

*South Atlantic Bancshares, Inc.
and Subsidiary*



Report on Consolidated Financial Statements

For the years ended December 31, 2018 and 2017

South Atlantic Bancshares, Inc. and Subsidiary

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Independent Auditor's Report

The Board of Directors
South Atlantic Bancshares, Inc. and Subsidiary
Myrtle Beach, South Carolina

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of South Atlantic Bancshares, Inc. and its Subsidiary which comprise the consolidated balance sheets as of December 31, 2018 and 2017, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for the years then ended and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of South Atlantic Bancshares, Inc. and its Subsidiary as of December 31, 2018 and 2017, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

As described in Note 2 to the financial statements, the consolidated financial statements for the year ended December 31, 2017, as well as shareholders' equity for the year ended December 31, 2016, have been restated to correctly reflect the accounting for the Company's 401(k) Employee Stock Ownership Plan and repurchased Company stock.

A handwritten signature in black ink that reads "Elliott Davis, LLC". The signature is written in a cursive, flowing style.

Columbia, South Carolina
March 11, 2019

South Atlantic Bancshares, Inc. and Subsidiary

Consolidated Balance Sheets

December 31, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Assets:		
Cash and cash equivalents:		
Cash and due from banks	\$ 8,420,048	\$ 6,399,310
Federal funds sold and interest-bearing deposits	<u>7,380,430</u>	<u>13,987,188</u>
Total cash and cash equivalents	<u>15,800,478</u>	<u>20,386,498</u>
Investment securities:		
Securities available-for-sale	49,240,294	35,854,923
Nonmarketable equity securities	<u>752,500</u>	<u>1,037,000</u>
Total investment securities	<u>49,992,794</u>	<u>36,891,923</u>
Mortgage loans held-for-sale	923,722	1,865,265
Loans receivable	531,034,918	434,917,988
Less allowance for loan losses	<u>4,399,945</u>	<u>3,748,508</u>
Loans, net	<u>526,634,973</u>	<u>431,169,480</u>
Premises, furniture and equipment, net	16,102,895	16,374,558
Bank-owned life insurance	9,467,137	9,225,239
Accrued interest receivable	1,806,034	1,517,998
Deferred tax assets	1,916,850	89,731
Goodwill	5,348,699	-
Core deposit intangible	1,395,602	-
Other assets	<u>826,687</u>	<u>882,971</u>
Total assets	<u>\$ 630,215,871</u>	<u>\$ 518,403,663</u>
Liabilities:		
Deposits:		
Noninterest-bearing transaction accounts	\$ 87,893,912	\$ 67,667,405
Interest-bearing transaction accounts	31,166,273	23,445,832
Savings and money market accounts	319,117,275	227,636,155
Time deposits \$250,000 and over	49,604,943	31,014,355
Other deposits	<u>42,556,349</u>	<u>39,462,231</u>
Total deposits	<u>530,338,752</u>	<u>439,225,978</u>
Advances from Federal Home Loan Bank	5,000,000	15,000,000
Federal funds purchased	10,453,000	-
Accrued interest payable	95,520	53,166
Other liabilities	<u>4,992,154</u>	<u>3,982,515</u>
Total liabilities	<u>550,879,426</u>	<u>458,261,659</u>
Commitments and contingencies (Notes 14, 16 and 19)		
Shareholders' equity:		
Preferred stock, \$1.00 par value per share, 5,000,000 shares authorized; no shares issued and outstanding		
	-	-
Common stock, \$1.00 par value, 25,000,000 shares authorized; 7,504,040 and 6,423,797 shares issued and outstanding at December 31, 2018 and 2017, respectively		
	7,504,040	6,423,797
Capital surplus	69,967,638	54,533,637
Retained earnings (deficit)	3,243,306	(214,148)
Accumulated other comprehensive loss	(743,291)	(144,190)
Treasury stock, 45,728 and 39,628 shares at December 31, 2018 and 2017, respectively	<u>(635,248)</u>	<u>(457,092)</u>
Total shareholders' equity	<u>79,336,445</u>	<u>60,142,004</u>
Total liabilities and shareholders' equity	<u>\$ 630,215,871</u>	<u>\$ 518,403,663</u>

See Notes to Consolidated Financial Statements

South Atlantic Bancshares, Inc. and Subsidiary

Consolidated Statements of Income

For the years ended December 31, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Interest income:		
Loans, including fees	\$ 24,927,041	\$ 18,938,716
Securities available-for-sale	1,229,407	1,021,661
Other interest income	<u>504,021</u>	<u>176,152</u>
Total	<u>26,660,469</u>	<u>20,136,529</u>
Interest expense:		
Deposits	2,070,220	1,057,516
Time deposits \$250,000 and over	695,601	538,282
Other borrowings	<u>129,372</u>	<u>96,286</u>
Total	<u>2,895,193</u>	<u>1,692,084</u>
Net interest income	23,765,276	18,444,445
Provision for loan losses	<u>710,000</u>	<u>915,000</u>
Net interest income after provision for loan losses	<u>23,055,276</u>	<u>17,529,445</u>
Noninterest income:		
Mortgage origination income	1,429,718	1,455,932
Merchant fee income	486,394	467,618
Service charges on deposit accounts	325,415	214,141
Loss on sale of investment securities	-	(58,413)
Bank-owned life insurance income	241,722	244,847
Other income	<u>1,041,307</u>	<u>789,718</u>
Total noninterest income	<u>3,524,556</u>	<u>3,113,843</u>
Noninterest expenses:		
Salaries and employee benefits	11,957,901	10,279,764
Net occupancy	1,967,976	1,254,285
Furniture and equipment	767,646	581,787
FDIC banking assessments	411,495	417,996
Advertising	766,632	640,859
Data processing fees	711,997	533,796
Merger related expenses	1,385,270	-
Other operating expenses	<u>4,241,827</u>	<u>3,339,551</u>
Total noninterest expenses	<u>22,210,744</u>	<u>17,048,038</u>
Income before income taxes	4,369,088	3,595,250
Income taxes	<u>911,634</u>	<u>379,439</u>
Net income	<u>\$ 3,457,454</u>	<u>\$ 3,215,811</u>
Income per common share		
Basic income per common share	<u>\$ 0.48</u>	<u>\$ 0.55</u>
Average common shares outstanding - basic	<u>7,176,015</u>	<u>5,809,334</u>
Diluted income per common share	<u>\$ 0.47</u>	<u>\$ 0.53</u>
Average common shares outstanding - diluted	<u>7,307,507</u>	<u>6,019,480</u>

See Notes to Consolidated Financial Statements

South Atlantic Bancshares, Inc. and Subsidiary

Consolidated Statements of Comprehensive Income

For the years ended December 31, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Net income	\$ 3,457,454	\$ 3,215,811
Other comprehensive income:		
Unrealized gains (losses) on securities available-for-sale	(749,756)	1,333,671
Reclassification adjustment for losses realized in net income	<u>-</u>	<u>58,413</u>
Net unrealized gains (losses) on securities	(749,756)	1,392,084
Income tax benefit (expense)	<u>150,655</u>	<u>(516,982)</u>
Net-of-tax amount	<u>(599,101)</u>	<u>875,102</u>
Comprehensive income	<u>\$ 2,858,353</u>	<u>\$ 4,090,913</u>

See Notes to Consolidated Financial Statements

South Atlantic Bancshares, Inc. and Subsidiary
Consolidated Statements of Changes in Shareholders' Equity
For the years ended December 31, 2018 and 2017

	Common Stock		Capital surplus	Retained earnings (deficit)	Accumulated other comprehensive loss	Treasury stock	Total
	Shares	Amount					
Balance, December 31, 2016	3,831,322	\$ 3,831,322	\$ 32,068,766	\$ 2,496,892	\$ (997,418)	\$ (580,753)	\$ 36,818,809
Net income	-	-	-	3,215,811	-	-	3,215,811
Other comprehensive income, net of tax expense of \$516,982	-	-	-	-	875,102	-	875,102
Stock and warrant compensation expense	-	-	68,912	-	-	-	68,912
Stock dividend, 10%	584,016	584,016	5,456,048	(5,948,725)	-	(91,339)	-
Proceeds from capital raise, net	1,632,654	1,632,654	17,145,499	-	-	-	18,778,153
Proceeds from exercise of stock options	375,805	375,805	(305,588)	-	-	-	70,217
Reclassification of accumulated other comprehensive loss due to tax rate change	-	-	-	21,874	(21,874)	-	-
Contribution of treasury stock to KSOP plan	-	-	100,000	-	-	215,000	315,000
Balance, December 31, 2017	6,423,797	6,423,797	54,533,637	(214,148)	(144,190)	(457,092)	60,142,004
Net income	-	-	-	3,457,454	-	-	3,457,454
Other comprehensive loss, net of tax benefit of \$150,655	-	-	-	-	(599,101)	-	(599,101)
Stock and warrant compensation expense	-	-	104,074	-	-	-	104,074
Stock issued - Atlantic Bancshares, Inc. merger	1,062,731	1,062,731	15,143,917	-	-	-	16,206,648
Proceeds from exercise of stock options	17,512	17,512	142,260	-	-	-	159,772
Purchase of treasury stock	-	-	-	-	-	(446,906)	(446,906)
Contribution of treasury stock to KSOP plan	-	-	43,750	-	-	268,750	312,500
Balance, December 31, 2018	<u>7,504,040</u>	<u>\$ 7,504,040</u>	<u>\$ 69,967,638</u>	<u>\$ 3,243,306</u>	<u>\$ (743,291)</u>	<u>\$ (635,248)</u>	<u>\$ 79,336,445</u>

See Notes to Consolidated Financial Statements

South Atlantic Bancshares, Inc. and Subsidiary

Consolidated Statements of Cash Flows

For the years ended December 31, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Cash flows from operating activities:		
Net income	\$ 3,457,454	\$ 3,215,811
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	710,000	915,000
Depreciation expense	933,991	765,902
Discount accretion and premium amortization	255,571	578,803
Amortization of core deposit intangibles	234,398	-
Stock and warrant compensation expense	104,074	68,912
Loss on sale of securities	-	58,413
Contribution of treasury stock to KSOP plan	312,500	315,000
Deferred tax benefit (expense)	(72,573)	(147,379)
Accretion on acquired loans	(382,280)	-
Amortization of deferred loan costs and fees, net	(462,582)	(298,437)
(Increase) decrease in loans held for sale	941,543	(336,618)
Increase in cash surrender value of BOLI	(241,898)	(244,847)
Increase in accrued interest receivable	(171,245)	(219,681)
Increase in accrued interest payable	19,256	20,146
(Increase) decrease in other assets	301,974	(226,655)
Increase in other liabilities	680,771	246,616
Net cash provided by operating activities	<u>6,620,954</u>	<u>4,710,986</u>
Investing activities:		
Purchase of securities available-for-sale	(15,618,288)	(7,115,889)
Proceeds from sales of securities available-for-sale	-	11,411,532
Proceeds from maturities, calls, and paydowns of securities available-for-sale	1,910,311	3,240,603
(Purchase) sale of nonmarketable equity securities	284,500	(40,000)
Net increase in loans to customers	(32,227,235)	(64,762,886)
Purchases of premises, furniture and equipment	(491,991)	(1,059,572)
Cash received from acquisitions, net	<u>14,304,699</u>	<u>-</u>
Net cash used by investing activities	<u>(31,838,004)</u>	<u>(58,326,214)</u>
Financing activities:		
Decrease in noninterest-bearing deposits	(17,384,072)	(11,314,656)
Increase in interest-bearing deposits	37,849,236	68,277,959
Proceeds from Federal Home Loan Bank Advances	10,000,000	40,000,000
Repayments of Federal Home Loan Bank Advances	(20,000,000)	(40,000,000)
Increase (decrease) in federal funds purchased	10,453,000	(9,042,700)
Proceeds from exercise of stock options	159,772	70,217
Purchase of treasury stock	(446,906)	-
Proceeds from stock offering, net	<u>-</u>	<u>18,778,153</u>
Net cash provided by financing activities	<u>20,631,030</u>	<u>66,768,973</u>
Net increase (decrease) in cash and cash equivalents	<u>(4,586,020)</u>	<u>13,153,747</u>
Cash and cash equivalents, beginning of year	<u>20,386,498</u>	<u>7,232,751</u>
Cash and cash equivalents, end of year	<u>\$ 15,800,478</u>	<u>\$ 20,386,498</u>
Cash paid during the year for:		
Interest	\$ 2,852,839	\$ 1,671,938
Income taxes	549,703	909,696
Noncash investing and financing activities:		
Assets acquired, net of cash	\$ 81,859,744	\$ -
Liabilities assumed	70,999,575	-
Net assets acquired	10,860,169	-
Goodwill and fair value acquisition adjustments	5,348,699	-
Unrealized gain (loss) on securities available-for-sale	\$ (749,756)	\$ 1,392,084

See Notes to Consolidated Financial Statements

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies

Organization:

South Atlantic Bancshares, Inc. and Subsidiary (the "Company") was incorporated to serve as a bank holding company for its subsidiary, South Atlantic Bank (the "Bank"). The Bank commenced business on November 28, 2007. The principal business activity of the Bank is to provide banking services to domestic markets, principally in Horry, Georgetown, Charleston, and Beaufort counties, South Carolina. The Bank is a state-chartered commercial bank, and its deposits are insured by the Federal Deposit Insurance Corporation. The consolidated financial statements include the accounts of the parent company and its wholly-owned subsidiary after elimination of all significant intercompany balances and transactions.

Management's estimates:

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the dates of the balance sheets and the statements of income for the periods covered. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for losses on loans, including valuation allowances for impaired loans, business combination accounting, including valuation of goodwill and core deposit intangibles, and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans. In connection with the determination of the allowances for losses on loans and foreclosed real estate, management obtains independent appraisals for significant properties. Management must also make estimates in determining the estimated useful lives and methods for depreciating premises and equipment.

While management uses available information to recognize losses on loans and foreclosed real estate, future additions to the allowances may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowances for losses on loans and foreclosed real estate. Such agencies may require the Company to recognize additions to the allowances based on their judgments about information available to them at the time of their examination. Because of these factors, it is reasonably possible that the allowances for losses on loans and foreclosed real estate may change materially in the near term.

Concentrations of credit risk:

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of loans receivable, investment securities, federal funds sold and amounts due from banks.

The Company makes loans to individuals and small businesses for various personal and commercial purposes primarily in Horry, Georgetown, Charleston, and Beaufort counties in South Carolina. Additionally, management is not aware of any concentrations of loans to classes of borrowers or industries that would be similarly affected by economic conditions.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Concentrations of credit risk, continued:

In addition to monitoring potential concentrations of loans to particular borrowers or groups of borrowers, industries and geographic regions, management monitors exposure to credit risk from concentrations of lending products and practices such as loans that subject borrowers to substantial payment increases (e.g. principal deferral periods, loans with initial interest-only periods, etc.), and loans with high loan-to-value ratios. Management has determined that there is no concentration of credit risk associated with its lending policies or practices. Additionally, there are industry practices that could subject the Company to increased credit risk should economic conditions change over the course of a loan's life. However, to offset this risk, the Company makes variable rate loans and fixed rate principal-amortizing loans with maturities prior to the loan being fully amortized (i.e. balloon payment loans usually five to seven years). These loans are underwritten and monitored to manage the associated risks. Therefore, management believes that these particular practices do not subject the Company to unusual credit risk.

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

Cash and Cash Equivalents:

Cash and cash equivalents consists of cash and due from banks and interest-bearing cash with banks. Cash and cash equivalents have maturities of three months or less. Accordingly, the carrying amount of such instruments is considered a reasonable estimate of fair value. The Company is required by regulation to maintain an average cash reserve balance based on a percentage of deposits. The amount of the required cash reserve balance at December 31, 2018 was approximately \$32,000. There was no required amount as of December 31, 2017.

Securities Available-for-Sale:

Securities available-for-sale are carried at amortized cost and adjusted to estimated market value by recognizing the aggregate unrealized gains or losses in a valuation account. Aggregate market valuation adjustments are recorded in shareholders' equity net of deferred income taxes. Reductions in market value considered by management to be other than temporary are reported as a realized loss and a reduction in the cost basis of the security. The adjusted cost basis of investments available-for-sale is determined by specific identification and is used in computing the gain or loss upon sale.

Nonmarketable Equity Securities:

Nonmarketable equity securities include the cost of the Company's investment in the stock of the Federal Home Loan Bank. The stock has no quoted market value and no ready market exists. Investment in Federal Home Loan Bank stock is a condition of borrowing from the Federal Home Loan Bank. At December 31, 2018 and 2017, the investment in Federal Home Loan Bank stock was \$752,500 and \$1,037,000, respectively. Dividends received on the stock are included in the nonmarketable equity securities component of interest income.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Loans held-for-sale:

The Bank's mortgage activities are comprised of accepting residential mortgage loan applications, qualifying borrowers to standards established by investors, funding residential mortgages, and selling mortgages to investors under pre-existing commitments. Funded residential mortgages held temporarily for sale to investors are recorded at cost which approximates market value. Application and origination fees collected by the Bank are recognized as income upon sale to the investor.

Loans receivable:

Loans are stated at their unpaid principal balance adjusted for any unamortized deferred fees and costs. Interest income is accrued on the unpaid principal balance using the simple interest method and is recorded in the period earned.

When serious doubt exists as to the collectability of a loan or when a loan becomes contractually 90 days past due as to principal or interest, interest income is generally discontinued unless the estimated net realizable value of collateral exceeds the principal balance and accrued interest. When interest accruals are discontinued, income earned but not collected is reversed.

Loan origination and commitment fees and certain direct loan origination costs (principally salaries and employee benefits) are deferred and amortized to income over the contractual life of the related loans or commitments, adjusted for prepayments, using a method that approximates a level yield.

The Company identifies impaired loans through its normal internal loan review process. Loans on the Company's problem loan watch list are considered potentially impaired loans. These loans are evaluated in determining whether all outstanding principal and interest are expected to be collected. Loans are not considered impaired if a minimal payment delay occurs and all amounts due, including accrued interest at the contractual interest rate for the period of delay, are expected to be collected.

Troubled debt restructurings ("TDRs"):

The Company designates loan modifications as TDRs when, for economic or legal reasons related to the borrower's financial difficulties, it grants a concession to the borrower that it would not otherwise consider. Loans on nonaccrual status at the date of modification are initially classified as nonaccrual TDRs. Loans on accruing status at the date of modification are initially classified as accruing TDRs at the date of modification, if the note is reasonably assured of repayment and performance is in accordance with its modified terms. Such loans may be designated as nonaccrual loans subsequent to the modification date if reasonable doubt exists as to the collection of interest or principal under the restructuring agreement. Nonaccrual TDRs are returned to accrual status when there is economic substance to the restructuring, there is well documented credit valuation of the borrower's financial condition, the remaining balance is reasonably assured of repayment in accordance with its modified terms, and the borrower has demonstrated repayment performance in accordance with the modified terms for a reasonable period of time (generally a minimum of six months).

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Allowance for loan losses:

The provision for loan losses charged to operating expenses reflects the amount deemed appropriate by management to establish an adequate reserve to meet the probable loan losses present in the current portfolio. Management's judgment is based on periodic and regular evaluation of individual loans, the overall risk characteristics of the various portfolio segments, and prevailing economic conditions. Loans that are determined to be uncollectable are charged against the allowance. Provisions for loan losses and recoveries on loans previously charged off are added to the allowance.

While management uses the best information available to make evaluations, future adjustments may be necessary if economic conditions differ substantially from the assumptions used in making the evaluation. The allowance for loan losses is subject to periodic evaluation by various regulatory authorities and may be subject to adjustment upon their examination.

Business combinations and method of accounting for loans acquired:

The Company accounts for its acquisitions under Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 805, Business Combinations, which requires the use of the acquisition method of accounting. All identifiable assets acquired, including loans, are recorded at fair value. No allowance for loan losses related to the acquired loans is recorded on the acquisition date because the fair value of the loans acquired incorporates assumptions regarding credit risk. As provided for under GAAP, management has up to twelve months following the date of the acquisition to finalize the fair values of acquired assets and assumed liabilities. Once management has finalized the fair values of acquired assets and assumed liabilities within this twelve month period, management considers such values to be the Day 1 fair values ("Day 1 Fair Values").

There are two methods to account for acquired loans as part of a business combination. Acquired loans that contain evidence of credit deterioration on the date of purchase are carried at the net present value of expected future proceeds in accordance with ASC 310-30. All other acquired loans are recorded at their initial fair value, adjusted for subsequent advances, pay downs, amortization or accretion of any premium or discount on purchase, charge-offs and any other adjustment to carrying value in accordance with ASC 310-20.

In determining the Day 1 Fair Values of acquired loans without evidence of credit deterioration at the date of acquisition, management includes (i) no carryover of any previously recorded allowance for loan losses and (ii) an adjustment of the unpaid principal balance to reflect an appropriate market rate of interest, given the risk profile and grade assigned to each loan. This adjustment will be accreted into earnings as a yield adjustment, using the effective yield method, over the remaining life of each loan.

To the extent that current information indicates it is probable that the Company will collect all amounts according to the contractual terms thereof, such loan is not considered impaired and is not considered in the determination of the required allowance for loan losses. To the extent that current information indicates it is probable that the Company will not be able to collect all amounts according to the contractual terms thereon, such loan is considered impaired and is considered in the determination of the required level of allowance for loan and lease losses.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Business combinations and method of accounting for loans acquired, continued:

Subsequent to the acquisition date, increases in cash flows expected to be received in excess of the Company's initial estimates are reclassified from nonaccretable difference to accretable yield and are accreted into interest income on a level-yield basis over the remaining life of the loan. Decreases in cash flows expected to be collected are recognized as impairment through the provision for loan losses.

Goodwill and core deposit intangible:

Goodwill represents the excess of the purchase price over the fair value of the net identifiable assets acquired in a business combination. Goodwill is not amortized but instead is subject to review for impairment annually, or more frequently if deemed necessary. Also in connection with business combinations, the Company records core deposit intangibles, representing the value of the acquired core deposit base. Core deposit intangibles are amortized over their estimated useful lives ranging up to 10 years.

Premises and equipment:

Premises, furniture and equipment are stated at cost, less accumulated depreciation. The provision for depreciation is computed by the straight-line method, based on the estimated useful lives for buildings and improvements of 40 years, for furniture and equipment of five to 10 years and for software of three years. Leasehold improvements are amortized over the life of each respective lease. The cost of assets sold or otherwise disposed of and the related allowance for depreciation are eliminated from the accounts and the resulting gains or losses are reflected in the income statement when incurred. Maintenance and repairs are charged to current expense. The costs of major renewals and improvements are capitalized.

Other real estate owned:

Other real estate owned includes real estate acquired through foreclosure. Other real estate owned is initially recorded at fair value at the date of foreclosure less estimated costs of disposal, which establishes a new cost. After foreclosure, valuations are periodically performed by management and are carried at the lower of cost or fair value less estimated costs of disposal. Any write-down to fair value at the time of transfer to foreclosed assets is charged to the allowance for loan losses. Property is evaluated regularly to ensure the recorded amount is supported by its current fair value and valuation allowances to reduce the carrying amount to fair value less estimated costs to dispose are recorded as necessary. Revenue and expense from the operations of foreclosed assets and changes in the valuation allowances are included in net expenses from foreclosed assets in other operating expenses.

Income taxes:

The Company accounts for income taxes in accordance with ASC 740, "Income Taxes". Under ASC 740, deferred tax assets or liabilities are computed based upon the difference between financial statement and income tax bases of assets and liabilities using the enacted marginal tax rate. The Company has provided a valuation allowance on its net deferred tax assets where it is more likely than not such assets will not be realized.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Income taxes, continued:

The Company recognizes the tax benefit from an uncertain tax position only if it is more likely than not the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such positions are then measured based on the largest benefit that has a greater than 50% likelihood of being realized upon settlement. See Note 12, "Income Taxes" for additional information. The Company records any penalties and interest attributed to uncertain tax positions as a component of income tax expense.

The Company adopted ASU 2018-02, Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income, which is considered a change in accounting principle, during the year ended December 31, 2017. Because the adjustment to deferred taxes is required to be included in income from continuing operations, the tax effects of items within accumulated other comprehensive income (commonly referred to as "stranded" tax effects) would not reflect the appropriate tax rate. Adoption of this ASU eliminated the "stranded" tax effects associated with the change in the federal corporate income tax rate in the Tax Cuts and Jobs Act of 2017, and was reflected in the financial statements as of December 31, 2017.

Advertising expense:

Advertising and public relations costs are generally expensed as incurred. External costs incurred in producing media advertising are expensed the first time the advertising takes place. External costs relating to direct mailing costs are expended in the period in which the direct mailings are sent.

Income per share:

Basic income per share represents income available to shareholders divided by the weighted-average number of common shares outstanding during the period. Dilutive income per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued. The only potential common share equivalents are those related to stock options and warrants. Stock options and warrants which are anti-dilutive are excluded from the calculation of diluted net income per share. The dilutive effect of options and warrants outstanding under the Company's stock compensation plan is reflected in diluted earnings per share by the application of the treasury stock method. Retroactive recognition has been given for the effects of all stock dividends.

Stock-based compensation:

The Company accounts for stock options and warrants under the fair value recognition provisions of FASB ASC 718, Stock Based Compensation. Compensation expense is recognized as salaries and benefits in the consolidated statements of income.

Merchant fee income:

Merchant fee income represents fees received by the Bank related to credit card processing. These fees are recorded on the accrual basis of accounting.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Statement of cash flows:

For purposes of reporting cash flows in the financial statements, the Company considers certain highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. Cash equivalents include amounts due from banks, federal funds sold, and interest bearing deposits. Generally, federal funds are sold for one-day periods.

Changes in the valuation account of securities available-for-sale, including the deferred tax effects, are considered non-cash transactions for purposes of the statement of cash flows and are presented in detail in the notes to the consolidated financial statements.

Off-balance-sheet financial instruments:

In the ordinary course of business, the Company enters into off-balance-sheet financial instruments consisting of commitments to extend credit and letters of credit. These financial instruments are recorded in the financial statements when they become payable by the customer.

Recently issued accounting pronouncements:

The following is a summary of recent authoritative pronouncements that could impact the accounting, reporting, and/or disclosure of financial information by the Company.

In May 2014, the FASB issued guidance to change the recognition of revenue from contracts with customers. The core principle of the new guidance is that an entity should recognize revenue to reflect the transfer of goods and services to customers in an amount equal to the consideration the entity receives or expects to receive. The guidance was effective for the Company for reporting periods beginning after December 15, 2017. The Company applied the guidance using a modified retrospective approach. The Company's revenue is comprised of net interest income and noninterest income. The scope of the guidance explicitly excludes net interest income as well as many other revenues for financial assets and liabilities including loans, leases, securities, and derivatives. Accordingly, the majority of our revenues were not affected. The Company has performed an assessment of our revenue contracts related to revenue streams that are within the scope of the standard. Our accounting policies have not changed materially since the principles of revenue recognition from the ASU are largely consistent with existing guidance and current practices applied by our businesses. We have not identified material changes to the timing or amount of revenue recognition.

In August 2015, the FASB deferred the effective date of ASU 2014-09, Revenue from Contracts with Customers. As a result of the deferral, the guidance in ASU 2014-09 was effective for the Company for reporting periods beginning after December 15, 2017. The Company applied the guidance using a modified retrospective approach. These amendments had no material effect on the Company's financial statements.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Recently issued accounting pronouncements, continued:

In January 2016, the FASB amended the Financial Instruments topic of the Accounting Standards Codification to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The amendments were effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company applied the guidance as of the beginning of the fiscal year 2018. The amendments related to equity securities without readily determinable fair values were applied prospectively to equity investments that existed as of the date of adoption of the amendments. These amendments had no material effect on the Company's financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). ASU 2016-02 applies a right-of-use ("ROU") model that requires a lessee to record, for all leases with a lease term of more than 12 months, an asset representing its right to use the underlying asset and a liability to make lease payments. For leases with a term of 12 months or less, a practical expedient is available whereby a lessee may elect, by class of underlying asset, not to recognize an ROU asset or lease liability. At inception, lessees must classify all leases as either finance or operating based on five criteria. Balance sheet recognition of finance and operating leases is similar, but the pattern of expense recognition in the income statement, as well as the effect on the statement of cash flows, differs depending on the lease classification. For public business entities, the amendments in ASU 2016-02 are effective for interim and annual periods beginning after December 15, 2018. We expect to adopt the guidance using the modified retrospective approach on January 1, 2019 and elect the practical expedients for transition including the transition option provided in ASU 2018-11. The practical expedients allow us to largely account for our existing operating leases consistent with current guidance except for the incremental balance sheet recognition for leases. The Company expects that the adoption of ASU 2016-02 will result in the recognition of right-of-use assets and lease liabilities totaling approximately \$8 million. Therefore, the Company expected the provisions of ASU No. 2016-02 to have an immaterial impact on the Company's regulatory capital ratios.

In March 2016, the FASB amended the Revenue from Contracts with Customers topic of the Accounting Standards Codification to clarify the implementation guidance on principal versus agent considerations. The updates to the principal versus agent guidance: (i) require an entity to determine whether it is a principal or an agent for each distinct good or service (or a distinct bundle of goods or services) to be provided to the customer; (ii) illustrate how an entity that is a principal might apply the control principle to goods, services, or rights to services, when another party is involved in providing goods or services to a customer and (iii) clarify that the purpose of certain specific control indicators is to support or assist in the assessment of whether an entity controls a good or service before it is transferred to the customer, provide more specific guidance on how the indicators should be considered, and clarify that their relevance will vary depending on the facts and circumstances. The Company's revenue is primarily comprised of net interest income on financial assets and financial liabilities, which is explicitly excluded from the scope of ASU 2014-09, and non-interest income. A description of the Company's revenue streams accounted for under ASC 606, Revenue from contracts with customers follows:

Deposit service charges: The Company earns fees from its deposit customers for transaction-based, account maintenance, and overdraft services. Transaction-based fees are recognized at the time the transaction is executed as that is the point in time the Company fulfills the customer's request. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges on deposits are withdrawn from the customer's account balance.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Recently issued accounting pronouncements, continued:

Debit and credit card income: The Company earns interchange fees from debit and credit cardholder transactions conducted through payment networks. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, with the transaction processing services provided to the cardholder. Fees are recognized on a daily basis.

In April 2016, the FASB amended the Revenue from Contracts with Customers topic of the Accounting Standards Codification to clarify guidance related to identifying performance obligations and accounting for licenses of intellectual property. The amendments were effective for the Company for reporting periods beginning after December 15, 2017.

In June 2016, the FASB issued guidance to change the accounting for credit losses and modify the impairment model for certain debt securities. The amendments will be effective for the Company for reporting periods beginning after December 15, 2020. Early adoption is permitted for all organizations for periods beginning after December 15, 2018. The Company will apply the amendments to the ASU through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. While early adoption is permitted beginning in first quarter 2019, we do not expect to elect that option. We are evaluating the impact of the ASU on our consolidated financial statements. We expect the ASU will have no material impact on the recorded allowance for loan losses given the change to estimated losses over the contractual life of the loans adjusted for expected prepayments. In addition to our allowance for loan losses, we will also record an allowance for credit losses on debt securities instead of applying the impairment model currently utilized. The amount of the adjustments will be impacted by each portfolio's composition and credit quality at the adoption date as well as economic conditions and forecasts at that time.

In August 2016, the FASB amended the Statement of Cash Flows topic of the Accounting Standards Codification to clarify how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments were effective for the Company for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. These amendments had no material effect on the Company's financial statements.

In October 2016, the FASB amended the Income Taxes topic of the Accounting Standards Codification to modify the accounting for intra-entity transfers of assets other than inventory. The amendments were effective for the Company for fiscal years beginning after December 15, 2017 including interim periods within those fiscal years. These amendments had no material effect on the Company's financial statements.

In November 2016, the FASB amended the Statement of Cash Flows topic of the Accounting Standards Codification to clarify how restricted cash is presented and classified in the statement of cash flows. The amendments were effective for the Company for fiscal years beginning after December 15, 2017 including interim periods within those fiscal years. These amendments had no material effect on the Company's financial statements.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Recently issued accounting pronouncements, continued:

In March 2017, the FASB amended the requirements in the Compensation—Retirement Benefits Topic of the Accounting Standards Codification related to the income statement presentation of the components of net periodic benefit cost for an entity's sponsored defined benefit pension and other postretirement plans. The amendments were effective for the Company for interim and annual periods beginning after December 15, 2017. These amendments had no material effect on the Company's financial statements.

In March 2017, the FASB amended the requirements in the Receivables—Nonrefundable Fees and Other Costs Topic of the Accounting Standards Codification related to the amortization period for certain purchased callable debt securities held at a premium. The amendments shorten the amortization period for the premium to the earliest call date. The amendments will be effective for the Company for interim and annual periods beginning after December 15, 2018. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

In May 2017, the FASB amended the requirements in the Compensation—Stock Compensation Topic of the Accounting Standards Codification related to changes to the terms or conditions of a share-based payment award. The amendments provide guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting. The amendments were effective for the Company for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. These amendments had no material effect on the Company's financial statements.

In February 2018, the FASB issued (2018-02), Income Statement (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income, which required Companies to reclassify the stranded effects in other comprehensive income (loss) to retained earnings as a result of the change in the tax rates under the Tax Cuts and Jobs Act. The Company adopted this pronouncement by retrospective application to each period (or periods) in which the effect of the change in the tax rate under the Tax Cuts and Jobs Act was recognized. The impact of the reclassification from other comprehensive loss to retained earnings (deficit) was \$21,874 at December 31, 2017. There was no impact for the year ended December 31, 2018 as a result of this pronouncement.

In February 2018, the FASB amended the Financial Instruments Topic of the Accounting Standards Codification. The amendments clarify certain aspects of the guidance issued in ASU 2016-01. The amendments were effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years beginning after June 15, 2018. These amendments had no material effect on the Company's financial statements.

In May 2018, the FASB amended the Financial Services—Depository and Lending Topic of the Accounting Standards Codification to remove outdated guidance related to Circular 202. The amendments were effective upon issuance and did not have a material effect on the financial statements.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Recently issued accounting pronouncements, continued:

In June 2018, the FASB amended the Compensation—Stock Compensation Topic of the Accounting Standards Codification. The amendments expand the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from nonemployees. The amendments are effective for fiscal years beginning after December 15, 2018, including interim periods within that fiscal year. Early adoption is permitted, but no earlier than an entity's adoption date of Topic 606. The Company does not expect these amendments to have a material effect on its financial statements.

In August 2018, the FASB amended the Fair Value Measurement Topic of the Accounting Standards Codification. The amendments remove, modify, and add certain fair value disclosure requirements based on the concepts in the FASB Concepts Statement, Conceptual Framework for Financial Reporting—Chapter 8: Notes to Financial Statements. The amendments are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted. An entity is permitted to early adopt any removed or modified disclosures upon issuance of this ASU and delay adoption of the additional disclosures until their effective date. The Company does not expect these amendments to have a material effect on its financial statements.

In November 2018, the FASB issued guidance to amend the Financial Instruments—Credit Losses topic of the Accounting Standards Codification. The guidance aligns the implementation date of the topic for annual financial statements of nonpublic companies with the implementation date for their interim financial statements. The guidance also clarifies that receivables arising from operating leases are not within the scope of the topic, but rather, should be accounted for in accordance with the leases topic. The amendments will be effective for the Company for reporting periods beginning after December 15, 2020. Early adoption is permitted for all organizations for periods beginning after December 15, 2018. The Company is currently in the process of evaluating the impact of adoption of this guidance on the financial statements.

In December 2018, the FASB issued guidance that providing narrow-scope improvements for lessors, that provides relief in the accounting for sales, use and similar taxes, the accounting for other costs paid by a lessee that may benefit a lessor, and variable payments when contracts have lease and non-lease components. The amendments will be effective for the Company for reporting periods beginning after December 15, 2018. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

Risks and uncertainties:

In the normal course of its business, the Company encounters two significant types of risks: economic and regulatory. There are three main components of economic risk: interest rate risk, credit risk, and market risk. The Company is subject to interest rate risk to the degree that its interest-bearing liabilities mature or reprice at different speeds, or on different basis, than its interest-earning assets. Credit risk is the risk of default on the Company's loan portfolio that results from a borrower's inability or unwillingness to make contractually required payments. Market risk reflects changes in the value of collateral underlying loans receivable and the valuation of real estate held by the Company.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Risks and uncertainties, continued:

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

Reclassifications:

Certain captions and amounts in the 2017 consolidated financial statements were reclassified to conform with the 2018 presentation. Any such reclassifications had no impact of net income, earnings per common share, or shareholders' equity.

Note 2. Restatement of Prior Period Financial Information

The consolidated financial statements for the year ended December 31, 2017 and shareholders' equity as of December 31, 2016 have been restated to correctly account for the Company's 401(k) Employee Stock Ownership Plan and repurchased Company stock. The Company repurchased common stock during the years ended December 31, 2014 and December 31, 2017 and did not account for those shares under ASC Topic 505-30, Treasury Stock. In addition, a portion of those repurchased shares were contributed to the Company's 401(k) Employee Stock Ownership Plan and immediately allocated to employees on a pro rata basis for services rendered in the years ended December 31, 2017 and 2016. The Company did not account for these contributions as stock compensation expense during the aforementioned years. As such, the financial information was affected and restated herein.

The tables below quantify the differences between the amounts reported previously and the amounts reported as per the restatement.

	For the year ended	
	December 31, 2016	
	<u>(As reported)</u>	<u>(As restated)</u>
Shareholders' equity:		
Common stock	\$ 3,831,322	\$ 3,831,322
Capital surplus	32,001,966	32,068,766
Retained earnings	2,603,929	2,496,892
Accumulated other comprehensive loss	(997,418)	(997,418)
Treasury stock	-	(580,753)
Total shareholders' equity	<u>\$ 37,439,799</u>	<u>\$ 36,818,809</u>

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 2. Restatement of Prior Period Financial Information, Continued

	For the year ended December 31, 2017	
	(As reported)	(As restated)
Balance sheet:		
Other assets	\$ 1,697,958	\$ 882,971
Other liabilities	4,203,331	3,982,515
Shareholders' equity:		
Common stock	\$ 6,423,797	\$ 6,423,797
Capital surplus	54,366,837	54,533,637
Retained earnings (deficit)	-	(214,148)
Accumulated other comprehensive loss	(144,190)	(144,190)
Treasury stock	-	(457,092)
Total shareholders' equity	<u>\$ 60,646,444</u>	<u>\$ 60,142,004</u>
Income statement:		
Salaries and employee benefits	\$ 9,964,764	\$ 10,279,764
Income tax expense	495,989	379,439
Net income	\$ 3,414,261	\$ 3,215,811
Income per common share:		
Basic income per common share	<u>\$ 0.58</u>	<u>\$ 0.55</u>
Average common shares outstanding - basic	<u>5,858,988</u>	<u>5,809,334</u>
Diluted income per common share	<u>\$ 0.57</u>	<u>\$ 0.53</u>
Average common shares outstanding - dilutive	<u>6,040,546</u>	<u>6,019,480</u>

Note 3. Business Combinations

Acquisition of Atlantic Bancshares, Inc.

On April 2, 2018, the Company acquired all of the common stock of Atlantic Bancshares, Inc., the holding company for Atlantic Community Bank, ("Atlantic Community"). Under the terms of the merger agreement, each share of Atlantic Community common stock was converted into 0.2452 shares of the Company's common stock.

The following table presents a summary of total consideration paid by the Company at the acquisition date.

Common stock issued (1,062,731 @ \$15.25 per share)	\$ 16,206,648
Cash paid in lieu of fractional shares	<u>2,220</u>
Total consideration paid	<u>\$ 16,208,868</u>

The assets acquired and liabilities assumed from Atlantic Community were recorded at their fair value as of the closing date of the merger. Fair values are preliminary and subject to refinement for up to one year after closing date of the acquisition as additional information regarding the closing date fair values became available. Goodwill of \$5,348,699 was recorded at the time of the acquisition. The following table summarizes the consideration paid by the Company in the merger with Atlantic Community and the amounts of the assets acquired and liabilities assumed recognized at the acquisition date.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 3. Business Combinations, Continued

<u>April 2, 2018</u>	<u>As Reported by Atlantic Community</u>	<u>Fair Value Adjustments</u>	<u>As Recorded by the Company</u>
Assets			
Cash and cash equivalents	\$ 14,306,919	\$ -	\$ 14,306,919
Securities available-for-sale	712,397	(29,676) (a)	682,721
Loans	64,983,111	(1,879,715) (b)	63,103,396
Allowance for loan losses	(796,185)	796,185 (c)	-
Fixed assets	170,337	-	170,337
OREO, net of allowance	183,774	(183,774) (d)	-
Accrued interest receivable	131,488	(14,697) (e)	116,791
Core deposit intangible	-	1,630,000 (f)	1,630,000
Deferred tax asset	1,561,635	56,061 (g)	1,617,696
Other assets	171,883	60,001 (h)	231,884
Total assets acquired	<u>\$ 81,425,359</u>	<u>\$ (434,385)</u>	<u>\$ 81,859,744</u>
Liabilities			
Deposits	\$ 70,634,306	\$ 13,304 (i)	\$ 70,647,610
Accrued interest payable	23,098	-	23,098
Other liabilities	69,928	258,939 (j)	328,867
Total liabilities assumed	<u>\$ 70,727,332</u>	<u>\$ 272,243</u>	<u>\$ 70,999,575</u>
Net identifiable assets acquired over liabilities assumed			\$ 10,860,169
Total consideration paid			<u>16,208,868</u>
Goodwill			<u>\$ 5,348,699</u>

Explanation of fair value adjustments:

- (a) Adjustment reflects opening fair value of securities portfolio, which was established as the new book basis of the portfolio.
- (b) Adjustment represents the amount necessary to adjust loans to their fair value due to interest rate and credit factors, based on the Company's third party valuation report.
- (c) Adjustment reflects the elimination of Atlantic Community's historical allowance for loan losses.
- (d) Adjustment reflects the elimination of Atlantic Community's OREO and the historical allowance for OREO.
- (e) Adjustment reflects the impact of acquisition accounting fair value adjustments.
- (f) Adjustment reflects the fair value adjustment to record the estimated core deposit intangible based on the Company's third party valuation report.
- (g) Adjustment reflects the tax impact of acquisition accounting fair value adjustments.
- (h) Adjustment reflects the fair value adjustment based on the Company's evaluation of acquired other assets.
- (i) Adjustment represents the fair value adjustment due to interest rate factors, based on the Company's third party valuation report.
- (j) Adjustment represents the fair value adjustment based on the Company's third party valuation of acquired other liabilities.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 3. Business Combinations, Continued

The table below summarizes the total contractually required principal and interest payments, management's estimate of expected total cash payments and fair value of loans as of April 2, 2018 for purchased credit impaired ("PCI") loans. Contractually required principal and interest payments have been adjusted for estimated payments.

Contractual principal and interest at acquisition	\$ 6,598,025
Nonaccretable difference	<u>(986,167)</u>
Expected cash flows at acquisition	5,611,858
Accretable yield	<u>(742,182)</u>
Basis in PCI loans at acquisition - estimated fair value	<u>\$ 4,869,676</u>

Note 4. Core Deposit Intangibles

In connection with business combination, the Company recorded core deposit intangibles, representing the value of the acquired core deposit base. As of December 31, 2018, core deposit intangible was \$1,395,602. There was no core deposit intangible as of December 31, 2017. The estimated future amortization is subject to change to the extent management determines it is necessary to make adjustments to the carrying value or estimated useful life of the core deposit intangibles.

Amortization expense for core deposit intangible is expected to be as follows.

Year 1	\$ 284,240
Year 2	251,909
Year 3	219,579
Year 4	187,248
Year 5	154,917
Thereafter	<u>297,709</u>
Total	<u>\$ 1,395,602</u>

Amortization expense of \$234,398 related to the core deposit intangible was recognized in 2018.

Note 5. Investment Securities

The amortized cost and estimated fair values of securities available-for-sale were:

	December 31, 2018			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Mortgage-backed securities	\$ 21,469,084	\$ 14,514	\$ 532,368	\$ 20,951,230
SBA loan pools	1,750,853	-	23,891	1,726,962
SBA asset-backed securities	483,178	9,144	-	492,322
Obligations of state and local governments	24,078,054	294,327	702,601	23,669,780
Corporate debt securities	<u>2,400,000</u>	-	-	<u>2,400,000</u>
	<u>\$ 50,181,169</u>	<u>\$ 317,985</u>	<u>\$ 1,258,860</u>	<u>\$ 49,240,294</u>

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 5. Investment Securities, Continued

	December 31, 2017			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Mortgage-backed securities	\$ 11,058,127	\$ 7,874	\$ 283,103	\$ 10,782,898
SBA loan pools	869,963	-	6,531	863,432
Obligations of state and local governments	<u>24,117,952</u>	<u>456,076</u>	<u>365,435</u>	<u>24,208,593</u>
	<u>\$ 36,046,042</u>	<u>\$ 463,950</u>	<u>\$ 655,069</u>	<u>\$ 35,854,923</u>

The following is a summary of maturities of securities available-for-sale as of December 31, 2018. The amortized cost and estimated fair values are based on the contractual maturity dates except for mortgage-backed securities.

	Securities Available-for-Sale	
	Amortized Cost	Estimated Fair Value
Due after one year but within five years	\$ 483,178	\$ 492,322
Due after five years but within ten years	22,290,267	21,813,372
Due after ten years	5,938,640	5,983,370
Mortgage-backed securities	<u>21,469,084</u>	<u>20,951,230</u>
Total	<u>\$ 50,181,169</u>	<u>\$ 49,240,294</u>

The following table shows gross unrealized losses and fair value, aggregated by investment category, and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2018 and 2017.

	December 31, 2018					
	Less than twelve months		Twelve months or more		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
Available-for-sale:						
Mortgage-backed securities	\$ 9,708,710	\$ 85,977	\$ 8,737,701	\$ 446,391	\$ 18,446,411	\$ 532,368
SBA loan pools	1,216,105	3,187	510,857	20,704	1,726,962	23,891
Obligations of state and local governments	<u>2,301,120</u>	<u>15,264</u>	<u>14,892,410</u>	<u>687,337</u>	<u>17,193,530</u>	<u>702,601</u>
	<u>\$ 13,225,935</u>	<u>\$ 104,428</u>	<u>\$ 24,140,968</u>	<u>\$ 1,154,432</u>	<u>\$ 37,366,903</u>	<u>\$ 1,258,860</u>

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 5. Investment Securities, Continued

	December 31, 2017					
	Less than twelve months		Twelve months or more		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
Available-for-sale:						
Mortgage-backed securities	\$ 3,554,984	\$ 90,413	\$ 5,193,838	\$ 192,690	\$ 8,748,822	\$ 283,103
SBA loan pools	-	-	863,432	6,531	863,432	6,531
Obligations of state and local governments	1,126,360	4,001	14,101,383	361,434	15,227,743	365,435
	<u>\$ 4,681,344</u>	<u>\$ 94,414</u>	<u>\$ 20,158,653</u>	<u>\$ 560,655</u>	<u>\$ 24,839,997</u>	<u>\$ 655,069</u>

There were twenty-three securities with an unrealized loss for greater than twelve months at December 31, 2018 and eighteen at December 31, 2017.

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, and industry analysts' reports. As management has the ability to hold debt securities until maturity, or for the foreseeable future if classified as available for sale, no declines are deemed to be other than temporary.

Sales of investment securities available-for-sale for the years ended December 31, 2018 and 2017 are as follows:

	<u>2018</u>	<u>2017</u>
Proceeds	\$ -	\$ 11,411,532
Realized gains	-	20,485
Realized losses	-	(78,898)
Total investment securities losses, net	<u>\$ -</u>	<u>\$ (58,413)</u>

At December 31, 2018, securities with book values of \$465,723 and market values of \$498,659 were pledged to secure public funds. At December 31, 2017, a security with a book value of \$498,359 and market value of \$542,870 was pledged to secure public funds.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 6. Loans Receivable

Following is a summary of loans by major classification as of December 31:

	<u>2018</u>	<u>2017</u>
All Loans:		
Commercial	\$ 40,684,299	\$ 32,355,458
Commercial real estate	327,526,926	263,780,763
Consumer	8,791,851	7,394,163
Consumer real estate	<u>154,092,067</u>	<u>131,525,823</u>
Total gross loans receivable	531,095,143	435,056,207
Less: Unearned origination fees, net	60,225	138,219
Allowance for loan losses	<u>4,399,945</u>	<u>3,748,508</u>
	<u>\$ 526,634,973</u>	<u>\$ 431,169,480</u>

Loans receivable, net at December 31, 2018 and 2017 for purchased non-credit impaired loans and nonacquired loans are summarized by category as follows:

	<u>2018</u>	<u>2017</u>
Purchased Non-Credit Impaired Loans (ASC 310-20) and Nonacquired Loans:		
Commercial	\$ 40,554,881	\$ 32,355,458
Commercial real estate	325,517,519	263,780,763
Consumer	8,750,871	7,394,163
Consumer real estate	<u>153,520,066</u>	<u>131,525,823</u>
Total gross loans	528,343,337	435,056,207
Less: Unearned origination fees, net	60,225	138,219
Allowance for loan losses	<u>4,399,945</u>	<u>3,748,508</u>
	<u>\$ 523,883,167</u>	<u>\$ 431,169,480</u>

Loans receivable, net at December 31, 2018 and 2017 for purchased credit impaired loans are summarized by category as follows:

	<u>2018</u>	<u>2017</u>
Purchased Credit Impaired Loans (ASC 310-30):		
Commercial	\$ 129,418	\$ -
Commercial real estate	2,009,407	-
Consumer	40,980	-
Consumer real estate	<u>572,001</u>	-
Total gross loans	2,751,806	-
Less: Unearned origination fees, net	-	-
Allowance for loan losses	-	-
	<u>\$ 2,751,806</u>	<u>\$ -</u>

Included in the loan totals at December 31, 2018 was \$41,869,097 in purchased loans. No allowance for loan losses related to the purchased loans is recorded on the acquisition date because the fair value of the loans purchased incorporates assumptions regarding credit risk. Subsequent to the purchase date and after any credit discounts have been fully used, the methods utilized to estimate the required allowance for loan losses are the same as originated loans.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 6. Loans Receivable, Continued

There are two methods to account for purchased loans as part of a business combination. Purchased loans that contain evidence of credit deterioration on the date of purchase are carried at the net present value of expected future proceeds in accordance with ASC 310-30 and are considered purchased credit impaired ("PCI") loans. All other purchased loans are recorded at their initial fair value, adjusted for subsequent advances, pay downs, amortization or accretion of any premium or discount on purchase, chargeoffs and any other adjustment to carrying value in accordance with ASC 310-20.

PCI loans are aggregated into pools of loans based on common risk characteristics such as the type of loan, payment status, or collateral type. The Company estimates the amount and timing of expected cash flows for each purchased loan pool and the expected cash flows in excess of the amount paid are recorded as interest income over the remaining life of the pool (accretable yield). The excess of the pool's contractual principal and interest over expected cash flows is not recorded (nonaccretable difference).

Over the life of the loan pool, expected cash flows continue to be estimated. If the present value of expected cash flows is less than the carrying amount, a loss is recorded. If the present value of expected cash flows is greater than the carrying amount, it is recognized as part of future interest income.

At December 31, 2018, the outstanding balance and recorded investment of PCI loans was \$2.8 million. The Company had no PCI loans prior to 2018.

The table below presents changes in the value of PCI loans for the year ended December 31, 2018.

Balance at the beginning of period	\$	-
Fair value of PCI loans acquired		4,869,676
Net reductions for payments, foreclosures, and accretion		<u>2,117,870</u>
Balance at end of period, net of allowance for loan losses on PCI loans	\$	<u>2,751,806</u>

The table below presents changes in the value of the accretable yield for PCI loans for the year ended December 31, 2018.

	Three Months Ended <u>June 30</u>	Three Months Ended <u>September 30</u>	Three Months Ended <u>December 31</u>	Twelve Months Ended <u>December 31</u>
Accretable yield, beginning of period	\$ -	\$ 671,430	\$ 607,221	\$ -
Additions	742,182	-	-	742,182
Accretion	(70,752)	(64,209)	(57,050)	(192,011)
Reclassification from (to) nonaccretable difference	-	-	-	-
Other changes, net	-	-	-	-
Accretable yield, end of period	<u>\$ 671,430</u>	<u>\$ 607,221</u>	<u>\$ 550,171</u>	<u>\$ 550,171</u>

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 6. Loans Receivable, Continued

The following is a summary of information pertaining to our allowance for loan losses (by purpose code) as of and for the year ended December 31, 2018. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

	Commercial	Commercial Real Estate	Consumer	Consumer Real Estate	Total
Allowance for loan losses:					
Beginning balance	\$ 273,947	\$ 2,281,289	\$ 35,491	\$ 1,157,781	\$ 3,748,508
Charge-offs	-	(74,577)	(18,858)	-	(93,435)
Recoveries	24,600	1,922	8,350	-	34,872
Provisions	86,520	480,143	42,349	100,988	710,000
Ending balance	<u>\$ 385,067</u>	<u>\$ 2,688,777</u>	<u>\$ 67,332</u>	<u>\$ 1,258,769</u>	<u>\$ 4,399,945</u>
Ending balances:					
Individually evaluated for impairment	<u>\$ 27,756</u>	<u>\$ -</u>	<u>\$ 38,707</u>	<u>\$ 43,393</u>	<u>\$ 109,856</u>
Collectively evaluated for impairment	<u>\$ 357,311</u>	<u>\$ 2,688,777</u>	<u>\$ 28,625</u>	<u>\$ 1,215,376</u>	<u>\$ 4,290,089</u>
Loans receivable:					
Ending balance - total	<u>\$ 40,684,299</u>	<u>\$ 327,526,926</u>	<u>\$ 8,791,851</u>	<u>\$ 154,092,067</u>	<u>\$ 531,095,143</u>
Ending balances:					
Individually evaluated for impairment	<u>\$ 167,057</u>	<u>\$ 16,791</u>	<u>\$ 38,707</u>	<u>\$ 499,450</u>	<u>\$ 722,005</u>
Collectively evaluated for impairment	<u>\$ 40,517,242</u>	<u>\$ 327,510,135</u>	<u>\$ 8,753,144</u>	<u>\$ 153,592,617</u>	<u>\$ 530,373,138</u>
Purchased credit impaired loans	<u>\$ 129,418</u>	<u>\$ 2,009,407</u>	<u>\$ 40,980</u>	<u>\$ 572,001</u>	<u>\$ 2,751,806</u>

The following is a summary of information pertaining to our allowance for loan losses (by purpose code) as of and for the year ended December 31, 2017. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

	Commercial	Commercial Real Estate	Consumer	Consumer Real Estate	Total
Allowance for loan losses:					
Beginning balance	\$ 186,637	\$ 2,461,964	\$ 19,331	\$ 856,439	\$ 3,524,371
Charge-offs	(11,003)	(674,222)	(15,073)	(13,370)	(713,668)
Recoveries	21,108	972	-	725	22,803
Provisions	77,205	492,575	31,233	313,987	915,000
Ending balance	<u>\$ 273,947</u>	<u>\$ 2,281,289</u>	<u>\$ 35,491</u>	<u>\$ 1,157,781</u>	<u>\$ 3,748,508</u>
Ending balances:					
Individually evaluated for impairment	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 47,263</u>	<u>\$ 47,263</u>
Collectively evaluated for impairment	<u>\$ 273,947</u>	<u>\$ 2,281,289</u>	<u>\$ 35,491</u>	<u>\$ 1,110,518</u>	<u>\$ 3,701,245</u>
Loans receivable:					
Ending balance - total	<u>\$ 32,355,458</u>	<u>\$ 263,780,763</u>	<u>\$ 7,394,163</u>	<u>\$ 131,525,823</u>	<u>\$ 435,056,207</u>
Ending balances:					
Individually evaluated for impairment	<u>\$ 33,008</u>	<u>\$ 250,699</u>	<u>\$ 45,533</u>	<u>\$ 93,622</u>	<u>\$ 422,862</u>
Collectively evaluated for impairment	<u>\$ 32,322,450</u>	<u>\$ 263,530,064</u>	<u>\$ 7,348,630</u>	<u>\$ 131,432,201</u>	<u>\$ 434,633,345</u>

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 6. Loans Receivable, Continued

Credit Quality Indicators

Loans are categorized into risk categories based on relevant information about the ability of borrowers to service their debt, such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The following definitions are utilized for risk ratings, which are consistent with the definitions used in supervisory guidance:

Special Mention - Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

Substandard - Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful - Loans classified as doubtful have all the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

Loss - Loans classified as loss are considered uncollectable.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans.

The following is an analysis of our loan portfolio by credit quality indicators at December 31, 2018:

All Loans:	Commercial	Commercial Real Estate	Consumer	Consumer Real Estate	Total
Grade:					
Pass	\$ 40,544,839	\$ 320,538,565	\$ 8,724,730	\$ 153,054,188	\$ 522,862,322
Special mention	111,705	6,408,990	20,228	410,206	6,905,130
Substandard	27,755	579,370	46,893	627,673	1,281,691
Doubtful	-	-	-	-	-
Loss	-	-	-	-	-
Total	<u>\$ 40,684,299</u>	<u>\$ 327,526,926</u>	<u>\$ 8,791,851</u>	<u>\$ 154,092,067</u>	<u>\$ 531,095,143</u>
	Commercial	Commercial Real Estate	Consumer	Consumer Real Estate	Total
Purchased non-credit impaired loans (ASC 310-20) and nonacquired loans:					
Grade:					
Pass	\$ 40,544,839	\$ 318,795,545	\$ 8,690,040	\$ 152,728,718	\$ 520,759,142
Special mention	-	6,142,604	19,440	249,689	6,411,733
Substandard	10,042	579,370	41,391	541,659	1,172,462
Doubtful	-	-	-	-	-
Loss	-	-	-	-	-
Total	<u>\$ 40,554,881</u>	<u>\$ 325,517,519</u>	<u>\$ 8,750,871</u>	<u>\$ 153,520,066</u>	<u>\$ 528,343,337</u>

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 6. Loans Receivable, Continued

	Commercial	Commercial Real Estate	Consumer	Consumer Real Estate	Total
Purchased Credit impaired loans (ASC 310-30):					
Grade:					
Pass	\$ -	\$ 1,743,020	\$ 34,690	\$ 325,470	\$ 2,103,180
Special mention	111,705	266,387	788	160,517	539,397
Substandard	17,713	-	5,502	86,014	109,229
Doubtful	-	-	-	-	-
Loss	-	-	-	-	-
Total	<u>\$ 129,418</u>	<u>\$ 2,009,407</u>	<u>\$ 40,980</u>	<u>\$ 572,001</u>	<u>\$ 2,751,806</u>

The following is an analysis of our loan portfolio by credit quality indicators at December 31, 2017:

	Commercial	Commercial Real Estate	Consumer	Consumer Real Estate	Total
Grade:					
Pass	\$ 32,304,672	\$ 258,457,847	\$ 7,348,630	\$ 131,231,513	\$ 429,342,662
Special mention	17,778	4,744,255	-	200,688	4,962,721
Substandard	33,008	578,661	45,533	93,622	750,824
Doubtful	-	-	-	-	-
Loss	-	-	-	-	-
Total	<u>\$ 32,355,458</u>	<u>\$ 263,780,763</u>	<u>\$ 7,394,163</u>	<u>\$ 131,525,823</u>	<u>\$ 435,056,207</u>

The following is a past due aging analysis of our loan portfolio at December 31, 2018:

	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable	Recorded Investment> 90 Days and Accruing
All Loans:							
Commercial	\$ -	\$ -	\$ -	\$ -	\$ 40,684,299	\$ 40,684,299	\$ -
Commercial real estate	-	-	139,301	139,301	327,387,625	327,526,926	-
Consumer	-	-	-	-	8,791,851	8,791,851	-
Consumer real estate	-	-	-	-	154,092,067	154,092,067	-
Total	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 139,301</u>	<u>\$ 39,301</u>	<u>\$ 530,955,842</u>	<u>\$ 531,095,143</u>	<u>\$ -</u>

	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable	Recorded Investment> 90 Days and Accruing
Purchased non-credit impaired Loans (ASC 310-20) and nonacquired loans:							
Commercial	\$ -	\$ -	\$ -	\$ -	\$ 40,554,881	\$ 40,554,881	\$ -
Commercial real estate	-	-	139,301	139,301	325,378,218	325,517,519	-
Consumer	-	-	-	-	8,750,871	8,750,871	-
Consumer real estate	-	-	-	-	153,520,066	153,520,066	-
Total	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 139,301</u>	<u>\$ 139,301</u>	<u>\$ 528,204,036</u>	<u>\$ 528,343,337</u>	<u>\$ -</u>

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 6. Loans Receivable, Continued

	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable	Recorded Investment > 90 Days and Accruing
Purchased credit impaired loans (ASC 310-30):							
Commercial	\$ -	\$ -	\$ -	\$ -	\$ 129,418	\$ 129,418	\$ -
Commercial real estate	-	-	-	-	2,009,407	2,009,407	-
Consumer	-	-	-	-	40,980	40,980	-
Consumer real estate	-	-	-	-	572,001	572,001	-
Total	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,751,806</u>	<u>\$ 2,751,806</u>	<u>\$ -</u>

The following is a past due aging analysis of our loan portfolio at December 31, 2017:

	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable	Recorded Investment > 90 Days and Accruing
Commercial	\$ -	\$ -	\$ 33,008	\$ 33,008	\$ 32,322,450	\$ 32,355,458	\$ -
Commercial real estate	-	-	-	-	263,780,763	263,780,763	-
Consumer	-	-	-	-	7,394,163	7,394,163	-
Consumer real estate	-	-	-	-	131,525,823	131,525,823	-
Total	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 33,008</u>	<u>\$ 33,008</u>	<u>\$ 435,023,199</u>	<u>\$ 435,056,207</u>	<u>\$ -</u>

The following is an analysis of our impaired loan (including nonaccrual loans) portfolio detailing the related allowance recorded at December 31, 2018:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance needed:					
Commercial	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial real estate	156,092	156,092	-	366,980	13,386
Consumer	-	-	-	-	-
Consumer real estate	456,057	475,639	-	456,108	13,458
	<u>612,149</u>	<u>631,731</u>	<u>-</u>	<u>823,088</u>	<u>26,844</u>
With an allowance recorded:					
Commercial	\$ 27,756	\$ 27,756	\$ 27,756	\$ 29,076	\$ 2,499
Commercial real estate	-	-	-	-	-
Consumer	38,707	38,707	38,707	41,861	1,574
Consumer real estate	43,393	128,160	43,393	41,040	1,481
	<u>109,856</u>	<u>194,623</u>	<u>109,856</u>	<u>111,977</u>	<u>5,554</u>
Total:					
Commercial	\$ 27,756	\$ 27,756	\$ 27,756	\$ 29,076	\$ 2,499
Commercial real estate	156,092	156,092	-	366,980	13,386
Consumer	38,707	38,707	38,707	41,861	1,574
Consumer real estate	499,450	603,799	43,393	497,148	14,939
	<u>\$ 722,005</u>	<u>\$ 826,354</u>	<u>\$ 109,856</u>	<u>\$ 935,065</u>	<u>\$ 32,398</u>

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 6. Loans Receivable, Continued

The following is an analysis of our impaired loan (including nonaccrual loans) portfolio detailing the related allowance recorded at December 31, 2017:

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
With no related allowance needed:					
Commercial	\$ 33,008	\$ 44,011	\$ -	\$ 98,145	\$ 7,507
Commercial real estate	250,699	250,699	-	234,295	5,202
Consumer	45,533	45,533	-	48,581	88
Consumer real estate	<u>46,359</u>	<u>65,941</u>	-	<u>52,665</u>	<u>370</u>
	<u>375,599</u>	<u>406,184</u>	-	<u>433,686</u>	<u>13,167</u>
With an allowance recorded:					
Commercial	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial real estate	-	-	-	-	-
Consumer	-	-	-	-	-
Consumer real estate	<u>47,263</u>	<u>132,029</u>	<u>47,263</u>	<u>48,989</u>	<u>1,605</u>
	<u>47,263</u>	<u>132,029</u>	<u>47,263</u>	<u>48,989</u>	<u>1,605</u>
Total:					
Commercial	\$ 33,008	\$ 44,011	\$ -	\$ 98,145	\$ 7,507
Commercial real estate	250,699	250,699	-	234,295	5,202
Consumer	45,533	45,533	-	48,581	88
Consumer real estate	<u>93,622</u>	<u>197,970</u>	<u>47,263</u>	<u>101,654</u>	<u>1,975</u>
	<u>\$ 422,862</u>	<u>\$ 538,213</u>	<u>\$ 47,263</u>	<u>\$ 482,674</u>	<u>\$ 14,772</u>

The following is an analysis of our nonaccrual loan portfolio recorded at December 31, 2018 and 2017:

	<u>2018</u>	<u>2017</u>
Commercial Real Estate	\$ 139,301	\$ -
Consumer Real Estate	<u>420,433</u>	<u>33,008</u>
Total	<u>\$ 559,734</u>	<u>\$ 33,008</u>

Troubled Debt Restructurings

The following table summarizes the carrying balance of troubled debt restructurings ("TDRs") as of December 31, 2018 and 2017:

	<u>2018</u>	<u>2017</u>
Performing TDRs	\$ 162,272	\$ 389,854
Nonperforming TDRs	<u>-</u>	<u>-</u>
	<u>\$ 162,272</u>	<u>\$ 389,854</u>

Loans classified as TDRs may be removed from this status for disclosure purposes after a specified period of time if the restructured agreement specifies an interest rate equal to or greater than the rate that the lender was willing to accept at the time of the restructuring for a new loan with comparable risk, the loan is performing in accordance with the terms specified by the restructured agreement, and compliance with certain other requirements.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 6. Loans Receivable, Continued

The following is an analysis of TDRs identified during 2018:

	For the year ended December 31, 2018		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings			
Commercial	1	\$ 27,756	\$ 27,756

During the year ended December 31, 2018, the Bank modified one loan that was considered to be a TDR. The loan was originally a revolving line of credit restructured to a six year fixed rate loan. No loans previously identified as TDRs went into default (as defined by non-accrual classification) during the year ended December 31, 2018.

Note 7. Premises, Furniture and Equipment

Premises, furniture and equipment is summarized as follows as of December 31:

	2018	2017
Land	\$ 5,421,993	\$ 5,421,993
Buildings and leasehold improvements	11,399,858	11,142,922
Furniture and equipment	4,640,123	4,335,206
Software	750,401	645,228
Automobile	32,895	32,895
Construction in progress	55,200	69,981
Total	22,300,470	21,648,225
Less accumulated depreciation	6,197,575	5,273,667
Premises, furniture and equipment, net	\$ 16,102,895	\$ 16,374,558

Depreciation expense for the years ended December 31, 2018 and 2017 was \$933,991 and \$765,902, respectively.

Note 8. Deposits

At December 31, 2018, the scheduled maturities of time deposits are as follows:

2019	\$ 69,610,499
2020	17,591,630
2021	1,074,365
2022	129,632
2023	683,210
Total	\$ 89,089,336

The Bank had brokered deposits of \$5,000,000 and \$17,029,000 as of December 31, 2018 and 2017, respectively. Interest expense on time deposits that meet or exceed the FDIC insurance limit of \$250,000 was \$695,601 and \$538,282 for the years ended December 31, 2018 and 2017, respectively.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 9. Advances from Federal Home Loan Bank

Advances from the Federal Home Loan Bank (FHLB) consisted of the following at December 31:

<u>Description</u>	<u>Current Interest Rate</u>	<u>2018</u>	<u>2017</u>
FHLB advances maturing:			
March 16, 2018	1.47%	\$ -	\$ 15,000,000
March 22, 2019	2.54%	<u>5,000,000</u>	<u>-</u>
Total		<u>\$ 5,000,000</u>	<u>\$ 15,000,000</u>

Pursuant to collateral agreements with the FHLB, advances are secured by stock in the FHLB and by qualifying first mortgage, home equity lines of credit and commercial real estate loans. As of December 31, 2018, the pledged collateral totaled approximately \$35,929,365 million. Certain advances are subject to prepayment penalties.

Note 10. Stock Compensation Plan

The Company has adopted a 2007 Stock Incentive Plan and a 2017 Stock Incentive Plan, under which an aggregate of 659,130 and 575,000 shares of common stock, respectively, have been reserved for issuance as stock options by the Company. The options are granted at an exercise price at least equal to the fair value of the common stock at the date of grant and expire ten years from the date of the grant. The vesting period for option grants will vary based on the timing of the grant. Options that expire without issuance, forfeitures, shares used as partial payment to the Company for the purchase price of the award, or an award settled in cash, including for payroll taxes, are added back to the shares available to be awarded under the plan. As of December 31, 2018, a total of 18,742 and 575,000 shares were remaining in the plans to be issued.

In connection with the merger of Atlantic Community, the Company assumed the obligations of Atlantic Bancshares, Inc. which included five different Incentive Stock Option plans. As a result, the Company registered an aggregate 115,612 shares of common stock related to these plans. There are no additional shares available to be awarded under any of the Plans. All options were fully vested at the time of the merger.

Activity in the Company's stock option plans is summarized in the following table. All information has been retroactively adjusted for stock dividends.

	<u>2018</u>		<u>2017</u>	
	<u>Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Shares</u>	<u>Weighted Average Exercise Price</u>
Outstanding at January 1,	98,120	\$ 10.12	429,724	\$ 7.56
Granted	9,000	12.05	81,785	10.41
Acquired in a merger	115,612	7.92	-	-
Exercised	(17,512)	9.12	(413,389)	7.52
Forfeited/Expired	-	-	-	-
Outstanding at December 31,	<u>205,220</u>	<u>\$ 9.05</u>	<u>98,120</u>	<u>\$ 10.12</u>
Exercisable at December 31,	<u>139,896</u>	<u>\$ 8.31</u>	<u>12,804</u>	<u>\$ 8.78</u>

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 10. Stock Compensation Plan, Continued

The aggregate intrinsic value of the 205,220 and 98,120 stock options outstanding at December 31, 2018 and 2017 was \$396,424 and \$242,784, respectively. The aggregate intrinsic value of 139,896 and 12,804 stock options exercisable at December 31, 2018 and 2017 was \$364,284 and \$96,947, respectively. Intrinsic value represents the amount by which the fair market value of the underlying stock exceeds the exercise price of the stock option.

The following table summarizes information about stock options outstanding under the Company's Plans at December 31, 2018 and 2017:

	<u>2018</u>	<u>2017</u>
Number of options	205,220	98,120
Weighted average remaining life	7 years	8 years
Weighted average exercise price	\$ 9.05	\$ 10.12
High exercise price	\$ 14.55	\$ 14.55
Low exercise price	\$ 5.10	\$ 8.68
Aggregate intrinsic value	\$ 396,424	\$ 242,784

During 2018, the Company granted a total of 9,000 stock options. These options ratably vest over the terms below. The fair value of each option granted was estimated on the date of the grant using the Black-Scholes option pricing, resulting in a total expense of \$19,643. The Black-Scholes model with assumptions for stock options granted in 2018 are presented below:

	<u>2018</u>	
	<u>October 9</u>	<u>December 18</u>
Grant date		
Total number of options granted	1,500	7,500
Expected volatility	10.11%	10.11%
Expected term	10 years	10 years
Expected dividend	0.00%	0.00%
Risk-free rate	2.45%	2.45%
Grant date fair value	2.191	2.181
Vesting	5 years	3 years
Exercise Price	\$14.20	\$11.62

The Black-Scholes model with assumptions for stock options granted in 2017 are presented below:

	<u>2017</u>			
	<u>January 6</u>	<u>January 6</u>	<u>July 5</u>	<u>September 28</u>
Grant date				
Total number of options granted	14,025	66,000	1,100	660
Expected volatility	10.11%	10.11%	10.11%	10.11%
Expected term	10 years	10 years	10 years	10 years
Expected dividend	0.00%	0.00%	0.00%	0.00%
Risk-free rate	2.45%	2.45%	2.45%	2.45%
Grant date fair value	2.604	2.604	1.945	2.191
Vesting	5 years	3 years	5 years	2 years
Exercise Price	\$10.32	\$10.32	\$14.30	\$14.30

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 10. Stock Compensation Plan, Continued

As of December 31, 2018, there was \$186,614 of total unrecognized compensation cost related to non-vested stock option grants under the plans. The cost is expected to be recognized over a weighted-average period of seven years as of December 31, 2018.

Note 11. Stock Warrants

The organizers of the Company received stock warrants giving them the right to purchase one share of common stock for every share they purchased in the initial offering of the Company's common stock up to 13,310 shares at a price of \$7.51 per share, as adjusted for the stock dividends. The warrants vest ratably over a five year period and terminate ten years after date of grant. During 2017, the warrants expiration date was extended another ten years. Warrants held by directors of the Company will expire 90 days after the director ceases to be a director or officer of the Company (365 days if due to death or disability).

In 2018 and 2017, no warrants were issued or cancelled. At December 31, 2018, there were 119,790 outstanding and exercisable. These warrants will expire in 2027 unless otherwise extended.

Note 12. Income Taxes

The Tax Cuts and Jobs Act (TCJA) was signed into law by the President on December 22, 2017. The TCJA includes the reduction in the corporate tax rate from a top rate of 35% in 2017 to a flat rate of 21% by 2018, changes in business deductions, and many international provisions.

Income tax expense is summarized as follows for the years ended December 31:

	<u>2018</u>	<u>2017</u>
Current income tax expense:		
Federal	\$ 873,795	\$ 456,665
State	<u>110,412</u>	<u>70,153</u>
Total	<u>984,207</u>	<u>526,818</u>
Deferred income tax expense (benefit):		
Federal	96,930	(404)
State	<u>(169,503)</u>	<u>(146,975)</u>
Total	<u>(72,573)</u>	<u>(147,379)</u>
Income tax expense	<u>\$ 911,634</u>	<u>\$ 379,439</u>

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 12. Income Taxes, Continued

The gross amounts of deferred tax assets and deferred tax liabilities are as follows as of December 31:

	<u>2018</u>	<u>2017</u>
Deferred tax assets:		
Allowance for loan losses	\$ 790,597	\$ 638,974
Net operating loss carryforward	1,325,026	66,483
Organization and start-up costs	60,532	50,588
Federal and state credits	527,939	526,696
Unrealized loss on securities available-for-sale	197,584	46,929
Deferred compensation	253,397	156,308
Purchase accounting adjustments	26,522	-
Other	83,474	-
Total deferred tax assets	3,265,071	1,485,978
Valuation allowance	<u>(174,062)</u>	<u>(67,226)</u>
Net deferred tax assets	<u>3,091,009</u>	<u>1,418,752</u>
Deferred tax liabilities:		
Accumulated depreciation	928,087	1,048,767
Loan origination costs	224,945	163,371
Prepaid expenses	21,127	17,409
Other	-	99,474
Total deferred tax liabilities	<u>1,174,159</u>	<u>1,329,021</u>
Net deferred tax asset	<u>\$ 1,916,850</u>	<u>\$ 89,731</u>

Deferred tax assets represent the future tax benefit of deductible differences and, if it is more likely than not that a tax asset will not be realized, a valuation allowance is required to reduce the recorded deferred tax assets to net realizable value. Management's judgment is based on estimates concerning future income earned and positive earnings for the years ended December 31, 2018 and 2017. Management has concluded that sufficient positive evidence exists to overcome any and all negative evidence in order to meet the "more likely than not" standard regarding the realization of the net deferred tax assets. As of December 31, 2018 and 2017 a small valuation allowance in the amount of \$174,062 and \$67,226 respectively, remains for state holding company losses. Net deferred tax assets are recorded in other assets on the Company's consolidated balance sheet.

The Company has a federal net operating loss carryforward of \$5,598,905 as of December 31, 2018. The Company did not have a federal net operating loss carryforward as of December 31, 2017. The Company has a state net operating loss carryforward of \$3,778,631 and \$1,368,119 as of December 31, 2018 and 2017, respectively. These net operating loss carryforwards begin to expire in the year 2028.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 12. Income Taxes, Continued

A reconciliation between the income tax expense and the amount computed by applying the Federal statutory rate of 34% in 2017 and 21% in 2018 to income before income taxes follows for the years ended December 31, 2018 and 2017:

	<u>2018</u>	<u>2017</u>
Tax expense at statutory rate	\$ 917,508	\$ 1,222,385
State income tax, net of federal income tax benefit	(46,682)	(50,703)
Change in valuation allowance	67,045	58,908
Cash surrender value of life insurance	(50,762)	(83,248)
Other municipal income	(142,951)	(233,127)
ISO/NQSO	14,472	(352,490)
Impact of federal tax rate change	-	(298,718)
Merger expenses	61,766	-
Other	<u>91,238</u>	<u>116,432</u>
Income tax expense	<u>\$ 911,634</u>	<u>\$ 379,439</u>

Tax returns for 2015 and subsequent years are subject to examination by taxing authorities. The Company has analyzed the tax positions taken or expected to be taken on its tax returns and concluded it has no liability related to uncertain tax positions in accordance with ASC Topic 740.

Note 13. Employee Benefits

The Bank sponsors a defined contribution 401(k) plan covering substantially all full-time employees. Under the plan and present policies, participants are permitted to make contributions up to the deferral limits allowed by the Internal Revenue Service. The Company contributes to the Plan annually upon approval by the Board of Directors. The amount of the contributions made is at the discretion of the Board with vesting of these employer contributions occurring over the employees initial five years of employment. During the years ended December 31, 2018 and 2017, the Bank recognized \$207,234 and \$163,524, respectively, in expenses related to this plan which are included in salaries and employee benefits.

On January 1, 2013, we converted our defined contribution 401(k) contribution plan into a 401(k) Employee Stock Ownership Plan ("KSOP"), which provides a mechanism for Company employees to invest in the Company. Each employee who has attained age twenty-one, employed at least 90 days, has completed at least 500 hours of service in a Plan year, and is employed the last business day of the plan year is eligible to participate in the KSOP. Upon approval of the Board to contribute shares to employees, the Company recognizes the related compensation expense in the year the shares are allocated to employees. For the years ended December 31, 2018 and 2017, there was compensation expense of \$312,500 and \$315,000 related to contribution of shares to the KSOP, which are included in salaries and employee benefits. 25,000 and 20,000 shares were contributed and allocated to employees for 2018 and 2017, respectively.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 13. Employee Benefits, Continued

The Bank has a Salary Continuation Plan (the "Plan") for certain senior officers. The Plan provides an annual post-retirement cash payment beginning after a chosen retirement date for certain officers of the Bank. The officers will receive an annual payment from the Bank equal to the promised benefits. In connection with this plan, life insurance contracts were purchased on the officers. The cash value of the life insurance contracts increased \$241,722 and \$244,847 for the years ended December 31, 2018 and 2017, respectively and are included in noninterest income. Cash values of the policies were \$9,467,137 and \$9,225,239 at December 31, 2018 and 2017, respectively. The corresponding liability associated with the Plan was \$985,643 and \$605,403 at December 31, 2018 and 2017, respectively and is included in other liabilities. Expenses related to the Plan were \$380,312 and \$320,331 for the years ended December 31, 2018 and 2017, respectively and are included in salaries and employee benefits.

The Bank also has a Director Retirement Plan ("Director Plan") for its Board of Directors. The Director Plan provides an additional source of retirement income to a Director for a period of time upon their separation from the Bank in recognition of their service to the Bank. The corresponding liability associated with the Director Plan was \$221,008 and \$138,921 for the years ended December 31, 2018 and 2017, respectively, and is included in other liabilities. Expenses related to the Director Plan were \$82,087 and \$59,721 for the years ended December 31, 2018 and 2017, respectively and are included in other operating expenses.

Note 14. Leases

The Bank has entered into agreements to lease various office facilities under non-cancellable operating lease agreements. Lease expense totaled \$936,353 and \$399,672 for the years ended December 31, 2018 and December 31, 2017, respectively and is included in net occupancy. Minimum future rental payments under non-cancelable operating leases having remaining terms in excess of one year, for each of the next five years and thereafter in the aggregate are:

2019	\$	902,857
2020		910,117
2021		892,634
2022		909,897
2023 and thereafter		<u>8,537,762</u>
Total		<u>\$ 12,153,267</u>

The Company is leasing a portion of its Murrells Inlet location to an unrelated tenant. Lease income generated from this tenant totaled \$41,113 and \$37,629 during the years ended December 31, 2018 and 2017, respectively and is included in other income.

Note 15. Related Party Transactions

Certain parties (principally certain directors and executive officers of the Company, their immediate families, and their business interests) are loan customers of and have other transactions in the normal course of business with the Company. Related party loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and do not involve more than the normal risk of collectability. As of December 31, 2018 and 2017, the Company had related party loans totaling \$11,274,189 and \$11,262,521, respectively.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 15. Related Party Transactions, Continued

In 2017, three executives of the Bank exercised 402,799 stock options with the Company. A note receivable, in the amount of \$3,392,274, was issued for the exercise of the options. The total for the note receivable was determined to be the contractual exercise price of the stock options, adjusted for federal and state income taxes. The note receivable bears an interest rate of 1.15% per annum and is due and payable on demand by the Company, no later than June 8, 2020. During 2018, the loan balance increased \$385,000 for tax expenses related to exercised options. The balance as of December 31, 2018 was \$3,777,274.

Deposits by directors, including their affiliates and executive officers, were approximately \$38,197,159 and \$16,736,841 at December 31, 2018 and 2017, respectively.

Note 16. Commitments and Contingencies

The Company is subject to claims and lawsuits which arise primarily in the ordinary course of business. Management is not aware of any legal proceedings which would have a material adverse effect on the financial position or operating results of the Company.

Note 17. Income per Share

Basic income per share is computed by dividing net income by the weighted-average number of common shares outstanding. Diluted income per share is computed by dividing net income 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 warrants and stock options. Retroactive recognition has been given for the effects of all stock dividends. The effect from stock options on incremental shares from the assumed conversions for basic income per share and diluted income per share are presented below:

	<u>2018</u>	<u>2017</u>
Income per common share - basic computation:		
Net income	\$ 3,457,454	\$ 3,215,811
Average common shares outstanding - basic	<u>7,176,015</u>	<u>5,809,334</u>
Basic income per common share	<u>\$ 0.48</u>	<u>\$ 0.55</u>
Income per common share - diluted computation:		
Net income	\$ 3,457,454	\$ 3,215,811
Average common shares outstanding - basic	7,176,015	5,809,334
Incremental shares from assumed conversions:		
Stock options and warrants	<u>131,492</u>	<u>210,146</u>
Average common shares outstanding - diluted	<u>7,307,507</u>	<u>6,019,480</u>
Diluted income per common share	<u>\$ 0.47</u>	<u>\$ 0.53</u>

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 18. Regulatory Matters

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

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum ratios (set forth in the table below) of Tier 1, Common Equity Tier 1 (CET1), and total capital as a percentage of assets and off-balance-sheet exposures, adjusted for risk-weights ranging from 0% to 150%. Tier 1 capital of the Bank consists of common stockholders' equity, excluding the unrealized gain or loss on securities available-for-sale, minus certain intangible assets, while CET1 is comprised of Tier 1 capital, adjusted for certain regulatory deductions and limitations. Tier 2 capital consists of the allowance for loan losses subject to certain limitations. Total capital for purposes of computing the capital ratios consists of the sum of Tier 1 and Tier 2 capital.

The Company and the Bank are also required to maintain capital at a minimum level based on average assets (as defined), which is known as the leverage ratio. Only the strongest institutions are allowed to maintain capital at the minimum requirement. All others are subject to maintaining ratios 1% to 2% above the minimum.

Effective March 31, 2015, quantitative measures established by applicable regulatory standards, including the newly implemented Basel III revised capital adequacy standards and relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank Act"), require the Bank to maintain (i) a minimum ratio of Tier 1 capital to average total assets, after certain adjustments, of 4.00%, (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of 6.00%, (iii) a minimum ratio of total-capital to risk-weighted assets of 8.00% and (iv) a minimum ratio of CET1 to risk-weighted assets of 4.50%. A "well-capitalized" institution must generally maintain capital ratios 2% higher than the minimum guidelines.

In order to avoid restrictions on capital distributions or discretionary bonus payments to executives, the Bank will also be required to maintain a "capital conservation buffer" in addition to its minimum risk-based capital requirements. This buffer will be required to consist solely of CET1, but the buffer will apply to all three risk-based measurements (CET1, Tier 1 and total capital). The capital conservation buffer will be phased in incrementally over time, beginning January 1, 2017, and becoming fully effective on January 1, 2019, and will ultimately consist of an additional amount of Tier 1 capital equal to 2.5% of risk-weighted assets. The capital conservation buffer in effect for the year ended December 31, 2018 was 1.875%.

As of its most recent regulatory examination, the Bank was deemed well-capitalized under the regulatory framework for prompt corrective action. To be categorized well-capitalized, the Bank must maintain total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table below. There are no conditions or events that management believes have changed the Bank's categories.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 18. Regulatory Matters, Continued

The following table summarizes the capital ratios and the regulatory minimum requirements of the Bank at December 31, 2018 and 2017.

	<u>Actual</u>		<u>For capital adequacy purposes Minimum</u>		<u>To be well-capitalized under prompt corrective action provisions Minimum</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
December 31, 2018						
Total capital (to risk-weighted assets)	\$ 61,676,000	12.12%	40,712,000	8.00%	\$ 50,890,000	10.00%
Tier 1 capital (to risk-weighted assets)	57,276,000	11.25%	30,534,000	6.00%	40,712,000	8.00%
Tier 1 capital (to average assets)	57,276,000	9.36%	24,482,000	4.00%	30,603,000	5.00%
Common equity tier 1 capital (to risk-weighted assets)	57,276,000	11.25%	22,901,000	4.50%	33,079,000	6.50%
December 31, 2017						
Total capital (to risk-weighted assets)	\$ 47,752,000	11.49%	\$ 33,241,000	8.00%	\$ 41,551,000	10.00%
Tier 1 capital (to risk-weighted assets)	44,003,000	10.59%	24,931,000	6.00%	33,241,000	8.00%
Tier 1 capital (to average assets)	44,003,000	8.57%	20,548,000	4.00%	25,685,000	5.00%
Common equity tier 1 capital (to risk-weighted assets)	44,003,000	10.59%	18,698,000	4.50%	27,008,000	6.50%

Note 19. Unused Lines of Credit

As of December 31, 2018, the Company had available lines of credit to purchase federal funds from unrelated banks totaling \$45,500,000. These lines of credit are available on a one to fourteen day basis for general corporate purposes. As of December 31, 2018, the outstanding balance on the lines was \$10,453,000. At December 31, 2017, there was no outstanding line of credit for federal funds.

The Company also has an additional line of credit with the Federal Home Loan Bank with available funds totaling \$35,929,365. As of December 31, 2018 and December 31, 2017, the balance outstanding on this line was \$5,000,000 and \$15,000,000, respectively.

Note 20. Shareholders' Equity

In November 2017, the Board of Directors declared a ten percent stock dividend payable on November 28, 2017, to shareholders of record at November 13, 2017. As a result of the stock dividend, 584,016 shares were issued. All share and per share amounts have been retroactively adjusted to reflect these dividends.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 20. Shareholders' Equity, Continued

The ability of South Atlantic Bancshares, Inc. and Subsidiary to pay cash dividends is dependent upon receiving cash in the form of dividends from its banking subsidiary. However, certain restrictions exist regarding the ability of the subsidiary to transfer funds to South Atlantic Bancshares, Inc. and Subsidiary. The approval of the South Carolina Board of Financial Institutions is required to pay dividends in excess of the Bank's net profits (as defined) for the current year plus retained net profits (as defined) for the preceding two years, less any required transfers to surplus. As of December 31, 2018, the Bank had \$10,649,252 in retained earnings available for dividends.

Note 21. Financial Instruments with Off-Balance-Sheet Risk

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments consist of commitments to extend credit and standby letters of credit. 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. A commitment involves, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The Company's exposure to credit loss in the event of nonperformance by the other party to the instrument is represented by the contractual notional amount of the instrument. Since certain commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company uses the same credit policies in making commitments to extend credit as it does for on-balance-sheet instruments. Letters of credit are conditional commitments issued to guarantee a customer's performance to a third party and have essentially the same credit risk as other lending facilities.

Collateral held for commitments to extend credit and letters of credit varies, but may include accounts receivable, inventory, property, plant, equipment, and income-producing commercial properties.

The following table summarizes the Bank's off-balance-sheet financial instruments at December 31, 2018 and 2017 whose contract amounts represent credit risk:

	<u>2018</u>	<u>2017</u>
Commitments to extend credit	\$ 147,270,990	\$ 66,742,000
Letters of credit	<u>822,000</u>	<u>1,005,000</u>
Total	<u>\$ 147,997,868</u>	<u>\$ 67,747,000</u>

Note 22. Fair Value of Financial Instruments

Accounting standards require disclosures about the fair value of assets and liabilities recognized in the balance sheet in periods subsequent to initial recognition, whether the measurements are made on a recurring basis (for example, available-for-sale investment securities) or on a nonrecurring basis (for example, impaired loans).

The accounting standard defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. It also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 22. Fair Value of Financial Instruments, Continued

- Level 1 Quoted market prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as U.S. Treasuries, and money market funds.
- Level 2 Observable inputs other than Level 1 prices such as 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 assets or liabilities. Level 2 assets and liabilities include debt securities with quoted prices that are traded less frequently than exchange-traded instruments, mortgage-backed securities, municipal bonds, corporate debt securities, and derivative contracts whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data. This category generally includes certain derivative contracts and impaired loans.
- Level 3 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 the determination of fair value requires significant management judgment or estimation. For example, this category generally includes certain private equity investments, retained residual interests in securitizations, residential mortgage servicing rights, and highly-structured or long-term derivative contracts.

Following is a description of valuation methodologies used for assets and liabilities recorded at fair value on a recurring basis:

Investment Securities Available-for-Sale - Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange such as the New York Stock Exchange, Treasury securities that are traded by dealers or brokers in active over-the counter markets and money market funds. Level 2 securities include mortgage backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

Mortgage Loans Held-for-Sale - The fair values of mortgages held for sale are derived from an active market of similar loans and as such are classified as Level 2 in the fair value hierarchy.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 22. Fair Value of Financial Instruments, Continued

The tables below present the balances of assets and liabilities measured at fair value on a recurring basis by level within the hierarchy.

	December 31, 2018			
	Total	Level 1	Level 2	Level 3
Obligations of state and local governments	\$ 23,699,780	\$ -	\$ 23,669,780	\$ -
Mortgage-backed securities	20,951,230	-	20,951,230	-
SBA loan pools	1,726,962	-	1,726,962	-
SBA asset-backed securities	492,322	-	492,322	-
Corporate debt securities	2,400,000	-	2,400,000	-
Loans held-for-sale	923,722	-	923,722	-
Total	<u>\$ 50,194,016</u>	<u>\$ -</u>	<u>\$ 50,194,016</u>	<u>\$ -</u>

	December 31, 2017			
	Total	Level 1	Level 2	Level 3
Obligations of state and local governments	\$ 24,208,593	\$ -	\$ 24,208,593	\$ -
Mortgage-backed securities	10,782,898	-	10,782,898	-
SBA loan pools	863,432	-	863,432	-
Loans held-for-sale	1,865,265	-	1,865,265	-
Total	<u>\$ 37,720,188</u>	<u>\$ -</u>	<u>\$ 37,720,188</u>	<u>\$ -</u>

Certain assets and liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Following is a description of valuation methodologies used for assets and liabilities recorded at fair value on a non-recurring basis.

Impaired Loans - The Company does not record loans at fair value on a recurring basis, however, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan are considered impaired. Once a loan is identified as individually impaired, management measures impairment. The fair value of impaired loans is estimated using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring a specific allowance represent loans for which the fair value of expected repayments or collateral exceed the recorded investment in such loans. At December 31, 2018 and 2017, substantially all of the impaired loans were evaluated based upon the fair value of the collateral. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the loan as nonrecurring Level 3.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 22. Fair Value of Financial Instruments, Continued

Other Real Estate Owned - Foreclosed assets are adjusted to fair value upon transfer of the loans to other real estate owned. Real estate acquired in settlement of loans is recorded initially at estimated fair value of the property less estimated selling costs at the date of foreclosure. The initial recorded value may be subsequently reduced by additional allowances, which are charges to earnings if the estimated fair value of the property less estimated selling costs declines below the initial recorded value. Fair value is based upon independent market prices, appraised values of the collateral, or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company recorded the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the foreclosed asset as nonrecurring Level 3. As of December 31, 2018 and 2017, respectively, the Company had no OREO.

The following table presents the assets and liabilities carried on the balance sheet by caption and by level within the valuation hierarchy (as described above) as of December 31, 2018 and 2017, for which a nonrecurring change in fair value has been recorded during the years ended December 31, 2018 and 2017.

	December 31, 2018			
	Total	Level 1	Level 2	Level 3
Impaired loans				
Commercial	\$ 139,301	\$ -	\$ 139,301	\$ -
Commercial real estate	16,791	-	16,791	-
Consumer	-	-	-	-
Consumer real estate	456,057	-	456,057	-
Total impaired loans	<u>\$ 612,149</u>	<u>\$ -</u>	<u>\$ 612,149</u>	<u>\$ -</u>
	December 31, 2017			
	Total	Level 1	Level 2	Level 3
Impaired loans				
Commercial	\$ 33,008	\$ -	\$ 33,088	\$ -
Commercial real estate	250,699	-	250,699	-
Consumer	45,533	-	45,533	-
Consumer real estate	46,359	-	46,359	-
Total impaired loans	<u>\$ 375,599</u>	<u>\$ -</u>	<u>\$ 375,599</u>	<u>\$ -</u>

The following methods and assumptions were used to estimate the fair value of significant financial instruments:

Cash and Due from Banks - The carrying amount is a reasonable estimate of fair value.

Federal Funds Sold and Interest Bearing Deposits - Federal funds are sold for a term of one day, and the carrying amount approximates the fair value.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 22. Fair Value of Financial Instruments, Continued

Securities Available-for-Sale - Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

Nonmarketable Equity Securities - The carrying value of these securities approximates the fair value since no ready market exists for the stocks.

Mortgage Loans Held-for-Sale - The carrying value of mortgage loans held for sale approximates fair value.

Loans Receivable - During the first quarter of 2018, the Company adopted ASU 2016-01, *Recognition and Measurement of Financial Assets and Liabilities*. The amendments included within this standard, which are applied prospectively, require the Company to measure and disclose fair value of balance sheet financial instruments using an exit price notion. Prior to adopting the amendments included in the standard, the Company measured fair value under an entry price notion. The entry price notion previously applied by the Company used a discounted cash flows technique to calculate the present value of expected future cash flows for a financial instrument. The exit price notion uses the same approach, but also incorporates other factors, such as enhanced credit risk, illiquidity risk, and market factors that sometimes exist in exit prices in dislocated markets.

As of December 31, 2018, the technique used by the Company to estimate the exit price of the loan portfolio consists of similar procedures to those used as of December 31, 2017, but with added emphasis on both illiquidity risk and credit risk not captured by the previously applied entry price notion. The fair value of the Company's loan portfolio has always included a credit risk assumption in the determination of the fair value of its loans. This credit risk assumption is intended to approximate the fair value that a market participant would realize in a hypothetical orderly transaction. The Company's loan portfolio is initially fair valued using a segmented approach. The Company divides its loan portfolio into the following categories: variable rate loans, impaired loans and all other loans. The results are then adjusted to account for credit risk as described above.

However, under the new guidance, the Company believes a further credit risk discount must be applied through the use of a discounted cash flow model to compensate for illiquidity risk, based on certain assumptions included within the discounted cash flow model, primarily the use of discount rates that better capture inherent credit risk over the lifetime of a loan. This consideration of enhanced credit risk provides an estimated exit price for the Company's loan portfolio.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 22. Fair Value of Financial Instruments, Continued

For variable-rate loans that reprice frequently and have no significant change in credit risk, fair values approximate carrying values. Fair values for impaired loans are estimated using discounted cash flow models or based on the fair value of the underlying collateral.

As of December 31, 2017, the fair value of the Company's loan portfolio included a credit risk assumption in the determination of the fair value of its loans. This credit risk assumption was intended to approximate the fair value that a market participant would realize in a hypothetical orderly transaction.

Bank Owned Life Insurance - The carrying amount is a reasonable estimate of fair value.

Deposits - The fair value of demand deposits, savings, and money market accounts is the amount payable on demand at the reporting date. The fair values of certificates of deposit and other time deposits are estimated using a discounted cash flow calculation that applies current interest rates to a schedule of aggregated expected maturities.

Advances from Federal Home Loan Bank - For disclosure purposes, the fair value of the FHLB fixed rate borrowing is estimated using discounted cash flows, based on the current incremental borrowing rates for similar types of borrowing arrangements. The carrying value of advances from Federal Home Loan Bank approximates fair value.

Accrued Interest Receivable and Payable - The carrying value of these instruments is a reasonable estimate of fair value.

Off-Balance Sheet Financial Instruments - Fair values of off-balance sheet lending commitments are based on fees currently charged to enter into similar agreements taking into account the remaining terms of the agreements and the counterparties' credit standing.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 22. Fair Value of Financial Instruments, Continued

The carrying values and estimated fair values of the Company's financial instruments as of December 31, 2018 and 2017 are as follows:

	2018		2017	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial Assets:				
Cash and due from banks	\$ 8,420,048	\$ 8,420,048	\$ 6,399,310	\$ 6,399,310
Federal funds sold and interest bearing deposits	7,380,430	7,380,430	13,987,188	13,987,188
Securities available-for-sale	49,240,294	49,240,294	38,854,923	38,854,923
Nonmarketable equity securities	752,500	752,500	1,037,000	1,037,000
Loans held for sale	923,722	923,722	1,865,265	1,865,265
Loans receivable	531,034,918	518,042,350	434,917,988	438,324,000
Bank owned life insurance	9,467,137	9,467,137	9,225,239	9,225,239
Accrued interest receivable	1,806,034	1,806,034	1,517,998	1,517,998
Financial Liabilities:				
Demand deposit, interest-bearing transaction, and savings accounts	438,177,460	438,177,460	368,749,392	368,749,392
Certificates of deposit and other time deposits	92,161,292	92,550,666	70,476,586	68,746,586
Advances from Federal Home Loan Bank	5,000,000	5,000,000	15,000,000	15,000,000
Federal funds purchased	10,453,000	10,453,000	-	-
Accrued interest payable	95,520	95,520	53,166	53,166
	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Off-Balance Sheet Financial Instruments:				
Commitments to extend credit	\$ 147,270,990	\$ -	\$ 147,270,990	\$ -
Letters of credit	726,878	-	726,878	-

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 23. South Atlantic Bancshares, Inc. and Subsidiary (Parent Company Only)

Following is condensed financial information of South Atlantic Bancshares, Inc. (parent company only) as of and for the years ended December 31:

Condensed Balance Sheets

	<u>2018</u>	<u>2017</u>
Assets		
Cash	\$ 13,749,674	\$ 15,112,110
Investment in bank subsidiary	64,221,312	44,310,623
Loans	3,787,268	3,402,268
Other assets	324,746	181,535
Total assets	<u>\$ 82,083,000</u>	<u>\$ 63,006,536</u>
Liabilities and shareholders' equity		
Other liabilities	\$ 2,746,555	2,864,532
Shareholders' equity	<u>79,336,445</u>	<u>60,142,004</u>
Total liabilities and shareholders' equity	<u>\$ 82,083,000</u>	<u>\$ 63,006,536</u>

Condensed Statements of Income

Income	<u>\$ 39,789</u>	<u>\$ 23,529</u>
Expenses:		
Salaries and benefits	421,886	386,031
Merger expenses	1,252,211	-
Other	<u>113,563</u>	<u>50,626</u>
Total	<u>1,787,660</u>	<u>436,657</u>
Loss before income taxes and equity in undistributed income of banking subsidiary	(1,747,871)	(98,128)
Income tax benefit	298,121	511,004
Equity in undistributed income of banking subsidiary	<u>4,907,204</u>	<u>3,117,935</u>
Net income	<u>\$ 3,457,454</u>	<u>\$ 3,215,811</u>

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 23. South Atlantic Bancshares, Inc. and Subsidiary (Parent Company Only), Continued

Condensed Statements of Cash Flows

	<u>2018</u>	<u>2017</u>
Operating activities		
Net income	\$ 3,457,454	\$ 3,215,811
Adjustments to reconcile net income to net cash used in operating activities		
Equity in undistributed income of banking subsidiary	(4,907,204)	(3,117,935)
Stock and warrant compensation expense	104,074	68,912
Contribution of treasury stock to ESOP plan	312,500	315,000
Increase in investment in bank	-	(5,000,000)
Decrease in accrued expenses and other liabilities	(117,977)	(170,109)
(Increase) decrease in other assets	<u>(143,211)</u>	<u>28,520</u>
Net cash used in operating activities	<u>(1,294,364)</u>	<u>(4,659,801)</u>
Investing activities:		
Net increase in loans	(385,000)	(367,627)
Net cash received from acquisitions	<u>604,062</u>	<u>-</u>
Net cash provided by (used in) investing activities	<u>219,062</u>	<u>(367,627)</u>
Financing activities:		
Proceeds from exercise of stock options	159,772	70,217
Purchase of treasury stock	(446,906)	-
Proceeds from stock offering, net	<u>-</u>	<u>18,778,153</u>
Net cash provided by (used in) financing activities	<u>(287,134)</u>	<u>18,848,370</u>
Net increase (decrease) in cash and cash equivalents	(1,362,436)	13,820,942
Cash, beginning of year	<u>15,112,110</u>	<u>1,291,168</u>
Cash, end of year	<u>\$ 13,749,674</u>	<u>\$ 15,112,110</u>
Noncash operating and investing activities:		
Loans issued in cashless exercise of stock options	<u>\$ -</u>	<u>\$ (3,085,349)</u>

Note 24. Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Nonrecognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed events occurring through March 11, 2019, the date the financial statements were available to be issued and no subsequent events occurred requiring accrual or disclosure, with the exception of the building purchase as discussed below.

South Atlantic Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 24. Subsequent Events, Continued

On March 15, 2019, the Company plans to purchase a new operations center to support our growth. The 18,000 square building located at 3990 River Oaks Drive in Carolina Forest will house our deposit, loan and mortgage operations.