, but are not limited to:

- *Accounting for Loan Modifications* - Loan modifications that do not meet the conditions of the CARES Act may still qualify as a modification that does not need to be accounted for as a TDR. This includes modifications such as payment deferrals, fee waivers, extensions of repayment terms, or insignificant delays in payment. See Note 5 *Loans and Allowance for Loan Losses* for more information.
- *Past Due Reporting* - With regard to loans not otherwise reportable as past due, financial institutions are not expected to designate loans with deferrals granted due to COVID-19 as past due. A loan's payment date is governed by the due date stipulated in the legal agreement. If a financial institution agrees to a payment deferral, these loans would not be considered past due during the deferral.
- *Nonaccrual Status and Charge-offs* - During short-term COVID-19 modifications, these loans generally should not be reported as nonaccrual or as classified.

The Company began offering short-term loan modifications to assist borrowers during the COVID-19 national emergency. The Company offered deferral options of: 1) three months deferral of payment and then three months of interest only, 2) three months of interest only, 3) three months deferral of payment, 4) six months of interest only. These modifications generally meet the criteria of both Section 4013 of the CARES Act and the joint interagency statement, and therefore, the Company does not account for such loan modifications as TDRs. On August 3, 2020, the Federal Financial Institutions Examination Council on behalf of its members (collectively "the FFIEC members") issued a joint statement on additional loan accommodations related to COVID-19. The joint statement clarifies that for loan modifications in which Section 4013 is being applied, subsequent modifications could also be eligible under Section 4013. To be eligible, each loan modification must be (1) related to the COVID event; (2) executed on a loan that was not more than 30 days past due as of December 31, 2019; and (3) executed between March 1, 2020, and the earlier of (A) 60 days after the date of termination of the National Emergency or (B) December 31, 2020. All of the Company's loan modifications granted under Section 4013 of the CARES Act are in compliance with the aforementioned FFIEC requirements. Accordingly, the Company does not account for such loan modifications as TDRs.

Reclassifications:

Certain captions and amounts in the 2019 consolidated financial statements were reclassified to conform to the 2020 financial statement presentation. These reclassifications had no impact on net income or shareholders' equity as previously reported.



SMARTFINANCIAL, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 2. Business Combinations

Acquisition of Progressive Financial Inc.

On March 1, 2020, the Company completed the merger of Progressive Financial Group, Inc., a Tennessee corporation (“PFG”), pursuant to an Agreement and Plan of Merger dated October 29, 2019 (the “Merger Agreement”).

In connection with the merger, the Company acquired \$301 million of assets and assumed \$272 million of liabilities. Pursuant to the Merger Agreement, each outstanding share of Progressive common stock was converted into and cancelled in exchange to the right to receive \$474.82 in cash, and 62,3808 shares of SmartFinancial common stock. SmartFinancial issued 1,292,578 shares of SmartFinancial common stock and paid \$9.8 million in cash as consideration for the Merger. The fair value of consideration paid exceeded the fair value of the identifiable assets and liabilities acquired and resulted in the establishment of goodwill in the amount of \$9.3 million, representing the intangible value of Progressive’s business and reputation within the markets it served. None of the goodwill recognized is expected to be deductible for income tax purposes. The Company is amortizing the related core deposit intangible of \$1.4 million using the effective yield method over 120 months (10 years), which represents the expected useful life of the asset.

The Company’s operating results for the three and nine month periods ended September 30, 2020, include the operating results of the acquired business for the period subsequent to the merger date of March 1, 2020.

The purchased assets and assumed liabilities were recorded at their acquisition date fair values ⁽¹⁾ and are summarized in the table below (*in thousands*).

	As recorded by PFG	Fair value adjustments ⁽¹⁾	
Assets:			
Cash & cash equivalents	\$ 55,971	\$ —	\$
Investment securities available-for-sale	27,054	203	
Restricted investments	692		
Loans	191,672	(3,691)	
Allowance for loan losses	(2,832)	2,832	
Premises and equipment, net	15,681	(2,919)	
Bank owned life insurance	5,560	—	
Deferred tax asset, net	—	1,173	
Intangibles	—	1,370	
Other real estate owned	3,695	(1,474)	
Interest Receivable	1,061	(280)	
Prepays	375	(174)	
Goodwill	231	(231)	
Other assets	1,881	—	
Total assets acquired	<u>\$ 301,041</u>	<u>\$ (3,191)</u>	<u>\$</u>
Liabilities:			
Deposits	\$ 271,276	\$ —	\$
Time deposit premium	—	729	
Payables and other liabilities	776	—	
Total liabilities assumed	<u>272,052</u>	<u>729</u>	
Excess of assets assumed over liabilities assumed	<u>\$ 28,989</u>		
Aggregate fair value adjustments		<u>\$ (3,920)</u>	
Total identifiable net assets			
Consideration transferred:			
Cash			
Common stock issued (1,292,578 shares)			
Total fair value of consideration transferred			
Goodwill			<u>\$</u>

⁽¹⁾ Fair values are preliminary and are subject to refinement for a period of one year after the closing date of an acquisition as information relative to the closing date fair value becomes available.

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The following table presents additional information related to the purchased credit impaired loans (ASC 310-30) of the acquired loan portfolio at the acquisition date (*in thousands*):

Accounted for pursuant to ASC 310-30:	
Contractually required principal and interest	\$
Non-accretable differences	
Cash flows expected to be collected	
Accretable yield	
Fair value	\$

The following table discloses the impact of the merger with PFG since the acquisition date through the three and nine month periods ended September 30, 2020. The table also presents certain pro-forma information (net interest income and noninterest income ("Revenue") and net income) as if the PFG acquisition had occurred on January 1, 2019. The pro-forma financial information is not necessarily indicative of the results of operations had the acquisitions been effective as of these dates.

Merger-related costs from the PFG acquisition for the three and nine month periods ended September 30, 2020, were \$290 thousand and \$3.9 million, respectively, have been excluded from the pro-forma information presented below. The actual results and pro-forma information were as follows (*in thousands*):

	Three Months Ended September 30,		Nine Month September
	Revenue	Net Income	Revenue
2020:			
Actual PFG results included in statement of income since acquisition date	\$ 3,029	\$ 1,228	\$ 7,189
Supplemental consolidation pro-forma as if PFG had been acquired January 1, 2019	30,163	6,609	87,852
2019:			
Supplemental consolidation pro-forma as if PFG had been acquired January 1, 2019	\$ 27,409	\$ 8,989	\$ 87,464

Note 3. Earnings Per Share

Basic earnings per common share is computed by dividing net income available to common stockholders by the weighted-average number of common shares outstanding. Diluted earnings per common 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



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presented below. There were 114 thousand and 85 thousand antidilutive shares for the three and nine month periods ended September 30, 2020, respectively, and none for the three and nine month periods ended September 30, 2019.

The following is a summary of the basic and diluted earnings per share computation (*dollars in thousands, except per share data*):

	Three Months Ended September 30,		Nine Month September
	2020	2019	2020
Basic earnings per share computation:			
Net income available to common stockholders	\$ 6,395	\$ 5,963	\$ 15,302
Average common shares outstanding – basic	15,160,579	13,955,859	14,903,757
Basic earnings per share	\$ 0.42	\$ 0.43	\$ 1.03
Diluted earnings per share computation:			
Net income available to common stockholders	\$ 6,395	\$ 5,963	\$ 15,302
Average common shares outstanding – basic	15,160,579	13,955,859	14,903,757
Incremental shares from assumed conversions:			
Stock options and restricted stock	50,032	97,573	61,698
Average common shares outstanding - diluted	15,210,611	14,053,432	14,965,455
Diluted earnings per common share	\$ 0.42	\$ 0.42	\$ 1.02

Note 4. Securities

The amortized cost, gross unrealized gains and losses and fair value of securities available-for-sale are summarized as follows (*in thousands*):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
September 30, 2020:				
U.S. Government-sponsored enterprises (GSEs)	\$ 30,311	\$ 49	\$ (150)	\$
Municipal securities	88,864	1,948	(3)	
Other debt securities	17,519	49	(66)	
Mortgage-backed securities (GSEs)	74,424	1,938	(249)	
Total	\$ 211,118	\$ 3,984	\$ (468)	\$
December 31, 2019:				
U.S. Government-sponsored enterprises (GSEs)	\$ 19,015	\$ 41	\$ (56)	\$
Municipal securities	63,792	618	(19)	
Other debt securities	3,481	22	(33)	
Mortgage-backed securities (GSEs)	91,531	382	(426)	
Total	\$ 177,819	\$ 1,063	\$ (534)	\$

At September 30, 2020, and December 31, 2019, securities with a carrying value totaling approximately \$74.9 million and \$92.3 million, respectively, were pledged to secure public funds and securities sold under agreements to repurchase.



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Proceeds from sale of securities available for sale, gross gains and gross losses on sales and redemptions for the three and nine months ended September 30, 2020 and 2019 were as follows (*in thousands*):

	Three Months Ended September 30,		Nine Month Septembe
	2020	2019	2020
Proceeds from sales	\$ 4,884	\$ -	\$ 11,759
Gross gains	\$ 17	\$ -	\$ 43
Gross losses	\$ (26)	\$ -	\$ (37)
Proceeds from redemptions	\$ 30,350	\$ 5,250	\$ 45,800

The amortized cost and estimated fair value of securities at September 30, 2020, by contractual maturity for non-mortgage backed securities are shown below (*in thousands*). Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost
Due in one year or less	\$ 4,623
Due from one year to five years	5,009
Due from five years to ten years	26,195
Due after ten years	100,867
	136,694
Mortgage-backed securities	74,424
Total	\$ 211,118

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 (*in thousands*):

	Less than 12 Months			12 Months or Greater			Total	
	Fair Value	Gross Unrealized Losses	Number of Securities	Fair Value	Gross Unrealized Losses	Number of Securities	Fair Value	Gross Unrealiz Losses
September 30, 2020:								
U.S. Government-sponsored enterprises (GSEs)	\$ 20,985	\$ (149)	5	\$ 140	\$ (1)	1	\$ 21,125	\$
Municipal securities	3,892	(3)	3	—	—	—	3,892	
Other debt securities	3,980	(55)	2	973	(11)	1	4,953	
Mortgage-backed securities (GSEs)	10,456	(114)	7	7,636	(135)	3	18,092	
Total	\$ 39,313	\$ (321)	17	\$ 8,749	\$ (147)	5	\$ 48,062	\$
December 31, 2019:								
U.S. Government-sponsored enterprises (GSEs)	\$ 2,972	\$ (43)	2	\$ 5,987	\$ (13)	2	\$ 8,959	\$
Municipal securities	3,656	(16)	4	527	(3)	1	4,183	
Other debt securities	—	—	—	947	(33)	1	947	
Mortgage-backed securities (GSEs)	13,208	(194)	10	19,988	(232)	31	33,196	
Total	\$ 19,836	\$ (253)	16	\$ 27,449	\$ (281)	35	\$ 47,285	\$

The Company reviews the securities portfolio on a quarterly basis to monitor its exposure to other-than-temporary impairment. A determination as to whether a security's decline in fair value is other-than-temporary takes into consideration numerous factors and the relative significance of any single factor can vary by security. Some factors the Company may consider in the other-than-temporary impairment analysis include the length of time and extent to which

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the security has been in an unrealized loss position, changes in security ratings, financial condition and near-term prospects of the issuer, as well as security and industry specific economic conditions.

Based on this evaluation, the Company concluded that any unrealized losses at September 30, 2020, represented a temporary impairment, as these unrealized losses are primarily attributable to changes in interest rates and current market conditions, and not credit deterioration of the issuers. As of September 30, 2020, the Company does not intend to sell any of the securities, does not expect to be required to sell any of the securities, and expects to recover the entire amortized cost of all of the securities.

The following is the amortized cost and carrying value of other investments (*in thousands*):

		September 30, 2020
Federal Reserve Bank stock	\$	8,641
Federal Home Loan Bank stock		5,838
First National Bankers Bank stock		350
Total	\$	14,829

Our restricted investments consist of non-marketable equity securities that have no readily determinable market value. Accordingly, when evaluating these securities for impairment, management considers the ultimate recoverability of the par value rather than recognizing temporary declines in value. As of September 30, 2020, the Company determined that there was no impairment on its other investments.

Note 5. Loans and Allowance for Loan Losses

Portfolio Segmentation:

Major categories of loans are summarized as follows (*in thousands*):

	September 30, 2020			December 31, 2019		
	PCI Loans ¹	All Other Loans	Total	PCI Loans ¹	All Other Loans	
Commercial real estate	\$ 16,469	\$ 1,014,182	\$ 1,030,651	\$ 15,255	\$ 890,051	\$
Consumer real estate	10,801	429,509	440,310	6,541	410,941	
Construction and land development	6,409	268,763	275,172	4,458	223,168	
Commercial and industrial	317	644,181	644,498	407	336,668	
Consumer and other	87	13,339	13,426	326	9,577	
Total loans	34,083	2,369,974	2,404,057	26,987	1,870,405	
Less: Allowance for loan losses	—	(18,817)	(18,817)	(156)	(10,087)	
Loans, net	\$ 34,083	\$ 2,351,157	\$ 2,385,240	\$ 26,831	\$ 1,860,318	\$

¹Purchased credit-impaired loans ("PCI loans") are loans with evidence of credit deterioration at purchase.

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.

As previously mentioned in Note 1 – *Presentation of Financial Information*, the CARES Act established the PPP, administered directly by the SBA. The PPP provides loans of up to \$10 million to small businesses who were affected by economic conditions as a result of COVID-19 to provide cash-flow assistance to employers who maintain their payroll

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(including healthcare and certain related expenses), mortgage interest, rent, leases, utilities and interest on existing debt during the COVID-19 emergency. PPP loans carry an interest rate of one percent, and a maturity of two or five years. These loans are fully guaranteed by the SBA and are not included in the Company's loan loss allowance calculations. The loans may be eligible for forgiveness by the SBA to the extent that the proceeds are used to cover eligible payroll costs, interest costs, rent, and utility costs over a period of up to 24 weeks after the loan is made as long as certain conditions are met regarding employee retention and compensation levels. PPP loans deemed eligible for forgiveness by the SBA will be repaid by the SBA to the Company. The SBA pays the Company fees for processing PPP loans in the following amounts: (1) five percent for loans of not more than \$350,000; (2) three percent for loans of more than \$350,000 and less than \$2,000,000; and (3) one percent for loans of at least \$2,000,000. These processing fees are accounted for as loan origination fees and recognized over the contractual loan term as a yield adjustment on the loans. PPP loans are included in the Commercial and Industrial loan class. As of September 30, 2020, the Company had approximately 2,950 PPP loans outstanding, with an outstanding principal balance of \$300.8 million.

The composition of loans by loan classification for impaired and performing loan status is summarized in the tables below (*in thousands*):

	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	
September 30, 2020:						
Performing loans	\$ 1,013,631	\$ 428,514	\$ 268,763	\$ 643,581	\$ 13,339	\$
Impaired loans	551	995	—	600	—	
	1,014,182	429,509	268,763	644,181	13,339	
PCI loans	16,469	10,801	6,409	317	87	
Total loans	<u>\$ 1,030,651</u>	<u>\$ 440,310</u>	<u>\$ 275,172</u>	<u>\$ 644,498</u>	<u>\$ 13,426</u>	<u>\$</u>
December 31, 2019:						
Performing loans	\$ 889,795	\$ 409,394	\$ 222,621	\$ 336,508	\$ 9,577	\$
Impaired loans	256	1,547	547	160	—	
	890,051	410,941	223,168	336,668	9,577	
PCI loans	15,255	6,541	4,458	407	326	
Total loans	<u>\$ 905,306</u>	<u>\$ 417,482</u>	<u>\$ 227,626</u>	<u>\$ 337,075</u>	<u>\$ 9,903</u>	<u>\$</u>

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The following tables show the allowance for loan losses allocation by loan classification for impaired, PCI, and performing loans (*in thousands*):

	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other
September 30, 2020:					
Performing loans	\$ 7,729	\$ 3,366	\$ 2,060	\$ 5,055	\$ 121
Impaired loans	—	78	—	408	—
	7,729	3,444	2,060	5,463	121
PCI loans	—	—	—	—	—
Total loans	\$ 7,729	\$ 3,444	\$ 2,060	\$ 5,463	\$ 121
December 31, 2019:					
Performing loans	\$ 4,491	\$ 2,159	\$ 1,127	\$ 1,766	\$ 65
Impaired loans	—	343	—	132	—
	4,491	2,502	1,127	1,898	65
PCI loans	17	74	—	59	6
Total loans	\$ 4,508	\$ 2,576	\$ 1,127	\$ 1,957	\$ 75

The following tables detail the changes in the allowance for loan losses by loan classification (*in thousands*):

	Three Months Ended September 30, 2020				
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other
Beginning balance	\$ 6,595	\$ 3,313	\$ 1,795	\$ 4,443	\$ 10
Charged-off loans	—	(21)	—	(60)	(8)
Recoveries of charge-offs	11	17	—	55	1
Provision (reallocation) charged to expense	1,123	135	265	1,025	8
Ending balance	\$ 7,729	\$ 3,444	\$ 2,060	\$ 5,463	\$ 12

	Three Months Ended September 30, 2019				
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other
Beginning balance	\$ 4,102	\$ 2,189	\$ 946	\$ 1,746	\$ 7
Charged-off loans	(36)	(1)	—	(20)	—
Recoveries of charge-offs	39	17	3	12	6
Provision (reallocation) charged to expense	155	65	94	410	—
Ending balance	\$ 4,260	\$ 2,270	\$ 1,043	\$ 2,148	\$ 13

	Nine Months Ended September 30, 2020				
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other
Beginning balance	\$ 4,508	\$ 2,576	\$ 1,127	\$ 1,957	\$ 7
Loans charged-off	—	(23)	—	(77)	(23)
Recoveries of loans charged-off	16	34	2	103	6
Provision (reallocation) charged to expense	3,205	857	931	3,480	21
Ending balance	\$ 7,729	\$ 3,444	\$ 2,060	\$ 5,463	\$ 12

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	Nine Months Ended September 30, 2019				
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other
Beginning balance	\$ 3,639	\$ 1,789	\$ 795	\$ 1,746	\$ —
Loans charged-off	(36)	(3)	—	(353)	—
Recoveries of loans charged-off	63	37	7	66	—
Provision (reallocation) charged to expense	594	447	241	689	—
Ending balance	<u>\$ 4,260</u>	<u>\$ 2,270</u>	<u>\$ 1,043</u>	<u>\$ 2,148</u>	<u>\$ —</u>

We maintain the allowance at a level that we deem appropriate to adequately cover the probable losses inherent in the loan portfolio. Our provision for loan losses for the nine months ended September 30, 2020, is \$8.7 million compared to \$1.9 million in the same period of 2019, an increase of \$6.8 million. As of September 30, 2020, and December 31, 2019, our allowance for loan losses was \$18.8 million and \$10.2 million, respectively, which we deemed to be adequate at each of the respective dates. The increase in the allowance for loan losses at September 30, 2020, as compared to December 31, 2019, is primarily attributable to the ongoing economic uncertainties related to the COVID-19 pandemic. Also, during 2020, the Company updated the Allowance for Loan Loss policy to increase the additional basis points allowed for the unallocated risk portion from 100 basis points to 125 basis points. In addition, the Company added a new qualitative factor based on the percentage of COVID modified loans / total loans. The qualitative factors were also expanded to provide additional granularity related to the hospitality and restaurant industries which are most impacted by the pandemic within our footprint. The changes in our economic factors and the addition of the COVID modified factors equated to an additional \$8.3 million in reserve. Our allowance for loan loss as a percentage of total loans was 0.78% at September 30, 2020 and 0.54% at December 31, 2019.

The following tables outline the amount of each loan classification and the amount categorized into each risk rating (*in thousands*):

	September 30, 2020				
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other
Non PCI Loans:					
Pass	\$ 666,865	\$ 394,794	\$ 247,424	\$ 619,308	\$ 13,004
Watch	336,122	32,578	21,269	23,655	294
Special mention	10,547	463	—	385	—
Substandard	648	1,588	70	728	17
Doubtful	—	86	—	105	24
Total	<u>1,014,182</u>	<u>429,509</u>	<u>268,763</u>	<u>644,181</u>	<u>13,339</u>
PCI Loans:					
Pass	8,248	8,974	1,383	222	70
Watch	6,819	255	4,491	—	12
Special mention	19	56	—	—	—
Substandard	1,383	1,516	535	95	5
Doubtful	—	—	—	—	—
Total	<u>16,469</u>	<u>10,801</u>	<u>6,409</u>	<u>317</u>	<u>87</u>
Total loans	<u>\$ 1,030,651</u>	<u>\$ 440,310</u>	<u>\$ 275,172</u>	<u>\$ 644,498</u>	<u>\$ 13,426</u>

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	December 31, 2019				
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other
Non PCI Loans:					
Pass	\$ 860,447	\$ 407,336	\$ 216,459	\$ 328,564	\$ 9,462
Watch	25,180	989	6,089	6,786	40
Special mention	4,057	738	—	1,033	—
Substandard	367	1,713	620	228	51
Doubtful	—	165	—	57	24
Total	<u>890,051</u>	<u>410,941</u>	<u>223,168</u>	<u>336,668</u>	<u>9,577</u>
PCI Loans:					
Pass	12,473	5,258	902	41	300
Watch	2,234	38	3,556	—	13
Special mention	139	60	—	—	—
Substandard	409	1,185	—	366	13
Doubtful	—	—	—	—	—
Total	<u>15,255</u>	<u>6,541</u>	<u>4,458</u>	<u>407</u>	<u>326</u>
Total loans	<u>\$ 905,306</u>	<u>\$ 417,482</u>	<u>\$ 227,626</u>	<u>\$ 337,075</u>	<u>\$ 9,903</u>

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 indicator 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 an aging analysis of our loan portfolio (*in thousands*):

	September 30, 2020						
	30-60 Days Past Due and Accruing	61-89 Days Past Due and Accruing	Past Due 90 Days or More and Accruing	Nonaccrual	Total Past Due and Nonaccrual	PCI Loans	Current Loans
Commercial real estate	\$ 561	\$ 616	\$ —	\$ 418	\$ 1,595	\$ 16,469	\$ 1,012,587
Consumer real estate	975	124	—	1,586	2,685	10,801	426,824
Construction and land development	10	—	—	—	10	6,409	268,753
Commercial and industrial	16	6	—	204	226	317	643,955
Consumer and other	70	522	—	40	632	87	12,707
Total	<u>\$ 1,632</u>	<u>\$ 1,268</u>	<u>\$ —</u>	<u>\$ 2,248</u>	<u>\$ 5,148</u>	<u>\$ 34,083</u>	<u>\$ 2,364,826</u>

	December 31, 2019						
	30-60 Days Past Due and Accruing	61-89 Days Past Due and Accruing	Past Due 90 Days or More and Accruing	Nonaccrual	Total Past Due and Nonaccrual	PCI Loans	Current Loans
Commercial real estate	\$ 466	\$ 22	\$ —	\$ 124	\$ 612	\$ 15,255	\$ 889,439
Consumer real estate	1,564	30	—	1,872	3,466	6,541	407,475
Construction and land development	507	—	607	620	1,734	4,458	221,434
Commercial and industrial	559	53	—	57	669	407	335,999
Consumer and other	86	14	—	70	170	326	9,407
Total	<u>\$ 3,182</u>	<u>\$ 119</u>	<u>\$ 607</u>	<u>\$ 2,743</u>	<u>\$ 6,651</u>	<u>\$ 26,987</u>	<u>\$ 1,863,754</u>

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Impaired Loans:

The following is an analysis of the impaired loan portfolio, including PCI loans, detailing the related allowance recorded (*in thousands*):

	September 30, 2020			December 31, 2015	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance
Impaired loans without a valuation allowance:					
Commercial real estate	\$ 551	\$ 551	\$ —	\$ 256	\$ 261
Consumer real estate	795	795	—	553	553
Construction and land development	—	—	—	547	547
Commercial and industrial	—	—	—	—	—
Consumer and other	—	—	—	—	—
	<u>1,346</u>	<u>1,346</u>	<u>—</u>	<u>1,356</u>	<u>1,361</u>
Impaired loans with a valuation allowance:					
Commercial real estate	—	—	—	—	—
Consumer real estate	200	200	78	994	994
Construction and land development	—	—	—	—	—
Commercial and industrial	600	600	408	160	160
Consumer and other	—	—	—	—	—
	<u>800</u>	<u>800</u>	<u>486</u>	<u>1,154</u>	<u>1,154</u>
PCI loans:					
Commercial real estate	—	—	—	17	95
Consumer real estate	1,852	2,113	—	1,205	1,371
Construction and land development	—	—	—	—	—
Commercial and industrial	279	242	—	396	534
Consumer and other	26	24	—	45	51
	<u>2,157</u>	<u>2,379</u>	<u>—</u>	<u>1,663</u>	<u>2,055</u>
Total impaired loans	<u>\$ 4,303</u>	<u>\$ 4,525</u>	<u>\$ 486</u>	<u>\$ 4,173</u>	<u>\$ 4,570</u>

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	Three Months Ended September 30,		
	2020		
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment
Impaired loans without a valuation allowance:			
Commercial real estate	\$ 552	\$ 3	\$ 258
Consumer real estate	758	3	568
Construction and land development	—	—	701
Commercial and industrial	—	—	—
Consumer and other	—	—	—
	<u>1,310</u>	<u>6</u>	<u>1,527</u>
Impaired loans with a valuation allowance:			
Commercial real estate	198	—	—
Consumer real estate	440	4	396
Construction and land development	—	—	—
Commercial and industrial	379	2	352
Consumer and other	—	—	—
	<u>1,017</u>	<u>6</u>	<u>748</u>
PCI loans:			
Commercial real estate	8	—	2,520
Consumer real estate	1,869	38	1,151
Construction and land development	—	—	—
Commercial and industrial	305	2	—
Consumer real estate	27	—	—
	<u>2,209</u>	<u>40</u>	<u>3,671</u>
Total impaired loans	<u>\$ 4,536</u>	<u>\$ 52</u>	<u>\$ 5,946</u>

	Nine Months Ended September 30,		
	2020		
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment
Impaired loans without a valuation allowance:			
Commercial real estate	\$ 374	\$ 7	\$ 435
Consumer real estate	653	17	768
Construction and land development	289	—	637
Commercial and industrial	—	—	25
Consumer and other	—	—	14
	<u>1,316</u>	<u>24</u>	<u>1,879</u>
Impaired loans with a valuation allowance:			
Commercial real estate	198	2	12
Consumer real estate	712	18	248
Construction and land development	—	—	14
Commercial and industrial	269	7	498
Consumer and other	—	—	28
	<u>1,179</u>	<u>27</u>	<u>800</u>
PCI loans:			
Commercial real estate	250	1	1,894
Consumer real estate	1,344	77	851
Construction and land development	58	—	—
Commercial and industrial	343	5	—
Consumer and other	29	—	—
	<u>2,024</u>	<u>83</u>	<u>2,745</u>
Total impaired loans	<u>\$ 4,519</u>	<u>\$ 134</u>	<u>\$ 5,424</u>

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Troubled Debt Restructurings:

At September 30, 2020, and December 31, 2019, impaired loans included loans that were classified as TDRs. The restructuring of a loan is considered a TDR if both (i) the borrower is experiencing financial difficulties and (ii) the creditor has granted a concession.

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

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

The most common concessions granted by the Company generally include one or more modifications to the terms of the debt, such as (i) a reduction in the interest rate for the remaining life of the debt; (ii) an extension of the maturity date at an interest rate lower than the current market rate for new debt with similar risk; (iii) a temporary period of interest-only payments; and (iv) a reduction in the contractual payment amount for either a short period or remaining term of the loan.

As of September 30, 2020, and December 31, 2019, management had approximately \$8 thousand and \$61 thousand, respectively, in loans that met the criteria for TDR, none of which were on nonaccrual. A loan is placed back on accrual status when both principal and interest are current and it is probable that the Company will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement.

There was one loan that was modified as a TDR during the nine month period ended September 30, 2020, and no loans were modified during the nine month period ended September 30, 2019. There were no loans that were modified as TDRs during the past nine months and for which there was a subsequent payment default.

The Company began offering short-term loan modifications to assist borrowers during the COVID-19 national emergency. The Coronavirus Aid Relief and Economic Security ("CARES") Act along with a joint agency statement issued by banking agencies, provides that short-term modifications made in response to COVID-19 does not need to be accounted for as a TDR. Accordingly, the Company does not account for such loan modifications as TDRs. See Note 1 *Presentation of Financial Information* for more information. At September 30, 2020, the Company had 289 loans remaining under COVID-19 modifications that amounted to \$232.5 million, or 9.7% of the total loans outstanding.

Foreclosure Proceedings and Balances:

As of September 30, 2020, there was only one residential property secured by real estate included in other real estate owned and there was one consumer mortgage loan collateralized by residential real estate property that was in the process of foreclosure.

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Purchased Credit Impaired Loans:

The Company has acquired loans where 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 are as follows (*in thousands*):

	September 30, 2020	I
Commercial real estate	\$ 24,179	\$
Consumer real estate	13,353	
Construction and land development	1,910	
Commercial and industrial	7,567	
Consumer and other	199	
Total loans	47,208	
Less: Remaining purchase discount	(13,125)	
Total loans, net of purchase discount	34,083	
Less: Allowance for loan losses	—	
Carrying amount, net of allowance	\$ 34,083	\$

Activity related to the accretable yield on loans acquired with deteriorated credit quality is as follows (*in thousands*):

	Three Months Ended September 30,		Nine M Sept
	2020	2019	2020
Accretable yield, beginning of period	\$ 11,777	\$ 8,280	\$ 8,454
Additions	—	—	2,515
Accretion income	(1,267)	(1,073)	(4,401)
Reclassification	265	1,033	2,428
Other changes, net	7,405	390	9,184
Accretable yield, end of period	\$ 18,180	\$ 8,630	\$ 18,180

Note 6. Goodwill and Intangible Assets

In accordance with 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. The Company performs its annual goodwill impairment test as of December 31 of each year and at December 31, 2019, 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. Considering the recent economic conditions resulting from the COVID-19 pandemic, as of September 30, 2020, the Company performed a Step 1 goodwill impairment test (which compares the fair value of a reporting unit with its carrying amount, including goodwill). The results indicated that there was no impairment as of September 30, 2020. Management will continue to evaluate the economic conditions at future reporting periods for applicable changes.

The Company's other intangible assets consist of core deposit intangibles, and is initially recognized based on a valuation performed as of the consummation date. The core deposit intangible is amortized over the average remaining life of the acquired customer deposits.

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The carrying amount of goodwill and other intangible assets as of the dates indicated is summarized below (*in thousands*):

	September 30, 2020
Goodwill:	
Balance, beginning of period	\$ 65,614
Adjustment to values initially recorded for Acquisition of Foothills Bancorp, Inc.	—
Acquisition of PFG	8,302
Adjustment to values initially recorded for Acquisition of PFG	1,014
Balance, end of the period	<u>\$ 74,930</u>
Core deposit intangible:	
Balance, beginning of period	\$ 14,550
Acquisition of PFG	1,370
Balance, gross core deposit intangible	15,920
Less: accumulated amortization	(4,140)
Net core deposit intangible, net	<u>\$ 11,780</u>

The aggregate amortization of core deposit intangibles expense for the three and nine month periods ended September 30, 2020, was \$402 thousand and \$1.2 million, respectively, and for the three and nine months ended September 30, 2019, was \$341 thousand and \$1.0 million, respectively.

The estimated aggregate amortization expense for future periods for core deposit intangibles is as follows (*in thousands*):

Remainder of 2020	\$
2021	
2022	
2023	
2024	
Thereafter	
Total	\$

Note 7. Borrowings and Line of Credit

Borrowings:

At September 30, 2020, total borrowings were \$319.4 million compared to \$31.6 million at December 31, 2019. The \$287.8 million increase was primarily due to borrowings from the Federal Reserve Bank Payroll Protection Program Liquidity Facility ("PPPLF") of \$237.8 million in the second quarter of 2020 and an increase in Federal Home Loan Bank ("FHLB") borrowings of \$50.0 million. Borrowings consist of the following (*dollars in thousands*):

	September 30, 2020	De
Securities sold under customer repurchase agreements	\$ 6,193	\$
FHLB borrowings	75,000	
PPPLF borrowings	237,780	
Other borrowings	418	
Total	<u>\$ 319,391</u>	<u>\$</u>

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Line of Credit:

The Company has a Loan and Security Agreement and revolving note with ServisFirst Bank, pursuant to which ServisFirst Bank has made a \$25.0 million revolving line of credit available to the Company. The maturity of the line of credit is September 24, 2021. At September 30, 2020, there was no outstanding balance under the line of credit, and the entire amount of the line of credit remained available to the Company.

Note 8. 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 90 days of service the Company matches 100% of employee contributions up to 3% of compensation and 50% of employee contributions on the next 2% of compensation. The Company's contribution to the Plan for the three and nine month periods ending September 30, 2020, was \$282 thousand and \$840 thousand, respectively. The Company's contribution to the Plan for the three and nine months periods ending September 30, 2019, was \$187 thousand and \$602 thousand, respectively.

Equity Incentive Plans:

The Compensation Committee of the Company's Board of Directors may grant or award eligible participants stock options, restricted stock, restricted stock units, stock appreciation rights, and other stock-based awards or any combination of awards (collectively referred to herein as "Rights"). At September 30, 2020, the Company had one active equity incentive plan available for future grants, the 2015 Stock Incentive Plan, which had 28,549 rights issued and 1,878,894 Rights available for future grants or awards.

In addition, the Company has 33,250 Rights issued from the Cornerstone Bancshares, Inc. 2002 Long Term Incentive Plan, 41,250 Rights issued from the Cornerstone Non-Qualified Plan Options, and 2,266 Rights issued from the Capstone Stock Option Plan. These plans do not have any Rights available for future grants or awards.

Stock Options:

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

	<u>Number</u>	
Outstanding at December 31, 2019	136,658	\$
Granted	—	
Exercised	(27,858)	
Forfeited	(3,485)	
Outstanding at September 30, 2020	<u>105,315</u>	\$



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Information pertaining to stock options outstanding at September 30, 2020, is as follows:

Exercise Prices	Options Outstanding			Options Exercisable		
	Number Outstanding	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable		
\$ 6.60	20,000	1.45 years	\$ 6.60	20,000		\$
6.80	13,250	0.42 years	6.80	13,250		
9.48	18,500	2.45 years	9.48	18,500		
9.60	22,750	3.25 years	9.60	22,750		
11.76	2,266	1.75 years	11.76	2,266		
15.05	28,549	4.83 years	15.05	28,549		
Outstanding, end of period	<u>105,315</u>	<u>2.81 years</u>	<u>\$ 10.18</u>	<u>105,315</u>		<u>\$</u>

The Company did not recognize any stock option-based compensation expense during the three and nine months ended September 30, 2020, as all stock options issued are fully vested. During the three and nine month periods ended September 30, 2019, stock option-based compensation expense was \$58 thousand and \$122 thousand, respectively.

The intrinsic value of options exercised during the three and nine month periods ended September 30, 2020 was \$75 thousand and \$141 thousand, respectively. The intrinsic value of options exercised during the three and nine month periods ended September 30, 2019 was \$53 thousand and \$165 thousand, respectively. The aggregate intrinsic value of total options outstanding and exercisable options at September 30, 2020, was \$401 thousand. Cash received from options exercised under all share-based payment arrangements for the nine month period ended September 30, 2020 was \$282 thousand.

No options vested during the periods ended September 30, 2020, and 2019, respectively. The income tax expense/benefit recognized for the exercise of options during the three and nine months ended September 30, 2020, was an expense of \$3 thousand and a benefit of \$19 thousand, respectively, and for the three and nine months ended September 30, 2019, a benefit of \$10 thousand and \$37 thousand, respectively.

As of September 30, 2020, all options were fully vested and currently no future compensation cost will be recognized related to nonvested stock-based compensation arrangements granted under the Plans.

Stock Appreciation Rights ("SARs"):

A summary of the status of SARs plans is presented in the following table:

	Number	Weighted-Average Exercise Price
Outstanding at December 31, 2019	67,000	\$
Granted	18,000	
Exercised	—	
Forfeited	—	
Outstanding at September 30, 2020	<u>85,000</u>	<u>\$</u>



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Information pertaining to SARs outstanding at September 30, 2020, is as follows:

Exercise Prices	Number Outstanding	SARs Outstanding		SARs Exercisable	
		Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
\$ 15.19	18,000	3.25 years	\$ 15.19	—	\$ —
18.12	21,000	2.25 years	18.12	—	—
21.61	34,000	1.25 years	21.61	—	—
21.72	12,000	0.25 years	21.72	12,000	12,000
Outstanding, end of period	85,000	1.78 years	\$ 19.40	12,000	\$ 12,000

SARs compensation expense of (\$63) thousand and (\$89) thousand was recognized for the three and nine month periods ended September 30, 2020, respectively, and (\$7) thousand and \$73 thousand for three and nine month periods ended September 30, 2019, respectively. The credit in expense for the three and nine month period ended September 30, 2020, and the three month period ended September 30, 2019, was due to adjustments related to the fair value evaluation of SARs.

Restricted Stock Awards:

A summary of the activity of the Company's unvested restricted stock awards for the period ended September 30, 2020 is presented below:

	Number	
Balance at December 31, 2019	65,400	\$ —
Granted	41,613	
Vested	(7,295)	
Forfeited/expired	(1,500)	
Balance at September 30, 2020	98,218	\$ —

The Company measures the fair value of restricted stock awards based on the price of the Company's common stock on the grant date, and compensation expense is recorded over the vesting period. The compensation expense for restricted stock awards during the three and nine months ended September 30, 2020, was \$142 thousand and \$365 thousand, respectively, and was \$95 thousand and \$310 thousand, during the three and nine month periods ended September 30, 2019, respectively. As of September 30, 2020, there was \$1.1 million, respectively, of unrecognized compensation cost related to non-vested restricted stock awards granted under the plan. The cost is expected to be recognized over a weighted average period of 3.10 years. The grant-date fair value of restricted stock awards vested was \$134 thousand for the period ended September 30, 2020.

Note 9. Commitments and Contingent Liabilities

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 on the balance sheet. 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.



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A summary of the Company's total contractual amount for all off-balance sheet commitments are as follows (in thousands):

	September 30,		I
	2020		
Commitments to extend credit	\$	468,447	\$
Standby letters of credit		5,530	

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 September 30, 2020, and December 31, 2019, the carrying amount of liabilities related to the Company's obligation to perform under standby letters of credit was insignificant.

The Company is subject in the normal course of business to various pending and threatened legal proceedings in which claims for monetary damages are asserted. Management, after consultation with legal counsel, does not anticipate that the aggregate ultimate liability arising out of litigation pending or threatened against the Company will be material to the Company's consolidated financial position. On an on-going basis, the Company assesses any potential liabilities or contingencies in connection with such legal proceedings. For those matters where it is deemed probable that the Company will incur losses and the amount of the losses can be reasonably estimated, the Company would record an expense and corresponding liability in its consolidated financial statements.

Note 10. Fair Value Disclosures

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 business 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.



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

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

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

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

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

The tables below present the recorded amount of assets and liabilities measured at fair value on a recurring basis as follows (*in thousands*):

Description	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
September 30, 2020:			
Assets:			
Securities available-for-sale:			
U.S. Government-sponsored enterprises (GSEs)	\$ 30,210	\$ —	\$ 30,210
Municipal securities	90,809	—	90,809
Other debt securities	17,502	—	17,502
Mortgage-backed securities (GSEs)	76,113	—	76,113
Total securities available-for-sale	<u>\$ 214,634</u>	<u>\$ —</u>	<u>\$ 214,634</u>
Liabilities:			
Derivative financial instruments	<u>\$ 6,791</u>	<u>\$ —</u>	<u>\$ 6,791</u>
December 31, 2019:			
Assets:			
Securities available-for-sale:			
U.S. Government-sponsored enterprises (GSEs)	\$ 19,000	\$ —	\$ 19,000
Municipal securities	64,391	—	64,391
Other debt securities	3,470	—	3,470
Mortgage-backed securities (GSEs)	91,487	—	91,487
Total securities available-for-sale	<u>\$ 178,348</u>	<u>\$ —</u>	<u>\$ 178,348</u>
Liabilities:			
Derivative financial instruments	<u>\$ 3,446</u>	<u>\$ —</u>	<u>\$ 3,446</u>

During the nine month period ending September 30, 2020, there were no transfers between Level 1 and Level 2 in the fair value hierarchy.



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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*):

	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
September 30, 2020:			
Impaired loans	\$ 3,817	\$ —	\$ —
Other real estate owned	3,932	—	—
December 31, 2019:			
Impaired loans	\$ 2,185	\$ —	\$ —
Other real estate owned	1,757	—	—

For Level 3 assets measured at fair value on a non-recurring basis, the significant unobservable inputs used in the fair value measurements are presented below (*dollars in thousands*):

	Fair Value	Valuation Technique	Significant Other Unobservable Input
September 30, 2020:			
Impaired loans	\$ 3,817	Appraisal	Appraisal discounts
Other real estate owned	3,932	Appraisal	Appraisal discounts
December 31, 2019:			
Impaired loans	\$ 2,185	Appraisal	Appraisal discounts
Other real estate owned	1,757	Appraisal	Appraisal discounts

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. An impaired loan 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 was 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.

Other real estate owned: Other real estate owned, consisting of properties obtained through foreclosure or in satisfaction of loans, are initially recorded at fair value less estimated costs to sell upon transfer of the loans to other real estate.



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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.

Carrying value and estimated fair value:

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

	Carrying Amount	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
September 30, 2020:				
Assets:				
Cash and cash equivalents	\$ 541,815	\$ 541,815	\$ —	\$ —
Securities available-for-sale	214,634	—	214,634	—
Other investments	14,829	N/A	N/A	N/A
Loans and loans held for sale	2,415,349	—	—	2,406,262
Liabilities:				
Noninterest-bearing demand deposits	669,733	—	669,733	—
Interest-bearing demand deposits	534,128	—	534,128	—
Money market and savings deposits	871,098	—	871,098	—
Time deposits	577,064	—	581,389	—
Borrowings	319,391	—	315,340	—
Subordinated debt	39,325	—	—	33,644
Derivative financial instruments	6,791	—	6,791	—
December 31, 2019:				
Assets:				
Cash and cash equivalents	\$ 183,971	\$ 183,971	\$ —	\$ —
Securities available-for-sale	178,348	—	178,348	—
Other investments	12,913	N/A	N/A	N/A
Loans, net and loans held for sale	1,893,005	—	—	1,879,825
Liabilities:				
Noninterest-bearing demand deposits	364,155	—	364,155	—
Interest-bearing demand deposits	380,234	—	380,234	—
Money market and savings deposits	623,284	—	623,284	—
Time deposits	679,541	—	681,902	—
Borrowings	31,623	—	31,029	—
Subordinated debt	39,261	—	—	35,868
Derivative financial instruments	3,446	—	3,446	—

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. 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.

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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 unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

Note 11. 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 derivative instruments that are designated and qualify as a fair value hedge, the gain or loss on the derivative net investment hedge instrument as well as the offsetting gain or loss 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 tax-exempt 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 ASU 2017-12, *Derivatives and Hedging (Topic 815) - Targeted Improvements to Accounting for Hedging Activities*, which allows such partial term hedge designations.

A summary of the Company's fair value hedge relationships for the periods presented are as follows (*dollars in thousands*):

	Balance Sheet Location	Weighted Average Remaining Maturity (In Years)	Weighted Average Pay Rate	Receive Rate	Notional Amount
Liability derivatives					
September 30, 2020:					
Interest rate swap agreements - securities	Other liabilities	7.38	3.08 %	3 month LIBOR	\$ 36,000
December 31, 2019:					
Interest rate swap agreements - securities	Other liabilities	8.20	3.09 %	3 month LIBOR	\$ 36,000

The effects of the Company's fair value hedge relationships reported in interest income on tax-exempt available-for-sale securities on the consolidated income statement were as follows (*in thousands*):

	Three Months Ended September 30,			Nine Mo Septer 2020
	2020	2019		
Interest income on tax-exempt securities	\$ 565	\$ 400	\$	1,586
Effects of fair value hedge relationships	(201)	(62)		(522)
Reported interest income on tax-exempt securities	<u>\$ 364</u>	<u>\$ 338</u>	<u>\$</u>	<u>1,064</u>
Gain (loss) on fair value hedging relationship				
Interest rate swap agreements - securities:				
Hedged items	\$ 299	\$ (1,045)	\$	(3,345)
Derivative designated as hedging instruments	\$ (299)	\$ 1,045	\$	3,345

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The following amounts were recorded on the balance sheet related to cumulative basis adjustments for fair value hedges (*in thousands*):

Line item on the balance sheet	Carrying Amount of the Hedged Assets		Cumulative Amount of Fa Value Hedging Adjustme Included in Other Comprehe Income
September 30, 2020:			
Securities available-for-sale	\$	43,643	\$
December 31, 2019:			
Securities available-for-sale	\$	42,710	\$

Note 12. Leases

A lease is defined as a contract, or part of a contract, that conveys the right to control the use of identified property, plant or equipment for a period of time in exchange for consideration. On January 1, 2019, the Company adopted ASU No. 2016-02 and all subsequent ASUs that modified this topic (collectively referred to as "Topic 842"). For the Company, Topic 842 primarily affected the accounting treatment for operating lease agreements in which the Company is the lessee.

Substantially all of the leases in which the Company is the lessee are comprised of real estate for branches and office space with terms extending through 2034. All of our leases are classified as operating leases, and therefore, were previously not recognized on the Company's consolidated balance sheet. With the adoption of Topic 842, operating lease agreements are required to be recognized on the consolidated balance sheet as a right-of-use ("ROU") asset and a corresponding lease liability.

The following table represents the consolidated balance sheet classification of the Company's ROU assets and lease liabilities. The Company elected not to include short-term leases (i.e., leases with initial terms of twelve months or less), or equipment leases (deemed immaterial) on the consolidated balance sheet (*in thousands*):

	Classification	September 30, 2020	D
Assets:			
Operating lease right-of-use assets	Other assets	\$ 5,286	\$
Liabilities:			
Operating lease liabilities	Other liabilities	\$ 5,315	\$

The calculated amount of the ROU assets and lease liabilities in the table above are impacted by the length of the lease term and the discount rate used to present value the minimum lease payments. The Company's lease agreements often include one or more options to renew at the Company's discretion. If at lease inception the Company considers the exercising of a renewal option to be reasonably certain, the Company will include the extended term in the calculation of the ROU asset and lease liability. Regarding the discount rate, Topic 842 requires the use of the rate implicit in the lease whenever this rate is readily determinable. As this rate is rarely determinable, the Company utilizes its incremental borrowing rate at lease inception, on a collateralized basis, over a similar term. For operating leases existing prior to January 1, 2019, the rate for the remaining lease term as of January 1, 2019 was used.

As of September 30, 2020, the weighted average remaining lease term was 10.78 years and the weighted average discount rate was 2.72%.

The following table represents lease costs and other lease information, in thousands. As the Company elected, for all classes of underlying assets, not to separate lease and non-lease components and instead to account for them as a single



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lease component, the variable lease cost primarily represents variable payments such as common area maintenance (*in thousands*).

	Three Months Ended		Nine Months Ended
	September 30,		
	2020	2019	2020
Lease costs:			
Operating lease costs	\$ 272	\$ 149	\$ 7
Short-term lease costs	—	2	—
Variable lease costs	29	23	—
Total	<u>\$ 301</u>	<u>\$ 174</u>	<u>\$ 7</u>
Other information:			
Cash paid for amounts included in the measurement of lease liabilities:			
Operating cash flows from operating leases	<u>\$ 264</u>	<u>\$ 145</u>	<u>\$ 7</u>

Future minimum payments for operating leases with initial or remaining terms of one year or more as of September 30, 2020, were as follows (*in thousands*):

September 30, 2021	\$
September 30, 2022	
September 30, 2023	
September 30, 2024	
September 30, 2025	
Thereafter	
Total future minimum lease payments	
Amounts representing interest	
Present value of net future minimum lease payments	\$

Note 13. Regulatory Matters

Regulatory Capital Requirements:

The final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective January 1, 2015, subject to a phase-in period for certain aspects of the new rules. In order to avoid restrictions on capital distributions and discretionary bonus payments to executives, under the new rules a covered banking organization is also required to maintain a "capital conservation buffer" in addition to its minimum risk-based capital requirements. This buffer is required to consist solely of common equity Tier 1, and the buffer applies to all three risk-based measurements (CET1, Tier 1 capital and total capital). The capital conservation buffer was phased in incrementally over time, beginning January 1, 2016 and became fully effective on January 1, 2019. As of January 1, 2019, an additional amount of Tier 1 common equity equal to 2.5% of risk-weighted assets is required for compliance with the capital conservation buffer. The ratios for the Company and the Bank are currently sufficient to satisfy the fully phased-in conservation buffer. At September 30, 2020, the Company and the Bank exceeded the minimum regulatory requirements and exceeded the threshold for the "well capitalized" regulatory classification.

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 (the "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. Because this test involves a measure of net income, any charge on the Bank's income statement, such as an impairment of goodwill, could impair the Bank's ability to pay dividends to the Company. Under Tennessee corporate law, the Company is not



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permitted to pay dividends if, after giving effect to such payment, it 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. In addition, in deciding whether or not to declare a dividend of any particular size, the Company's board of directors must consider its and the Bank's current and prospective capital, liquidity, and other needs. In addition to state law limitations on the Company's ability to pay dividends, the Federal Reserve imposes limitations on the Company's ability to pay dividends. Federal Reserve regulations limit dividends, stock repurchases and discretionary bonuses to executive officers if the Company's regulatory capital is below the level of regulatory minimums plus the applicable capital conservation buffer.

During the three months ended September 30, 2020, the Bank paid \$1.4 million in dividends to the Company. During the nine months ended September 30, 2020, the Bank paid \$8.9 million in dividends to the Company. Since the fourth quarter of 2019, the Company has paid a quarterly common stock dividend of \$0.05 per share. The amount and timing of all future dividend payments by the Company, if any, is subject to discretion of the Company's board of directors and will depend on the Company's earnings, capital position, financial condition and other factors, including new regulatory capital requirements, as they become known to the Company.

Regulatory Capital Levels:

Actual and required capital levels at September 30, 2020, and December 31, 2019 are presented below (*dollars in thousands*):

	Actual		Minimum for capital adequacy purposes		Minimum
	Amount	Ratio	Amount	Ratio	capital
					requirement
September 30, 2020					
SmartFinancial:					
Total Capital (to Risk Weighted Assets)	\$ 323,297	13.81 %	\$ 187,225	8.00 %	
Tier 1 Capital (to Risk Weighted Assets)	265,155	11.33 %	140,419	6.00 %	
Common Equity Tier 1 Capital (to Risk Weighted Assets)	265,155	11.33 %	105,314	4.50 %	
Tier 1 Capital (to Average Assets) ²	265,155	8.78 %	120,766	4.00 %	
SmartBank:					
Total Capital (to Risk Weighted Assets)	\$ 312,869	13.37 %	\$ 187,217	8.00 %	\$ 234
Tier 1 Capital (to Risk Weighted Assets)	294,052	12.57 %	140,413	6.00 %	187
Common Equity Tier 1 Capital (to Risk Weighted Assets)	294,052	12.57 %	105,310	4.50 %	152
Tier 1 Capital (to Average Assets) ²	294,052	9.74 %	120,762	4.00 %	150
December 31, 2019					
SmartFinancial:					
Total Capital (to Risk Weighted Assets)	\$ 287,937	14.02 %	\$ 164,313	8.00 %	
Tier 1 Capital (to Risk Weighted Assets)	238,433	11.61 %	123,235	6.00 %	
Common Equity Tier 1 Capital (to Risk Weighted Assets)	238,433	11.61 %	92,426	4.50 %	
Tier 1 Capital (to Average Assets)	238,433	10.34 %	92,258	4.00 %	
SmartBank:					
Total Capital (to Risk Weighted Assets)	\$ 273,432	13.31 %	\$ 164,305	8.00 %	\$ 205
Tier 1 Capital (to Risk Weighted Assets)	263,189	12.81 %	123,229	6.00 %	164
Common Equity Tier 1 Capital (to Risk Weighted Assets)	263,189	12.81 %	92,422	4.50 %	133
Tier 1 Capital (to Average Assets)	263,189	11.41 %	92,254	4.00 %	115

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¹The prompt corrective action provisions are applicable at the Bank level only.
²Average assets for the above calculations were based on the most recent quarter.

Note 14. Other Comprehensive Income (Loss)

The changes in each component of accumulated other comprehensive income (loss), net of tax, were as follows (in thousands):

	Three Months Ended September 30, 2020	
	Securities Available-for- Sale	Fair Value Municipal Security Hedges
Beginning balance, June 30, 2020	\$ 2,668	\$ (2,076)
Other comprehensive income (loss)	(64)	492
Reclassification of amounts included in net income	(8)	—
Net other comprehensive income (loss) during period	(72)	492
Ending balance, September 30, 2020	\$ 2,596	\$ (1,584)
	Three Months Ended September 30, 2019	
	Securities Available-for- Sale	Fair Value Municipal Security Hedges
Beginning balance, June 30, 2019	\$ 2,075	\$ (2,646)
Other comprehensive income (loss)	(1,535)	1,808
Reclassification of amounts included in net income	1	—
Net other comprehensive income (loss) during period	(1,534)	1,808
Ending balance, September 30, 2019	\$ 541	\$ (838)
	Nine Months Ended September 30, 2020	
	Securities Available-for- Sale	Fair Value Municipal Security Hedges
Beginning balance, December 31, 2019	\$ 391	\$ (223)
Other comprehensive income (loss)	2,201	(1,361)
Reclassification of amounts included in net income	4	—
Net other comprehensive income (loss) during period	2,205	(1,361)
Ending balance, September 30, 2020	\$ 2,596	\$ (1,584)
	Nine Months Ended September 30, 2019	
	Securities Available-for- Sale	Fair Value Municipal Security Hedges
Beginning balance, December 31, 2018	\$ (1,979)	\$ (786)
Other comprehensive income (loss)	2,495	(52)
Reclassification of amounts included in net income	25	—
Net other comprehensive income (loss) during period	2,520	(52)
Ending balance, September 30, 2019	\$ 541	\$ (838)

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Note 15. Subsequent Events

On October 8, 2020 the Company repaid \$237.8 million to the Federal Reserve Bank (“FRB”) relating to the outstanding borrowings from the PPPLF. These borrowings were used to assist with the funding of PPP loans. The Company utilized its excess liquidity to fund the repayment.



ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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"). SmartBank provides a comprehensive suite of commercial and consumer banking services to clients through 36 full-service bank branches and two loan production offices in select markets in East and Middle Tennessee, Alabama and the Florida Panhandle.

While we offer a wide range of commercial banking services, we focus on making loans secured primarily by commercial real estate and other types of secured and unsecured commercial loans to small and medium-sized businesses in a number of industries, as well as loans to individuals for a variety of purposes. Our principal sources of funds for loans and investing in securities are deposits and, to a lesser extent, borrowings. We offer a broad range of deposit products, including checking ("NOW"), savings, money market accounts and certificates of deposit. We actively pursue business relationships by utilizing the business contacts of our senior management, other bank officers and our directors, thereby capitalizing on our knowledge of our local market areas.

Forward-Looking Statement

SmartFinancial, Inc. ("SmartFinancial") may from time to time make written or oral statements, including statements contained in this report and information incorporated by reference herein (including, without limitation, certain statements in "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 2), that constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act") and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). These statements, including statements regarding the potential effects of the COVID-19 pandemic on the Company's business and financial results and conditions, are based on assumptions and estimates and are not guarantees of future performance. 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 (and their derivatives), 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, including changes to statutes, regulations or regulatory policies or practices as a result of, or in response to, the COVID-19 pandemic;
- 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 Progressive Financial Group, Inc ("PFG") may not be fully realized or may take longer than anticipated to realize;
- disruption from the merger with customers, suppliers or employees or other business partners' relationships;
- the risk of successful integration of the PFG's 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 dilution caused by SmartFinancial's issuance of additional shares of its common stock in connection with the PFG 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 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 TDFI, the Board of Governors of the Federal Reserve System (the "Federal Reserve"), and other regulatory authorities, including the FDIC, which 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 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, impairments to goodwill, regulatory restrictions or limitations, and changes in the company's regulatory capital and minimum capital 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;
- adverse results from current or future litigation, regulatory examinations or other legal and/or regulatory actions, including as a result of the Company's participation in and execution of government programs related to the COVID-19 pandemic;
- the impact of the COVID-19 pandemic on the Company's assets, business, cash flows, financial condition, liquidity, prospects and results of operations;
- potential increases in the provision for loan losses resulting from the COVID-19 pandemic; and
- the impact of Tennessee's anti-takeover statutes and certain of our charter provisions on potential acquisitions of us.

These and other factors that could cause results to differ materially from those described in the forward-looking statements can be found in SmartFinancial's most recent annual report on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K, in each case filed with or furnished to the Securities and Exchange Commission (the "SEC") and available on the SEC's website (www.sec.gov). Undue reliance should not be placed on forward-looking statements. SmartFinancial disclaims any obligation to update or revise any forward-looking statements contained in this release, which speak only as of the date hereof, whether as a result of new information, future events, or otherwise.

Certain captions and amounts in the prior periods presented were reclassified to conform to the current presentation. Such reclassifications had no effect on net income or shareholders' equity.

Executive Summary

The following is a summary of the Company's financial highlights and significant events during the third quarter and first nine months of 2020:

- Completed the acquisition and integration of Progressive Financial Group, Inc. ("PFG").
- Originated approximately 2,950 Paycheck Protection Program ("PPP") loans totaling \$300.8 million.



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- Net income totaled \$6.4 million, or \$0.42 per diluted common share, during the third quarter of 2020 compared to \$6.0 million, or \$0.42 per diluted common share, for the same period in 2019.
- Net income totaled \$15.3 million, or \$1.02 per diluted common share, during the first nine months of 2020 compared to \$19.8 million, or \$1.41 per diluted common share, for the same period in 2019.
- Annualized return on average assets was 0.76% at September 30, 2020 compared to 1.01% at September 30, 2019.
- Allowance for loan losses increased to \$18.8 million, an increase of 40.1% from the first quarter of 2020, in response to the current economic conditions related to COVID-19.
- The COVID-19 pandemic has caused economic and social disruption on an unprecedented scale. Congress, the President, and the Federal Reserve have taken several actions designed to curtail the fallout. On March 27, 2020, the CARES Act was signed into law. It contained substantial tax and spending provisions intended to address the impact of the COVID-19 pandemic. The CARES Act provided for a nearly \$350 billion program designed to aid small and medium-sized businesses through federally guaranteed loans distributed through banks. These loans were intended to guarantee payroll and other costs to help those businesses remain viable and allow their workers to pay their bills. The initial \$350 billion program was supplemented in late April 2020 with \$310 billion in funding. On June 5, 2020, the Paycheck Protection Program Flexibility Act (the “new Act”) was signed into law and made significant changes to the PPP to provide additional relief for small businesses that have been unable to rehire employees due to lack of employee availability or have been unable to operate as normal due to COVID-19. The new Act increased flexibility for small businesses that have been unable to rehire employees due to lack of employee availability or have been unable to operate as normal due to COVID-19. It extended the period that businesses have to use PPP funds to qualify for loan forgiveness to 24 weeks, up from 8 weeks under the original rules. The new Act also relaxed the requirement that businesses must adhere to in order to qualify for loan forgiveness. In addition, the new Act extended the payment deferral period for PPP loans until the date when the amount of loan forgiveness is remitted to the lender. For PPP recipients who do not apply for forgiveness, the loan deferral period is 10 months after the applicable forgiveness period ends. The PPP program expired August 8, 2020.

Analysis of Results of Operations

Third quarter of 2020 compared to 2019

Net income was \$6.4 million, or \$0.42 per diluted common share, for the third quarter of 2020, compared to \$6.0 million, or \$0.42 per diluted common share, for the third quarter of 2019. The tax equivalent net interest margin was 3.39% for the third quarter of 2020 compared to 3.91% for the third quarter of 2019. Noninterest income to average assets was 0.49% for the third quarter of 2020, increasing from 0.37% for the third quarter of 2019. Noninterest expense to average assets decreased to 2.28% in the third quarter of 2020, from 2.48% in the third quarter of 2019.

First nine months of 2020 compared to 2019

Net income was \$15.3 million, or \$1.02 per diluted common share, for the first nine months of 2020, compared to \$19.8 million, or \$1.41 per diluted common share, for the first nine months of 2019. The decrease in net income for this period was primarily from the \$6.4 million termination fee recognized in the second quarter of 2019. The tax equivalent net interest margin was 3.62% for the first nine months of 2020 compared to 3.99% for the first nine months of 2019. Noninterest income to average assets was 0.46% for the first nine months of 2020, decreasing from 0.71% for the first nine months of 2019. Noninterest expense to average assets decreased to 2.52% in the first nine months of 2020, from 2.71% in the first nine months of 2019. The results above include operating effects of the PFG acquisition, which was completed on March 1, 2020.

Net Interest Income and Yield Analysis

Third quarter of 2020 compared to 2019

Net interest income, taxable equivalent, increased to \$26.2 million for the third quarter of 2020, up from \$21.3 million for the third quarter of 2019. Net interest income was positively impacted, compared to the prior year, primarily by the full-quarters effects of the Company's March 1, 2020 acquisition of PFG, the increase in loan balances and the reduction in interest expense on interest bearing liabilities. Average interest-earning assets increased from \$2.16 billion for the third quarter of 2019, to \$3.08 billion for the third quarter of 2020, primarily as a result of the acquisition of PFG being completed on March 1, 2020, and the Company's participation in the PPP. Over this period, average loan balances



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increased by \$568.2 million, average interest-bearing deposits increased by \$336.9 million, average noninterest-bearing deposits increased \$296.2 million and average borrowings increased \$306.0 million. The tax equivalent net interest margin decreased to 3.39% for the third quarter of 2020, compared to 3.91% for the third quarter of 2019. The yield on earning assets decreased from 5.05% for the third quarter of 2019, to 3.88% for the third quarter of 2020, primarily due to rate cuts by the Federal Reserve over the past year and, to a lesser extent, loan yields declining from market competition. The cost of average interest-bearing deposits decreased from 1.37% for the third quarter of 2019, to 0.59% for the third quarter of 2020, primarily due to a lower interest rate environment during the period.

The following tables summarizes the major components of net interest income and the related yields and costs for the periods presented (*dollars in thousands*):

	Three Months Ended September 30,					
	2020			2019		
	Average Balance	Interest	Yield/Rate	Average Balance	Interest	
Assets:						
Loans, including fees ¹	\$ 2,410,173	28,508	4.71 %	\$ 1,842,007	25,471	
Loans held for sale	8,048	113	5.57 %	4,189	44	
Taxable securities	132,642	546	1.64 %	118,955	748	
Tax-exempt securities ²	88,129	515	2.32 %	56,598	448	
Federal funds sold and other earning assets	438,785	327	0.30 %	135,444	743	
Total interest-earning assets	3,077,777	30,009	3.88 %	2,157,193	27,454	
Noninterest-earning assets	262,764			191,940		
Total assets	\$ 3,340,541			\$ 2,349,133		
Liabilities and Stockholders' Equity:						
Interest-bearing demand deposits	\$ 509,999	\$ 199	0.16 %	\$ 343,827	\$ 511	
Money market and savings deposits	833,022	704	0.34 %	637,290	1,829	
Time deposits	615,714	1,994	1.29 %	640,679	3,265	
Total interest-bearing deposits	1,958,735	2,897	0.59 %	1,621,796	5,605	
Borrowings	319,265	334	0.42 %	13,310	15	
Subordinated debt	39,311	584	5.91 %	39,226	584	
Total interest-bearing liabilities	2,317,311	3,815	0.65 %	1,674,332	6,204	
Noninterest-bearing deposits	649,489			353,315		
Other liabilities	25,834			18,286		
Total liabilities	2,992,634			2,045,933		
Stockholders' equity	347,907			303,200		
Total liabilities and stockholders' equity	\$ 3,340,541			\$ 2,349,133		
Net interest income, taxable equivalent		\$ 26,194			\$ 21,250	
Interest rate spread			3.22 %			
Tax equivalent net interest margin			3.39 %			
Percentage of average interest-earning assets to average interest-bearing liabilities			132.82 %			
Percentage of average equity to average assets			10.41 %			

¹Includes nonaccrual loans and accretion income on acquired loans of \$960 thousand and \$1.2 million for the quarters ended September 30, 2020 and 2019, respectively. Also includes accretion of loan fees on PPP loans of \$1.8 million for the quarter ended September 30, 2020. No loan fees on PPP loans are included for the quarter ended September 30, 2019.

²Yields related to investment securities exempt from income taxes are stated on a taxable-equivalent basis assuming a federal income tax rate of 21.0%. The taxable-equivalent adjustment was \$151 thousand for the three month period ended September 30, 2020 and \$110 thousand for the three month period ended September 30, 2019.

First nine months of 2020 compared to 2019

Net interest income, taxable equivalent, increased to \$88.2 million for the first nine months of 2020, up from \$81.9 million for the first nine months of 2019. Net interest income was positively impacted, compared to the prior year, primarily due to increases in loan balances and a reduction in interest expense on deposits. Average interest-earning assets increased from \$2.12 billion for the first nine months of 2019, to \$2.76 billion for the first nine months of 2020, primarily as a result of the acquisition of PFG completed March 1, 2020, organic loan growth and the Company's participation in the PPP. Over this period, average loan balances increased by \$428.6 million, average interest-bearing deposits increased by \$200.9 million, average noninterest-bearing deposits increased \$246.6 million and average borrowings increased \$184.8 million.

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The tax equivalent net interest margin decreased to 3.62% for the first nine months of 2020, compared to 3.99% for the first nine months of 2019. The yield on earning assets decreased from 5.17% for the first nine months of 2019, to 4.27% for the first nine months of 2020, primarily due to rate cuts by the Federal Reserve over the past year and, to a lesser extent loan yields declining from market competition. The cost of average interest-bearing deposits decreased from 1.37% for the first nine months of 2019, to 0.79% for the first nine months of 2020, primarily due to a lower interest rate environment during the period.

	Nine Months Ended September 30,				
	2020			2019	
	Average Balance	Interest	Yield/ Cost	Average Balance	Interest
Assets:					
Loans, including fees ¹	\$ 2,252,075	\$ 83,487	4.95 %	\$ 1,823,523	\$ 75,645
Loans held for sale	6,409	231	4.81 %	3,589	123
Taxable Securities	123,895	1,813	1.95 %	134,230	2,591
Tax-exempt securities ²	81,604	1,486	2.43 %	55,585	1,512
Federal funds and other earning assets	296,449	1,206	0.54 %	102,528	2,056
Total interest-earning assets	2,760,432	88,223	4.27 %	2,119,455	81,927
Noninterest-earning assets	248,293			205,984	
Total assets	<u>\$ 3,008,725</u>			<u>\$ 2,325,439</u>	
Liabilities and Stockholders' Equity:					
Interest-bearing demand deposits	\$ 451,074	782	0.23 %	\$ 326,764	1,397
Money market and savings deposits	749,316	2,707	0.48 %	669,067	4,302
Time deposits	667,303	7,527	1.51 %	633,601	5,850
Total interest-bearing deposits	1,867,693	11,016	0.79 %	1,621,108	16,644
Borrowings	203,202	674	0.44 %	18,377	250
Subordinated debt	39,290	1,751	5.95 %	39,205	1,757
Total interest-bearing liabilities	2,110,185	13,441	0.85 %	1,678,690	18,651
Noninterest-bearing deposits	537,860			336,895	
Other liabilities	23,826			14,509	
Total liabilities	2,671,871			2,030,094	
Stockholders' equity	336,854			295,345	
Total liabilities and stockholders' equity	<u>\$ 3,008,725</u>			<u>\$ 2,325,439</u>	
Net interest income, taxable equivalent		<u>\$ 74,782</u>			<u>\$ 63,276</u>
Interest rate spread			3.42 %		
Tax equivalent net interest margin			3.62 %		
Percentage of average interest-earning assets to average interest-bearing liabilities			130.81 %		
Percentage of average equity to average assets			11.20 %		

¹Includes nonaccrual loans and accretion income on acquired loans of \$3.7 million and \$4.3 million for the nine months ended September 30, 2020 and 2019, respectively. Also includes accretion of loan fees on PPP loans of \$3.7 million for the nine months ended September 30, 2020. No loan fees on PPP loans are included for the nine months ended September 30, 2019.

²Yields related to investment securities exempt from income taxes are stated on a taxable-equivalent basis assuming a federal income tax rate of 21.0%. The taxable-equivalent adjustment was \$422 thousand for the nine month period ended September 30, 2020 and \$336 thousand for the nine month period ended September 30, 2019.

Noninterest Income

The following table summarizes noninterest income by category (*in thousands*):

	Three Months Ended			Nine Month
	September 30,			Septemb
	2020	2019	2020	
Service charges on deposit accounts	\$ 892	\$ 767	\$ 2,370	
Gain on sale of securities, net	(9)	1	6	
Mortgage banking	1,029	518	2,544	
Investment services	359	260	1,159	
Insurance commissions	560	—	1,302	
Interchange and debit card transaction fees	868	148	1,652	
Merger termination fee	—	—	—	
Other	422	502	1,417	
Total noninterest income	\$ 4,121	\$ 2,196	\$ 10,450	

Third quarter of 2020 compared to 2019

Noninterest income increased by \$1.9 million, or 87.7%, during the third quarter of 2020 compared to the same period in 2019. This quarterly change in total noninterest income primarily resulted from the following:

- Increase in service charges on deposit accounts, related to the PFG acquisition and deposit growth;
- Increase in mortgage banking, from increased volume due to low rate environment;
- Increase in investment services, stemming from increased production from personnel hires in 2019;
- Addition of insurance commissions from the PFG acquisition; and
- Increase in interchange and debit card transaction fees, related to the PFG acquisition and deposit growth.

First nine months of 2020 compared to 2019

Noninterest income decreased by \$1.9 million, or 15.1%, during the first nine months of 2020 compared to the same period in 2019. This change in total noninterest income primarily resulted from the following:

- Decrease in merger termination fee recognized in the second quarter of 2019;
- Increase in service charges on deposit accounts, related to the PFG acquisition and deposit growth;
- Increase in mortgage banking, from increased volume due to low rate environment;
- Increase in investment services, stemming from increased production from personnel hires in 2019;
- Addition of insurance commissions from the PFG acquisition; and
- Increase in interchange and debit card transaction fees, related to the PFG acquisition and deposit growth.

Noninterest Expense

The following table summarizes noninterest expense by category (*in thousands*):

	Three Months Ended September 30,		Nine Month Septemb
	2020	2019	2020
Salaries and employee benefits	\$ 11,032	\$ 9,072	\$ 31,395
Occupancy and equipment	2,186	1,635	6,093
FDIC insurance	534	(219)	894
Other real estate and loan related expense	643	335	1,535
Advertising and marketing	253	263	653
Data processing	558	273	1,689
Professional services	594	573	2,172
Amortization of intangibles	402	341	1,169
Software as service contracts	573	560	1,604
Merger related and restructuring expenses	290	73	3,863
Other	2,102	1,802	5,699
Total noninterest expense	<u>\$ 19,167</u>	<u>\$ 14,708</u>	<u>\$ 56,766</u>

Third quarter of 2020 compared to 2019

Noninterest expense increased by \$4.5 million, or 30.3%, in the third quarter of 2020 as compared to the same period in 2019. The quarterly increase in total noninterest expense primarily resulted from the following:

- Increase in salary and employee benefits due to the overall franchise growth, including the acquisition of PFG;
- Increase in occupancy and equipment associated with ongoing infrastructure and facilities added to accommodate our growth in operations and the additional branches of the PFG acquisition;
- Increase in FDIC insurance is related to increase in assets due to overall assets growth stemming from our acquisition of PFG, deposit growth and production of PPP loans. The Company reported the third quarter of 2019 from the FDIC, as result of the FDIC Insurance exceeding 1.38% of insured deposits as of June 30, 2019;
- Increase in other real estate and loan related expenses, primarily attributable to increased activity in loan related production and an evaluation adjustment on other real estate owned;
- Increase in data processing is attributable to credit recognized from core processor in third quarter of 2019;
- Increase in merger related and restructure expenses from the acquisition of PFG; and
- Increase in other noninterest expenses due to overall franchise growth.

First nine months of 2020 compared to 2019

Noninterest expense increased by \$9.7 million, or 20.5%, in the first nine months of 2020 as compared to the same period in 2019. The quarterly increase in total noninterest expense primarily resulted from the following:

- Increase in salary and employee benefits due to the overall franchise growth, including the acquisition of PFG;
- Increase in occupancy and equipment associated with ongoing infrastructure and facilities added to accommodate our growth in operations and the additional branches of the PFG acquisition;
- Increase in FDIC insurance related to increase in assets due to overall assets growth stemming from our acquisition of PFG, deposit growth and production of PPP loans. The Company reported the third quarter of 2019 from the FDIC, as result of the FDIC Insurance exceeding 1.38% of insured deposits as of June 30, 2019;
- Increase in other real estate and loan related expenses, primarily attributable to increased activity in loan related production;
- Increase in data processing is attributable to credit recognized from core processor in third quarter of 2019;



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- Increase in professional services from increases in legal and auditing services;
- Increase in merger related and restructure expenses from the acquisition of PFG; and
- Increase in other noninterest expenses due to overall franchise growth.

Taxes

Third quarter of 2020 compared to 2019

In the third quarter of 2020 income tax expense totaled \$2.0 million compared to \$1.9 million a year ago. The effective tax rate was approximately 23.5% in the third quarter of 2020 compared to 24.6% a year ago. The lower effective tax rate for the third quarter of 2020 compared to same quarter in 2019 was due to having a proportionately higher amount of non-taxable income in relation to income before taxes, as well as tax benefit derived from the reconciliation of our tax rates from operations.

First nine months of 2020 compared to 2019

In the first nine months of 2020 income tax expense totaled \$4.6 million compared to \$6.4 million a year ago. The effective tax rate was approximately 21.0% for first nine months of 2020 compared to 24.5% a year ago. The lower effective tax rate for the first nine months of 2020 compared to same period in 2019 was primarily from the CARES Act legislation and having a proportionately higher amount of non-taxable income in relation to income before taxes and a tax benefit realized from the recognition of net operating loss carryforwards from past acquisitions.

Loan Portfolio

The Company had total net loans outstanding, including organic and purchased loans, of approximately \$2.39 billion at September 30, 2020 compared to \$1.89 billion at December 31, 2019. Loans secured by real estate, consisting of commercial or residential property, are the principal component of our loan portfolio.

Organic Loans

Our organic net loans, which excludes loans purchased through acquisitions, increased by \$440.9 million, or 29.1%, from December 31, 2019, to \$1.96 billion at September 30, 2020. Included in the growth was \$300.8 million of PPP loans that were originated and funded during the second and third quarters of 2020. Total net deferred fees associated with the PPP loans was approximately \$11.0 million and \$3.7 million was accreted into income during the second and third quarters of 2020.

Purchased Loans

Purchased non-credit impaired loans of \$393.1 million at September 30, 2020 increased by \$44.0 million from December 31, 2019. Since December 31, 2019, our net purchased credit impaired ("PCI") loans increased by \$7.3 million to \$34.1 million at September 30, 2020. The increase in purchased non-credit impaired loans and PCI loans is related to the acquisition of PFG and offset by maturities, paydowns and payoffs.



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

	September 30, 2020			
	Organic Loans	Purchased Non-Credit Impaired Loans	Purchased Credit Impaired Loans	Total Amount
Commercial real estate-mortgage	\$ 812,191	\$ 201,993	\$ 16,469	\$ 1,030,65
Consumer real estate-mortgage	295,912	133,596	10,801	440,30
Construction and land development	246,112	22,650	6,409	275,17
Commercial and industrial	611,439	32,742	317	644,49
Consumer and other	9,119	4,220	87	13,42
Total gross loans receivable, net of deferred fees	1,974,773	395,201	34,083	2,404,05
Allowance for loan losses	(16,704)	\$ (2,113)	—	(18,81)
Total loans, net	<u>\$ 1,958,069</u>	<u>\$ 393,088</u>	<u>\$ 34,083</u>	<u>\$ 2,385,24</u>

	December 31, 2019			
	Organic Loans	Purchased Non-Credit Impaired Loans	Purchased Credit Impaired Loans	Total Amount
Commercial real estate-mortgage	\$ 705,691	\$ 184,360	\$ 15,255	\$ 905,30
Consumer real estate-mortgage	295,915	115,026	6,541	417,48
Construction and land development	210,421	12,747	4,458	227,62
Commercial and industrial	306,521	30,147	407	337,07
Consumer and other	2,817	6,760	326	9,90
Total gross loans receivable, net of deferred fees	1,521,365	349,040	26,987	1,897,39
Allowance for loan losses	(10,087)	—	(156)	(10,24)
Total loans, net	<u>\$ 1,511,278</u>	<u>\$ 349,040</u>	<u>\$ 26,831</u>	<u>\$ 1,887,14</u>

Loan Portfolio Maturities

The following table sets forth the maturity distribution of our loans at September 30, 2020, including the interest rate sensitivity for loans maturing after one year (*in thousands*):

	One Year or Less	One through Five Years	Over Five Years	Total	Rate Structure Maturing Over
					Fixed Rate
Commercial real estate-mortgage	\$ 114,310	\$ 422,885	\$ 494,121	\$ 1,031,316	\$ 668,389
Consumer real estate-mortgage	27,080	169,931	243,299	440,310	209,880
Construction and land development	83,912	96,043	95,216	275,171	91,711
Commercial and industrial	86,276	476,926	82,421	645,623	520,240
Consumer and other	4,591	6,658	388	11,637	6,738
Total Loans	<u>\$ 316,169</u>	<u>\$ 1,172,443</u>	<u>\$ 915,445</u>	<u>\$ 2,404,057</u>	<u>\$ 1,496,958</u>

Nonaccrual, Past Due, and Restructured Loans

Nonperforming loans as a percentage of total gross loans, net of deferred fees, was 0.09% as of September 30, 2020, which decreased from 0.18% as of December 31, 2019. Total nonperforming assets as a percentage of total assets as of September 30, 2020 totaled 0.18% compared to 0.21% as of December 31, 2019. Acquired PCI loans that are included in loan pools are reclassified at acquisition to accrual status and thus are not included as nonperforming assets.



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The following table summarizes the Company's nonperforming assets for the periods presented (*in thousands*):

	September 30, 2020	I
Nonaccrual loans	\$ 2,248	\$
Accruing loans past due 90 days or more	—	—
Total nonperforming loans	2,248	—
Other real estate owned	3,932	—
Total nonperforming assets	\$ 6,180	\$
Restructured loans not included above	\$ 8	\$

Potential Problem Loans

At September 30, 2020 potential problem loans amounted to approximately \$1.1 million or 0.04% 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.

COVID-19 Loan Modifications

As a result of the CARES Act, the Company began offering short-term loan modifications to assist borrowers during the COVID-19 pandemic. At September 30, 2020, COVID-19 modified loans amounted to \$232.5 million, or 9.7% of the total loans outstanding.

The Company offered deferral options of: 1) three months deferral of payment and then three months of interest only, 2) three months of interest only, 3) three months deferral of payment, 4) six months of interest only, and approximately all of the \$232.5 million remaining COVID-19 modified loans will mature during the fourth quarter of 2020.

Included in the COVID-19 modified loans were \$56.2 million and \$30.4 million of hospitality and restaurant loans, respectively. These sectors had increased vulnerability from COVID-19. At September 30, 2020, the short-term loan modifications were still expected to mature on the original maturity schedule. All of the COVID-19 modified loans were transitioned into watchlist categories internally.

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. Our provision for loan losses for the nine months ended September 30, 2020, is \$8.7 million compared to \$1.9 million in the same period of 2019, an increase of \$6.8 million. As of September 30, 2020, and December 31, 2019, our allowance for loan losses was \$18.8 million and \$10.2 million, respectively, which we deemed to be adequate at each of the respective dates. The increase in the allowance for loan losses at September 30, 2020, as compared to December 31, 2019, is primarily attributable to the ongoing economic uncertainties related to the COVID-19 pandemic. Also, during 2020, the Company updated the Allowance for Loan Loss policy to increase the additional basis points allowed for the unallocated risk portion from 100 basis points to 125 basis points. In addition, the Company added a new qualitative factor based on the percentage of COVID modified loans / total loans. The qualitative factors were also expanded to provide additional granularity related to the hospitality and restaurant industries which are most impacted by the pandemic within our footprint. The changes in our economic factors and the addition of the COVID modified factors equated to an additional \$8.3 million in reserve. Our allowance for loan loss as a percentage of total loans was 0.78% at September 30, 2020 and 0.54% at December 31, 2019.

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. A provision for loan losses is recorded for any deterioration in these loans subsequent to the acquisition. As of September 30, 2020, the notional balances on PCI loans was \$47.2



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million while the carrying value was \$34.1 million. At September 30, 2020, there were no loan loss allowances on PCI loans.

The following table sets forth, based on our best estimate, the allocation of the allowance to types of loans for the periods presented, and the percentage of loans in each category to total loans (*dollars in thousands*):

	September 30, 2020		December 31,	
	Amount	Percent	Amount	
Commercial real estate-mortgage	\$ 7,729	42.9 %	\$ 4,508	
Consumer real estate-mortgage	3,444	18.3 %	2,576	
Construction and land development	2,060	11.4 %	1,127	
Commercial and industrial	5,463	26.8 %	1,957	
Consumer and other	121	0.6 %	75	
Total allowance for loan losses	<u>\$ 18,817</u>	<u>100.0 %</u>	<u>\$ 10,243</u>	

The allocation by category is determined based on the loans individually 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, non PCI, loans were approximately \$475 thousand at December 31, 2019 compared to \$486 thousand at September 30, 2020.



Analysis of the Allowance for Loan Losses

The following is a summary of changes in the allowance for loan losses for the periods presented including the ratio of the allowance for loan losses to total loans as of the end of each period (*dollars in thousands*):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
Balance at beginning of period	\$ 16,254	\$ 9,097	\$ 10,243	\$ 10,243
Provision for loan losses	2,634	724	8,683	8,683
Charged-off loans:				
Commercial real estate-mortgage	—	(36)	—	—
Consumer real estate-mortgage	(21)	(1)	(23)	(23)
Construction and land development	—	—	—	—
Commercial and industrial	(60)	(20)	(77)	(77)
Consumer and other	(89)	(50)	(231)	(231)
Total charged-off loans	(170)	(107)	(331)	(331)
Recoveries of previously charged-off loans:				
Commercial real estate-mortgage	11	39	16	16
Consumer real estate-mortgage	17	17	34	34
Construction and land development	—	3	2	2
Commercial and industrial	55	12	103	103
Consumer and other	16	7	67	67
Total recoveries of previously charged-off loans	99	78	222	222
Net loan charge-offs	(71)	(29)	(109)	(109)
Balance at end of period	\$ 18,817	\$ 9,792	\$ 18,817	\$ 18,817
Ratio of allowance for loan losses to total loans outstanding at end of period	0.78 %	0.53 %	0.78 %	0.78 %
Ratio of net loan charge-offs to average loans outstanding for the period (annualized)	— %	0.01 %	— %	— %

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 portfolio, past loan loss experience, known and inherent risks in the portfolio, the views of the Bank's regulators, adverse situations that may affect borrowers' 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.

Securities Portfolio

Our securities portfolio, consisting primarily of Federal agency bonds, state and municipal securities, and mortgage-backed securities, amounted to fair values of \$214.6 million and \$178.3 million at September 30, 2020 and December 31, 2019, respectively. Our investments to assets ratio decreased from 7.3% at December 31, 2019 to 6.3% at September 30, 2020. Our securities portfolio serves many purposes including serving as a potential liquidity source, collateral for public funds, and as a stable source of income. All of the Company's securities are designated as available-for-sale.

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The following table shows the amortized cost of the Company's securities by investment categories (*in thousands*):

	September 30, 2020		L
U.S. Government-sponsored enterprises (GSEs)	\$	30,311	\$
Municipal securities		88,864	
Other debt securities		17,519	
Mortgage-backed securities		74,424	
Total securities	\$	211,118	\$

The following table presents the contractual maturity of the Company's securities by contractual maturity date and average yields based on amortized cost (for all obligations on a fully taxable basis) at September 30, 2020. The composition and maturity / repricing distribution of the securities portfolio is subject to change depending on rate sensitivity, capital and liquidity needs (*dollars in thousands*):

	Maturity By Years			
	1 or Less	1 to 5	5 to 10	Over 10
U.S. Government agencies	\$ —	\$ 641	\$ 7,402	\$ 22,268
State and political subdivisions	4,624	3,385	4,757	76,098
Other debt securities	—	983	14,036	2,500
Mortgage-backed securities	—	3,569	13,524	57,331
Total securities	\$ 4,624	\$ 8,578	\$ 39,719	\$ 158,197
Weighted average yield ⁽¹⁾	1.92 %	1.22 %	3.24 %	2.56 %

(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, IRAs and 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 September 30, 2020, brokered deposits represented approximately 3.0% of total deposits.

The Company believes its deposit product offerings are properly structured to attract and retain core low-cost deposit relationships. The average cost of interest-bearing deposits for the three months ended September 30, 2020 was 0.59% compared to 1.37% for the same period in 2019 and 0.79% and 1.37% for the nine months ended September 30, 2020 and September 30, 2019, respectively. The decreased cost of interest-bearing deposits was due to changes in rates caused by federal rate-changes during the periods.

Total deposits as of September 30, 2020 were \$2.65 billion, which was an increase of \$604.8 million from December 31, 2019. This increase was primarily from the completed acquisition of PFG and deposits related to the PPP loans. As of September 30, 2020, the Company had outstanding time deposits under \$250,000 with balances of \$437.1 million and time deposits over \$250,000 with balances of \$140.0 million.

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The following table summarizes the maturities of time deposits \$250,000 or more (*in thousands*).

Three months or less	\$
Three to six months	
Six to twelve months	
More than twelve months	
Total	\$

Borrowings

The Company uses short-term borrowings and long-term debt to provide both funding and, to a lesser extent, regulatory capital using debt at the Company level which can be downstreamed as Tier 1 capital to the Bank. Borrowings totaled \$319.4 million at September 30, 2020, and primarily consisted of \$75.0 million in FHLB borrowings, \$237.8 million from the PPPLF and short-term borrowings totaled \$6.2 million and consisted entirely of securities sold under repurchase agreements. Long-term debt totaled \$39.3 million at September 30, 2020 and December 31, 2019, respectively and consisted entirely of subordinated debt. For more information regarding our borrowings, see "Part I - Item 1. Consolidated Financial Statements - Note 7 – Borrowings and Line of Credit."

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 Bank's Common Equity Tier 1 capital, Tier 1 capital, leverage and total capital ratios. At September 30, 2020 and December 31, 2019, our capital ratios, including our Bank's 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. For more information regarding our capital, leverage and total capital ratios, see "Part I - Item 1. Consolidated Financial Statements - Note 13 - Regulatory Matters."

Liquidity and Off-Balance Sheet Arrangements

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. At September 30, 2020, we had \$468.4 million of pre-approved but unused lines of credit and \$5.5 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. For more information regarding our off-balance sheet arrangements, see "Part I - Item 1. Consolidated Financial Statements - Note 9 – Commitments and Contingent Liabilities."

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 dynamic interest rate forecast over the next 12 and 24 months, limits in the decline in net interest income are as follows:

September 30, 2020:	Estimated % Change in Net Interest Income Over 12 Months		Maximum Percentage in Net Interest Income from the Base Case Projection of Net Interest Income
	Increase +	Decrease -	Next 12 Months
	An instantaneous, parallel rate increase or decrease of the following at the beginning of the third quarter:		
± 100 basis points	4.15%	0.68%	8%
± 200 basis points	6.36%	1.01%	14%

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:

September 30, 2020:	Current Estimated Instantaneous Rate Change		Economic Value
	Increase +	Decrease -	
Instantaneous, Parallel Change in Prevailing Interest Rates Equal to:			
±100 basis points	7.07%	(3.35)%	
±200 basis points	8.86%	14.17%	

At September 30, 2020, our model results indicated that we were within these policy limits.

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.



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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.

The Company has \$4.6 million in investments that mature throughout the next 12 months. The Company also anticipates \$17.8 million of principal payments from mortgage-backed securities over the same period. The Company also has unused borrowing capacity in the amount of \$304.2 million available with the Federal Reserve, FHLB, several correspondent banks and a line of credit. With these sources of funds, the Company currently anticipates adequate liquidity to meet the expected obligations of its customers.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

This item is not required for a Smaller Reporting Company.

ITEM 4. CONTROLS AND PROCEDURES

Under the supervision and with the participation of management, including SmartFinancial's Chief Executive Officer and Chief Financial Officer, SmartFinancial has evaluated the effectiveness of its disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")), as of September 30, 2020 (the "Evaluation Date"). Based on such evaluation, SmartFinancial's Chief Executive Officer and Chief Financial Officer have concluded that, as of the Evaluation Date, SmartFinancial's disclosure controls and procedures were effective to ensure that information required to be disclosed by SmartFinancial in the reports that it files or submits under the Exchange Act is (i) accumulated and communicated to SmartFinancial's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decision regarding the required disclosure and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

There were no changes in SmartFinancial's internal control over financial reporting during SmartFinancial's fiscal quarter ended September 30, 2020 that have materially affected, or are reasonably likely to materially affect, SmartFinancial's internal control over financial reporting.



PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

SmartFinancial, Inc. and its wholly owned subsidiary, SmartBank, are periodically involved as a plaintiff or a defendant in various legal actions in the ordinary course of business. While the outcome of these matters is not currently determinable, management does not expect the disposition of any of these matters to have a material adverse impact on the Company's financial condition, financial statements or results of operations.

Item 1A. Risk Factors.

The Company disclosed risk factors in its Annual Report on Form 10-K for the year ended December 31, 2019. The risks described may not be the only risks facing us. Additional risks and uncertainties not currently known to us or that are currently considered to not be material also may materially adversely affect our business, financial condition, and/or operating results. The following risk factors have been included in this Quarterly Report on Form 10-Q in response to the global market disruptions that have resulted from the COVID-19 pandemic.

The ongoing COVID-19 pandemic and measures implemented to prevent its spread could have a material adverse effect on our business, results of operations and financial condition, and such effects will depend on future developments, which are highly uncertain and are difficult to predict.

Global health concerns relating to the COVID-19 outbreak and related government actions taken to reduce the spread of the virus have been weighing on the macroeconomic environment, and the outbreak has significantly increased economic uncertainty and reduced economic activity. The outbreak has resulted in authorities implementing numerous measures to try to contain the virus, such as travel bans and restrictions, quarantines, shelter in place or total lock-down orders and business limitations and shutdowns. Such measures have significantly contributed to rising unemployment and negatively impacted consumer and business spending. The United States government has taken steps to attempt to mitigate some of the more severe anticipated economic effects of the virus, including the passage of the CARES Act, but there can be no assurance that such steps will be effective or achieve their desired results in a timely fashion.

The outbreak has adversely impacted and is likely to further adversely impact our workforce and operations and the operations of our borrowers, customers and business partners. In particular, we may experience financial losses due to a number of operational factors impacting us or our borrowers, customers or business partners, including but not limited to:

- credit losses resulting from financial stress being experienced by our borrowers as a result of the outbreak and related governmental actions, particularly in the hospitality, energy, industries;
- declines in collateral values;
- third party disruptions, including outages at network providers and other suppliers;
- increased cyber and payment fraud risk, as cybercriminals attempt to profit from the disruption, given increased online and remote activity;
- risk of litigation or other third-party claims, including with respect to our participation in the Payroll Protection Program and any other government-sponsored stimulus programs; and
- operational failures due to changes in our normal business practices necessitated by the outbreak and related governmental actions.

These factors may remain prevalent for a significant period of time and may continue to adversely affect our business, results of operations and financial condition even after the COVID-19 outbreak has subsided.

The spread of COVID-19 has caused us to modify our business practices (including restricting employee travel, and developing work from home and social distancing plans for our employees), and we may take further actions as may be required by government authorities or as we determine are in the best interests of our employees, customers and business partners. There is no certainty that such measures will be sufficient to mitigate the risks posed by the virus or will otherwise be satisfactory to government authorities.



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The extent to which the coronavirus outbreak impacts our business, results of operations and financial condition will depend on future developments, which are highly uncertain and are difficult to predict, including, but not limited to, the duration and spread of the outbreak, its severity, the actions to contain the virus or treat its impact, and how quickly and to what extent normal economic and operating conditions can resume. Even after the COVID-19 outbreak has subsided, we may continue to experience materially adverse impacts to our business as a result of the virus's global economic impact, including the availability of credit, adverse impacts on our liquidity and any recession that has occurred or may occur in the future.

There are no comparable recent events that provide guidance as to the effect the spread of COVID-19 as a global pandemic may have, and, as a result, the ultimate impact of the outbreak is highly uncertain and subject to change. We do not yet know the full extent of the impacts on our business, our operations or the global economy as a whole. However, the effects could have a material impact on our results of operations and heighten many of our known risks described in the "Risk Factors" section of our Annual Report on Form 10-K for the year ended December 31, 2019.

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

- (a) Not applicable
- (b) Not applicable
- (c) Issuer Purchases of Registered Equity Securities

On November 20, 2018, the Company announced that its board of directors has authorized a stock repurchase plan pursuant to which the Company may purchase up to \$10.0 million in shares of the Company's outstanding common stock. Stock repurchases under the plan will be made from time to time in the open market, at the discretion of the management of the Company, and in accordance with applicable legal requirements. The stock repurchase plan does not obligate the Company to repurchase any dollar amount or number of shares, and the program may be extended, modified, amended, suspended, or discontinued at any time. As of September 30, 2020, we have purchased \$2.1 million of the authorized \$10.0 million and may purchase up to an additional \$7.9 million in the Company's outstanding common stock.

The following table summarizes the Company's repurchase activity during the three months ended September 30, 2020.

Period	Total Number of Shares Repurchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	M: Nu App Dolla Share Yet Be Under or Pro tho
July 1, 2020 to July 31, 2020	—	\$ —	—	\$
August 1, 2020 to August 31, 2020	—	—	—	
September 1, 2020 to September 31, 2020	—	—	—	
Total	—	\$ —	—	\$

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not Applicable.

Item 5. Other Information.

None.



SIGNATURES

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

Date: November 6, 2020

SmartFinancial, Inc.

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

Date: November 6, 2020

/s/ Ronald J. Gorczynski
Ronald J. Gorczynski
Executive Vice President and Chief Financial Officer
(principal financial officer and accounting officer)

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Section 2: EX-31.1 (EX-31.1)

EXHIBIT 31.1

CERTIFICATION

I, William Y. Carroll, certify that:

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

Date: November 6, 2020

/s/ William Y. Carroll
William Y. Carroll
President and Chief Executive Officer

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Section 3: EX-31.2 (EX-31.2)

EXHIBIT 31.2

CERTIFICATION

I, Ronald J. Gorczynski, certify that:

1. I have reviewed this quarterly report on Form 10-Q of SmartFinancial, Inc. (the "Registrant");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the

circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;
4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control 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 Registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter (the Registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of the Registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Date: November 6, 2020

/s/ Ronald J. Gorczynski
Ronald J. Gorczynski
Executive Vice President and Chief Financial Officer

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Section 4: EX-32.1 (EX-32.1)

EXHIBIT 32.1

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of SmartFinancial, Inc., (the "Company") on Form 10-Q for the quarter ended September 30, 2020, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, William Y. Carroll, Jr., President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

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

Date: November 6, 2020

/s/ William Y. Carroll, Jr.
William Y. Carroll, Jr.
President and Chief Executive Officer

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Section 5: EX-32.2 (EX-32.2)

EXHIBIT 32.2

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of SmartFinancial, Inc., (the "Company") on Form 10-Q for the quarter ended September 30, 2020, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Ronald J. Gorczynski, Executive Vice President and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

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

Date: November 6, 2020

/s/ Ronald J. Gorczynski
Ronald J. Gorczynski
Executive Vice President and Chief Financial Officer

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