

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2016

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

For the transition period from _____ to _____

Commission File Number: **333-203449**



SmartFinancial, Inc.

(Exact name of small business issuer as specified in its charter)

Tennessee

(State or other jurisdiction of incorporation or organization)

62-1173944

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

5401 Kingston Pike, Suite 600 Knoxville, Tennessee

(Address of principal executive offices)

37919

(Zip Code)

865-453-2650

(Registrant's telephone number, including area code)

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

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

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such period that the registrant was required to submit and post such files).

Yes No

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

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

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

Yes No

As of November 11, 2016 there were 5,888,408 shares of common stock, \$1.00 par value per share, issued and outstanding.

TABLE OF CONTENTS

PART I – FINANCIAL INFORMATION

<u>Item 1.</u>	<u>Financial Statements (Unaudited)</u>	<u>4</u>
<u>Item 2.</u>	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>29</u>
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>43</u>
<u>Item 4.</u>	<u>Controls and Procedures</u>	<u>43</u>

PART II – OTHER INFORMATION

<u>Item 1.</u>	<u>Legal Proceedings</u>	<u>44</u>
<u>Item 1A.</u>	<u>Risk Factors</u>	<u>44</u>
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>44</u>
<u>Item 3.</u>	<u>Defaults Upon Senior Securities</u>	<u>44</u>
<u>Item 4.</u>	<u>Mine Safety Disclosures</u>	<u>44</u>
<u>Item 5.</u>	<u>Other Information</u>	<u>44</u>
<u>Item 6.</u>	<u>Exhibits</u>	<u>44</u>

FORWARD-LOOKING STATEMENTS

SmartFinancial, Inc. (“SmartFinancial”) may from time to time make written or oral statements, including statements contained in this report (including, without limitation, certain statements in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in Item 2), that constitute forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 (the “Exchange Act”). The words “expect,” “anticipate,” “intend,” “consider,” “plan,” “believe,” “seek,” “should,” “estimate,” and similar expressions are intended to identify such forward-looking statements, but other statements may constitute forward-looking statements. These statements should be considered subject to various risks and uncertainties. Such forward-looking statements are made based upon management’s belief as well as assumptions made by, and information currently available to, management pursuant to “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995. SmartFinancial’s actual results may differ materially from the results anticipated in forward-looking statements due to a variety of factors. Such factors include, without limitation, those specifically described in Item 1A of Part I of the Company’s 2015 Annual Report on Form 10-K, as well as the following: (i) the possibility that our asset quality would decline or that we experience greater loan losses than anticipated, (ii) increased levels of other real estate, primarily as a result of foreclosures, (iii) the impact of liquidity needs on our results of operations and financial condition, (iv) competition from financial institutions and other financial service providers, (v) economic conditions in the local markets where we operate, (vi) our ability to realize all of the anticipated benefits of the merger between Cornerstone Community Bank and SmartBank, (vii) the impact of our Series B Preferred Stock on net income available to holders of our Common Stock and earnings per common share, (viii) the impact of negative developments in the financial industry and U.S. and global capital and credit markets, (ix) the impact of recently enacted legislation on our business, (x) the relatively greater credit risk of commercial real estate loans and construction and land development loans in our loan portfolio, (xi) adverse impact on operations and financial condition of changes in interest rates, (xii) the impact of recently enacted legislation on our business, (xiii) the impact of federal and state regulations on our operations and financial performance, (xiv) our ability to retain the services of key personnel, (xv) the impact of Tennessee’s anti-takeover statutes and certain charter provisions on potential acquisitions of the holding company, and (xvi) our ability to adapt to technological changes. Many of such factors are beyond SmartFinancial’s ability to control or predict, and readers are cautioned not to put undue reliance on such forward-looking statements. SmartFinancial does not intend to update or reissue any forward-looking statements contained in this report as a result of new information or other circumstances that may become known to SmartFinancial.

Non-GAAP Financial Measures

Under SEC Regulation G, public companies making disclosures containing financial measures that are not in accordance with GAAP must also disclose, along with each non-GAAP financial measure, certain additional information, including a reconciliation of the non-GAAP financial measure to the closest comparable GAAP financial measure, as well as a statement of the company’s reasons for utilizing the non-GAAP financial measure. The SEC has exempted from the definition of non-GAAP financial measures certain commonly used financial measures that are not based on GAAP. However, two non-GAAP financial measures commonly used by financial institutions, namely tax-equivalent net interest income and tax-equivalent net interest margin (as presented in the tables in the section labeled “Net Interest Income and Yield Analysis”), have not been specifically exempted by the SEC, and may therefore constitute non-GAAP financial measures under Regulation G. We are unable to state with certainty whether the SEC would regard those measures as subject to Regulation G. Management believes that these non-GAAP financial measures are useful in evaluating the Company’s financial performance and facilitate comparisons with the performance of other financial institutions. However, that information should be considered supplemental in nature and not as a substitute for related financial information prepared in accordance with GAAP.

PART I – FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SMARTFINANCIAL, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS

	Unaudited September 30, 2016	December 31, 2015
ASSETS		
Cash and due from banks	\$ 39,773,759	\$ 40,358,647
Interest-bearing deposits at other financial institutions	18,813,107	33,405,986
Federal funds sold	—	6,200,000
Total cash and cash equivalents	58,586,866	79,964,633
Securities available for sale	138,627,905	166,413,218
Restricted investments, at cost	4,451,250	4,451,050
Loans, net of allowance for loan losses of \$4,964,351 at September 30, 2016 and \$4,354,513 at December 31, 2015	792,178,219	723,360,786
Bank premises and equipment, net	27,862,914	25,037,510
Foreclosed assets	2,535,520	5,357,950
Goodwill and core deposit intangible, net	6,674,641	6,941,107
Other assets	9,808,430	12,436,625
Total assets	\$ 1,040,725,745	\$ 1,023,962,879
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand deposits	\$ 145,508,791	\$ 131,418,580
Interest-bearing demand deposits	152,216,383	149,423,954
Money market and savings deposits	271,259,319	236,900,945
Time deposits	291,857,348	340,739,072
Total deposits	860,841,841	858,482,551
Securities sold under agreement to repurchase	24,202,095	28,068,215
Federal Home Loan Bank advances and other borrowings	43,048,423	34,187,462
Accrued expenses and other liabilities	7,463,484	3,047,792
Total liabilities	935,555,843	923,786,020
Stockholders' equity:		
Preferred stock - \$1 par value; 2,000,000 shares authorized; 12,000 issued and outstanding in 2016 and 2015	12,000	12,000
Common stock - \$1 par value; 40,000,000 shares authorized; 5,885,408 and 5,806,477 shares issued and outstanding in 2016 and 2015, respectively	5,885,408	5,806,477
Additional paid-in capital	83,329,811	82,616,015
Retained earnings	15,493,873	12,094,488
Accumulated other comprehensive income (loss)	448,810	(352,121)
Total stockholders' equity	105,169,902	100,176,859
Total liabilities and stockholders' equity	\$ 1,040,725,745	\$ 1,023,962,879

The Notes to Consolidated Financial Statements are an integral part of these statements.

SMARTFINANCIAL, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME

	Unaudited Three Months Ended September 30,		Unaudited Nine Months Ended September 30,	
	2016	2015	2016	2015
INTEREST INCOME				
Loans, including fees	\$ 10,110,680	\$ 6,655,919	\$ 29,439,355	\$ 15,851,555
Securities and interest-bearing deposits at other financial institutions	601,624	452,114	1,983,606	1,233,366
Federal funds sold and other earning assets	51,172	41,077	164,653	97,004
Total interest income	<u>10,763,476</u>	<u>7,149,110</u>	<u>31,587,614</u>	<u>17,181,925</u>
INTEREST EXPENSE				
Deposits	1,065,092	687,992	3,039,044	1,688,661
Securities sold under agreements to repurchase	16,614	7,394	48,353	13,071
Federal Home Loan Bank advances and other borrowings	17,165	31,326	91,714	34,838
Total interest expense	<u>1,098,871</u>	<u>726,712</u>	<u>3,179,111</u>	<u>1,736,570</u>
Net interest income before provision for loan losses	9,664,605	6,422,398	28,408,503	15,445,355
Provision for loan losses	260,567	32,397	616,543	356,325
Net interest income after provision for loan losses	<u>9,404,038</u>	<u>6,390,001</u>	<u>27,791,960</u>	<u>15,089,030</u>
NONINTEREST INCOME				
Customer service fees	295,951	207,878	850,632	487,193
Gain on sale of securities	18,224	—	199,587	52,255
Gain on sale of loans and other assets	286,966	66,041	706,371	161,896
Gain (loss) on sale of foreclosed assets	130,383	(445,980)	184,626	(426,168)
Other noninterest income	472,300	350,648	1,294,318	817,676
Total noninterest income	<u>1,203,824</u>	<u>178,587</u>	<u>3,235,534</u>	<u>1,092,852</u>
NONINTEREST EXPENSES				
Salaries and employee benefits	4,311,708	3,184,662	13,292,864	7,721,381
Net occupancy and equipment expense	965,159	707,670	3,120,234	1,826,556
Depository insurance	153,353	144,417	440,100	339,376
Foreclosed assets	78,988	90,574	199,419	179,796
Advertising	179,145	131,875	536,657	353,341
Data processing	456,889	292,996	1,352,882	696,773
Professional services	558,368	907,755	1,564,973	1,593,621
Amortization of intangible assets	79,761	58,301	266,467	139,851
Service contracts	271,921	196,553	873,160	507,548
Other operating expenses	994,324	778,505	2,827,086	1,755,973
Total noninterest expenses	<u>8,049,616</u>	<u>6,493,308</u>	<u>24,473,842</u>	<u>15,114,216</u>
Income before income tax expense	2,558,246	75,280	6,553,652	1,067,666
Income tax expense	947,354	152,189	2,402,267	740,081
Net income	1,610,892	(76,909)	4,151,385	327,585
Preferred stock dividends	270,000	30,000	752,000	90,000
Net income (loss) available to common stockholders	<u>\$ 1,340,892</u>	<u>\$ (106,909)</u>	<u>\$ 3,399,385</u>	<u>\$ 237,585</u>
EARNINGS PER COMMON SHARE				
Basic	\$ 0.23	\$ (0.03)	\$ 0.58	\$ 0.07
Diluted	<u>0.22</u>	<u>(0.03)</u>	<u>0.56</u>	<u>0.06</u>
Weighted average common shares outstanding				
Basic	5,834,520	3,936,638	5,820,834	3,391,274
Diluted	<u>6,096,333</u>	<u>4,243,853</u>	<u>6,092,035</u>	<u>3,698,822</u>

Dividends per share

—	—	—	—
---	---	---	---

The Notes to Consolidated Financial Statements are an integral part of these statements.

SMARTFINANCIAL, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Unaudited Three Months Ended September 30,	
	2016	2015
Net income (loss)	\$ 1,610,892	\$ (76,909)
Other comprehensive income, net of tax:		
Unrealized holding gains arising during the period, net of tax expense of \$114,925 and \$335,110 in 2016 and 2015, respectively	185,360	546,758
Reclassification adjustment for gains included in net income, net of tax expense of \$6,925 and \$19,857 in 2016 and 2015, respectively	(11,299)	—
Total other comprehensive income	174,061	546,758
Comprehensive income	\$ 1,784,953	\$ 469,849

	Unaudited Nine Months Ended September 30,	
	2016	2015
Net income	\$ 4,151,385	\$ 327,585
Other comprehensive income, net of tax:		
Unrealized holding gains arising during the period, net of tax expense of \$573,073 and \$280,318 in 2016 and 2015, respectively	924,675	457,361
Reclassification adjustment for gains included in net income, net of tax expense of \$75,843 and \$19,857 in 2016 and 2015, respectively	(123,744)	(32,398)
Total other comprehensive income	800,931	424,963
Comprehensive income	\$ 4,952,316	\$ 752,548

The Notes to Consolidated Financial Statements are an integral part of these statements.

SMARTFINANCIAL, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY - UNAUDITED
For the Nine Months Ended September 30, 2016

	Preferred Shares	Common Shares	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
BALANCE, December 31, 2015	12,000	5,806,477	\$ 12,000	\$ 5,806,477	\$ 82,616,015	\$ 12,094,488	\$ (352,121)	\$ 100,176,859
Net income	—	—	—	—	—	4,151,385	—	4,151,385
Other comprehensive income	—	—	—	—	—	—	800,931	800,931
Exercise of stock options	—	78,931	—	78,931	614,161	—	—	693,092
Cash dividend on preferred stock	—	—	—	—	—	(752,000)	—	(752,000)
Stock compensation expense	—	—	—	—	99,635	—	—	99,635
BALANCE, September 30, 2016	<u>12,000</u>	<u>5,885,408</u>	<u>\$ 12,000</u>	<u>\$ 5,885,408</u>	<u>\$ 83,329,811</u>	<u>\$ 15,493,873</u>	<u>\$ 448,810</u>	<u>\$ 105,169,902</u>

The Notes to Consolidated Financial Statements are an integral part of these statements.

SMARTFINANCIAL, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Unaudited	
	Nine Months Ended September 30,	
	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 4,151,385	\$ 327,585
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,624,809	1,299,931
Provision for loan losses	616,543	356,325
Stock compensation expense	99,635	111,184
Gains from sale of securities	(199,587)	(52,255)
Net gains from sale of loans and other assets	(706,371)	(161,896)
Net gains from sale of foreclosed assets	(184,626)	426,168
Changes in other assets and liabilities:		
Accrued interest receivable	355,796	145,316
Accrued interest payable	(23,177)	11,495
Other assets and liabilities	6,480,504	(264,618)
Net cash provided by operating activities	<u>12,214,911</u>	<u>2,199,235</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from security sales, maturities, and paydowns	50,055,118	21,561,120
Purchase of securities	(21,351,789)	(3,000,000)
Purchase of restricted investments	(200)	(38,000)
Loan originations and principal collections, net	(66,811,239)	(33,220,666)
Purchase of bank premises and equipment	(3,932,566)	(772,357)
Proceeds from sale of foreclosed assets	1,152,775	1,282,966
Cash and cash equivalents received in merger	—	33,501,510
Net cash (used in) provided by investing activities	<u>(40,887,901)</u>	<u>19,314,573</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	2,359,290	42,723,491
Net increase (decrease) in securities sold under agreements to repurchase	(3,866,120)	8,684,178
Issuance of common stock	693,092	3,016,304
Payment of dividends on preferred stock	(752,000)	(90,000)
Proceeds from Federal Home Loan Bank advances and other borrowings	38,100,000	—
Repayment of Federal Home Loan Bank advances and other borrowings	(29,239,039)	(32,651,502)
Net cash provided by financing activities	<u>7,295,223</u>	<u>21,682,471</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(21,377,767)	43,196,279
CASH AND CASH EQUIVALENTS, beginning of year	79,964,633	46,739,376
CASH AND CASH EQUIVALENTS, end of period	<u>\$ 58,586,866</u>	<u>\$ 89,935,655</u>
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid during the period for interest	\$ 3,202,288	\$ 1,725,076
Cash paid during the period for taxes	1,570,558	806,000
NONCASH INVESTING AND FINANCING ACTIVITIES		
Change in unrealized losses on securities available for sale	\$ (1,298,161)	\$ 687,732
Acquisition of real estate through foreclosure	1,431,857	1,706,063
Financed sales of foreclosed assets	3,286,138	1,005,000

The Notes to Consolidated Financial Statements are an integral part of these statements.

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

Note 1. Presentation of Financial Information

Nature of Business:

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

Interim Financial Information (Unaudited):

The financial information in this report for September 30, 2016 and September 30, 2015 has not been audited. The information included herein should be read in conjunction with the Company’s 2015 annual consolidated financial statements and footnotes included elsewhere. The consolidated financial statements presented herein conform to U.S. generally accepted accounting principles and to general industry practices. In the opinion of SmartFinancial’s management, the accompanying interim financial statements contain all material adjustments necessary to present fairly the financial condition, the results of operations, and cash flows for the interim period. Results for interim periods are not necessarily indicative of the results to be expected for a full year.

Basis of Presentation and Accounting Estimates:

All adjustments consisting of normal recurring accruals, that in the opinion of management, are necessary for a fair presentation of the financial position and the results of operations for the periods covered by the report have been included. The accompanying unaudited consolidated financial statements and related notes should be read in conjunction with those appearing in the 2015 Annual Report previously filed on Form 10-K.

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

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

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

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

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

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

Reclassifications:

Certain amounts in the prior consolidated financial statements have been reclassified to conform to the current period presentation. The reclassifications had no effect on net income, total assets or stockholders’ equity as previously reported.

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

Note 1. Presentation of Financial Information, Continued

Recently Issued Accounting Pronouncements:

During interim periods, the Company follows the accounting policies set forth in its annual audited financial statements for the year ended December 31, 2015 as filed with the Securities and Exchange Commission. The following is a summary of recent authoritative pronouncements that could impact the accounting, reporting, and/or disclosure of financial information by the Company issued since December 31, 2015 .

In January 2016, the FASB issued guidance that primarily affects the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments in ASU No. 2016-01 - *Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* . In addition, the FASB clarified guidance related to the valuation allowance assessment when recognizing deferred tax assets resulting from unrealized losses on available-for-sale debt securities. The guidance will be effective in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is evaluating the impact of this update on its financial statements.

In February 2016, the FASB issued guidance that requires lessees to recognize almost all leases on their balance sheet as a right-of-use asset and a lease liability in ASU 2016-02: *Leases (Topic 842)*. For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. Classification will be based on criteria that are largely similar to those applied in current lease accounting, but without explicit bright lines. Lessor accounting is similar to the current model, but updated to align with certain changes to the lessee model and the new revenue recognition standard. Existing sale-leaseback guidance, including guidance for real estate, is replaced with a new model applicable to both lessees and lessors. The new guidance will be effective for public business entities for annual periods beginning after December 15, 2018. The Company is evaluating the impact of this update on its financial statements.

In March 2016, FASB issued ASU No. 2016-05, *Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships* . The amendments in this Update clarify that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument under Topic 815 does not, in and of itself, require dedesignation of that hedging relationship provided that all other hedge accounting criteria continue to be met. The amendments in this update are effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption is permitted and the amendments can be adopted either on a prospective basis or a modified retrospective basis. The guidance is not expected to have a significant impact on the Company's financial position, results of operations or disclosures.

In March 2016, FASB issued ASU No. 2016-09, *Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*. The amendments in this ASU simplify several aspects of share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities and classification on the statement of cash flows. Excess tax benefits and tax deficiencies will be recognized as income tax expense or benefit in the income statement in the period exercise or vesting occurs. In the statement of cash flows, excess tax benefits should be classified with other income tax cash flows as an operating activity. Cash paid by an employer for tax withholding when directly withholding shares should be classified as a financing activity. An entity can make an entity-wide policy election to either estimate the number of awards that are expected to vest or account for forfeitures when they occur. The threshold for determining whether an award is classified as equity or a liability is raised to permit withholding up to the maximum statutory tax rate in the applicable jurisdiction. The amendment in this update are effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption is permitted and if early adopted, all provisions must be adopted in the same period. The guidance is not expected to have a significant impact on the Company's financial position, results of operations or disclosures.

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

Note 1. Presentation of Financial Information, Continued

Recently Issued Accounting Pronouncements (Continued):

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

Earnings per common share:

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

Note 2. Business Combination

On August 31, 2015 the Company, at the time named Cornerstone Bancshares, Inc., completed its merger with SmartFinancial, Inc ("Legacy SmartFinancial"), after which the Company changed its name to SmartFinancial, Inc. While Cornerstone was the acquiring entity for legal purposes, the merger was accounted for as a reverse merger using the acquisition method of accounting, in accordance with the provisions of FASB ASC 805-10 Business Combinations. Under this guidance, for accounting purposes, Legacy SmartFinancial is considered the acquirer in the merger, and as a result the historical financial statements of the combined entity are the historical financial statements of Legacy SmartFinancial.

The merger was effected by the issuance of shares of Cornerstone stock to shareholders of Legacy SmartFinancial. The assets and liabilities of Cornerstone as of the effective date of the merger were recorded at their respective estimated fair values and combined with those of Legacy SmartFinancial. The excess of the purchase price over the net estimated fair values of the acquired assets and liabilities was allocated to identifiable intangible assets with the remaining excess allocated to goodwill.

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

Calculation of Purchase Price	
Shares of CSBQ common stock outstanding as of August 31, 2015	6,643,341
Market price of CSBQ common stock on August 31, 2015	\$ 3.85
Estimated fair value of CSBQ common stock (in thousands)	25,577
Estimated fair value of CSBQ stock options (in thousands)	2,858
Total consideration (in thousands)	<u>\$ 28,435</u>

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

Note 2. Business Combination, Continued

Allocation of Purchase Price (in thousands)

Total consideration above	\$	28,435
Fair value of assets acquired and liabilities assumed:		
Cash and cash equivalents		33,502
Investment securities available for sale		74,254
Loans		314,827
Premises and equipment		9,019
Bank owned life insurance		1,278
Core deposit intangible		2,750
Other real estate owned		5,672
Prepaid and other assets		4,301
Deposits		(349,462)
Securities sold under agreements to repurchase		(17,622)
FHLB advances and other borrowings		(42,307)
Payables and other liabilities		(11,943)
Total fair value of net assets acquired		24,269
Goodwill	\$	4,166

The measurement period for the merger concluded on August 31, 2016 and there were no adjustments to the initial fair values recorded as part of the business combination.

Note 3. Earnings per share

The following is a summary of the basic and diluted earnings per share for the three and nine month periods ended September 30, 2016 and September 30, 2015 .

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income (loss) available to common shareholders	\$ 1,340,892	\$ (106,909)	\$ 3,399,385	\$ 237,585
Weighted average common shares outstanding	5,834,520	3,936,638	5,820,834	3,391,274
Effect of dilutive stock options	261,813	307,215	271,201	307,548
Diluted shares	6,096,333	4,243,853	6,092,035	3,698,822
Basic earnings per common share	\$ 0.23	\$ (0.03)	\$ 0.58	\$ 0.07
Diluted earnings per common share	\$ 0.22	\$ (0.03)	\$ 0.56	\$ 0.06

For the three and nine months ended September 30, 2016 and 2015 , the effects of outstanding antidilutive stock options are excluded from the computation of diluted earnings per common share because the exercise price of such options is higher than the market price. There were 18,100 and 22,309 antidilutive stock options as of September 30, 2016 and 2015 , respectively.

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

Note 4. Securities

The amortized cost and fair value of securities available-for-sale at September 30, 2016 and December 31, 2015 are summarized as follows (in thousands):

	September 30, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government-sponsored enterprises (GSEs)	\$ 18,297	\$ 21	\$ (30)	\$ 18,288
Municipal securities	7,661	137	(6)	7,792
Mortgage-backed securities	111,943	1,009	(404)	112,548
	<u>\$ 137,901</u>	<u>\$ 1,167</u>	<u>\$ (440)</u>	<u>\$ 138,628</u>

	December 31, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government-sponsored enterprises (GSEs)	\$ 22,745	\$ 48	\$ (50)	\$ 22,743
Municipal securities	7,614	52	(17)	7,649
Mortgage-backed securities	136,625	375	(979)	136,021
	<u>\$ 166,984</u>	<u>\$ 475</u>	<u>\$ (1,046)</u>	<u>\$ 166,413</u>

At September 30, 2016, securities with a fair value totaling approximately \$92,182,000 were pledged to secure public funds and securities sold under agreements to repurchase.

For the three and nine months ended September 30, 2016, there were available-for-sale securities sold with proceeds totaling \$5,578,023 and \$13,748,623 which resulted in gross gains realized of \$18,224 and \$199,587, respectively. For the nine months ended September 30, 2015 there were available-for-sale securities sold with proceeds totaling \$10,968,362 and gross gains realized of and \$52,255. For the three months ended September 30, 2015 there were no available-for-sale securities sold.

The amortized cost and estimated fair value of securities at September 30, 2016, by contractual maturity, are shown below (in thousands). Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Fair Value
Due in one year or less	\$ 2,030	\$ 2,036
Due from one year to five years	13,606	13,595
Due from five years to ten years	6,323	6,366
Due after ten years	3,999	4,083
	<u>25,958</u>	<u>26,080</u>
Mortgage-backed securities	111,943	112,548
	<u>\$ 137,901</u>	<u>\$ 138,628</u>

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

Note 4. Securities, Continued

The following tables present the gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities available-for-sale have been in a continuous unrealized loss position, as of September 30, 2016 and December 31, 2015 (in thousands):

	As of September 30, 2016					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Government- sponsored enterprises (GSEs)	8,404	(30)	—	—	8,404	(30)
Municipal securities	1,552	(6)	—	—	1,552	(6)
Mortgage-backed securities	27,845	(230)	11,269	(174)	39,114	(404)
	<u>37,801</u>	<u>(266)</u>	<u>11,269</u>	<u>(174)</u>	<u>49,070</u>	<u>(440)</u>

	As of December 31, 2015					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Government- sponsored enterprises (GSEs)	\$ 8,464	\$ (50)	\$ —	\$ —	\$ 8,464	\$ (50)
Municipal securities	2,456	(17)	—	—	2,456	(17)
Mortgage-backed securities	72,641	(470)	16,325	(509)	88,966	(979)
	<u>\$ 83,561</u>	<u>\$ (537)</u>	<u>\$ 16,325</u>	<u>\$ (509)</u>	<u>\$ 99,886</u>	<u>\$ (1,046)</u>

At September 30, 2016 , the categories of temporarily impaired securities, and management’s evaluation of those securities, are as follows:

U.S. Government-sponsored enterprises : At September 30, 2016 , 4 (or four) investment in U.S. GSE securities had unrealized losses. This unrealized loss related principally to changes in market interest rates. The contractual terms of the investments does not permit the issuer to settle the security at a price less than the amortized cost bases of the investment. Because the Bank does not intend to sell the investments and it is more likely than not that the Bank will not be required to sell the investments before recovery of its amortized cost bases, which may be maturity, the Bank does not consider these investments to be other-than temporarily impaired at September 30, 2016 .

Municipal securities : At September 30, 2016 , 4 (or four) investments in obligations of municipal securities had unrealized losses. The Bank believes the unrealized losses on those investments were caused by the interest rate environment and do not relate to the underlying credit quality of the issuers. Because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Bank does not consider these investments to be other-than temporarily impaired at September 30, 2016 .

Mortgage-backed securities : At September 30, 2016 , 32 (or thirty two) investments in residential mortgage-backed securities had unrealized losses. This impairment is believed to be caused by the current interest rate environment. The contractual cash flows of those investments are guaranteed by an agency of the U.S. Government. Because the decline in market value is attributable to the current interest rate environment and not credit quality, and because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Bank does not deem these investments to be other-than-temporarily impaired at September 30, 2016 .

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

Note 5. Loans and Allowance for Loan Losses

Portfolio Segmentation:

At September 30, 2016 and December 31, 2015, loans are summarized as follows (in thousands):

	September 30, 2016			December 31, 2015		
	PCI Loans	All Other Loans	Total	PCI Loans	All Other Loans	Total
Commercial real estate	\$ 15,750	\$ 378,596	\$ 394,346	\$ 20,050	\$ 349,727	\$ 369,777
Consumer real estate	9,765	173,763	183,528	12,764	148,930	161,694
Construction and land development	1,704	127,029	128,733	2,695	102,783	105,478
Commercial and industrial	1,616	81,918	83,534	2,768	82,183	84,951
Consumer and other	—	7,001	7,001	—	5,815	5,815
Total loans	28,835	768,307	797,142	38,277	689,438	727,715
Less: Allowance for loan losses	—	(4,964)	(4,964)	—	(4,354)	(4,354)
Loans, net	<u>\$ 28,835</u>	<u>\$ 763,343</u>	<u>\$ 792,178</u>	<u>\$ 38,277</u>	<u>\$ 685,084</u>	<u>\$ 723,361</u>

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

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

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

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

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

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

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

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

Note 5. Loans and Allowance for Loan Losses, Continued

Credit Risk Management:

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

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

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

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

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

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

The composition of loans by loan classification for impaired and performing loan status at September 30, 2016 and December 31, 2015, is summarized in the tables below (amounts in thousands):

	September 30, 2016					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	\$ 377,352	\$ 171,513	\$ 126,164	\$ 81,647	\$ 7,001	\$ 763,677
Impaired loans	1,244	2,250	865	271	—	4,630
	378,596	173,763	127,029	81,918	7,001	768,307
PCI loans	15,750	9,765	1,704	1,616	—	28,835
Total	\$ 394,346	\$ 183,528	\$ 128,733	\$ 83,534	\$ 7,001	\$ 797,142

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

Note 5. Loans and Allowance for Loan Losses, Continued

Credit Risk Management (Continued):

	December 31, 2015					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	\$ 347,775	\$ 145,289	\$ 101,751	\$ 81,715	\$ 5,815	\$ 682,345
Impaired loans	1,952	3,641	1,032	468	—	7,093
	<u>349,727</u>	<u>148,930</u>	<u>102,783</u>	<u>82,183</u>	<u>5,815</u>	<u>689,438</u>
PCI loans	20,050	12,764	2,695	2,768	—	38,277
Total loans	\$ 369,777	\$ 161,694	\$ 105,478	\$ 84,951	\$ 5,815	\$ 727,715

The following tables show the allowance for loan losses allocation by loan classification for impaired, PCI, and performing loans as of September 30, 2016 and December 31, 2015 (amounts in thousands):

	September 30, 2016					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	\$ 2,246	\$ 1,243	\$ 861	\$ 544	\$ 38	\$ 4,932
Impaired loans	—	—	—	32	—	32
Total	\$ 2,246	\$ 1,243	\$ 861	\$ 576	\$ 38	\$ 4,964

	December 31, 2015					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	\$ 1,906	\$ 1,015	\$ 627	\$ 519	\$ 29	\$ 4,096
Impaired loans	—	—	—	258	—	258
Total	\$ 1,906	\$ 1,015	\$ 627	\$ 777	\$ 29	\$ 4,354

There was no allowance for PCI loans at September 30, 2016 or December 31, 2015 .

The following tables detail the changes in the allowance for loan losses for the nine month period ending September 30, 2016 and year ending December 31, 2015 , by loan classification (amounts in thousands):

	September 30, 2016					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Beginning balance	\$ 1,906	\$ 1,015	\$ 627	\$ 777	\$ 29	\$ 4,354
Loans charged off	—	(80)	(14)	(18)	(120)	(232)
Recoveries of loans charged off	41	64	34	43	43	225
Provision (reallocation) charged to operating expense	299	244	214	(226)	86	617
Ending balance	\$ 2,246	\$ 1,243	\$ 861	\$ 576	\$ 38	\$ 4,964

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

Note 5. Loans and Allowance for Loan Losses, Continued

Credit Risk Management (Continued):

	December 31, 2015					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Beginning balance	\$ 1,734	\$ 906	\$ 690	\$ 524	\$ 26	\$ 3,880
Loans charged off	(95)	(247)	(50)	—	(114)	(506)
Recoveries of charge-offs	—	—	26	19	12	57
Provision (reallocation) charged to operating expense	267	356	(39)	234	105	923
Ending balance	<u>\$ 1,906</u>	<u>\$ 1,015</u>	<u>\$ 627</u>	<u>\$ 777</u>	<u>\$ 29</u>	<u>\$ 4,354</u>

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

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

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

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

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

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

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

Note 5. Loans and Allowance for Loan Losses, Continued

Credit Risk Management (Continued):

The following tables outline the amount of each loan classification and the amount categorized into each risk rating as of September 30, 2016 and December 31, 2015 (amounts in thousands):

Non PCI Loans

	September 30, 2016					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$ 378,314	\$ 172,647	\$ 126,074	\$ 81,379	\$ 6,756	\$ 765,170
Watch	160	553	90	268	1	1,072
Special mention	—	106	—	—	244	350
Substandard	122	457	865	271	—	1,715
Doubtful	—	—	—	—	—	—
Total	<u>\$ 378,596</u>	<u>\$ 173,763</u>	<u>\$ 127,029</u>	<u>\$ 81,918</u>	<u>\$ 7,001</u>	<u>\$ 768,307</u>

PCI Loans

	September 30, 2016					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$ 12,408	\$ 7,452	\$ 1,045	\$ 1,539	\$ —	\$ 22,444
Watch	1,064	1,676	644	26	—	3,410
Special mention	—	—	—	13	—	13
Substandard	2,278	637	15	8	—	2,938
Doubtful	—	—	—	30	—	30
Total	<u>\$ 15,750</u>	<u>\$ 9,765</u>	<u>\$ 1,704</u>	<u>\$ 1,616</u>	<u>\$ —</u>	<u>\$ 28,835</u>
Total loans	<u>\$ 394,346</u>	<u>\$ 183,528</u>	<u>\$ 128,733</u>	<u>\$ 83,534</u>	<u>\$ 7,001</u>	<u>\$ 797,142</u>

Non PCI Loans

	December 31, 2015					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$ 349,030	\$ 146,645	\$ 101,751	\$ 81,683	\$ 5,815	\$ 684,924
Watch	184	327	—	—	—	511
Special mention	387	—	—	32	—	419
Substandard	126	1,958	1,032	468	—	3,584
Doubtful	—	—	—	—	—	—
Total	<u>\$ 349,727</u>	<u>\$ 148,930</u>	<u>\$ 102,783</u>	<u>\$ 82,183</u>	<u>\$ 5,815</u>	<u>\$ 689,438</u>

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

Credit Risk Management (Continued):

PCI Loans

	December 31, 2015					
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$ 17,127	\$ 11,635	\$ 1,947	\$ 2,458	\$ —	\$ 33,167
Watch	—	260	—	—	—	260
Special mention	1,975	—	526	221	—	2,722
Substandard	948	869	222	89	—	2,128
Doubtful	—	—	—	—	—	—
Total	\$ 20,050	\$ 12,764	\$ 2,695	\$ 2,768	\$ —	\$ 38,277
Total loans	\$ 369,777	\$ 161,694	\$ 105,478	\$ 84,951	\$ 5,815	\$ 727,715

Past Due Loans:

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

The following tables present the aging of the recorded investment in loans as of September 30, 2016 and December 31, 2015 (amounts in thousands):

	September 30, 2016						
	30-89 Days Past Due and Accruing	Past Due 90 Days or More and Accruing	Nonaccrual	Total Past Due and NonAccrual	PCI Loans	Current Loans	Total Loans
Commercial real estate	\$ 66	\$ —	\$ —	\$ 66	\$ 15,750	\$ 378,530	\$ 394,346
Consumer real estate	609	106	166	881	9,765	172,882	183,528
Construction and land development	—	—	865	865	1,704	126,164	128,733
Commercial and industrial	—	—	224	224	1,616	81,694	83,534
Consumer and other	20	9	—	29	—	6,972	7,001
Total	\$ 695	\$ 115	\$ 1,255	\$ 2,065	\$ 28,835	\$ 766,242	\$ 797,142

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

Note 5. Loans and Allowance for Loan Losses, Continued

Past Due Loans (Continued):

	December 31, 2015						
	30-89 Days Past Due and Accruing	Past Due 90 Days or More and Accruing	Nonaccrual	Total Past Due and NonAccrual	PCI Loans	Current Loans	Total Loans
Commercial real estate	\$ 471	\$ 258	\$ —	\$ 729	\$ 20,050	\$ 348,998	\$ 369,777
Consumer real estate	581	232	1,351	2,164	12,764	146,766	161,694
Construction and land development	137	—	483	620	2,695	102,163	105,478
Commercial and industrial	207	12	418	637	2,768	81,546	84,951
Consumer and other	12	—	—	12	—	5,803	5,815
Total	\$ 1,408	\$ 502	\$ 2,252	\$ 4,162	\$ 38,277	\$ 685,276	\$ 727,715

Impaired Loans:

The following is an analysis of the impaired loan portfolio, excluding PCI loans, detailing the related allowance recorded as of September 30, 2016 and December 31, 2015 (amounts in thousands):

	At September 30, 2016			For the nine months ended September 30, 2016	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Commercial real estate	\$ 1,244	\$ 1,244	\$ —	\$ 1,769	\$ 71
Consumer real estate	2,250	2,809	—	3,039	80
Construction and land development	865	865	—	1,009	3
Commercial and industrial	47	47	—	48	3
Consumer and other	—	—	—	—	—
	<u>4,406</u>	<u>4,965</u>	<u>—</u>	<u>5,865</u>	<u>157</u>
Impaired loans with a valuation allowance:					
Commercial real estate	—	—	—	—	—
Consumer real estate	—	—	—	—	—
Construction and land development	—	—	—	—	—
Commercial and industrial	224	296	32	369	63
Consumer and other	—	—	—	—	—
	<u>224</u>	<u>296</u>	<u>32</u>	<u>369</u>	<u>63</u>
Total impaired loans	\$ 4,630	\$ 5,261	\$ 32	\$ 6,234	\$ 220

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

Note 5. Loans and Allowance for Loan Losses, Continued

Impaired Loans (Continued):

	At December 31, 2015			For the year ended December 31, 2015	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Commercial real estate	\$ 1,952	\$ 1,952	\$ —	\$ 1,898	\$ 73
Consumer real estate	3,641	4,341	—	4,003	81
Construction and land development	1,033	1,033	—	1,044	26
Commercial and industrial	49	49	—	54	3
Consumer and other	—	—	—	—	—
	<u>6,675</u>	<u>7,375</u>	<u>—</u>	<u>6,999</u>	<u>183</u>
Impaired loans with a valuation allowance:					
Commercial real estate	—	—	—	—	—
Consumer real estate	—	—	—	—	—
Construction and land development	—	—	—	—	—
Commercial and industrial	418	418	258	448	—
Consumer and other	—	—	—	—	—
	<u>418</u>	<u>418</u>	<u>258</u>	<u>448</u>	<u>—</u>
Total impaired loans	<u>\$ 7,093</u>	<u>\$ 7,793</u>	<u>\$ 258</u>	<u>\$ 7,447</u>	<u>\$ 183</u>

Troubled Debt Restructurings:

At September 30, 2016 and December 31, 2015, impaired loans included loans that were classified as Troubled Debt Restructurings ("TDRs"). The restructuring of a loan is considered a TDR if both (i) the borrower is experiencing financial difficulties and (ii) the creditor has granted a concession.

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

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

The most common concessions granted by the Company generally include one or more modifications to the terms of the debt, such as (i) a reduction in the interest rate for the remaining life of the debt; (ii) an extension of the maturity date at an interest rate lower than the current market rate for new debt with similar risk; (iii) a temporary period of interest-only payments; and (iv) a reduction in the contractual payment amount for either a short period or remaining term of the loan. As of September 30, 2016 and December 31, 2015, management had approximately, \$3,388,000 and \$4,990,000, respectively, in loans that met the criteria for restructured, which included approximately \$451,000 and \$1,297,000, respectively, of loans on nonaccrual. A loan is placed back on accrual status when both principal and interest are current and it is probable that management will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement.

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

Note 5. Loans and Allowance for Loan Losses, Continued

Troubled Debt Restructurings (Continued):

The following table presents a summary of loans that were modified as troubled debt restructurings during the nine month period ended September 30, 2016 (amounts in thousands):

September 30, 2016	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Construction and land development	1	\$ 483	\$ 483
Commercial and industrial	1	385	385

There were no loans modified as troubled debt restructurings during the year ended December 31, 2015 .

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

Purchased Credit Impaired Loans:

The Company has acquired loans which there was, at acquisition, evidence of deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. The carrying amount of those loans as of is as follows:

	September 30, 2016
Commercial real estate	\$ 18,678
Consumer real estate	13,644
Construction and land development	2,577
Commercial and industrial	2,597
Consumer and other	—
Total loans	\$ 37,496
Less remaining purchase discount	(8,661)
Total loans, net of purchase discount	28,835
Less: Allowance for loan losses	—
Carrying amount, net of allowance	\$ 28,835

Activity related to the accretable portion of the purchase discount on loans acquired with deteriorated credit quality is as follows for the three and nine months period ended September 30, 2016 and 2015 :

	Three Months Ended September 30, 2016	Three Months Ended September 30, 2015	Nine Months Ended September 30, 2016	Nine Months Ended September 30, 2015
Accretable yield, beginning of period	\$ 10,209	\$ 7,179	\$ 10,216	\$ 7,983
Additions	—	4,282	—	4,282
Accretion income	(661)	(162)	(1,876)	(886)
Reclassification to accretable	174	55	1,511	110
Other changes, net	(334)	(521)	(463)	(656)
Accretable yield	\$ 9,388	\$ 10,833	\$ 9,388	\$ 10,833

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

Note 6. Commitments and Contingent Liabilities

Off Balance Sheet Arrangements In the normal course of business, the Bank has entered into off-balance sheet financial instruments which include commitments to extend credit (i.e., including unfunded lines of credit) and standby letters of credit. Commitments to extend credit are usually the result of lines of credit granted to existing borrowers under agreements that the total outstanding indebtedness will not exceed a specific amount during the term of the indebtedness. Typical borrowers are commercial concerns that use lines of credit to supplement their treasury management functions; thus their total outstanding indebtedness may fluctuate during any time period based on the seasonality of their business and the resultant timing of their cash flows. Other typical lines of credit are related to home equity loans granted to consumers. Commitments to extend credit generally have fixed expiration dates or other termination clauses and may require payment of a fee.

Standby letters of credit are generally issued on behalf of an applicant (our client) to a specifically named beneficiary and are the result of a particular business arrangement that exists between the applicant and the beneficiary. Standby letters of credit have fixed expiration dates and are usually for terms of two years or less unless terminated beforehand due to criteria specified in the standby letter of credit. A typical arrangement involves the applicant routinely being indebted to the beneficiary for such items as inventory purchases, insurance, utilities, lease guarantees or other third party commercial transactions. The standby letter of credit would permit the beneficiary to obtain payment from the Bank under certain prescribed circumstances. Subsequently, the Bank would seek reimbursement from the applicant pursuant to the terms of the standby letter of credit.

The Bank follows the same credit policies and underwriting practices when making these commitments as it does for on-balance sheet instruments. Each client's creditworthiness is evaluated on a case-by-case basis, and the amount of collateral obtained, if any, is based on management's credit evaluation of the customer. Collateral held varies but may include cash, real estate and improvements, marketable securities, accounts receivable, inventory, equipment and personal property.

The contractual amounts of these commitments are not reflected in the consolidated financial statements and would only be reflected if drawn upon. Since many of the commitments are expected to expire without being drawn upon, the contractual amounts do not necessarily represent future cash requirements. However, should the commitments be drawn upon and should customers default on their resulting obligation to the Bank the maximum exposure to credit loss, without consideration of collateral, is represented by the contractual amount of those instruments.

A summary of the Bank's total contractual amount for all off-balance sheet commitments at September 30, 2016 is as follows:

Commitments to extend credit	\$	135.8 million
Standby letters of credit	\$	2.9 million

Various legal claims also arise from time to time in the normal course of business. In the opinion of management, the resolution of claims outstanding at September 30, 2016 will not have a material effect on SmartFinancial's consolidated financial statements.

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

Note 7. Fair Value Disclosures

Determination of Fair Value:

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

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

Fair Value Hierarchy:

ASC Topic 820 also establishes a three-tier 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, as follows:

Level 1 - Quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access.

Level 2 - Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities in active markets, quoted prices in markets that are not active and other inputs that are observable or can be corroborated by observable market data.

Level 3 - Significant unobservable inputs that reflect a company’s own assumptions about the assumptions that market participants would use in pricing an asset or liability.

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

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

Cash and cash equivalents : The carrying amounts of cash and cash equivalents approximate fair values based on the short-term nature of the assets. Cash and cash equivalents are classified as Level 1 of the fair value hierarchy.

Securities : Fair values are estimated using pricing models and discounted cash flows that consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes, and credit spreads. Securities classified as available-for-sale are reported at fair value utilizing Level 2 inputs.

The carrying value of restricted investments approximates fair value based on the redemption provisions of the restrictive entities.

Loans : For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for fixed-rate loans are estimated using discounted cash flow analysis, using market interest rates for comparable loans. Fair value for nonperforming loans are estimated using discounted cashflow analyses of underlying collateral values where applicable. Generally, Level3 inputs are utilized in this estimate.

Deposits : The fair value of deposits with no stated maturity, such as noninterest-bearing and interest-bearing demand deposits, savings deposits, and money market accounts, is equal to the amount payable on demand at the reporting date. The carrying amounts of variable-rate, fixed-term certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cashflow calculation that applies market interest rates on comparable instruments to a schedule of aggregated expected monthly maturities on time deposits. Generally, Level 3 inputs are utilized in this estimate.

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

Note 7. Fair Value Disclosures, Continued

Fair Value Hierarchy (Continued):

Securities Sold Under Agreement to Repurchase: The carrying value of these liabilities approximates their fair value.

Federal Home Loan Bank Advances and Other Borrowings: The fair value of the FHLB fixed rate borrowings are estimated using discounted cash flows, based on the current incremental borrowing rates for similar types of borrowing arrangements. Level 3 inputs are used in this estimate.

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

Measurements of Fair Value:

Assets and liabilities recorded at fair value on a recurring basis are as follows (in thousands):

	Balance as of September 30, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Debt securities available-for-sale:				
U.S. Government-sponsored enterprises (GSEs)	\$ 18,288	\$ —	\$ 18,288	\$ —
Mortgage-backed securities	112,548	—	112,548	—
Municipal securities	7,792	—	7,792	—
Total securities available-for-sale	\$ 138,628	\$ —	\$ 138,628	\$ —

	Balance as of December 31, 2015	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Debt securities available-for-sale:				
U.S. Government-sponsored enterprises (GSEs)	\$ 22,743	\$ —	\$ 22,743	\$ —
Mortgage-backed securities:	136,021	—	136,021	—
Municipal securities	7,649	—	7,649	—
Total securities available-for-sale	\$ 166,413	\$ —	\$ 166,413	\$ —

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

Certain assets and liabilities are measured at fair value on a nonrecurring basis, which means the assets and liabilities 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). The tables below present information about assets and liabilities on the balance sheet at September 30, 2016 and December 31, 2015 which are measured at fair value on a nonrecurring basis.

	Balance as of September 30, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans	\$ 192	\$ —	\$ —	\$ 192
Foreclosed assets	2,536	—	—	2,536

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

Note 7. Fair Value Disclosures, Continued

Measurements of Fair Value (Continued):

	Balance as of December 31, 2015	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans	\$ 160	\$ —	\$ —	\$ 160
Foreclosed assets	5,358	—	—	5,358

For Level 3 assets measured at fair value on a non-recurring basis as of September 30, 2016, the significant unobservable inputs used in the fair value measurements are presented below (in thousands).

	Balance as of September 30, 2016	Valuation Technique	Significant Other Unobservable Input	Weighted Average of Input
Impaired loans	\$ 192	Cash Flow	Evaluation of Collectability	—%
Foreclosed assets	2,536	Appraisal	Appraisal Discounts	29.5%

The carrying amount and estimated fair value of the Company's financial instruments at September 30, 2016 and December 31, 2015 are as follows (in thousands):

	September 30, 2016		December 31, 2015	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Assets:				
Cash and cash equivalents	\$ 58,587	\$ 58,587	\$ 79,965	\$ 79,965
Securities available for sale	138,628	138,628	166,413	166,413
Restricted investments	4,451	4,451	4,451	4,451
Loans, net	792,178	804,515	723,361	721,338
Liabilities:				
Noninterest-bearing demand deposits	145,509	145,509	131,419	131,419
Interest-bearing demand deposits	152,216	152,216	149,424	149,424
Money Market and Savings deposits	271,259	271,259	236,901	236,901
Time deposits	291,857	292,376	340,739	342,873
Securities sold under agreements to repurchase	24,202	24,202	28,068	28,068
Federal Home Loan Bank advances and other borrowings	43,048	43,052	34,187	34,169

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

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

Note 7. Fair Value Disclosures, Continued

Measurements of Fair Value (Continued):

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

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

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

SmartFinancial, Inc. (the "Company" or "SmartFinancial") is a bank holding company incorporated under the laws of Tennessee and headquartered in Knoxville, Tennessee. The Company conducts its business operations primarily through its wholly-owned subsidiary, SmartBank, a Tennessee chartered community bank providing services through 15 offices in eastern Tennessee, northwest Florida, and north Georgia. On February 26, 2016, the Company merged SmartBank and Cornerstone Community Bank together, with SmartBank surviving the merger. This quarter completes the fourth full quarter's results from the combined company and the second full quarter's results of the merged bank.

Mergers and Acquisitions

Merger of Legacy SmartFinancial and Cornerstone Bancshares

On June 18, 2015, the shareholders of the Legacy SmartFinancial approved a merger with Cornerstone Bancshares, Inc. (Cornerstone) ticker symbol CSBQ, the one bank holding company of Cornerstone Community Bank, which became effective August 31, 2015. Legacy SmartFinancial shareholders received 1.05 shares of Cornerstone common stock in exchange for each share of the Legacy SmartFinancial common stock. After the merger, shareholders of Legacy SmartFinancial owned approximately 56% of the outstanding common stock of the combined entity on a fully diluted basis, after taking into account the exchange ratio and new shares issued as part of a capital raise through a private placement.

While Cornerstone was the acquiring entity for legal purposes, the merger was accounted for as a reverse merger using the acquisition method of accounting, in accordance with the provisions of FASB ASC 805-10 Business Combinations. Under this guidance, for accounting purposes, Legacy SmartFinancial was considered the acquirer in the merger, and as a result the historical financial statements of the combined entity are the historical financial statements of Legacy SmartFinancial.

The assets and liabilities of Cornerstone as of the effective date of the merger were recorded at their respective estimated fair values and combined with those of Legacy SmartFinancial. The excess of the purchase price over the net estimated fair values of the acquired assets and liabilities was allocated to identifiable intangible assets with the remaining excess allocated to goodwill.

In periods following the merger, the financial statements of the combined entity will include the results attributable to Cornerstone Community Bank beginning on the date the merger was completed. As a result of the merger Company assets increased approximately \$450 million and liabilities increased approximately \$421 million. The merger had a significant impact on all aspects of the Company's financial statements, and as a result, financial results after the merger may not be comparable to financial results prior to the merger.

Executive Summary

The following is a summary of the Company's financial highlights and significant events during the third quarter of 2016 :

- **Net income available to common shareholders totaled \$1.3 million or \$0.23 per share during the third quarter of 2016 .**
- **Annualized return on average assets for the three and nine months ended September 30, 2016 equaled 0.63 percent and 0.55 percent , respectively, compared to (0.04) percent and 0.08 percent in the same periods for 2015**
- **Annualized return on average equity for three and nine months ended September 30, 2016 equaled 6.14 percent and 5.38 percent , respectively, compared to (0.44) percent and 0.72 percent in the same periods for 2015**
- **Annualized net loan growth was approximately 12.42 percent in the third quarter of 2016 , with a healthy mix of construction & development, residential real estate, and commercial real estate loan growth.**
- **Non interest income as a percent of average assets increased to 0.47 percent as the sale of mortgage and SBA loans increased over 45 percent.**
- **Maintained outstanding asset quality with just 0.41 percent of nonperforming assets to total assets.**

Analysis of Results of Operations

Third quarter of 2016 compared to 2015

Net income was \$1.6 million in the third quarter of 2016 , which was up from \$(77) thousand in the third quarter of 2015 . Net income available to common shareholders was \$1,341 thousand , or \$0.22 per diluted common share, in the third quarter of 2016 , an increase from \$(107) thousand , or \$(0.03) per diluted common share, in the third quarter of 2015 . Net interest income to average assets of 3.76 percent in the third quarter of 2016 was up from 3.62 percent in the third quarter of 2015 due to a lower percentage of noninterest-earning assets and a higher percentage of noninterest-bearing deposits. Noninterest income to average assets of 0.47 percent was up from 0.10 percent in the third quarter of 2015 as a result of lower losses on the sale of foreclosed assets in 2016 compared to 2015 and higher gains on sale of mortgage and SBA loans. Noninterest expense to average assets decreased from 3.66 percent in the third quarter of 2015 to 3.13 percent in third quarter of 2016 primarily due to normalized post merger data processing costs, the completion of repairs at one branch, and a drop in salary and employee benefit expenses. The resulting pretax pre-provision income to average assets was 1.10 percent in the third quarter of 2016 , an improvement from 0.06 percent in the third quarter of 2015 .

First nine months of 2016 compared to 2015

Net income was \$4.2 million in the first nine months of 2016 , which was up from \$328 thousand in the first nine months of 2015 . Net income available to common shareholders was \$3.4 million , or \$0.56 per diluted common share, in the first nine months of 2016 , an increase from \$238 thousand , or \$0.06 per diluted common share, in the first nine months of 2015 . Net interest income to average assets of 3.76 percent in the first nine months of 2016 was up from 3.56 percent in the first nine months of 2015 , with the increase as a result of higher yields on earning assets and a lower percentage of non-earning assets. Noninterest income to average assets of 0.43 percent was up from 0.25 percent in the first nine months of 2015 as a result of lower losses on the sale of foreclosed assets in 2016 compared to 2015 higher gains on sale of mortgage and SBA loans, and higher fees on deposit accounts. Noninterest expense to average assets decreased from 3.48 percent in the first nine months of 2015 to 3.24 percent in the first nine months of 2016 as the company continued to gain efficiencies of scale from the merger. The resulting pretax pre-provision income to average assets was 0.95 percent in the first nine months of 2016 , an improvement from 0.33 percent in the first nine months of 2015 .

Net Interest Income and Yield Analysis

Third quarter of 2016 compared to 2015

Net interest income, taxable equivalent, improved to \$9.7 million in the third quarter of 2016 from \$6.4 million in the third quarter of 2015 . The increase in net interest income was primarily the result of a significant increase in earning assets primarily from the merger. Average earning assets increased from \$630.5 million in the third quarter of 2015 to \$953.7 million in the third quarter of 2016 . Over this period, average loan balances increased by \$298.7 million . In addition, average interest-bearing deposits increased by \$209.6 million and average noninterest-bearing deposits increased \$59.7 million . Net interest income to average assets of 3.76 percent for the third quarter in 2016 was up from 3.62 percent during the same period in 2015 . Net interest margin, taxable equivalent, was 4.03 percent in the quarter, compared to 4.04 percent a year ago. Net interest margin was negatively affected by a decrease in the yield on earning assets from 4.50 percent a year ago to 4.48 percent in the quarter and an increase in the cost of interest bearing deposits from 0.53 percent a year ago to 0.58 percent in the quarter.

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

	Three Months Ended September 30, 2016			Three Months Ended September 30, 2015		
	Average		Yield/	Average		Yield/
	Balance	Interest *	Cost*	Balance	Interest *	Cost*
Assets						
Loans (1)	\$ 788,585	\$ 10,112	5.09%	\$ 489,926	\$ 6,656	5.39%
Investment securities and interest-bearing due from banks (2)	159,683	615	1.53%	107,061	453	1.68%
Federal funds and other	5,442	51	3.72%	33,539	42	0.50%
Total interest-earning assets	953,710	10,778	4.48%	630,526	7,151	4.50%
Noninterest-earning assets	66,735			72,898		
Total assets	\$ 1,020,445			\$ 703,424		
Liabilities and Stockholders' Equity						
Interest-bearing demand deposits	\$ 147,102	\$ 73	0.20%	\$ 114,727	\$ 45	0.16%
Money market and savings deposits	268,307	283	0.42%	169,916	176	0.41%
Time deposits	312,889	709	0.90%	234,017	468	0.79%
Total interest-bearing deposits	728,298	1,065	0.58%	518,660	689	0.53%
Securities sold under agreement to repurchase	22,471	17	0.30%	11,095	7	0.25%
Federal Home Loan Bank advances and other borrowings	11,187	17	0.60%	13,806	31	0.89%
Total interest-bearing liabilities	761,956	1,099	0.57%	543,561	727	0.53%
Noninterest-bearing deposits	148,178			88,468		
Other liabilities	6,194			2,141		
Total liabilities	916,328			634,170		
Stockholders' equity	104,117			69,254		
Total liabilities and stockholders' equity	\$ 1,020,445			\$ 703,424		
Net interest income, taxable equivalent		\$ 9,679			\$ 6,424	
Interest rate spread (3)			3.91%			3.97%
Tax equivalent net interest margin (4)			4.03%			4.04%
Percentage of average interest-earning assets to average interest-bearing liabilities			125.17%			116.0%
Percentage of average equity to average assets			10.20%			9.85%
* Taxable equivalent basis						

- (1) Loans include nonaccrual loans. Loan fees included in loan income was \$556 thousand and \$483 thousand for the quarters ended September 2016 and 2015, respectively. Yields related to loans exempt from income taxes are stated on a taxable-equivalent basis assuming a federal income tax rate of 34.0 percent. The taxable-equivalent adjustment was \$1 thousand for the period ended September 30, 2016 and zero for the period ended September 30, 2015.
- (2) Yields related to investment securities exempt from income taxes are stated on a taxable-equivalent basis assuming a federal income tax rate of 34.0 percent. The taxable-equivalent adjustment was \$13 thousand for the period ended September 30, 2016 and \$1 thousand for the period ended September 30, 2015.
- (3) Net interest spread represents the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities.
- (4) Net interest margin represents net interest income divided by average interest-earning assets.

First nine months of 2016 compared to 2015

Net interest income, taxable equivalent, improved to \$28.5 million in the first nine months of 2016 from \$15.4 million in the same period of 2015. The increase in net interest income was primarily the result of a significant increase in earning assets primarily from the merger. Average earning assets increased from \$526.6 million for the first nine months of 2015 to \$936.4 million for the same period in 2016. Over this period, average loan balances increased by \$345.3 million. In addition, average interest-bearing deposits increased by \$287.0 million and average noninterest-bearing deposits increased \$68.9 million. Net interest income to average assets of 3.76 percent for the first nine months of 2016 was up from 3.56 percent during the same period in 2015. Net interest margin, taxable equivalent, was 4.06 percent for the first nine months of 2016, compared to 3.92 percent a year ago. Net interest margin was positively affected by a increase in the yield on earning assets from 4.36 percent a year ago to 4.51 percent in 2016.

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

	Nine Months Ended September 30, 2016			Nine Months Ended September 30, 2015		
	Average Balance	Interest *	Yield/ Cost*	Average Balance	Interest *	Yield/ Cost*
Assets						
Loans (1)	\$ 758,420	\$ 29,450	5.19%	\$ 413,155	\$ 15,852	5.13%
Investment securities and interest-bearing due from banks (2)	171,356	2,023	1.58%	100,209	1,237	1.65%
Federal funds and other	6,655	165	3.31%	13,279	97	0.98%
Total interest-earning assets	936,431	31,638	4.51%	526,643	17,186	4.36%
Noninterest-earning assets	69,202			53,633		
Total assets	<u>\$ 1,005,633</u>			<u>\$ 580,276</u>		
Liabilities and Stockholders' Equity						
Interest-bearing demand deposits	\$ 150,495	\$ 208	0.18%	\$ 110,229	\$ 120	0.15%
Money market and savings deposits	253,000	854	0.45%	137,627	397	0.39%
Time deposits	322,935	1,977	0.82%	191,568	1,173	0.82%
Total interest-bearing deposits	726,430	3,039	0.56%	439,424	1,690	0.51%
Securities sold under agreement to repurchase	21,155	49	0.31%	7,252	13	0.24%
Federal Home Loan Bank advances and other borrowings	15,311	91	0.79%	5,171	34	0.88%
Total interest-bearing liabilities	762,896	3,179	0.56%	451,847	1,737	0.51%
Noninterest-bearing deposits	134,777			65,881		
Other liabilities	5,209			1,622		
Total liabilities	902,882			519,350		
Stockholders' equity	102,751			60,926		
Total liabilities and stockholders' equity	<u>\$ 1,005,633</u>			<u>\$ 580,276</u>		
Net interest income, taxable equivalent		<u>\$ 28,459</u>			<u>\$ 15,449</u>	
Interest rate spread (3)			<u>3.95%</u>			<u>3.85%</u>
Tax equivalent net interest margin (4)			<u>4.06%</u>			<u>3.92%</u>
Percentage of average interest-earning assets to average interest-bearing liabilities			<u>122.75%</u>			<u>116.6%</u>
Percentage of average equity to average assets			10.22%			10.50%
* Taxable equivalent basis						

- (1) Loans include nonaccrual loans. Loan fees included in loan income was \$1.9 million and \$816 thousand for the nine months ended September 2016 and 2015 , respectively. Yields related to loans exempt from income taxes are stated on a taxable-equivalent basis assuming a federal income tax rate of 34.0 percent. The taxable-equivalent adjustment was \$12 thousand for the nine months ended September 30, 2016 and zero for the nine months ended September 30, 2015 .
- (2) Yields related to investment securities exempt from income taxes are stated on a taxable-equivalent basis assuming a federal income tax rate of 34.0 percent. The taxable-equivalent adjustment was \$39 thousand for the nine months ended September 30, 2016 and \$4 thousand for the nine months ended September 30, 2015 .
- (3) Net interest spread represents the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities.
- (4) Net interest margin represents net interest income divided by average interest-earning assets.

Rate and Volume Analysis

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

Third quarter of 2016 compared to 2015

Net interest income, taxable equivalent, increased by \$3.3 million between the quarters ended September 30, 2016 and 2015. The following is an analysis of the changes in net interest income comparing the changes attributable to rates and those attributable to volumes (in thousands):

	Three Months Ended September 30,		
	2016	Compared to	2015
	Increase (decrease) due to		
	Rate	Volume	Net
Interest-earning assets:			
Loans (1)	(602)	4,058	3,456
Investment securities and interest-bearing due from banks (2)	(61)	223	162
Federal funds and other	44	(35)	9
Total interest-earning assets	(619)	4,246	3,627
Interest-bearing liabilities:			
Interest-bearing demand deposits	15	13	28
Money market and savings deposits	5	102	107
Time deposits	84	157	241
Total interest-bearing deposits	104	272	376
Securities sold under agreement to repurchase	3	7	10
Federal Home Loan Bank advances and other borrowings	(8)	(6)	(14)
Total interest-bearing liabilities	99	273	372
Net interest income	(718)	3,973	3,255

(1) Loans include nonaccrual loans. Yields related to loans exempt from income taxes are stated on a taxable-equivalent basis assuming a federal income tax rate of 34.0 percent. The taxable-equivalent adjustment was \$1 thousand for the period ended September 30, 2016 and zero for the period ended September 30, 2015.

(2) Yields related to investment securities exempt from income taxes are stated on a taxable-equivalent basis assuming a federal income tax rate of 34.0 percent. The taxable-equivalent adjustment was \$13 thousand for the period ended September 30, 2016 and \$1 thousand for the period ended September 30, 2015.

First nine months of 2016 compared to 2015

Net interest income increased by \$13.0 million between the first nine months of September 30, 2016 compared to 2015 . The following is an analysis of the changes in net interest income comparing the changes attributable to rates, attributable to days, and those attributable to volumes (in thousands):

	Nine Months Ended September 30,			
	2016	Compared to	2015	
	Increase (decrease) due to			
	Rate	Days (1)	Volume	Net
Interest-earning assets:				
Loans (2)	292	58	13,248	13,598
Investment securities and interest-bearing due from banks (3)	(97)	5	878	786
Federal funds and other	117	—	(49)	68
Total interest-earning assets	312	63	14,077	14,452
Interest-bearing liabilities:				
Interest-bearing demand deposits	43	—	45	88
Money market and savings deposits	119	1	337	457
Time deposits	(6)	4	806	804
Total interest-bearing deposits	156	5	1,188	1,349
Securities sold under agreement to repurchase	11	—	25	36
Federal Home Loan Bank advances and other borrowings	(10)	—	67	57
Total interest-bearing liabilities	157	5	1,280	1,442
Net interest income	155	58	12,797	13,010

(1) In the nine months ended September 30, 2016 there were 274 days compared to 273 days in the nine months ended September 30, 2015 .

(2) Loans include nonaccrual loans. Yields related to loans exempt from income taxes are stated on a taxable-equivalent basis assuming a federal income tax rate of 34.0 percent. The taxable-equivalent adjustment was \$12 thousand for the nine months ended September 30, 2016 and zero for the nine months ended September 30, 2015 .

(3) Yields related to investment securities exempt from income taxes are stated on a taxable-equivalent basis assuming a federal income tax rate of 34.0 percent. The taxable-equivalent adjustment was \$39 thousand for the nine months ended September 30, 2016 and \$4 thousand for the nine months ended September 30, 2015 .

Noninterest Income

Third quarter of 2016 compared to 2015

Noninterest income totaled \$1.2 million in the third quarter of 2016 , compared to \$179 thousand in the third quarter of 2015 . Noninterest income to average assets of 0.47 percent for the quarter was up from 0.10 percent in 2015 primarily due to lower losses on the sale of foreclosed assets. Charges and fees on deposit accounts increased \$88 thousand primarily due to increased deposit accounts from the merger. Gains on the sale of loans, which includes mortgage and SBA loans, were \$287 thousand , up substantially from \$66 thousand a year ago.

(Dollars in thousands)	Three months ended September 30,	
	2016	2015
Service charges and fees on deposit accounts	\$ 296	\$ 208
Gain on sale of securities	18	—
Gain on sale of loans and other assets	287	66
Gain (loss) on sale of foreclosed assets	131	(446)
Other noninterest income	472	351
Total noninterest income	\$ 1,204	\$ 179

First nine months of 2016 compared to 2015

Noninterest income totaled \$3.2 million in the first nine months of 2016 , compared to \$1.1 million in the the first nine months of 2015 . Noninterest income to average assets of 0.43 percent was up from 0.25 percent in 2015 due to higher gains on sales of loans and securities. Charges and fees on deposit accounts increased \$364 thousand primarily due to increased deposit accounts from the merger. Gains on the sale of loans, which includes mortgage and SBA were \$706 thousand , up substantially from \$162 thousand a year ago.

(Dollars in thousands)	Nine months ended September 30,	
	2016	2015
Service charges and fees on deposit accounts	\$ 851	\$ 487
Gain on sale of securities	200	52
Gain on sale of loans and other assets	706	162
Gain (loss) on sale of foreclosed assets	185	(426)
Other noninterest income	1,294	818
Total noninterest income	<u>\$ 3,236</u>	<u>\$ 1,093</u>

Noninterest Expense

Third quarter of 2016 compared to 2015

Noninterest expense totaled \$8.0 million in the third quarter of 2016 compared to \$6.5 million in the third quarter of 2015 . Noninterest expense to average assets decreased from 3.66 percent a year ago to 3.13 percent in the quarter. Salaries and employee benefits, occupancy, data processing, and other noninterest expense categories in 2016 were all significantly impacted by the merger which added employees, branches and other facilities, and equipment to the Company's expense base. In the third quarter of 2016 professional services decreased compared to the prior year due to a reduction in expenses related to the merger.

(Dollars in thousands)	Three months ended September 30,	
	2016	2015
Salaries and employee benefits	\$ 4,312	\$ 3,185
Net occupancy and equipment expense	965	708
Depository insurance	153	144
Foreclosed assets	79	91
Advertising	179	132
Data processing	457	293
Professional services	558	908
Amortization of intangible assets	80	58
Service contracts	272	196
Other operating expenses	995	778
Total noninterest expense	<u>\$ 8,050</u>	<u>\$ 6,493</u>

First nine months of 2016 compared to 2015

Noninterest expense totaled \$24.5 million for the first nine months of 2016 compared to \$15.1 million in the same period in 2015 . Noninterest expense to average assets decreased from 3.48 percent a year ago to 3.24 percent in 2016 . Salaries and employee benefits, occupancy, data processing, and other noninterest expense categories in 2016 were all significantly impacted by the merger which added employees, branches and other facilities, and equipment to the Company's expense base. However, in 2015 there were additional professional service expenses as a result of the merger which resulted in a slight decrease for the first nine months of 2016 .

(Dollars in thousands)	Nine months ended September 30,	
	2016	2015
Salaries and employee benefits	\$ 13,293	\$ 7,721
Net occupancy and equipment expense	3,120	1,827
Depository insurance	440	339
Foreclosed assets	199	180
Advertising	537	353
Data processing	1,353	697
Professional services	1,565	1,594
Amortization of intangible assets	267	140
Service contracts	873	507
Other operating expenses	2,827	1,756
Total noninterest expense	\$ 24,474	\$ 15,114

Taxes

Third quarter of 2016 compared to 2015

In the third quarter of 2016 income tax expense totaled \$947 thousand compared to \$152 thousand a year ago. Income taxes a year ago were elevated by non-deductible merger expenses resulting in an effective tax rate of approximately 200.0 percent compared to approximately 37.0 percent in the third quarter of 2016 .

First nine months of 2016 compared to 2015

In the first nine months of 2016 income tax expense totaled \$2.4 million compared to \$740 thousand a year ago. Income taxes a year ago were elevated by non-deductible merger expenses resulting in an effective tax rate of approximately 69.3 percent compared to approximately 36.6 percent in the first nine months of 2016 .

Loan Portfolio Composition

The Company had total net loans outstanding, including organic and purchased loans, of approximately \$792.2 million at September 30, 2016 and \$723.4 million at December 31, 2015 . Loans secured by real estate, consisting of commercial or residential property, are the principal component of our loan portfolio. We do not generally originate traditional long-term residential fixed rate mortgages for our portfolio but we do originate and hold traditional second mortgage residential real estate loans, adjustable rate mortgages and home equity lines of credit. Even if the principal purpose of the loan is not to finance real estate, when reasonable, we attempt to obtain a security interest in the real estate in addition to any other available collateral to increase the likelihood of ultimate repayment or collection of the loan.

Organic Loans

Our organic net loans increased by \$130.2 million , or 28.8 percent , from December 31, 2015 , to \$581.8 million at September 30, 2016 as we continue to originate well-underwritten loans. Our goal of streamlining the credit process has improved our efficiency and is a competitive advantage in many of our markets. In addition, the overall business environment continues to rebound from recessionary conditions. Organic loans include loans which were originally purchased non-credit impaired loans but have been renewed since purchase.

Purchased Loans

Purchased non-credit impaired loans of \$181.6 million at September 30, 2016 were down from \$233.5 million at December 31, 2015 as a result of loan payoffs and renewals. Since December 31, 2015, our net purchased credit impaired (“PCI”) loans decreased by \$9.4 million to \$28.8 million at September 30, 2016. The activity within the purchased credit impaired loans will be impacted by how quickly these loans are resolved and/or our future acquisition activity.

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

	September 30, 2016				% of Gross Total
	Organic Loans	Purchased Non-Credit Impaired Loans	Purchased Credit Impaired Loans	Total Amount	
Commercial real estate-mortgage	\$ 270,783	\$ 107,813	\$ 15,750	\$ 394,346	49.5%
Consumer real estate-mortgage	127,813	45,950	9,765	183,528	23.0%
Construction and land development	117,937	9,092	1,704	128,733	16.1%
Commercial and industrial	63,983	17,935	1,616	83,534	10.5%
Consumer and other	6,210	791	—	7,001	0.9%
Total gross loans receivable, net of deferred fees	586,725	181,582	28,835	797,142	100.0%
Allowance for loan and lease losses	(4,964)	—	—	(4,964)	
Total loans, net	\$ 581,761	\$ 181,582	\$ 28,835	\$ 792,178	

	December 31, 2015				% of Gross Total
	Organic Loans	Purchased Non-Credit Impaired Loans	Purchased Credit Impaired Loans	Total Amount	
Commercial real estate-mortgage	\$ 229,203	\$ 120,524	\$ 20,050	\$ 369,777	50.8%
Consumer real estate-mortgage	95,233	53,697	12,764	161,694	22.2%
Construction and land development	73,028	29,755	2,695	105,478	14.5%
Commercial and industrial	53,761	28,422	2,768	84,951	11.7%
Consumer and other	4,692	1,123	—	5,815	0.8%
Total gross loans receivable, net of deferred fees	455,917	233,521	38,277	727,715	100.0%
Allowance for loan and lease losses	(4,354)	—	—	(4,354)	
Total loans, net	\$ 451,563	\$ 233,521	\$ 38,277	\$ 723,361	

Loan Portfolio Maturities

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

	One Year or Less	One through Five Years	Over Five Years	Total	Rate Structure for Loans Maturing Over One Year	
					Fixed Rate	Floating Rate
Commercial real estate-mortgage	\$ 31,305	\$ 219,562	\$ 143,479	\$ 394,346	\$ 251,627	\$ 111,414
Consumer real estate-mortgage	13,512	94,179	75,837	183,528	103,325	66,691
Construction and land development	43,018	52,182	33,533	128,733	34,627	51,088
Commercial and industrial	21,118	46,559	15,857	83,534	46,396	16,020
Consumer and other	4,045	2,705	251	7,001	2,272	684
Total Loans	\$ 112,998	\$ 415,187	\$ 268,957	\$ 797,142	\$ 438,247	\$ 245,897

Nonaccrual, Past Due, and Restructured Loans

Nonperforming loans as a percentage of total gross loans, net of deferred fees, was 0.17 percent as of September 30, 2016, which was down from 0.38 percent as of December 31, 2015. Total nonperforming assets as a percentage of total assets as of September 30, 2016 totaled 0.38 percent compared to 0.79 percent as of December 31, 2015. Acquired PCI loans that are included in loan pools are reclassified at acquisition to accrual status and thus are not included as nonperforming assets unless they are 90 days or greater past due.

The following table summarizes the Company's nonperforming assets for the periods presented.

(Dollars in thousands)	September 30, 2016	December 31, 2015
Nonaccrual loans	\$ 1,255	\$ 2,252
Accruing loans past due 90 days or more (1)	115	502
Total nonperforming loans	1,370	2,754
Foreclosed assets	2,536	5,358
Total nonperforming assets	\$ 3,906	\$ 8,112
Restructured loans not included above	\$ 2,938	\$ 3,693

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

Potential Problem Loans

At September 30, 2016 problem loans amounted to approximately \$617.3 thousand or 0.08 percent of total loans outstanding. Potential problem loans, which are not included in nonperforming loans, represent those loans with a well-defined weakness and where information about possible credit problems of borrowers has caused management to have doubts about the borrower's ability to comply with present repayment terms. This definition is believed to be substantially consistent with the standards established by the Bank's primary regulators, for loans classified as substandard or worse, but not considered nonperforming loans.

Allocation of the Allowance for Loan Losses

We maintain the allowance at a level that we deem appropriate to adequately cover the probable losses inherent in the loan portfolio. As of September 30, 2016 and December 31, 2015, our allowance for loan losses was \$5.0 million and \$4.4 million, respectively, which we deemed to be adequate at each of the respective dates. The increase in the allowance for loan losses in 2016 as compared to 2015 is the result of increases in the organic loan portfolio. Our allowance for loan loss as a percentage of total loans has increased slightly from 0.60 percent at December 31, 2015 to 0.63 percent at September 30, 2016. As a percentage of organic loans the allowance for loan losses decreased from 0.95 percent at December 31, 2015 to 0.85 percent at September 30, 2016.

Our purchased loans were recorded at fair value upon acquisition. The fair value adjustments on the performing purchased loans will be accreted into income over the life of the loans. As of September 30, 2016 the balance on PCI loans was \$37.5 million while the carrying value was \$28.8 million. These loans are subject to the same allowance methodology as our legacy portfolio. The calculated allowance is compared to the remaining fair value discount on a loan-by-loan basis to determine if additional provisioning should be recognized. At September 30, 2016, there were no allowances on PCI loans.

The following table sets forth, based on our best estimate, the allocation of the allowance to types of loans as of September 30, 2016 and December 31, 2015 and the percentage of loans in each category to total loans (in thousands):

	September 30, 2016		December 31, 2015	
	Amount	Percent	Amount	Percent
Commercial real estate-mortgage	\$ 2,246	45.2%	\$ 1,906	43.8%
Consumer real estate-mortgage	1,243	25.0%	1,015	23.3%
Construction and land development	861	17.3%	627	14.4%
Commercial and industrial	576	11.7%	777	17.8%
Consumer and other	38	0.8%	29	0.7%
Total allowance for loan losses	<u>\$ 4,964</u>	<u>100.0%</u>	<u>\$ 4,354</u>	<u>100.0%</u>

The increase in the overall allowance for loan losses is due to the increased balance of organic loans offset by improvements of our loan portfolio and the reduction of nonperforming loans and net charge-offs, which is largely influenced by the overall improvement in the economies in our market areas. The allocation by category is determined based on the assigned risk rating, if applicable, and environmental factors applicable to each category of loans. For impaired loans, those loans are reviewed for a specific allowance allocation. Specific valuation allowances related to impaired loans were approximately \$258 thousand at December 31, 2015 compared to \$32 thousand at September 30, 2016.

Analysis of the Allowance for Loan Losses

The following is a summary of changes in the allowance for loan losses for the periods ended September 30, 2016 and December 31, 2015 including the ratio of the allowance for loan losses to total loans as of the end of each period (in thousands):

	September 30, 2016	December 31, 2015
Balance at beginning of period	\$ 4,354	\$ 3,880
Provision for loan losses	617	923
Charged-off loans:		
Commercial real estate-mortgage	—	(95)
Consumer real estate-mortgage	(80)	(247)
Construction and land development	(14)	(50)
Commercial and industrial	(18)	—
Consumer and other	(120)	(114)
Total charged-off loans	(232)	(506)
Recoveries of previously charged-off loans:		
Commercial real estate-mortgage	41	—
Consumer real estate-mortgage	64	—
Construction and land development	34	26
Commercial and industrial	43	19
Consumer and other	43	12
Total recoveries of previously charged-off loans	225	57
Net charge-offs	(7)	(449)
Balance at end of period	\$ 4,964	\$ 4,354
Ratio of allowance for loan losses to total loans outstanding at end of period	0.63 %	0.60 %
Ratio of net charge-offs to average loans outstanding for the period	— %	(0.09)%

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

Investment Portfolio

Our investment portfolio, consisting primarily of Federal agency bonds, mortgage-backed securities, and state and municipal securities had a fair values of \$138.6 million and \$166.4 million at September 30, 2016 and December 31, 2015, respectively. Our investments to assets ratio has decreased from 16.3 percent at December 31, 2015 to 13.3 percent at September 30, 2016 as we reduced the ratio of investments to total assets on our balance sheet to allocate more funding to loans. Our investment portfolio serves many purposes including serving as a potential liquidity source, collateral for public funds, and as a stable source of income.

The following table shows the amortized cost of the Company's investment securities. In the periods ended September 30, 2016 and December 31, 2015 all investment securities were classified as available for sale.

Book Value of Investment Securities

(in thousands)	September 30, 2016	December 31, 2015
U.S. Government agencies	\$ 18,297	\$ 22,745
State and political subdivisions	7,661	7,614
Mortgage-backed securities	111,943	136,625
Total securities	\$ 137,901	\$ 166,984

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

Contractual Maturity of Investment Securities

September 30, 2016

(in thousands)

	Maturity By Years				
	1 or Less	1 to 5	5 to 10	Over 10	Total
Available for Sale					
U.S. Government agencies	\$ 2,030	\$ 12,984	\$ 3,283	\$ —	\$ 18,297
State and political subdivisions	—	622	3,040	3,999	7,661
Mortgage-backed securities	—	3,067	28,676	80,200	111,943
Total securities available for sale	\$ 2,030	\$ 16,673	\$ 34,999	\$ 84,199	\$ 137,901
Weighted average yield (1)	1.05%	1.71%	1.76%	1.75%	1.75%

(1) Based on amortized cost, taxable equivalent basis

Deposits

Deposits are the primary source of funds for the Company's lending and investing activities. The Company provides a range of deposit services to businesses and individuals, including noninterest-bearing checking accounts, interest-bearing checking accounts, savings accounts, money market accounts, IRAs and CDs. These accounts generally earn interest at rates the Company establishes based on market factors and the anticipated amount and timing of funding needs. The establishment or continuity of a core deposit relationship can be a factor in loan pricing decisions. While the Company's primary focus is on establishing customer relationships to attract core deposits, at times, the Company uses brokered deposits and other wholesale deposits to supplement its funding sources. As of September 30, 2016, brokered deposits represented approximately 8.7 percent of total deposits.

Following the merger in 2015 the overall mix of average deposits has shifted to a higher percentage of noninterest-bearing and money market and savings deposits, with reductions in the percentage of deposits held in interest-bearing demand accounts. The Company believes its deposit product offerings are properly structured to attract and retain core low-cost deposit relationships. The average cost of interest-bearing deposits for the three and nine months ended September 30, 2016 was 0.58 percent and 0.56 percent, respectively, compared to a 0.53 percent and 0.51 percent for the same periods in 2015. The increase in the costs were due to changes in deposit mix and higher rates on interest-bearing deposit accounts.

Total deposits as of September 30, 2016 were \$860.8 million, which was an increase of \$2.4 million from December 31, 2015. As of September 30, 2016 the Company had outstanding time deposits under \$100,000 with balances of \$118.6 million, time deposits over \$100,000 with balances of \$172.9 million, and a fair value premium for time deposits of approximately \$373 thousand.

The following table summarizes the maturities of time deposits \$100,000 or more as of September 30, 2016.

Remaining maturity: (Dollars in thousands)	September 30, 2016
Three months or less	\$ 26,702
Three to six months	37,552
Six to twelve months	44,304
More than twelve months	64,303
Total	\$ 172,861

Borrowings

The Company uses short-term borrowings and long-term debt to provide both funding and, to a lesser extent, regulatory capital using debt at the Company level which can be downstreamed as Tier 1 capital to the Bank. Short-term borrowings totaled \$43.0 million at September 30, 2016 comprised of \$32.0 million in FHLB advances maturing within twelve months with a purchase accounting fair value adjustment of approximately \$ 48 thousand and the remainder consisted of Federal Funds purchased. Short-term borrowings totaled \$32.0 million at December 31, 2015 comprised of \$28 million in FHLB advances maturing within twelve months and the remainder consisted of Federal Funds purchased. There was no long-term debt outstanding at September 30, 2016 as the company paid down the balance of \$2 million on the line of credit which was outstanding on December 31, 2015.

Capital Resources

The Company uses leverage analysis to examine the potential of the institution to increase assets and liabilities using the current capital base. The key measurements included in this analysis are the Bank's Common Equity Tier 1 capital, Tier 1 capital, leverage and total capital ratios. At September 30, 2016 and December 31, 2015, our capital ratios, including our Bank's capital ratios, exceeded regulatory minimum capital requirements. From time to time we may be required to support the capital needs of our bank subsidiary. We believe we have various capital raising techniques available to us to provide for the capital needs of our bank, if necessary.

Liquidity and Off-Balance Sheet Arrangements

At September 30, 2016, we had \$135.8 million of pre-approved but unused lines of credit and \$2.9 million of standby letters of credit. These commitments generally have fixed expiration dates and many will expire without being drawn upon. The total commitment level does not necessarily represent future cash requirements. If needed to fund these outstanding commitments,

the Bank has the ability to liquidate Federal funds sold or securities available-for-sale, or on a short-term basis to borrow and purchase Federal funds from other financial institutions.

Market Risk and Liquidity Risk Management

The Bank's Asset Liability Management Committee ("ALCO") is responsible for making decisions regarding liquidity and funding solutions based upon approved liquidity, loan, capital and investment policies. The ALCO must consider interest rate sensitivity and liquidity risk management when rendering a decision on funding solutions and loan pricing. To assist in this process the Bank has contracted with an independent third party to prepare quarterly reports that summarize several key asset-liability measurements. In addition, the third party will also provide recommendations to the Bank's ALCO regarding future balance sheet structure, earnings and liquidity strategies. Two critical areas of focus for ALCO are interest rate sensitivity and liquidity risk management. We do not believe there have been any material changes to the Company's interest rate sensitivity or liquidity risk from December 31, 2015 to the period ended September 30, 2016 .

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

This Item is not applicable to smaller reporting companies.

ITEM 4. CONTROLS AND PROCEDURES

Under the supervision and with the participation of management, including SmartFinancial's Chief Executive Officer and Chief Financial Officer, SmartFinancial has evaluated the effectiveness of its disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as of September 30, 2016 (the "Evaluation Date"). Based on such evaluation, such officers have concluded that, as of the Evaluation Date, SmartFinancial's disclosure controls and procedures were effective in alerting them on a timely basis to material information relating to SmartFinancial (including its consolidated subsidiaries) required to be included in SmartFinancial's periodic filings under the Exchange Act.

There were no changes in SmartFinancial's internal control over financial reporting during SmartFinancial's fiscal quarter ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, SmartFinancial's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

There are various claims and lawsuits in which SmartFinancial is periodically involved incidental to the Bank's business. In the opinion of management, no material loss is expected from any of such pending claims or lawsuits.

SmartFinancial and its wholly owned subsidiary, SmartBank, are periodically involved as a plaintiff or a defendant in various legal actions in the ordinary course of business. While the outcome of these matters is not currently determinable, neither SmartFinancial nor SmartBank is involved in any litigation that is expected to have a material impact on our financial position, results of operations, or cash flow. Management believes that any claims pending against SmartFinancial or SmartBank are without merit or that the ultimate liability, if any, resulting from such claims will not materially affect SmartBank's financial condition or SmartFinancial's consolidated financial position.

Item 1A. Risk Factors.

SmartFinancial, as a smaller reporting company, is not required to provide the information required by this Item.

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

None.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not Applicable.

Item 5. Other Information.

None.

Item 6. Exhibits

31.1	Certification pursuant to Rule 13a-14(a)/15d-14(a)
31.2	Certification pursuant to Rule 13a-14(a)/15d-14(a)
32.1	Certification pursuant to 18 USC Section 1350 – Sarbanes-Oxley Act of 2002
32.2	Certification pursuant to 18 USC Section 1350 – Sarbanes-Oxley Act of 2002
101	Interactive Data Files

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SmartFinancial, Inc.

Date: November 14, 2016

/s/ William Y. Carroll, Jr.

William Y. Carroll, Jr.

President and Chief Executive Officer

(principal executive officer)

Date: November 14, 2016

/s/ Christopher Bryan Johnson

Christopher Bryan Johnson

Executive Vice President and Chief Financial Officer

(principal financial officer and accounting officer)

CERTIFICATION

I, William Y. Carroll, Jr., certify that:

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

Date: November 14, 2016

/s/ William Y. Carroll, Jr.

William Y. Carroll, Jr.

President and Chief Executive Officer

CERTIFICATION

I, Christopher Bryan Johnson, certify that:

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

Date: November 14, 2016

/s/ Christopher Bryan Johnson

Christopher Bryan Johnson

Chief Financial Officer

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

In connection with the Quarterly Report of SmartFinancial, Inc., (the "Company"), on Form 10-Q for the quarter ended September 30, 2016, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, William Y. Carroll, Jr., President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that:

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

/s/ William Y. Carroll, Jr.

William Y. Carroll, Jr.

President and Chief Executive Officer

November 14, 2016

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

In connection with the Quarterly Report of SmartFinancial, Inc., (the "Company"), on Form 10-Q for the quarter ended September 30, 2016, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Christopher Bryan Johnson, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that:

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

/s/ Christopher Bryan Johnson

Christopher Bryan Johnson

Chief Financial Officer

November 14, 2016