

SOUTHERN FIRST BANCSHARES INC

Form 10-Q

November 01, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2018

OR

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

**For the Transition Period from to
Commission file number 000-27719**

Southern First Bancshares, Inc.

(Exact name of registrant as specified in its charter)

South Carolina

(State or other jurisdiction of incorporation or organization)

58-2459561

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

100 Verdae Boulevard, Suite 100

Greenville, S.C.

(Address of principal executive offices)

29606

(Zip Code)

864-679-9000

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address, and former fiscal year, if changed 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 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller Reporting Company

Emerging growth company

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 7,450,270 shares of common stock, par value \$0.01 per share, were issued and outstanding as of October 25, 2018.

SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY
September 30, 2018 Form 10-Q

INDEX

PART I – CONSOLIDATED FINANCIAL INFORMATION		Page
Item 1.	Consolidated Financial Statements	
	Consolidated Balance Sheets	3
	Consolidated Statements of Income	4
	Consolidated Statements of Comprehensive Income	5
	Consolidated Statements of Shareholders' Equity	6
	Consolidated Statements of Cash Flows	7
	Notes to Unaudited Consolidated Financial Statements	8
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	28
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	44
Item 4.	Controls and Procedures	45
PART II – OTHER INFORMATION		
Item 1.	Legal Proceedings	45
Item 1A.	Risk Factors	45
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	45
Item 3.	Defaults upon Senior Securities	45
Item 4.	Mine Safety Disclosures	45
Item 5.	Other Information	45
Item 6.	Exhibits	45

PART I. CONSOLIDATED FINANCIAL INFORMATION**Item 1. CONSOLIDATED FINANCIAL STATEMENTS****SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS**

	September 30, 2018 (Unaudited)	December 31, 2017 (Audited)
(dollars in thousands, except share data)		
ASSETS		
Cash and cash equivalents:		
Cash and due from banks	\$ 15,199	17,171
Federal funds sold	52,956	49,148
Interest-bearing deposits with banks	21,836	25,846
Total cash and cash equivalents	89,991	92,165
Investment securities:		
Investment securities available for sale	66,886	67,603
Other investments	4,929	4,462
Total investment securities	71,815	72,065
Mortgage loans held for sale	9,298	11,790
Loans	1,620,201	1,387,070
Less allowance for loan losses	(16,140)	(15,523)
Loans, net	1,604,061	1,371,547
Bank owned life insurance	33,793	33,132
Property and equipment, net	32,670	32,234
Deferred income taxes	7,998	3,782
Other assets	8,081	7,910
Total assets	\$ 1,857,707	1,624,625
LIABILITIES		
Deposits	\$ 1,589,483	1,381,123
Federal Home Loan Bank advances and other borrowings	68,500	67,200
Junior subordinated debentures	13,403	13,403
Other liabilities	19,377	13,213
Total liabilities	1,690,763	1,474,939
SHAREHOLDERS' EQUITY		
Preferred stock, par value \$.01 per share, 10,000,000 shares authorized, no shares issued and outstanding	-	-
Common stock, par value \$.01 per share, 10,000,000 shares authorized, 7,448,770 and 7,347,851 shares issued and outstanding at September 30, 2018 and December 31, 2017, respectively	74	73
Nonvested restricted stock	(770)	(502)
Additional paid-in capital	102,171	99,986
Accumulated other comprehensive loss	(1,622)	(456)
Retained earnings	67,091	50,585
Total shareholders' equity	166,944	149,686
Total liabilities and shareholders' equity	\$ 1,857,707	1,624,625
See notes to consolidated financial statements that are an integral part of these consolidated statements.		

SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	For the three months ended September 30,		For the nine months ended September 30,	
	2018	2017	2018	2017
(dollars in thousands, except share data)				
Interest income				
Loans	\$ 19,159	15,282	53,314	43,089
Investment securities	487	443	1,284	1,208
Federal funds sold	219	230	980	548
Total interest income	19,865	15,955	55,578	44,845
Interest expense				
Deposits	3,928	2,084	10,191	5,073
Borrowings	436	562	1,232	2,504
Total interest expense	4,364	2,646	11,423	7,577
Net interest income	15,501	13,309	44,155	37,268
Provision for loan losses	400	500	1,300	1,500
Net interest income after provision for loan losses	15,101	12,809	42,855	35,768
Noninterest income				
Mortgage banking income	1,354	1,403	4,311	4,063
Service fees on deposit accounts	257	324	769	886
ATM and debit card income	381	284	1,085	818
Income from bank owned life insurance	221	224	662	590
Other income	320	307	898	799
Total noninterest income	2,533	2,542	7,725	7,156
Noninterest expenses				
Compensation and benefits	6,599	5,698	18,808	16,496
Occupancy	1,350	1,043	3,763	3,042
Outside service and data processing costs	841	794	2,400	2,362
Insurance	376	258	987	845
Professional fees	275	334	1,208	1,029
Marketing	215	199	652	605
Other	532	480	1,554	1,550
Total noninterest expenses	10,188	8,806	29,372	25,929
Income before income tax expense	7,446	6,545	21,208	16,995
Income tax expense	1,664	2,295	4,702	6,030
Net income available to common shareholders	\$ 5,782	4,250	16,506	10,965
Earnings per common share				
Basic	\$ 0.78	0.58	2.24	1.59
Diluted	\$ 0.75	0.55	2.13	1.50
Weighted average common shares outstanding				
Basic	7,400,174	7,281,594	7,369,473	6,905,017
Diluted	7,746,205	7,668,476	7,741,483	7,291,164

See notes to consolidated financial statements that are an integral part of these consolidated statements.

SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

(dollars in thousands)	For the three months ended September 30,		For the nine months ended September 30,	
	2018	2017	2018	2017
Net income	\$ 5,782	\$ 4,250	16,506	10,965
Other comprehensive income (loss):				
Unrealized gain (loss) on securities available for sale:				
Unrealized holding gain (loss) arising during the period, pretax	(325)	130	(1,475)	626
Tax (expense) benefit	69	(43)	308	(213)
Reclassification of realized (gain) loss	-	-	1	(2)
Tax expense	-	-	-	-
Other comprehensive income (loss)	(256)	87	(1,166)	411
Comprehensive income	\$ 5,526	\$ 4,337	15,340	11,376

See notes to consolidated financial statements that are an integral part of these consolidated statements.

SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017
(Unaudited)

	Common stock		Preferred stock		Nonvested restricted	Additional paid-in	Accumulated other comprehensive	Retained	
(dollars in thousands, except share data)	Shares	Amount	Shares	Amount	stock	capital	income (loss)	earnings	Total
December 31, 2016	6,463,789	65	-	-	(600)	73,371	(504)	37,540	109,872
Net income	-	-	-	-	-	-	-	10,965	10,965
Net issuance of common stock	805,000	8	-	-	-	24,750	-	-	24,758
Proceeds from exercise of stock options	42,267	-	-	-	-	454	-	-	454
Issuance of restricted stock	3,125	-	-	-	(146)	146	-	-	-
Amortization of deferred compensation on restricted stock	-	-	-	-	246	-	-	-	246
Compensation expense related to stock options, net of tax	-	-	-	-	-	743	-	-	743
Other comprehensive income	-	-	-	-	-	-	411	-	411
September 30, 2017	7,319,098	\$ 73	-	\$ -	\$ (500)	\$ 99,464	\$ (93)	\$ 48,505	\$ 147,449
December 31, 2017	7,347,851	73	-	-	(502)	99,986	(456)	50,585	149,686
Net income	-	-	-	-	-	-	-	16,506	16,506
Proceeds from exercise of stock options	89,419	1	-	-	-	809	-	-	810
Issuance of restricted stock	11,500	-	-	-	(501)	501	-	-	-
Amortization of deferred compensation on restricted stock	-	-	-	-	233	-	-	-	233
Compensation expense related to stock options, net of tax	-	-	-	-	-	875	-	-	875
Other comprehensive loss	-	-	-	-	-	-	(1,166)	-	(1,166)
September 30, 2018	7,448,770	\$ 74	-	\$ -	\$ (770)	\$ 102,171	\$ (1,622)	\$ 67,091	\$ 166,944

See notes to consolidated financial statements that are an integral part of these consolidated statements.

**SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)

	For the nine months ended	
	September 30,	
	2018	2017
(dollars in thousands)		
Operating activities		
Net income	\$ 16,506	\$ 10,965
Adjustments to reconcile net income to cash provided by (used for) operating activities:		
Provision for loan losses	1,300	1,500
Depreciation and other amortization	1,303	1,053
Accretion and amortization of securities discounts and premium, net	341	422
(Gain) loss on sale of investment securities available for sale	1	(2)
(Gain) loss on sale of real estate owned	(7)	3
(Gain) loss on disposal of fixed assets	-	50
Write-down of real estate owned	-	7
Compensation expense related to stock options and grants	1,108	989
Gain on sale of loans held for sale	(4,093)	(4,520)
Loans originated and held for sale	(161,272)	(144,622)
Proceeds from sale of loans held for sale	167,857	147,819
Increase in cash surrender value of bank owned life insurance	(662)	(590)
Increase in deferred tax asset	(3,906)	(2,472)
Increase in other assets, net	(296)	(72)
Increase in other liabilities	6,164	3,773
Net cash provided by operating activities	24,344	14,303
Investing activities		
Increase (decrease) in cash realized from:		
Origination of loans, net	(233,814)	(165,160)
Purchase of property and equipment	(1,739)	(4,290)
Purchase of investment securities:		
Available for sale	(13,903)	(20,675)
Other	(6,782)	(1,811)
Payments and maturities, calls and repayments of investment securities:		
Available for sale	6,962	6,918
Other	6,315	4,489
Proceeds from sale of investment securities available for sale	5,841	-
Purchase of life insurance policies	-	(6,850)
Proceeds from sale of real estate owned	132	498
Net cash used for investing activities	(236,988)	(186,881)
Financing activities		
Increase (decrease) in cash realized from:		
Increase in deposits, net	208,360	251,426
Increase (decrease) in Federal Home Loan Bank advances and other borrowings	1,300	(76,000)
Proceeds from issuance of common stock	-	24,758
Proceeds from the exercise of stock options and warrants	810	454
Net cash provided by financing activities	210,470	200,638
Net (decrease) increase in cash and cash equivalents	(2,174)	28,060
Cash and cash equivalents at beginning of the period	92,165	46,552
Cash and cash equivalents at end of the period	\$ 89,991	\$ 74,612
Supplemental information		
Cash paid for		
Interest	\$ 10,824	\$ 7,404
Income taxes	3,906	5,490
Schedule of non-cash transactions		
Real estate acquired in settlement of loans	-	289
Unrealized gain (loss) on securities, net of income taxes	(1,167)	413
See notes to consolidated financial statements that are an integral part of these consolidated statements.		

**SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

NOTE 1 – Nature of Business and Basis of Presentation

Business Activity

Southern First Bancshares, Inc. (the "Company") is a South Carolina corporation that owns all of the capital stock of Southern First Bank (the "Bank") and all of the stock of Greenville First Statutory Trust I and II (collectively, the "Trusts"). The Trusts are special purpose non-consolidated entities organized for the sole purpose of issuing trust preferred securities. The Bank's primary federal regulator is the Federal Deposit Insurance Corporation (the "FDIC"). The Bank is also regulated and examined by the South Carolina Board of Financial Institutions. The Bank is primarily engaged in the business of accepting demand deposits and savings deposits insured by the FDIC, and providing commercial, consumer and mortgage loans to the general public.

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended September 30, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017 as filed with the Securities and Exchange Commission ("SEC") on February 28, 2018. The consolidated financial statements include the accounts of the Company and the Bank. In accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 810, "Consolidation," the financial statements related to the Trusts have not been consolidated.

Business Segments

In determining proper segment definition, the Company considers the materiality of a potential segment and components of the business about which financial information is available and regularly evaluated, relative to a resource allocation and performance assessment. The Company accounts for intersegment revenues and expenses as if the revenue/expense transactions were generated to third parties, that is, at current market prices. Please refer to "Note 9 – Reportable Segments" for further information on the reporting for the Company's three business segments.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, or GAAP, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amount of income and expenses during the reporting periods. 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, real estate acquired in the settlement of loans, fair value of financial instruments, evaluating other-than-temporary-impairment of investment securities and valuation of deferred tax assets.

Reclassifications

Certain amounts, previously reported, have been reclassified to state all periods on a comparable basis and had no effect on shareholders' equity or net income.

Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Non-recognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management performed an evaluation to determine whether there have been any subsequent events since the balance sheet date and determined that no subsequent events occurred requiring accrual or disclosure.

Revenue from Contracts with Customers

The Company records revenue from contracts with customers in accordance with Accounting Standards Codification Topic 606, "Revenue from Contracts with Customers" ("Topic 606"). Under Topic 606, the Company must identify the contract with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when (or as) the Company satisfies a performance obligation. Significant revenue has not been recognized in the current reporting period that results from performance obligations satisfied in previous periods.

The Company's primary sources of revenue are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of Topic 606. The Company has evaluated the nature of its contracts with customers and determined that further disaggregation of revenue from contracts with customers into more granular categories beyond what is presented in the Consolidated Statements of Income was not necessary. The Company generally fully satisfies its performance obligations on its contracts with customers as services are rendered and the transaction prices are typically fixed; charged either on a periodic basis or based on activity. Our accounting policies will not change materially since the principles of revenue recognition from the Accounting Standards Update are largely consistent with existing guidance and current practices applied by our business. The following is a discussion of revenues within the scope of the new guidance:

Service fees on deposit accounts - The Company earns fees from its deposit clients for various transaction-based, account maintenance, and overdraft or non-sufficient funds ("NSF") services. Transaction-based fees, which include services such as stop payment charges, statement rendering, and ACH fees, are recognized at the time the transaction is executed as that is the point in time the Company fulfills the client's request. Account maintenance fees, which relate primarily to monthly maintenance and account management, are earned over the course of a month, representing the period over which the Company satisfies the performance obligation. Overdraft and NSF fees are recognized at the point in time that the overdraft occurs or the NSF item is presented. Service charges on deposits are withdrawn from the client's account balance.

ATM and debit card income - The Company earns interchange fees from debit cardholder transactions conducted through the payment networks. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder.

Income Taxes

On December 22, 2017, the United States enacted tax reform legislation commonly known as the Tax Cuts and Jobs Act (the "Tax Act"), resulting in significant modifications to existing law. Authoritative guidance and interpretation by regulatory bodies is ongoing, and as such, the accounting for the effects of the Tax Act is not final and the full impact of the new regulation is still being evaluated.

Adoption of New Accounting Standards

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers" ("ASU 2014-09"), which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU replaces most existing revenue recognition guidance in GAAP. The new standard was effective for the Company on January 1, 2018. Adoption of ASU 2014-09 did not have a material impact on the Company's consolidated financial statements and related disclosures as the Company's primary sources of revenues are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of ASU 2014-09. The Company's revenue recognition pattern for revenue streams within the scope of ASU 2014-09, including but not limited to service charges on deposit accounts, ATM and debit card income, and gains/losses on the sale of other real estate owned, did not change significantly from current practice. The standard permits the use of either the full retrospective or modified retrospective transition method. The Company elected to use the modified retrospective transition method which requires application of ASU 2014-09 to uncompleted contracts at the date of adoption however, periods prior to the date of adoption will not be retrospectively revised as the impact of the ASU on uncompleted contracts at the date of adoption was not material.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities" ("ASU 2016-01"). The guidance affects the accounting for equity investments, financial liabilities under the fair value option and the presentation and disclosure requirements of financial instruments. ASU 2016-01 was effective for the Company on January 1, 2018 and resulted in the use of an exit price rather than an entrance price to determine the fair value of loans not measured at fair value on a non-recurring basis in the consolidated balance sheets. See Note 7 – Fair Value Accounting for further information regarding the valuation of these loans.

In February 2018, the FASB amended certain aspects of the guidance issued in ASU 2016-01, the Financial Instruments Topic of the ASC. The amendments clarify certain aspects of the guidance issued in ASU 2016-01. The amendments were effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years beginning after June 15, 2018 and did not have a material effect on the Company's financial statements.

In February 2018, the FASB Issued ASU 2018-02, "Income Statement (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income" ("ASU 2018-02"), which requires companies to reclassify the stranded effects in other comprehensive income to retained earnings as a result of the change in the tax rates under the Tax Act. The Company has opted to early adopt this pronouncement by retrospective application to each period (or periods) in which the effect of the change in the tax rate under the Tax Act is recognized. The impact of the reclassification from other comprehensive income to retained earnings did not have a material effect on the Company's financial statements.

Newly Issued, But Not Yet Effective Accounting Standards

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)" ("ASU 2016-02"). The FASB issued this ASU to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet by lessees for those leases classified as operating leases under current U.S. GAAP and disclosing key information about leasing arrangements. The amendments in this ASU are effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2018. Early application of this ASU is permitted for all entities. The Company leases certain properties under operating leases that will result in the recognition of lease assets and lease liabilities on the Company's balance sheet under the ASU. At September 30, 2018, the Company had contractual future minimum lease commitments of approximately \$15.2 million, before considering renewal options that are generally present, and is currently evaluating the impact of this pronouncement on its financial statements.

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments" ("ASU 2016-13"). Among other things, ASU 2016-13 requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to form their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, ASU 2016-13 amends the accounting for credit losses on debt securities and purchased financial assets with credit deterioration. The amendments in ASU 2016-13 are effective for fiscal years beginning after December 31, 2019, and interim periods within those years for public business entities that are SEC filers. Early adoption is permitted for fiscal years, and interim periods within those years, beginning after December 15, 2018, however, the Company does not currently plan to early adopt the ASU. We are evaluating the impact of the ASU on our consolidated financial statements. In addition to our allowance for loan losses, we will also record an allowance for credit losses on debt securities instead of applying the impairment model currently utilized. The amount of the adjustments will be impacted by each portfolio's composition and credit quality at the adoption date as well as economic conditions and forecasts at that time.

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

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

(dollars in thousands)	September 30, 2018									
	Less than one year		One to five years		Five to ten years		Over ten years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Available for sale										
US government agencies	\$ -	-	2,625	2.12%	6,009	2.75%	-	-	8,634	2.56%
SBA securities	-	-	-	-	-	-	3,472	2.67%	3,472	2.67%
State and political subdivisions	-	-	816	2.60%	4,186	3.09%	3,370	2.83%	8,372	2.94%
Asset-backed securities	-	-	-	-	-	-	6,586	2.91%	6,586	2.91%
Mortgage-backed securities	-	-	3,925	1.83%	9,119	1.80%	26,778	2.48%	39,822	2.26%
Total	\$ -	-	7,366	2.02%	19,314	2.37%	40,206	2.59%	66,886	2.47%

(dollars in thousands)	December 31, 2017									
	Less than one year		One to five years		Five to ten years		Over ten years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Available for sale										
US government agencies	\$ 995	1.15%	1,503	2.04%	6,155	2.40%	-	-	8,653	2.20%
SBA securities	-	-	-	-	-	-	4,063	2.45%	4,063	2.45%
State and political subdivisions	-	-	1,163	1.96%	7,162	2.84%	3,071	2.76%	11,396	2.73%
Mortgage-backed securities	432	0.99%	-	-	11,328	1.84%	31,731	2.06%	43,491	1.99%
Total	\$ 1,427	1.10%	2,666	1.59%	24,645	2.27%	38,865	2.15%	67,603	2.17%

The tables below summarize gross unrealized losses on investment securities and the fair market value of the related securities at September 30, 2018 and December 31, 2017, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position.

(dollars in thousands)	September 30, 2018									
	Less than 12 months				12 months or longer				Total	
	#	Fair value	Unrealized losses	#	Fair value	Unrealized losses	#	Fair value	Unrealized losses	
Available for sale										
US government agencies	3	\$ 3,368	\$ 86	6	\$ 4,764	\$ 263	9	\$ 8,132	\$ 349	
SBA securities	-	-	-	2	3,472	163	2	3,472	163	
State and political subdivisions	4	3,491	48	5	1,935	79	9	5,426	127	
Asset-backed securities	2	3,474	10	-	-	-	2	3,474	10	
Mortgage-backed securities										
FHLMC	-	-	-	10	7,651	361	10	7,651	361	
FNMA	4	5,476	60	23	23,656	873	27	29,132	933	
GNMA	1	1,206	70	2	1,776	96	3	2,982	166	
Total	14	\$ 17,015	\$ 274	48	\$ 43,254	\$ 1,835	62	\$ 60,269	\$ 2,109	

(dollars in thousands)	December 31, 2017									
	Less than 12 months				12 months or longer				Total	
	#	Fair value	Unrealized losses	#	Fair value	Unrealized losses	#	Fair value	Unrealized losses	
Available for sale										
US government agencies	5	\$ 4,184	\$ 22	4	\$ 3,968	\$ 75	9	\$ 8,152	\$ 97	
SBA securities	1	2,936	13	1	1,127	11	2	4,063	24	
State and political subdivisions	3	1,214	9	2	792	16	5	2,006	25	
Mortgage-backed securities										
FHLMC	3	2,897	26	7	6,056	123	10	8,953	149	
FNMA	11	14,345	135	13	14,597	251	24	28,942	386	
GNMA	2	2,270	40	1	971	42	3	3,241	82	
Total	25	\$ 27,846	\$ 245	28	\$ 27,511	\$ 518	53	\$ 55,357	\$ 763	

At September 30, 2018, the Company had 14 individual investments with a fair market value of \$17.0 million that were in an unrealized loss position for less than 12 months and 48 individual investments with a fair market value of \$43.3 million that were in an unrealized loss position for 12 months or longer. The unrealized losses were primarily attributable to changes in interest rates,

rather than deterioration in credit quality. The individual securities are each investment grade securities. The Company considers the length of time and extent to which the fair value of available-for-sale debt securities have been less than cost to conclude that such securities are not other-than-temporarily impaired. The Company also considers other factors such as the financial condition of the issuer, including credit ratings and specific events affecting the operations of the issuer, volatility of the security, underlying assets that collateralize the debt security, and other industry and macroeconomic conditions.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

As the Company has no intent to sell securities with unrealized losses and it is not more-likely-than-not that the Company will be required to sell these securities before recovery of amortized cost, the Company has concluded that these securities are not impaired on an other-than-temporary basis.

Other investments are comprised of the following and are recorded at cost which approximates fair value.

(dollars in thousands)	September 30, 2018	December 31, 2017
Federal Home Loan Bank stock	\$ 4,373	3,754
Investment in Trust Preferred securities	403	403
Other investments	153	305
Total other investments	\$ 4,929	4,462

The Company has evaluated the Federal Home Loan Bank ("FHLB") stock for impairment and determined that the investment in the FHLB stock is not other than temporarily impaired as of September 30, 2018 and ultimate recoverability of the par value of this investment is probable. All of the FHLB stock is used to collateralize advances with the FHLB.

At September 30, 2018, there were no securities pledged as collateral for borrowings or client deposits. At December 31, 2017, \$7.7 million of securities were pledged as collateral for repurchase agreements from brokers.

NOTE 3 – Mortgage Loans Held for Sale

Mortgage loans originated and intended for sale in the secondary market are reported as loans held for sale and carried at fair value under the fair value option with changes in fair value recognized in current period earnings. At the date of funding of the mortgage loan held for sale, the funded amount of the loan, the related derivative asset or liability of the associated interest rate lock commitment, less direct loan costs becomes the initial recorded investment in the loan held for sale. Such amount approximates the fair value of the loan. At September 30, 2018, mortgage loans held for sale totaled \$9.3 million compared to \$11.8 million at December 31, 2017.

Mortgage loans held for sale are considered de-recognized, or sold, when the Company surrenders control over the financial assets. Control is considered to have been surrendered when the transferred assets have been isolated from the Company, beyond the reach of the Company and its creditors; the purchaser obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets; and the Company does not maintain effective control over the transferred assets through an agreement that both entitles and obligates the Company to repurchase or redeem the transferred assets before their maturity or the ability to unilaterally cause the holder to return specific assets.

Gains and losses from the sale of mortgage loans are recognized based upon the difference between the sales proceeds and carrying value of the related loans upon sale and are recorded in mortgage banking income in the statement of income. Mortgage banking income also includes the gains and losses associated with the loans held for sale and the gains and losses from derivatives.

Mortgage loans sold by the Company to investors and which were believed to have met investor and agency underwriting guidelines at the time of sale may be subject to repurchase or indemnification in the event of specific default by the borrower or subsequent discovery that underwriting standards were not met. The Company may, upon mutual agreement, agree to repurchase the loans or indemnify the investor against future losses on such loans. In such cases, the Company bears any subsequent credit loss on the loans.

The Company establishes mortgage repurchase reserves related to various representations and warranties that reflect management's estimate of losses based on a combination of factors. The Company establishes a reserve at the time loans are sold and updates the reserve estimate on a quarterly basis during the estimated life of the loan.

NOTE 4 – Loans and Allowance for Loan Losses

The following table summarizes the composition of our loan portfolio. Total gross loans are recorded net of deferred loan fees and costs, which totaled \$2.8 million as of September 30, 2018 and \$2.3 million as of December 31, 2017.

(dollars in thousands)	September 30, 2018		December 31, 2017	
	Amount	% of Total	Amount	% of Total
Commercial				
Owner occupied RE	\$ 372,120	23.0 %	\$ 316,818	22.8 %
Non-owner occupied RE	399,166	24.6 %	312,798	22.6 %
Construction	68,415	4.2 %	51,179	3.7 %
Business	244,348	15.1 %	226,158	16.3 %
Total commercial loans	1,084,049	66.9 %	906,953	65.4 %
Consumer				
Real estate	311,271	19.2 %	273,050	19.7 %
Home equity	163,654	10.1 %	156,141	11.3 %
Construction	38,015	2.4 %	28,351	2.0 %
Other	23,212	1.4 %	22,575	1.6 %
Total consumer loans	536,152	33.1 %	480,117	34.6 %
Total gross loans, net of deferred fees	1,620,201	100.0%	1,387,070	100.0%
Less—allowance for loan losses	(16,140)		(15,523)	
Total loans, net	\$ 1,604,061		\$ 1,371,547	

Maturities and Sensitivity of Loans to Changes in Interest Rates

The information in the following tables summarizes the loan maturity distribution by type and related interest rate characteristics based on the contractual maturities of individual loans, including loans which may be subject to renewal at their contractual maturity. Renewal of such loans is subject to review and credit approval, as well as modification of terms upon maturity. Actual repayments of loans may differ from the maturities reflected below, because borrowers have the right to prepay obligations with or without prepayment penalties.

(dollars in thousands)	September 30, 2018			
	One year or less	After one but within five years	After five years	Total
Commercial				
Owner occupied RE	\$ 25,962	164,564	181,594	372,120
Non-owner occupied RE	35,003	213,384	150,779	399,166
Construction	19,455	26,137	22,823	68,415
Business	74,091	124,489	45,768	244,348
Total commercial loans	154,511	528,574	400,964	1,084,049
Consumer				
Real estate	37,128	67,254	206,889	311,271
Home equity	11,097	25,556	127,001	163,654
Construction	20,006	887	17,122	38,015
Other	7,961	10,714	4,537	23,212
Total consumer loans	76,192	104,411	355,549	536,152
Total gross loans, net of deferred fees	\$ 230,703	632,985	756,513	1,620,201
Loans maturing after one year with:				
Fixed interest rates				\$ 1,056,262
Floating interest rates				333,236

(dollars in thousands)	December 31, 2017			Total
	One year or less	After one but within five years	After five years	
Commercial				
Owner occupied RE	\$ 24,171	167,425	125,222	316,818
Non-owner occupied RE	39,519	165,764	107,515	312,798
Construction	13,086	12,796	25,297	51,179
Business	73,588	107,584	44,986	226,158
Total commercial loans	150,364	453,569	303,020	906,953
Consumer				
Real estate	30,172	61,809	181,069	273,050
Home equity	13,331	25,807	117,003	156,141
Construction	14,943	1,737	11,671	28,351
Other	7,203	11,371	4,001	22,575
Total consumer	65,649	100,724	313,744	480,117
Total gross loan, net of deferred fees	\$ 216,013	554,293	616,764	1,387,070
Loans maturing after one year with:				
Fixed interest rates				\$ 875,991
Floating interest rates				295,066

Portfolio Segment Methodology*Commercial*

Commercial loans are assessed for estimated losses by grading each loan using various risk factors identified through periodic reviews. The Company applies historic grade-specific loss factors to each loan class. In the development of statistically derived loan grade loss factors, the Company observes historical losses over 20 quarters for each loan grade. These loss estimates are adjusted as appropriate based on additional analysis of external loss data or other risks identified from current economic conditions and credit quality trends. The allowance also includes an amount for the estimated impairment on nonaccrual commercial loans and commercial loans modified in a troubled debt restructuring ("TDR"), whether on accrual or nonaccrual status.

Consumer

For consumer loans, the Company determines the allowance on a collective basis utilizing historical losses over 20 quarters to represent its best estimate of inherent loss. The Company pools loans, generally by loan class with similar risk characteristics. The allowance also includes an amount for the estimated impairment on nonaccrual consumer loans and consumer loans modified in a TDR, whether on accrual or nonaccrual status.

Credit Quality Indicators*Commercial*

We manage a consistent process for assessing commercial loan credit quality by monitoring its loan grading trends and past due statistics. All loans are subject to individual risk assessment. Our risk categories include Pass, Special Mention, Substandard, and Doubtful, each of which is defined by our banking regulatory agencies. Delinquency statistics are also an important indicator of credit quality in the establishment of our allowance for loan losses.

We categorize our loans into risk categories based on relevant information about the ability of the borrower to service their debt such as current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. A description of the general characteristics of the risk grades is as follows:

Pass—These loans range from minimal credit risk to average credit risk; however, still have acceptable credit risk.

Special mention—A special mention loan has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or the institution’s credit position at some future date.

Substandard—A substandard loan is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness, or weaknesses, that may jeopardize the liquidation of the debt. A substandard loan is characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful—A doubtful loan has all of the weaknesses inherent in one classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of the currently existing facts, conditions and values, highly questionable and improbable.

The tables below provide a breakdown of outstanding commercial loans by risk category.

	September 30, 2018				
(dollars in thousands)	Owner occupied RE	Non-owner occupied RE	Construction	Business	Total
Pass	\$ 368,266	394,880	68,415	238,167	1,069,728
Special mention	725	121	-	3,033	3,879
Substandard	3,129	4,165	-	3,148	10,442
Doubtful	-	-	-	-	-
	\$ 372,120	399,166	68,415	244,348	1,084,049

	December 31, 2017				
(dollars in thousands)	Owner occupied RE	Non-owner occupied RE	Construction	Business	Total
Pass	\$ 312,628	306,965	51,179	215,729	886,501
Special mention	1,770	2,082	-	5,540	9,392
Substandard	2,420	3,751	-	4,889	11,060
Doubtful	-	-	-	-	-
	\$ 316,818	312,798	51,179	226,158	906,953

The following tables provide past due information for outstanding commercial loans and include loans on nonaccrual status as well as accruing TDRs.

	September 30, 2018				
(dollars in thousands)	Owner occupied RE	Non-owner occupied RE	Construction	Business	Total
Current	\$ 372,120	398,973	68,415	244,246	1,083,754
30-59 days past due	-	-	-	13	13
60-89 days past due	-	-	-	-	-
Greater than 90 Days	-	193	-	89	282
	\$ 372,120	399,166	68,415	244,348	1,084,049

	December 31, 2017				
(dollars in thousands)	Owner occupied RE	Non-owner occupied RE	Construction	Business	Total
Current	\$ 316,818	312,477	51,179	224,861	905,335
30-59 days past due	-	129	-	416	545
60-89 days past due	-	-	-	-	-
Greater than 90 Days	-	192	-	881	1,073
	\$ 316,818	312,798	51,179	226,158	906,953

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

Consumer

The Company manages a consistent process for assessing consumer loan credit quality by monitoring its loan grading trends and past due statistics. All loans are subject to individual risk assessment. The Company's categories include Pass, Special Mention, Substandard, and Doubtful, which are defined above. Delinquency statistics are also an important indicator of credit quality in the establishment of the allowance for loan losses.

The tables below provide a breakdown of outstanding consumer loans by risk category.

	September 30, 2018				
(dollars in thousands)	Real estate	Home equity	Construction	Other	Total
Pass	\$ 305,496	160,544	38,015	22,999	527,054
Special mention	1,886	526	-	156	2,568
Substandard	3,889	2,584	-	57	6,530
Doubtful	-	-	-	-	-
	\$ 311,271	163,654	38,015	23,212	536,152

	December 31, 2017				
(dollars in thousands)	Real estate	Home equity	Construction	Other	Total
Pass	\$ 269,422	152,545	28,351	22,367	472,685
Special mention	715	1,025	-	88	1,828
Substandard	2,913	2,571	-	120	5,604
Doubtful	-	-	-	-	-
	\$ 273,050	156,141	28,351	22,575	480,117

The following tables provide past due information for outstanding consumer loans and include loans on nonaccrual status as well as accruing TDRs.

	September 30, 2018				
(dollars in thousands)	Real estate	Home equity	Construction	Other	Total
Current	\$ 310,665	163,309	38,015	23,082	535,071
30-59 days past due	249	345	-	55	649
60-89 days past due	357	-	-	75	432
Greater than 90 Days	-	-	-	-	-
	\$ 311,271	163,654	38,015	23,212	536,152

	December 31, 2017				
(dollars in thousands)	Real estate	Home equity	Construction	Other	Total
Current	\$ 271,284	154,821	28,351	22,506	476,962
30-59 days past due	681	325	-	69	1,075
60-89 days past due	131	995	-	-	1,126
Greater than 90 Days	954	-	-	-	954
	\$ 273,050	156,141	28,351	22,575	480,117

As of September 30, 2018 and December 31, 2017, total loans 30 days or more past due represented 0.08% and 0.34% of the Company's total loan portfolio, respectively. Commercial loans 30 days or more past due were 0.02% and 0.12% of the Company's total loan portfolio as of September 30, 2018 and December 31, 2017, respectively. As of September 30, 2018 and December 31, 2017, consumer loans 30 days or more past due were 0.07% and 0.23% of total loans, respectively.

Nonperforming assets

The following table shows the nonperforming assets and the related percentage of nonperforming assets to total assets and gross loans. Generally, a loan is placed on nonaccrual status when it becomes 90 days past due as to principal or interest, or when the Company believes, after considering economic and business conditions and collection efforts, that the borrower's financial condition is such that collection of the contractual principal or interest on the loan is doubtful. A payment of interest on a loan that is classified as nonaccrual is recognized as a reduction in principal when received.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

Following is a summary of our nonperforming assets, including nonaccruing TDRs.

(dollars in thousands)	September 30, 2018	December 31, 2017
Commercial		
Owner occupied RE	\$ -	-
Non-owner occupied RE	1,680	1,581
Construction	-	-
Business	89	910
Consumer		
Real estate	1,153	992
Home equity	850	1,144
Construction	-	-
Other	-	1
Nonaccruing troubled debt restructurings	2,194	2,673
Total nonaccrual loans, including nonaccruing TDRs	5,966	7,301
Other real estate owned	117	242
Total nonperforming assets	\$ 6,083	7,543
Nonperforming assets as a percentage of:		
Total assets	0.33%	0.46%
Gross loans	0.38%	0.54%
Total loans over 90 days past due	282	2,027
Loans over 90 days past due and still accruing	-	-
Accruing troubled debt restructurings	\$ 6,699	5,145

Impaired Loans

The table below summarizes key information for impaired loans. The Company's impaired loans include loans on nonaccrual status and loans modified in a TDR, whether on accrual or nonaccrual status. These impaired loans may have estimated impairment which is included in the allowance for loan losses. The Company's commercial and consumer impaired loans are evaluated individually to determine the related allowance for loan losses.

(dollars in thousands)	September 30, 2018			
	Unpaid Principal Balance	Impaired loans	Recorded investment Impaired loans with related allowance for loan losses	Related allowance for loan losses
Commercial				
Owner occupied RE	\$ 2,843	2,779	452	75
Non-owner occupied RE	6,341	3,046	2,245	742
Construction	-	-	-	-
Business	3,791	2,583	1,924	843
Total commercial	12,975	8,408	4,621	1,660
Consumer				
Real estate	2,930	2,831	2,172	1,214
Home equity	1,753	1,265	116	42
Construction	-	-	-	-
Other	161	161	161	19
Total consumer	4,844	4,257	2,449	1,275
Total	\$ 17,819	12,665	7,070	2,935

December 31, 2017

(dollars in thousands)	Recorded investment			
	Unpaid Principal Balance	Impaired loans	Impaired loans with related allowance for loan losses	Related allowance for loan losses
Commercial				
Owner occupied RE	\$ 2,281	2,235	464	179
Non-owner occupied RE	6,827	3,665	2,646	750
Construction	-	-	-	-
Business	3,735	2,764	1,993	1,061
Total commercial	12,843	8,664	5,103	1,990
Consumer				
Real estate	2,062	2,037	2,037	1,379
Home equity	2,010	1,575	680	286
Construction	-	-	-	-
Other	171	170	170	22
Total consumer	4,243	3,782	2,887	1,687
Total	\$ 17,086	12,446	7,990	3,677

The following table provides the average recorded investment in impaired loans and the amount of interest income recognized on impaired loans after impairment by portfolio segment and class.

(dollars in thousands)	Three months ended September 30, 2018		Three months ended September 30, 2017	
	Average recorded investment	Recognized interest income	Average recorded investment	Recognized interest income
Commercial				
Owner occupied RE	\$ 2,786	41	\$ 2,182	25
Non-owner occupied RE	3,048	29	4,322	57
Construction	-	-	-	-
Business	2,965	44	3,498	58
Total commercial	8,799	114	10,002	140
Consumer				
Real estate	2,850	34	2,361	40
Home equity	1,273	17	196	2
Construction	-	-	-	-
Other	162	1	176	1
Total consumer	4,285	52	2,733	43
Total	\$ 13,084	166	\$ 12,735	183

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

	Nine months ended September 30, 2018		Nine months ended September 30, 2017		Year ended December 31, 2017	
	Average recorded investment	Recognized interest income	Average recorded investment	Recognized interest income	Average recorded investment	Recognized interest income
(dollars in thousands)						
Commercial						
Owner occupied RE	\$ 2,792	103	\$ 2,198	78	2,255	104
Non-owner occupied RE	3,070	127	4,503	154	4,144	199
Construction	-	-	-	-	-	-
Business	3,031	123	3,585	165	2,823	162
Total commercial	8,893	353	10,286	397	9,222	465
Consumer						
Real estate	2,871	114	2,370	73	2,047	69
Home equity	1,283	61	196	4	1,576	97
Construction	-	-	-	-	-	-
Other	164	4	178	4	174	6
Total consumer	4,318	179	2,744	81	3,797	172
Total	\$ 13,211	532	\$ 13,030	478	13,019	637

Allowance for Loan Losses

The allowance for loan loss is management's estimate of credit losses inherent in the loan portfolio. The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The Company has an established process to determine the adequacy of the allowance for loan losses that assesses the losses inherent in the portfolio. While the Company attributes portions of the allowance to specific portfolio segments, the entire allowance is available to absorb credit losses inherent in the total loan portfolio. The Company's process involves procedures to appropriately consider the unique risk characteristics of the commercial and consumer loan portfolio segments. For each portfolio segment, impairment is measured individually for each impaired loan. The Company's allowance levels are influenced by loan volume, loan grade or delinquency status, historic loss experience and other economic conditions.

The following table summarizes the activity related to the allowance for loan losses by commercial and consumer portfolio segments:

	Three months ended September 30, 2018							Total	
	Commercial				Consumer				
	Owner occupied RE	Non-owner occupied RE	Construction	Business	Real Estate	Home equity	Other		
(dollars in thousands)									
Balance, beginning of period	\$ 2,699	3,581	544	3,849	3,446	1,431	282	268	16,100
Provision for loan losses	71	379	(44)	(17)	89	(93)	(7)	22	400
Loan charge-offs	-	-	-	(536)	-	-	-	(20)	(556)
Loan recoveries	-	25	-	89	1	80	-	1	196
Net loan charge-offs	-	25	-	(447)	1	80	-	(19)	(360)
Balance, end of period	\$ 2,770	3,985	500	3,385	3,536	1,418	275	271	16,140
Net charge-offs to average loans (annualized)									0.09%
Allowance for loan losses to gross loans									1.00%
Allowance for loan losses to nonperforming loans									270.53%

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

	Commercial							Three months ended September 30, 2017		
	Owner	Non-owner	Construction	Business	Real Estate	Home equity	Construction	Other	Total	
	occupied	occupied								Consumer
(dollars in thousands)	RE	RE								
Balance, beginning of period	\$ 2,964	2,981	350	3,857	3,061	1,608	328	295	15,444	
Provision for loan losses	(141)	634	(122)	213	160	(196)	(47)	(1)	500	
Loan charge-offs	-	-	-	(388)	-	-	-	(11)	(399)	
Loan recoveries	-	1	-	31	1	-	-	1	34	
Net loan charge-offs	-	1	-	(357)	1	-	-	(10)	(365)	
Balance, end of period	\$ 2,823	3,616	228	3,713	3,222	1,412	281	284	15,579	
Net charge-offs to average loans (annualized)									0.11%	
Allowance for loan losses to gross loans									1.17%	
Allowance for loan losses to nonperforming loans									278.05%	

	Commercial							Nine months ended September 30, 2018		
	Owner	Non-owner	Construction	Business	Real Estate	Home equity	Construction	Other	Total	
	occupied	occupied								Consumer
(dollars in thousands)	RE	RE								
Balance, beginning of period	\$ 2,534	3,230	325	3,848	3,495	1,600	210	281	15,523	
Provision for loan losses	236	857	175	(31)	114	(157)	65	41	1,300	
Loan charge-offs	-	(234)	-	(655)	(76)	(140)	-	(54)	(1,159)	
Loan recoveries	-	132	-	223	3	115	-	3	476	
Net loan charge-offs	-	(102)	-	(432)	(73)	(25)	-	(51)	(683)	
Balance, end of period	\$ 2,770	3,985	500	3,385	3,536	1,418	275	271	16,140	
Net charge-offs to average loans (annualized)									0.06%	

	Commercial							Nine months ended September 30, 2017		
	Owner	Non-owner	Construction	Business	Real Estate	Home equity	Construction	Other	Total	
	occupied	occupied								Consumer
(dollars in thousands)	RE	RE								
Balance, beginning of period	\$ 2,843	2,778	295	4,123	2,780	1,475	252	309	14,855	
Provision for loan losses	(20)	1,257	(67)	31	359	(75)	29	(14)	1,500	
Loan charge-offs	-	(433)	-	(518)	-	-	-	(11)	(962)	
Loan recoveries	-	14	-	77	83	12	-	-	186	
Net loan charge-offs	-	(419)	-	(441)	83	12	-	(11)	(776)	
Balance, end of period	\$ 2,823	3,616	228	3,713	3,222	1,412	281	284	15,579	
Net charge-offs to average loans (annualized)									0.08%	

The following table disaggregates the allowance for loan losses and recorded investment in loans by impairment methodology.

	Allowance for loan losses			Recorded investment in loans		
	Commercial	Consumer	Total	Commercial	Consumer	Total
	(dollars in thousands)	\$				
Individually evaluated	1,660	1,275	2,935	8,408	4,257	12,665
Collectively evaluated	8,990	4,225	13,205	1,075,641	531,895	1,607,536
Total	\$ 10,640	5,500	16,140	1,084,049	536,152	1,620,201

	Allowance for loan losses			Recorded investment in loans		
	Commercial	Consumer	Total	Commercial	Consumer	Total
	(dollars in thousands)	\$				
Individually evaluated	1,990	1,687	3,677	8,664	3,782	12,446
Collectively evaluated	7,947	3,899	11,846	898,289	476,335	1,374,624
Total	\$ 9,937	5,586	15,523	906,953	480,117	1,387,070

NOTE 5 – Troubled Debt Restructurings

At September 30, 2018, the Company had 26 loans totaling \$8.9 million compared to 21 loans totaling \$7.8 million at December 31, 2017, which were considered as TDRs. The Company considers a loan to be a TDR when the debtor experiences financial difficulties and the Company grants a concession to the debtor that it would not normally consider. Concessions can relate to the contractual interest rate, maturity date, or payment structure of the note. As part of the workout plan for individual loan relationships, the Company may restructure loan terms to assist borrowers facing financial challenges in the current economic environment. To date, the Company has restored four commercial loans previously classified as TDRs to accrual status.

The following table summarizes the concession at the time of modification and the recorded investment in the Company's TDRs before and after their modification.

	For the nine months ended September 30, 2018						
	Renewals deemed a concession	Reduced or deferred payments	Converted to interest only	Maturity date extensions	Total Number of loans	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
(dollars in thousands)							
Commercial							
Owner occupied RE	1	-	-	-	1	\$ 506	\$ 592
Business	4	-	-	-	4	1,207	1,532
Consumer							
Real estate	2	-	-	-	2	549	669
Total loans	7	-	-	-	7	\$ 2,262	\$ 2,793

	For the nine months ended September 30, 2017						
	Renewals deemed a concession	Reduced or deferred payments	Converted to interest only	Maturity date extensions	Total Number of loans	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
(dollars in thousands)							
Commercial							
Non-owner occupied RE	1	-	-	-	1	\$ 976	\$ 976
Business	1	1	-	-	2	378	387
Total loans	2	1	-	-	3	\$ 1,354	\$ 1,363

As of September 30, 2018 and 2017, there were no loans modified as TDRs for which there was a payment default (60 days past due) within 12 months of the restructuring date.

NOTE 6 – Derivative Financial Instruments

The Company utilizes derivative financial instruments primarily to hedge its exposure to changes in interest rates. All derivative financial instruments are recognized as either assets or liabilities and measured at fair value. The Company accounts for all of its derivatives as free-standing derivatives and does not designate any of these instruments for hedge accounting. Therefore, the gain or loss resulting from the change in the fair value of the derivative is recognized in the Company's statement of income during the period of change.

The Company enters into commitments to originate residential mortgage loans held for sale, at specified interest rates and within a specified period of time, with clients who have applied for a loan and meet certain credit and underwriting criteria (interest rate lock commitments). These interest rate lock commitments ("IRLCs") meet the definition of a derivative financial instrument and are reflected in the balance sheet at fair value with changes in fair value recognized in current period earnings. Unrealized gains and losses on the IRLCs are recorded as derivative assets and derivative liabilities, respectively, and are measured based on the value of the underlying mortgage loan, quoted mortgage-backed securities ("MBS") prices and an estimate of the probability that the mortgage loan will fund within the terms of the interest rate lock commitment, net of estimated commission expenses.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

The Company manages the interest rate and price risk associated with its outstanding IRLCs and mortgage loans held for sale by entering into derivative instruments such as forward sales of MBS. Management expects these derivatives will experience changes in fair value opposite to changes in fair value of the IRLCs and mortgage loans held for sale, thereby reducing earnings volatility. The Company takes into account various factors and strategies in determining the portion of the mortgage pipeline (IRLCs and mortgage loans held for sale) it wants to economically hedge.

The following table summarizes the Company's outstanding financial derivative instruments at September 30, 2018 and December 31, 2017.

(dollars in thousands)	Notional	Balance Sheet Location	September 30, 2018 Fair Value Asset/(Liability)
Mortgage loan interest rate lock commitments	\$ 20,943	Other assets	\$ 189
MBS forward sales commitments	15,750	Other assets	54
Total derivative financial instruments	\$ 36,693		\$ 243

(dollars in thousands)	Notional	Balance Sheet Location	December 31, 2017 Fair Value Asset/(Liability)
Mortgage loan interest rate lock commitments	\$ 15,430	Other assets	\$ 196
MBS forward sales commitments	10,750	Other liabilities	(28)
Total derivative financial instruments	\$ 26,180		\$ 168

NOTE 7 – Fair Value Accounting

FASB ASC 820, "Fair Value Measurement and Disclosures," defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. FASB ASC 820 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1 – Quoted market price in active markets

Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include certain debt and equity securities that are traded in an active exchange market.

Level 2 – Significant other observable inputs

Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include fixed income securities and mortgage-backed securities that are held in the Company's available-for-sale portfolio and valued by a third-party pricing service, as well as certain impaired loans.

Level 3 – Significant unobservable inputs

Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. These methodologies may result in a significant portion of the fair value being derived from unobservable data.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

The methods of determining the fair value of assets and liabilities presented in this note are consistent with our methodologies disclosed in Note 13 of the Company's 2017 Form 10-K, except for the valuation of loans held for investment which was impacted by the adoption of ASU 2016-01. Prior to adopting the amendments included in the standard, the Company was allowed to measure fair value under an entry price notion. The entry price notion previously applied by the Company used a discounted cash flows technique to calculate the present value of expected future cash flows for a financial instrument. The exit price notion uses the same approach, but also incorporates other factors, such as enhanced credit risk, illiquidity risk and market factors that sometimes exist in exit prices in dislocated markets. As of September 30, 2018, the technique used by the Company to estimate the exit price of the loan portfolio consists of similar procedures to those used as of December 31, 2017, but with added emphasis on both illiquidity risk and credit risk not captured by the previously applied entry price notion. This credit risk assumption is intended to approximate the fair value that a market participant would realize in a hypothetical orderly transaction. The Company's loan portfolio is initially fair valued using a segmented approach, using the eight categories as disclosed in Note 4 – Loans and Allowance for Loan Losses. Loans are considered a Level 2 and Level 3 classification.

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

The tables below present the recorded amount of assets and liabilities measured at fair value on a recurring basis as of September 30, 2018 and December 31, 2017.

(dollars in thousands)	September 30, 2018			
	Level 1	Level 2	Level 3	Total
Assets				
Securities available for sale				
US government agencies	\$ -	8,634	-	8,634
SBA securities	-	3,472	-	3,472
State and political subdivisions	-	8,372	-	8,372
Asset-backed securities	-	6,586	-	6,586
Mortgage-backed securities	-	39,822	-	39,822
Mortgage loans held for sale	-	9,298	-	9,298
Interest rate lock commitments	-	189	-	189
MBS forward sales commitments	-	54	-	54
Total assets measured at fair value on a recurring basis	\$ -	76,427	-	76,427
	December 31, 2017			
	Level 1	Level 2	Level 3	Total
Assets				
Securities available for sale:				
US government agencies	\$ -	8,653	-	8,653
SBA securities	-	4,063	-	4,063
State and political subdivisions	-	11,396	-	11,396
Mortgage-backed securities	-	43,491	-	43,491
Mortgage loans held for sale	-	11,790	-	11,790
Interest rate lock commitments	-	196	-	196
Total assets measured at fair value on a recurring basis	\$ -	79,589	-	79,589
Liabilities				
MBS forward sales commitments	\$ -	28	-	28
Total liabilities measured at fair value on a recurring basis	\$ -	28	-	28

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis

The tables below present the recorded amount of assets and liabilities measured at fair value on a nonrecurring basis as of September 30, 2018 and December 31, 2017.

(dollars in thousands)	As of September 30, 2018			
	Level 1	Level 2	Level 3	Total
Assets				
Impaired loans	\$ -	1,391	8,339	9,730
Other real estate owned	-	23	94	117
Total assets measured at fair value on a nonrecurring basis	\$ -	1,414	8,433	9,847

	As of December 31, 2017			
	Level 1	Level 2	Level 3	Total
Assets				
Impaired loans	\$ -	2,685	6,084	8,769
Other real estate owned	-	148	94	242
Total assets measured at fair value on a nonrecurring basis	\$ -	2,833	6,178	9,011

The Company had no liabilities carried at fair value or measured at fair value on a nonrecurring basis.

Impaired Loans

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan may be considered impaired and an allowance for loan losses may be established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures the impairment in accordance with FASB ASC 310, "Receivables." The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. In accordance with FASB ASC 820, "Fair Value Measurement and Disclosures," impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company considers the impaired loan as nonrecurring Level 2. The Company's current loan and appraisal policies require the Company to obtain updated appraisals on an "as is" basis at renewal, or in the case of an impaired loan, on an annual basis, either through a new external appraisal or an appraisal evaluation. The Company reviews the third party appraisal for appropriateness and adjusts the value downward to consider selling and closing costs, which typically range from 7% - 10% of the appraised value. For non-real estate loans, fair value of the impaired loan's collateral may be determined using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company considers the impaired loan as nonrecurring Level 3. The fair value of impaired loans may also be estimated using the present value of expected future cash flows to be realized on the loan, which is also considered a Level 3 valuation. These fair value estimates are subject to fluctuations in assumptions about the amount and timing of expected cash flows as well as the choice of discount rate used in the present value calculation.

Other Real Estate Owned ("OREO")

OREO, consisting of properties obtained through foreclosure or in satisfaction of loans, is reported at the lower of cost or fair value, determined on the basis of current appraisals, comparable sales, and other estimates of value obtained principally from independent sources, adjusted for estimated selling costs (Level 2). At the time of foreclosure, any excess of the loan balance over the fair value of the real estate held as collateral is treated as a charge against the allowance for loan losses. Gains or losses on sale and generally any subsequent adjustments to the value are recorded as a component of real estate owned activity. The unobservable inputs may vary depending on the individual assets and valuation approach. The Company reviews the third party appraisal for appropriateness and adjusts the value downward to consider selling and closing costs, which typically range from 7% to 10% of the appraised value. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company considers the OREO as nonrecurring Level 3.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

Fair Value of Financial Instruments

Financial instruments require disclosure of fair value information, whether or not recognized in the consolidated balance sheets, when it is practical to estimate the fair value. A financial instrument is defined as cash, evidence of an ownership interest in an entity or a contractual obligation which requires the exchange of cash. Certain items are specifically excluded from the disclosure requirements, including the Company's common stock, premises and equipment and other assets and liabilities.

The estimated fair values of the Company's financial instruments at September 30, 2018 and December 31, 2017 are as follows:

(dollars in thousands)	Carrying Amount	Fair Value	September 30, 2018		
			Level 1	Level 2	Level 3
Financial Assets:					
Other investments, at cost	\$ 4,929	4,929	-	-	4,929
Loans ¹	1,591,396	1,569,385	-	-	1,569,385
Financial Liabilities:					
Deposits	1,589,483	1,445,228	-	1,445,228	-
FHLB and other borrowings	68,500	68,548	-	68,548	-
Junior subordinated debentures	13,403	14,293	-	14,293	-

(dollars in thousands)	Carrying Amount	Fair Value	December 31, 2017		
			Level 1	Level 2	Level 3
Financial Assets:					
Other investments, at cost	\$ 4,462	4,462	-	-	4,462
Loans ¹	1,359,101	1,363,915	-	-	1,363,915
Financial Liabilities:					
Deposits	1,381,123	1,269,462	-	1,269,462	-
FHLB and other borrowings	67,200	67,890	-	67,890	-
Junior subordinated debentures	13,403	13,166	-	13,166	-

Carrying amount is net of the allowance for loan losses and previously presented impaired loans. In accordance with the prospective adoption of ASU No. 2016-01, the fair value of loans as of September 30, 2018 was measured using an exit price notion. The fair value of loans as of December 31, 2017 was measured using an entry price notion.

NOTE 8 – Earnings Per Common Share

The following schedule reconciles the numerators and denominators of the basic and diluted earnings per share computations for the three and nine months ended September 30, 2018 and 2017. Dilutive common shares arise from the potentially dilutive effect of the Company's stock options that were outstanding at September 30, 2018. The assumed conversion of stock options can create a difference between basic and dilutive net income per common share. At September 30, 2018 and 2017, there were 181,892 and 109,450 options, respectively, that were not considered in computing diluted earnings per common share because they were anti-dilutive.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

(dollars in thousands, except share data)	Three months ended		Nine months ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Numerator:				
Net income available to common shareholders	\$ 5,782	4,250	16,506	10,965
Denominator:				
Weighted-average common shares outstanding – basic	7,400,174	7,281,594	7,369,473	6,905,017
Common stock equivalents	346,031	386,882	372,010	386,147
Weighted-average common shares outstanding – diluted	7,746,205	7,668,476	7,741,483	7,291,164
Earnings per common share:				
Basic	\$ 0.78	0.58	2.24	1.59
Diluted	\$ 0.75	0.55	2.13	1.50

NOTE 9 – Reportable Segments

The Company's reportable segments represent the distinct product lines the Company offers and are viewed separately for strategic planning purposes by management. The three segments include Commercial and Retail Banking, Mortgage Banking, and Corporate. The following schedule presents financial information for each reportable segment.

(dollars in thousands)	Three months ended					Three months ended				
	September 30, 2018					September 30, 2017				
	Commercial and Retail Banking	Mortgage Banking	Corporate	Eliminations	Consolidated	Commercial and Retail Banking	Mortgage Banking	Corporate	Eliminations	Consolidated
Interest income	\$ 19,775	90	2	(2)	19,865	\$ 15,868	87	2	(2)	15,955
Interest expense	4,212	-	154	(2)	4,364	2,529	-	119	(2)	2,646
Net interest income (loss)	15,563	90	(152)	-	15,501	13,339	87	(117)	-	13,309
Provision for loan losses	400	-	-	-	400	500	-	-	-	500
Noninterest income	1,179	1,354	-	-	2,533	1,139	1,403	-	-	2,542
Noninterest expense	9,046	1,082	60	-	10,188	7,776	970	60	-	8,806
Net income (loss) before taxes	7,296	362	(212)	-	7,446	6,202	520	(177)	-	6,545
Income tax provision (benefit)	1,632	76	(44)	-	1,664	2,165	192	(62)	-	2,295
Net income (loss)	\$ 5,664	286	(168)	-	5,782	\$ 4,037	328	(115)	-	4,250
Total assets	\$ 1,847,633	9,649	180,420	(179,995)	1,857,707	\$ 1,548,771	8,476	160,905	(160,468)	1,557,684

(dollars in thousands)	Nine months ended					Nine months ended				
	September 30, 2018					September 30, 2017				
	Commercial and Retail Banking	Mortgage Banking	Corporate	Eliminations	Consolidated	Commercial and Retail Banking	Mortgage Banking	Corporate	Eliminations	Consolidated
Interest income	\$ 55,290	288	6	(6)	55,578	44,612	233	9	(9)	44,845
Interest expense	10,993	-	436	(6)	11,423	7,193	-	393	(9)	7,577
Net interest income (loss)	44,297	288	(430)	-	44,155	37,419	233	(384)	-	37,268
Provision for loan losses	1,300	-	-	-	1,300	1,500	-	-	-	1,500

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

Noninterest income	3,414	4,311	-	-	7,725	3,093	4,063	-	-	7,156
Noninterest expense	25,982	3,210	180	-	29,372	22,890	2,853	186	-	25,929
Net income before taxes	20,429	1,389	(610)	-	21,208	16,122	1,443	(570)	-	16,995
Income tax provision (benefit)	4,538	292	(128)	-	4,702	5,695	534	(199)	-	6,030
Net income (loss)	\$ 15,891	1,097	(482)	-	16,506	\$ 10,427	909	(371)	-	10,965
Total assets	\$ 1,847,633	9,649	180,420	(179,995)	1,857,707	\$ 1,548,771	8,476	160,905	(160,468)	1,557,684

Commercial and retail banking. The Company's primary business is to provide traditional deposit and lending products and services to its commercial and retail banking clients.

Mortgage banking. The mortgage banking segment provides mortgage loan origination services for loans that will be sold in the secondary market to investors.

Corporate. Corporate is comprised primarily of compensation and benefits for certain members of management and interest on parent company debt.

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

The following discussion reviews our results of operations for the three and nine month periods ended September 30, 2018 as compared to the three and nine month periods ended September 30, 2017 and assesses our financial condition as of September 30, 2018 as compared to December 31, 2017. You should read the following discussion and analysis in conjunction with the accompanying consolidated financial statements and the related notes and the consolidated financial statements and the related notes for the year ended December 31, 2017 included in our Annual Report on Form 10-K for that period. Results for the three and nine month periods ended September 30, 2018 are not necessarily indicative of the results for the year ending December 31, 2018 or any future period.

Cautionary Warning Regarding forward-looking statements

This report, including information included or incorporated by reference in this report, contains statements which constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Forward-looking statements may relate to our financial condition, results of operations, plans, objectives, or future performance. These statements are based on many assumptions and estimates and are not guarantees of future performance. Our actual results may differ materially from those anticipated in any forward-looking statements, as they will depend on many factors about which we are unsure, including many factors which are beyond our control. The words "may," "would," "could," "should," "will," "expect," "anticipate," "predict," "project," "potential," "believe," "continue," "assume," "intend," "plan," and "estimate," as well as similar expressions, are meant to identify such forward-looking statements. Potential risks and uncertainties that could cause our actual results to differ from those anticipated in any forward-looking statements include, but are not limited to, the following:

- Restrictions or conditions imposed by our regulators on our operations;
- Increases in competitive pressure in the banking and financial services industries;
- Changes in access to funding or increased regulatory requirements with regard to funding;
- Changes in deposit flows;
- Credit losses as a result of declining real estate values, increasing interest rates, increasing unemployment, changes in payment behavior or other factors;
- Credit losses due to loan concentration;
- Changes in the amount of our loan portfolio collateralized by real estate and weaknesses in the real estate market;
- Our ability to successfully execute our business strategy;
- Our ability to attract and retain key personnel;
- The success and costs of our expansion into the Greensboro, North Carolina, Raleigh, North Carolina and Atlanta, Georgia markets;
- Changes in the interest rate environment which could reduce anticipated or actual margins;
- Changes in political conditions or the legislative or regulatory environment, including governmental initiatives affecting the financial services industry;
- Changes in economic conditions resulting in, among other things, a deterioration in credit quality;
- Changes occurring in business conditions and inflation;

Increased cybersecurity risk, including potential business disruptions or financial losses;

Changes in technology;

The adequacy of the level of our allowance for loan losses and the amount of loan loss provisions required in future periods;

Examinations by our regulatory authorities, including the possibility that the regulatory authorities may, among other things, require us to increase our allowance for loan losses or write-down assets;

28

Changes in monetary and tax policies;

The rate of delinquencies and amounts of loans charged-off;

The rate of loan growth in recent years and the lack of seasoning of a portion of our loan portfolio;

Our ability to maintain appropriate levels of capital and to comply with our capital ratio requirements;

Adverse changes in asset quality and resulting credit risk-related losses and expenses;

Changes in accounting policies and practices; and

Other risks and uncertainties detailed in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2017, in Part II, Item 1A of this Quarterly Report on Form 10-Q, and from time to time in our other filings with the Securities and Exchange Commission (the "SEC").

If any of these risks or uncertainties materialize, or if any of the assumptions underlying such forward-looking statements proves to be incorrect, our results could differ materially from those expressed in, implied or projected by, such forward-looking statements. For information with respect to additional factors that could cause actual results to differ from the expectations stated in the forward-looking statements, see "Risk Factors" under Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2017 and "Risk Factors" under Part II, Item 1A of this Quarterly Report on Form 10-Q. We urge investors to consider all of these factors carefully in evaluating the forward-looking statements contained in this Quarterly Report on Form 10-Q. We make these forward-looking statements as of the date of this document and we do not intend, and assume no obligation, to update the forward-looking statements or to update the reasons why actual results could differ from those expressed in, or implied or projected by, the forward-looking statements.

OVERVIEW

Our business model continues to be client-focused, utilizing relationship teams to provide our clients with a specific banker contact and support team responsible for all of their banking needs. The purpose of this structure is to provide a consistent and superior level of professional service, and we believe it provides us with a distinct competitive advantage. We consider exceptional client service to be a critical part of our culture, which we refer to as "ClientFIRST."

At September 30, 2018, we had total assets of \$1.9 billion, a 14.3% increase from total assets of \$1.6 billion at December 31, 2017. The largest components of our total assets are loans, cash and cash equivalents and securities which were \$1.6 billion, \$90.0 million and \$71.8 million, respectively, at September 30, 2018. Comparatively, our loans, cash and cash equivalents and securities totaled \$1.4 billion, \$92.2 million and \$72.1 million, respectively, at December 31, 2017. Our liabilities and shareholders' equity at September 30, 2018 totaled \$1.7 billion and \$166.9 million, respectively, compared to liabilities of \$1.5 billion and shareholders' equity of \$149.7 million at December 31, 2017. The principal component of our liabilities is deposits which were \$1.6 billion and \$1.4 billion at September 30, 2018 and December 31, 2017, respectively.

Like most community banks, we derive the majority of our income from interest received on our loans and investments. Our primary source of funds for making these loans and investments is our deposits, on which we pay interest. Consequently, one of the key measures of our success is our amount of net interest income, or the difference between the income on our interest-earning assets, such as loans and investments, and the expense on our interest-bearing liabilities, such as deposits and borrowings. Another key measure is the spread between the yield we earn on these interest-earning assets and the rate we pay on our interest-bearing liabilities, which is called our net interest spread. In addition to earning interest on our loans and investments, we earn income through fees and other charges to our clients.

Our net income to common shareholders was \$5.8 million and \$4.3 million for the three months ended September 30, 2018 and 2017, respectively, an increase of \$1.5 million, or 36.0%. Diluted earnings per share ("EPS") was \$0.75 for the third quarter of 2018 as compared to \$0.55 for the same period in 2017. The increase in net income resulted primarily from an increase in net interest income and a decrease in income tax expense, partially offset by an increase in noninterest expense. As a result of the Tax Act which was passed in December 2017, our effective tax rate declined to 22.3% for the third quarter of 2018 from 35.1% for the third quarter of 2017.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

Our net income to common shareholders was \$16.5 million and \$11.0 million for the nine months ended September 30, 2018 and 2017, respectively, an increase of \$5.5 million, or 50.5%. Diluted EPS was \$2.13 for the nine months ended September 30, 2018 as compared to \$1.50 for the same period in 2017. The increase in net income resulted primarily from an increase in net interest income and noninterest income combined with a decrease in income tax expense, partially offset by an increase in noninterest expense. In addition, our effective tax rate declined to 22.2% from 35.5% for the nine months ended September 30, 2018 and 2017, respectively.

Economic conditions, competition, and the monetary and fiscal policies of the Federal government significantly affect most financial institutions, including the Bank. Lending and deposit activities and fee income generation are influenced by levels of business spending and investment, consumer income, consumer spending and savings, capital market activities, and competition among financial institutions, as well as customer preferences, interest rate conditions and prevailing market rates on competing products in our market areas.

RESULTS OF OPERATIONS

Net Interest Income and Margin

Our level of net interest income is determined by the level of earning assets and the management of our net interest margin. Our net interest income was \$15.5 million for the three month period ended September 30, 2018, a 16.5% increase over net interest income of \$13.3 million for the same period in 2017. Our average earning assets increased 15.8%, or \$233.4 million, during the third quarter of 2018 compared to the third quarter of 2017, while our average interest-bearing liabilities increased by \$180.7 million during the same period. Our net interest income was \$44.2 million for the nine month period ended September 30, 2018, an 18.5% increase over net interest income of \$37.3 million for the same period in 2017. In comparison, our average earning assets increased 17.7%, or \$248.3 million, during the first nine months of 2018 compared to the first nine months of 2017, while our average interest-bearing liabilities increased by \$183.2 million during the same period. The increase in average earning assets in both the three and nine month periods ended September 30, 2018 was primarily related to an increase in average loans, while the increase in average interest-bearing liabilities was primarily a result of an increase in interest-bearing deposits, partially offset by a decrease in our FHLB advances and other borrowings.

We have included a number of tables to assist in our description of various measures of our financial performance. For example, the "Average Balances, Income and Expenses, Yields and Rates" tables reflect the average balance of each category of our assets and liabilities as well as the yield we earned or the rate we paid with respect to each category during the three and nine month periods ended September 30, 2018 and 2017. A review of these tables show that our loans typically provide higher interest yields than do other types of interest-earning assets, which is why we direct a substantial percentage of our earning assets into our loan portfolio. Similarly, the "Rate/Volume Analysis" tables demonstrate the effect of changing interest rates and changing volume of assets and liabilities on our financial condition during the periods shown. We also track the sensitivity of our various categories of assets and liabilities to changes in interest rates, and we have included tables to illustrate our interest rate sensitivity with respect to interest-earning accounts and interest-bearing accounts.

The following tables set forth information related to our average balance sheets, average yields on assets, and average costs of liabilities. We derived these yields by dividing income or expense by the average balance of the corresponding assets or liabilities. We derived average balances from the daily balances throughout the periods indicated. During the same periods, we had no securities purchased with agreements to resell. All investments owned have an original maturity of over one year. Nonaccrual loans are included in the following tables. Loan yields have been reduced to reflect the negative impact on our earnings of loans on nonaccrual status. The net of capitalized loan costs and fees are amortized into interest income on loans.

Average Balances, Income and Expenses, Yields and Rates

(dollars in thousands)	For the Three Months Ended September 30,					
	Average Balance	Income/ Expense	2018 Yield/ Rate ⁽¹⁾	Average Balance	Income/ Expense	2017 Yield/ Rate ⁽¹⁾
Interest-earning assets						
Federal funds sold	\$ 44,532	\$ 219	1.95%	\$ 69,907	\$ 230	1.31%
Investment securities, taxable	66,706	446	2.65%	63,258	327	2.05%
Investment securities, nontaxable ⁽²⁾	5,431	53	3.89%	20,222	187	3.67%
Loans ⁽³⁾	1,592,279	19,159	4.77%	1,322,193	15,282	4.59%
Total interest-earning assets	1,708,948	19,877	4.61%	1,475,580	16,026	4.31%
Noninterest-earning assets	77,708			74,295		
Total assets	\$ 1,786,656			\$ 1,549,875		
Interest-bearing liabilities						
NOW accounts	\$ 240,454	121	0.20%	\$ 214,929	98	0.18%
Savings & money market	686,609	2,324	1.34%	518,918	1,098	0.84%
Time deposits	328,516	1,483	1.79%	326,732	888	1.08%
Total interest-bearing deposits	1,255,579	3,928	1.24%	1,060,579	2,084	0.78%
FHLB advances and other borrowings	36,151	285	3.13%	50,418	446	3.51%
Junior subordinated debentures	13,403	151	4.47%	13,403	116	3.43%
Total interest-bearing liabilities	1,305,133	4,364	1.33%	1,124,400	2,646	0.93%
Noninterest-bearing liabilities	317,423			280,181		
Shareholders' equity	164,100			145,294		
Total liabilities and shareholders' equity	\$ 1,786,656			\$ 1,549,875		
Net interest spread			3.28%			3.38%
Net interest income (tax equivalent) / margin		\$ 15,513	3.60%		\$ 13,380	3.60%
Less: tax-equivalent adjustment ⁽²⁾		12			71	
Net interest income		\$ 15,501			\$ 13,309	

(1) Annualized for the three month period.

(2) The tax-equivalent adjustment to net interest income adjusts the yield for assets earning tax-exempt income to a comparable yield on a taxable basis.

(3) Includes mortgage loans held for sale.

Our net interest margin, on a tax-equivalent basis, was 3.60% for both the three months ended September 30, 2018 and 2017.

While our net interest margin remained consistent from the prior year period, our average interest-earning assets grew by \$233.4 million during the third quarter of 2018 as compared to the same period in 2017, with the average yield on these assets increasing by 30 basis points to 4.61%. In addition, our average interest-bearing liabilities grew by \$180.7 million during the 2018 period while the rate on these liabilities increased 40 basis points to 1.33% for the three months ended September 30, 2018.

The increase in average interest-earning assets for the three months ended September 30, 2018, as compared to the same period in 2017, primarily related to a \$270.1 million increase in our average loan balances. In addition, the yield on our average loans increased 18 basis points during the third quarter of 2018 as compared to the same period of 2017, contributing to the increased yield in our average interest earning assets during the third quarter of 2018. The higher yield on our loan portfolio was due to loans being originated or renewed at market rates which are higher than those in the past.

In addition, the increase in our interest-bearing liabilities resulted primarily from a \$195.0 million increase in our interest-bearing deposits at an average rate of 1.24%, a 46 basis point increase from the average rate in the third quarter of 2017. This increased balance was partially offset by a \$14.3 million decrease in FHLB advances and other borrowings at an average rate of 3.13%, a 38 basis point decrease from the third quarter of 2017.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

Our net interest spread was 3.28% for the three months ended September 30, 2018 compared to 3.38% for the same period in 2017. The net interest spread is the difference between the yield we earn on our interest-earning assets and the rate we pay on our interest-bearing liabilities. The ten basis point decrease in our net interest spread was driven by the 40 basis point increase in the cost of our interest-bearing liabilities, partially offset by the 30 basis point increase in yield on our interest-earning assets for the 2018 period. We anticipate continued pressure on our net interest spread and net interest margin in future periods based on the possibility of additional Federal Reserve interest rate increases and a competitive rate environment.

Average Balances, Income and Expenses, Yields and Rates

	For the Nine Months Ended September 30,					
	2018			2017		
(dollars in thousands)	Average Balance	Income/ Expense	Yield/ Rate ⁽¹⁾	Average Balance	Income/ Expense	Yield/ Rate ⁽¹⁾
Interest-earning assets						
Federal funds sold	\$ 73,108	\$ 980	1.79%	\$ 65,026	\$ 548	1.13%
Investment securities, taxable	62,530	1,147	2.45%	55,545	850	2.05%
Investment securities, nontaxable ⁽²⁾	6,047	179	3.96%	19,984	577	3.86%
Loans ⁽³⁾	1,512,625	53,314	4.71%	1,265,408	43,089	4.55%
Total interest-earning assets	1,654,310	55,620	4.50%	1,405,963	45,064	4.29%
Noninterest-earning assets	76,091			68,852		
Total assets	\$ 1,730,401			\$ 1,474,815		
Interest-bearing liabilities						
NOW accounts	\$ 238,177	315	0.18%	\$ 220,066	304	0.18%
Savings & money market	651,306	6,000	1.23%	451,490	2,471	0.73%
Time deposits	324,443	3,876	1.60%	309,679	2,298	0.99%
Total interest-bearing deposits	1,213,926	10,191	1.12%	981,235	5,073	0.69%
FHLB advances and other borrowings	33,349	805	3.23%	82,810	2,172	3.51%
Junior subordinated debentures	13,403	427	4.26%	13,403	332	3.31%
Total interest-bearing liabilities	1,260,678	11,423	1.21%	1,077,448	7,577	0.94%
Noninterest-bearing liabilities	311,664			267,365		
Shareholders' equity	158,059			130,002		
Total liabilities and shareholders' equity	\$ 1,730,401			\$ 1,474,815		
Net interest spread			3.29%			3.35%
Net interest income (tax equivalent) / margin		\$ 44,197	3.57%		\$ 37,487	3.56%
Less: tax-equivalent adjustment ⁽²⁾		42			219	
Net interest income		\$ 44,155			\$ 37,268	

(1) Annualized for the nine month period.

(2) The tax-equivalent adjustment to net interest income adjusts the yield for assets earning tax-exempt income to a comparable yield on a taxable basis.

(3) Includes mortgage loans held for sale.

Our net interest margin, on a tax-equivalent basis, was 3.57% for the nine months ended September 30, 2018 compared to 3.56% for the first nine months of 2017. While our net interest margin increased only one basis point as compared to the same period in 2017, our average interest-earning assets grew by \$248.3 million during the same period, with the average yield on these assets increasing by 21 basis points. In addition, our average interest-bearing liabilities grew by \$183.2 million during the 2018 period while the rate on these liabilities increased 27 basis points for the nine months ended September 30, 2018.

The increase in our average interest-earning assets related primarily to a \$247.2 million increase in our average loan balances for the 2018 period with an increased yield of 16 basis points over the prior year period. The increase in our loan yield is due primarily to loans being originated or renewed at market rates which are higher than those in the past.

In addition, the increase in our average interest-bearing liabilities during the first nine months of 2018 was driven by a \$232.7 million increase in our average interest-bearing deposits at an average rate of 1.12%, a 43 basis point increase from the average rate for the first nine months of 2017, partially offset by a \$49.5 million decrease in FHLB advances and other borrowings at an average rate of 3.23%, or 28 basis points lower than the first nine months of 2017.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

Our net interest spread was 3.29% for the nine months ended September 30, 2018 compared to 3.35% for the same period in 2017. The six basis point decrease in our net interest spread for the 2018 period was driven by the 27 basis point increase in cost on our interest-bearing liabilities, partially offset by the 21 basis point increase in yield on our interest-earning assets. We anticipate continued pressure on our net interest spread and net interest margin in future periods based on the possibility of additional Federal Reserve interest rate increases and a competitive rate environment.

Rate/Volume Analysis

Net interest income can be analyzed in terms of the impact of changing interest rates and changing volume. The following tables set forth the effect which the varying levels of interest-earning assets and interest-bearing liabilities and the applicable rates have had on changes in net interest income for the periods presented.

(dollars in thousands)	September 30, 2018 vs. 2017				Three Months Ended September 30, 2017 vs. 2016			
	Increase (Decrease) Due to				Increase (Decrease) Due to			
	Volume	Rate	Volume	Total	Volume	Rate	Volume	Total
Interest income								
Loans	\$ 3,122	627	128	3,877	2,599	164	33	2,796
Investment securities	(60)	121	(17)	44	11	36	1	48
Federal funds sold	(84)	114	(41)	(11)	65	43	91	199
Total interest income	2,978	862	70	3,910	2,675	243	125	3,043
Interest expense								
Deposits	357	1,270	217	1,844	304	626	197	1,127
FHLB advances and other borrowings	(126)	(47)	13	(160)	(576)	96	(54)	(534)
Junior subordinated debt	-	34	-	34	-	21	-	21
Total interest expense	231	1,257	230	1,718	(272)	743	143	614
Net interest income	\$ 2,747	(395)	(160)	2,192	2,947	(500)	(18)	2,429

Net interest income, the largest component of our income, was \$15.5 million for the three months ended September 30, 2018 and \$13.3 million for the three months ended September 30, 2017, a \$2.2 million, or 16.5%, increase during the third quarter of 2018. The increase in net interest income is due to a \$3.9 million increase in interest income, partially offset by a \$1.7 million increase in interest expense. During the third quarter of 2018, the primary driver of the increase in net interest income was the \$270.1 million increase in our average loan balances as compared to the third quarter of 2017.

(dollars in thousands)	September 30, 2018 vs. 2017				Nine Months Ended September 30, 2017 vs. 2016			
	Increase (Decrease) Due to				Increase (Decrease) Due to			
	Volume	Rate	Volume	Total	Volume	Rate	Volume	Total
Interest income								
Loans	\$ 8,418	1,511	296	10,225	\$ 7,455	(538)	(108)	6,809
Investment securities	(111)	206	(19)	76	(149)	17	(2)	(134)
Federal funds sold	68	324	40	432	165	112	149	426
Total interest income	8,375	2,041	317	10,733	7,471	(409)	39	7,101
Interest expense								
Deposits	1,118	3,278	722	5,118	712	1,181	289	2,182
FHLB advances and other borrowings	(1,297)	(173)	103	(1,367)	(848)	210	(63)	(701)
Junior subordinated debt	-	95	-	95	-	52	-	52
Total interest expense	(179)	3,200	825	3,846	(136)	1,443	226	1,533
Net interest income	\$ 8,554	(1,159)	(508)	6,887	\$ 7,607	(1,852)	(187)	5,568

Net interest income for the nine months ended September 30, 2018 was \$44.2 million compared to \$37.3 million for the first nine months ended September 30, 2017, a \$6.9 million, or 18.5% increase during the first nine months of 2018 compared to the same period in 2017. The increase in net interest income is due to a \$10.7 million increase in interest income, offset in part by a \$3.8 million increase in interest expense. During the nine months ended September 30, 2018, the primary driver of the increase in net interest income was the \$247.2 million increase in average loan balances as compared to the nine months ended September 30, 2017.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

Provision for Loan Losses

We have established an allowance for loan losses through a provision for loan losses charged as an expense on our consolidated statements of income. We review our loan portfolio periodically to evaluate our outstanding loans and to measure both the performance of the portfolio and the adequacy of the allowance for loan losses. Please see the discussion included in Footnote 4 – Loans and Allowance for Loan Losses for a description of the factors we consider in determining the amount of the provision we expense each period to maintain this allowance.

For the three and nine months ended September 30, 2018, we incurred a noncash expense related to the provision for loan losses of \$400,000 and \$1.3 million, respectively, which resulted in an allowance for loan losses of \$16.1 million, or 1.00% of gross loans, at September 30, 2018. For the three and nine months ended September 30, 2017, our provision for loan losses of \$500,000 and \$1.5 million, respectively, resulted in an allowance for loan losses of \$15.6 million, or 1.17% of gross loans, at September 30, 2017. Factors such as past due loans, as well as nonperforming and classified loan balances are also considered in determining the amount of loan loss provision necessary to maintain our allowance for loan losses at an adequate level.

Noninterest Income

The following table sets forth information related to our noninterest income.

	Three months ended		Nine months ended	
	September 30,		September 30,	
(dollars in thousands)	2018	2017	2018	2017
Mortgage banking income	\$ 1,354	1,403	4,311	4,063
Service fees on deposit accounts	257	324	769	886
ATM and debit card income	381	284	1,085	818
Income from bank owned life insurance	221	224	662	590
Other income	320	307	898	799
Total noninterest income	\$ 2,533	2,542	7,725	7,156

Noninterest income decreased \$9,000 for the third quarter of 2018 as compared to the same period in 2017. The decrease in total noninterest income for the third quarter of 2018, as compared to the third quarter of 2017, resulted primarily from the following:

Mortgage banking income decreased \$49,000, or 3.5%, during the third quarter of 2018 primarily due to lower origination volume when compared to the same period in 2017.

Service fees on deposit accounts decreased \$67,000, or 20.7%, primarily due to lower volume of non-sufficient funds (“NSF”) fee income.

Partially offsetting these decreases in noninterest income in the third quarter of 2018 was a \$97,000 increase in ATM and debit card income which was driven by an increase in transaction volume.

Noninterest income increased \$569,000, or 8.0%, during the nine months ended September 30, 2018 as compared to the same period in 2017. The increase in total noninterest income during the nine months ended September 30, 2018, as compared to the same period in 2017, resulted primarily from the following:

Mortgage banking income increased \$248,000, or 6.1%, driven by higher origination volume during the nine months ended September 30, 2018.

ATM and debit card income increased \$267,000, or 32.6%, during the nine months ended September 30, 2018 primarily due to an increase in transaction volume.

Other income increased \$99,000, or 12.4%, primarily due to a \$50,000 loss recognized in the 2017 period related to our move from a leased space to our new building in Charleston, South Carolina, combined with \$36,000 of additional wire transfer fee income.

Partially offsetting these increases in noninterest income during the nine months ended September 30, 2018, was a \$117,000 decrease in service fees on deposit accounts driven by lower volume of NSF fee income.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

Noninterest expenses

The following table sets forth information related to our noninterest expenses.

(dollars in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Compensation and benefits	\$ 6,599	5,698	18,808	16,496
Occupancy	1,350	1,043	3,763	3,042
Outside service and data processing costs	841	794	2,400	2,362
Insurance	376	258	987	845
Professional fees	275	334	1,208	1,029
Marketing	215	199	652	605
Other	532	480	1,554	1,550
Total noninterest expense	\$ 10,188	8,806	29,372	25,929

Noninterest expense was \$10.2 million for the three months ended September 30, 2018, a \$1.4 million, or 15.7%, increase from noninterest expense of \$8.8 million for the three months ended September 30, 2017. The increase in total noninterest expense for the third quarter of 2018, as compared to the third quarter of 2017, resulted primarily from the following:

Compensation and benefits expense increased \$901,000, or 15.8%, relating primarily to increases in base compensation, incentive compensation and benefits expense. Base compensation increased by \$657,000 driven by the addition of 25 new employees – five of which were hired in conjunction with the opening of our new offices in the Triad region of North Carolina and Summerville, South Carolina; five of which were hired to support our Atlanta team; seven of which were hired in client services roles; and the remaining eight of which were hired to support loan and deposit growth as well as mortgage operations. Incentive compensation increased by \$84,000 and benefits expense increased by \$162,000 in the third quarter of 2018. The increase in incentive compensation and benefits expense related to the additional number of employees at September 30, 2018 compared to the 2017 period.

Occupancy expense increased by \$307,000, or 29.4%, driven primarily by a \$224,000 increase in rent expense related to our new offices in Atlanta, Georgia, the Triad region of North Carolina and Summerville, South Carolina combined with additional depreciation, maintenance and property expenses on the properties we own.

Insurance expense increased \$118,000, or 45.7%, relating primarily to an increase in FDIC insurance premiums. Noninterest expense was \$29.4 million for the nine months ended September 30, 2018, a \$3.4 million, or 13.3%, increase from noninterest expense of \$25.9 million for the nine months ended September 30, 2017. The increase in total noninterest expense for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, resulted primarily from the following:

Compensation and benefits expense increased \$2.3 million, or 14.0%, relating primarily to the addition of the 25 new employees discussed above. Compensation and benefits expense includes base and incentive compensation and benefits expense.

Occupancy expense increased by \$721,000, or 23.7%, driven primarily by a \$404,000 increase in rent expense combined with additional depreciation, maintenance and property expenses on the properties we own.

Professional fees increased by \$179,000, or 17.4%, due primarily to increased legal and accounting fees, and loan appraisal and loan attorney fees on our commercial and consumer loans.

Insurance expense increased \$142,000, or 16.8%, relating primarily to an increase in FDIC insurance premiums.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

Our efficiency ratio was 56.5% for the third quarter of 2018 as compared to 55.6% for the same period in 2017. The efficiency ratio represents the percentage of one dollar of expense required to be incurred to earn a full dollar of revenue and is computed by dividing noninterest expense by the sum of net interest income and noninterest income. The increase during the 2018 period relates primarily to the increase in noninterest expense, partially offset by the increase in interest income and noninterest income compared to the prior year.

We incurred income tax expense of \$1.7 million and \$2.3 million for the three months ended September 30, 2018 and 2017, respectively, and \$4.7 million and \$6.0 million for the nine months ended September 30, 2018 and 2017, respectively. Our effective tax rate was 22.3% and 35.1% for the three months ended September 30, 2018 and 2017, respectively, and 22.2% and 35.5% for the nine months ended September 2018 and 2017, respectively. The decrease in the effective tax rate during the 2018 periods is a result of The Tax Act which was passed in December 2017 and became effective January 1, 2018.

Balance Sheet Review

Investment Securities

At September 30, 2018, the \$71.8 million in our investment securities portfolio represented approximately 3.9% of our total assets. Our available for sale investment portfolio included U.S. government agency securities, SBA securities, state and political subdivisions, asset-backed securities and mortgage-backed securities with a fair value of \$66.9 million and an amortized cost of \$68.9 million resulting in an unrealized loss of \$2.1 million. At December 31, 2017, the \$72.1 million in our investment securities portfolio represented approximately 4.4% of our total assets. At December 31, 2017, we held investment securities available for sale with a fair value of \$67.6 million and an amortized cost of \$68.2 million for an unrealized loss of \$578,000.

Loans

Since loans typically provide higher interest yields than other types of interest earning assets, a substantial percentage of our earning assets are invested in our loan portfolio. Average loans for the nine months ended September 30, 2018 and 2017 were \$1.5 billion and \$1.3 billion, respectively. Before the allowance for loan losses, total loans outstanding at September 30, 2018 and December 31, 2017 were \$1.6 billion and \$1.4 billion, respectively.

The principal component of our loan portfolio is loans secured by real estate mortgages. As of September 30, 2018, our loan portfolio included \$1.4 billion, or 83.5%, of real estate loans. As of December 31, 2017, real estate loans made up 82.1% of our loan portfolio and totaled \$1.1 billion. Most of our real estate loans are secured by residential or commercial property. We obtain a security interest in real estate, in addition to any other available collateral. This collateral is taken to increase the likelihood of the ultimate repayment of the loan. Generally, we limit the loan-to-value ratio on loans to coincide with the appropriate regulatory guidelines. We attempt to maintain a relatively diversified loan portfolio to help reduce the risk inherent in concentration in certain types of collateral and business types. We do not generally originate traditional long term residential mortgages to hold in our loan portfolio, but we do issue traditional second mortgage residential real estate loans and home equity lines of credit. Home equity lines of credit totaled \$163.7 million as of September 30, 2018, of which approximately 45% were in a first lien position, while the remaining balance was second liens, compared to \$156.1 million as of December 31, 2017, with approximately 40% in first lien positions and the remaining balance in second liens. The average loan had a balance of approximately \$89,000 and a loan to value of 70% as of September 30, 2018, compared to an average loan balance of \$89,000 and a loan to value of approximately 71% as of December 31, 2017. Further, 0.2% and 0.8% of our total home equity lines of credit were over 30 days past due as of September 30, 2018 and December 31, 2017, respectively.

Following is a summary of our loan composition at September 30, 2018 and December 31, 2017. During the first nine months of 2018, our loan portfolio increased by \$233.1 million, or 16.8%. Our commercial and consumer loan portfolios each experienced growth during the nine months ended September 30, 2018 with a 19.5% increase in commercial loans and a 11.7% increase in consumer loans during the period. Of the \$233.1 million in loan growth during the first nine months of 2018, \$214.3 million of the increase was in loans secured by real estate, \$18.2 million in commercial business loans and \$637,000 in other consumer loan balances. Our consumer real estate portfolio includes high quality 1-4 family consumer real estate loans. Our average consumer real estate loan currently has a principal balance of \$381,000, a term of ten years, and an average rate of 4.40% as of September 30, 2018, compared to a principal balance of \$375,000 a term of ten years, and an average rate of 4.30% as of December 31, 2017.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

(dollars in thousands)	September 30, 2018		December 31, 2017	
	Amount	% of Total	Amount	% of Total
Commercial				
Owner occupied RE	\$ 372,120	23.0%	\$ 316,818	22.8%
Non-owner occupied RE	399,166	24.6%	312,798	22.6%
Construction	68,415	4.2%	51,179	3.7%
Business	244,348	15.1%	226,158	16.3%
Total commercial loans	1,084,049	66.9%	906,953	65.4%
Consumer				
Real estate	311,271	19.2%	273,050	19.7%
Home equity	163,654	10.1%	156,141	11.3%
Construction	38,015	2.4%	28,351	2.0%
Other	23,212	1.4%	22,575	1.6%
Total consumer loans	536,152	33.1%	480,117	34.6%
Total gross loans, net of deferred fees	1,620,201	100.0%	1,387,070	100.0%
Less—allowance for loan losses	(16,140)		(15,523)	
Total loans, net	\$ 1,604,061		\$ 1,371,547	

Nonperforming assets

Nonperforming assets include real estate acquired through foreclosure or deed taken in lieu of foreclosure and loans on nonaccrual status. Generally, a loan is placed on nonaccrual status when it becomes 90 days past due as to principal or interest, or when we believe, after considering economic and business conditions and collection efforts, that the borrower's financial condition is such that collection of the contractual principal or interest on the loan is doubtful. A payment of interest on a loan that is classified as nonaccrual is recognized as a reduction in principal when received. Our policy with respect to nonperforming loans requires the borrower to make a minimum of six consecutive payments in accordance with the loan terms and to show capacity to continue performing into the future before that loan can be placed back on accrual status. As of September 30, 2018 and December 31, 2017, we had no loans 90 days past due and still accruing.

Following is a summary of our nonperforming assets, including nonaccruing TDRs.

(dollars in thousands)	September 30, 2018	December 31, 2017
Commercial	\$ 1,769	2,491
Consumer	2,003	2,137
Nonaccruing troubled debt restructurings	2,194	2,673
Total nonaccrual loans	5,966	7,301
Other real estate owned	117	242
Total nonperforming assets	\$ 6,083	7,543

At September 30, 2018, nonperforming assets were \$6.1 million, or 0.33% of total assets and 0.38% of gross loans. Comparatively, nonperforming assets were \$7.5 million, or 0.46% of total assets and 0.54% of gross loans at December 31, 2017. Nonaccrual loans were \$6.0 million at September 30, 2018, a \$1.3 million decrease from December 31, 2017. During the first nine months of 2018, ten loans were put on nonaccrual status while eight nonaccrual loans were either paid or charged-off and five loans were returned to accrual status. The amount of foregone interest income on the nonaccrual loans in the first nine months of 2018 and 2017 was approximately \$201,000 and \$251,000, respectively.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

Nonperforming assets include other real estate owned which was comprised of two commercial properties totaling \$117,000 at September 30, 2018, a \$125,000 decrease from December 31, 2017. Both of these properties are located in the Upstate of South Carolina. We believe that these properties are appropriately valued at the lower of cost or market as of September 30, 2018.

At September 30, 2018 and December 31, 2017, the allowance for loan losses represented 270.5% and 212.6% of the total amount of nonperforming loans, respectively. A significant portion, or 84%, of nonperforming loans at September 30, 2018 was secured by real estate. Our nonperforming loans have been written down to approximately 54% of their original nonperforming balance. We have evaluated the underlying collateral on these loans and believe that the collateral on these loans is sufficient to minimize future losses. Based on the level of coverage on nonperforming loans and analysis of our loan portfolio, we believe the allowance for loan losses of \$16.1 million as of September 30, 2018 to be adequate.

As a general practice, most of our loans are originated with relatively short maturities of less than 10 years. As a result, when a loan reaches its maturity we frequently renew the loan and thus extend its maturity using the same credit standards as those used when the loan was first originated. Due to these loan practices, we may, at times, renew loans which are classified as nonperforming after evaluating the loan's collateral value and financial strength of its guarantors. Nonperforming loans are renewed at terms generally consistent with the ultimate source of repayment and rarely at reduced rates. In these cases, we will seek additional credit enhancements, such as additional collateral or additional guarantees to further protect the loan. When a loan is no longer performing in accordance with its stated terms, we will typically seek performance under the guarantee.

In addition, at September 30, 2018, 83% of our loans are collateralized by real estate and 80% of our impaired loans are secured by real estate. We utilize third party appraisers to determine the fair value of collateral dependent loans. Our current loan and appraisal policies require us to obtain updated appraisals on an annual basis, either through a new external appraisal or an appraisal evaluation. Impaired loans are individually reviewed on a quarterly basis to determine the level of impairment. As of September 30, 2018, we do not have any impaired real estate loans carried at a value in excess of the appraised value. We typically charge-off a portion or create a specific reserve for impaired loans when we do not expect repayment to occur as agreed upon under the original terms of the loan agreement.

At September 30, 2018, impaired loans totaled \$12.7 million for which \$7.1 million of these loans have a reserve of approximately \$2.9 million allocated in the allowance. During the first nine months of 2018, the average recorded investment in impaired loans was approximately \$13.2 million. Comparatively, impaired loans totaled \$12.4 million at December 31, 2017, of which \$8.0 million had a reserve of approximately \$3.7 million allocated in the allowance. During 2017, the average recorded investment in impaired loans was approximately \$13.0 million.

We consider a loan to be a TDR when the debtor experiences financial difficulties and we provide concessions such that we will not collect all principal and interest in accordance with the original terms of the loan agreement. Concessions can relate to the contractual interest rate, maturity date, or payment structure of the note. As part of our workout plan for individual loan relationships, we may restructure loan terms to assist borrowers facing challenges in the current economic environment. As of September 30, 2018, we determined that we had loans totaling \$8.9 million that we considered TDRs. As of December 31, 2017, we had loans totaling \$7.8 million that we considered TDRs.

Allowance for Loan Losses

The allowance for loan losses was \$16.1 million and \$15.6 million at September 30, 2018 and 2017, respectively, or 1.00% of outstanding loans at September 30, 2018 and 1.17% of outstanding loans at September 30, 2017. During the nine months ended September 30, 2018, we charged-off \$1.2 million of loans and recorded \$476,000 of recoveries on loans previously charged-off, for net charge-offs of \$683,000, or 0.06% of average loans, annualized. Comparatively, we charged-off \$962,000 of loans and recorded \$186,000 of recoveries on loans previously charged-off, resulting in net charge-offs of \$776,000, or 0.08% of average loans, annualized, for the first nine months of 2017.

At December 31, 2017, our allowance for loan losses was \$15.5 million, or 1.12% of outstanding loans, and we had net loans charged-off of \$1.3 million for the year ended December 31, 2017.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

Following is a summary of the activity in the allowance for loan losses.

	Nine months ended September 30,		Year ended December 31,
	2018	2017	2017
(dollars in thousands)			
Balance, beginning of period	\$ 15,523	14,855	14,855
Provision	1,300	1,500	2,000
Loan charge-offs	(1,159)	(962)	(1,638)
Loan recoveries	476	186	306
Net loan charge-offs	(683)	(776)	(1,332)
Balance, end of period	\$ 16,140	15,579	15,523

Deposits and Other Interest-Bearing Liabilities

Our primary source of funds for loans and investments is our deposits and advances from the FHLB. In the past, we have chosen to obtain a portion of our certificates of deposits from areas outside of our market in order to obtain longer term deposits than are readily available in our local market. Our internal guidelines regarding the use of brokered CDs limit our brokered CDs to 20% of total deposits. In addition, we do not obtain time deposits of \$100,000 or more through the Internet. These guidelines allow us to take advantage of the attractive terms that wholesale funding can offer while mitigating the related inherent risk.

Our retail deposits represented \$1.5 billion, or 95.6% of total deposits at September 30, 2018, while our out-of-market, or brokered, deposits represented \$70.6 million, or 4.4% of our total deposits at September 30, 2018. At December 31, 2017, retail deposits represented \$1.4 billion, or 98.0% of our total deposits, and brokered CDs were \$28.1 million, representing 2.0% of our total deposits. Our loan-to-deposit ratio was 101.9% at September 30, 2018 and 100.4% at December 31, 2017.

The following is a detail of our deposit accounts:

	September 30, 2018	December 31, 2017
(dollars in thousands)		
Non-interest bearing	\$ 300,331	295,680
Interest bearing:		
NOW accounts	237,860	229,945
Money market accounts	680,824	545,029
Savings	16,041	16,298
Time, less than \$100,000	62,744	55,461
Time and out-of-market deposits, \$100,000 and over	291,683	238,710
Total deposits	\$ 1,589,483	1,381,123

During the past 12 months, we continued our focus on increasing core deposits, which exclude out-of-market deposits and time deposits of \$250,000 or more, in order to provide a relatively stable funding source for our loan portfolio and other earning assets. Our core deposits were \$1.4 billion and \$1.2 billion at September 30, 2018, and December 31, 2017, respectively.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

The following table shows the average balance amounts and the average rates paid on deposits.

(dollars in thousands)	2018		Nine months ended September 30, 2017	
	Amount	Rate	Amount	Rate
Noninterest bearing demand deposits	\$ 296,737	-%	256,731	-%
Interest bearing demand deposits	238,177	0.18%	220,066	0.18%
Money market accounts	635,269	1.26%	435,939	0.76%
Savings accounts	16,037	0.05%	15,551	0.05%
Time deposits less than \$100,000	59,087	1.35%	50,345	0.81%
Time deposits greater than \$100,000	265,356	1.65%	259,258	1.03%
Total deposits	\$ 1,510,663	0.90%	1,237,890	0.55%

During the nine months ended September 30, 2018, our average transaction account balances increased by \$257.9 million, or 27.8%, from the nine months ended September 30, 2017, while our average time deposit balances increased by \$14.8 million during the same nine month period.

All of our time deposits are certificates of deposits. The maturity distribution of our time deposits of \$100,000 or more at September 30, 2018 was as follows:

(dollars in thousands)	September 30, 2018
Three months or less	\$ 39,563
Over three through six months	55,643
Over six through twelve months	69,629
Over twelve months	126,848
Total	\$ 291,683

Included in time deposits of \$100,000 or more at September 30, 2018 is \$40.1 million of wholesale CDs scheduled to mature within the next 12 months at a weighted average rate of 2.04%. Time deposits that meet or exceed the FDIC insurance limit of \$250,000 at September 30, 2018 and December 31, 2017 were \$198.9 million and \$131.7 million, respectively.

Liquidity and Capital Resources

Liquidity represents the ability of a company to convert assets into cash or cash equivalents without significant loss, and the ability to raise additional funds by increasing liabilities. Liquidity management involves monitoring our sources and uses of funds in order to meet our day-to-day cash flow requirements while maximizing profits. Liquidity management is made more complicated because different balance sheet components are subject to varying degrees of management control. For example, the timing of maturities of our investment portfolio is fairly predictable and subject to a high degree of control at the time investment decisions are made. However, net deposit inflows and outflows are far less predictable and are not subject to the same degree of control.

At September 30, 2018 and December 31, 2017, our liquid assets, consisting of cash and due from banks and federal funds sold, amounted to \$90.0 million and \$92.2 million, or 4.8% and 5.7% of total assets, respectively. Our investment securities at September 30, 2018 and December 31, 2017 amounted to \$71.8 million and \$72.1 million, or 3.9% and 4.4% of total assets, respectively.

Our ability to maintain and expand our deposit base and borrowing capabilities serves as our primary source of liquidity. We plan to meet our future cash needs through the liquidation of temporary investments, the generation of deposits, loan payoffs, and from additional borrowings. In addition, we will receive cash upon the maturity and sale of loans and the maturity of investment securities. We maintain four federal funds purchased lines of credit with correspondent banks totaling \$72.0 million for which there were no borrowings against the lines of credit at September 30, 2018.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

We are also a member of the FHLB, from which applications for borrowings can be made. The FHLB requires that securities, qualifying mortgage loans, and stock of the FHLB owned by the Bank be pledged to secure any advances from the FHLB. The unused borrowing capacity currently available from the FHLB at September 30, 2018 was \$255.3 million, based on the Bank's \$4.4 million investment in FHLB stock, as well as qualifying mortgages available to secure any future borrowings. However, we are able to pledge additional securities to the FHLB in order to increase our available borrowing capacity. In addition, at September 30, 2018 and December 31, 2017, we had \$212.7 million and \$165.1 million, respectively, of letters of credit outstanding with the FHLB to secure client deposits.

We also have a line of credit with another financial institution for \$15.0 million, which was unused at September 30, 2018. The line of credit bears interest at LIBOR plus 2.50% and matures on June 30, 2020.

We believe that our existing stable base of core deposits, borrowings from the FHLB, and short-term repurchase agreements will enable us to successfully meet our long-term liquidity needs. However, as short-term liquidity needs arise, we have the ability to sell a portion of our investment securities portfolio to meet those needs.

Total shareholders' equity was \$166.9 million at September 30, 2018 and \$149.7 million at December 31, 2017. The \$17.3 million increase from December 31, 2017 is primarily related to net income of \$16.5 million during the first nine months of 2018, \$810,000 from the exercise of stock options, and \$1.1 million of equity compensation expense, partially offset by a \$1.2 million decrease in accumulated other comprehensive income.

The following table shows the return on average assets (net income divided by average total assets), return on average equity (net income divided by average equity), equity to assets ratio (average equity divided by average assets), and tangible common equity ratio (total equity less preferred stock divided by total assets) annualized for the nine months ended September 30, 2018 and the year ended December 31, 2017. Since our inception, we have not paid cash dividends.

	September 30, 2018	December 31, 2017
Return on average assets	1.28%	0.87%
Return on average equity	13.96%	9.66%
Return on average common equity	13.96%	9.66%
Average equity to average assets ratio	9.13%	8.98%
Tangible common equity to assets ratio	8.99%	9.21%

Under the capital adequacy guidelines, regulatory capital is classified into two tiers. These guidelines require an institution to maintain a certain level of Tier 1 and Tier 2 capital to risk-weighted assets. Tier 1 capital consists of common shareholders' equity, excluding the unrealized gain or loss on securities available for sale, minus certain intangible assets. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight factor of 0% to 100% based on the risks believed to be inherent in the type of asset. Tier 2 capital consists of Tier 1 capital plus the general reserve for loan losses, subject to certain limitations. We are also required to maintain capital at a minimum level based on total average assets, which is known as the Tier 1 leverage ratio.

At both the Company and Bank level, we are subject to various regulatory capital requirements administered by the federal banking agencies. The capital rules require banks and bank holding companies to maintain a minimum total risk-based capital ratio of at least 8%, a total Tier 1 capital ratio of at least 6%, a minimum common equity Tier 1 capital ratio of at least 4.5%, and a leverage ratio of at least 4%. Bank holding companies and banks are also required to hold a capital conservation buffer of common equity Tier 1 capital of 2.5% to avoid limitations on capital distributions and discretionary executive compensation payments. The capital conservation buffer will be phased in incrementally over time, becoming fully effective on January 1, 2019, and will consist of an additional amount of common equity equal to 2.5% of risk-weighted assets.

To be considered "well-capitalized" for purposes of certain rules and prompt corrective action requirements, the Bank must maintain a minimum total risk-based capital ratio of at least 10%, a total Tier 1 capital ratio of at least 8%, a common equity Tier 1 capital ratio of at least 6.5%, and a leverage ratio of at least 5%. As of September 30, 2018, our capital ratios exceed these ratios and we remain "well capitalized."

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

The following table summarizes the capital amounts and ratios of the Bank and the regulatory minimum requirements.

(dollars in thousands)	Actual		For capital adequacy purposes minimum		September 30, 2018 To be well capitalized under prompt corrective action provisions minimum	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to risk weighted assets)	\$ 192,621	12.18%	\$ 126,554	8.00%	\$ 158,192	10.00%
Tier 1 Capital (to risk weighted assets)	176,481	11.16%	94,915	6.00%	126,554	8.00%
Common Equity Tier 1 Capital (to risk weighted assets)	176,481	11.16%	71,186	4.50%	102,825	6.50%
Tier 1 Capital (to average assets)	176,481	9.87%	71,557	4.00%	89,446	5.00%

(dollars in thousands)	Actual		For capital adequacy purposes minimum		December 31, 2017 To be well capitalized under prompt corrective action provisions minimum	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to risk weighted assets)	\$ 175,016	12.99%	\$ 107,749	8.00%	\$ 134,686	10.00%
Tier 1 Capital (to risk weighted assets)	159,493	11.84%	80,812	6.00%	107,749	8.00%
Common Equity Tier 1 Capital (to risk weighted assets)	159,493	11.84%	60,609	4.50%	87,546	6.50%
Tier 1 Capital (to average assets)	159,493	10.04%	63,573	4.00%	79,466	5.00%

The following table summarizes the capital amounts and ratios of the Company and the minimum regulatory requirements.

(dollars in thousands)	Actual		For capital adequacy purposes minimum		September 30, 2018 To be well capitalized under prompt corrective action provisions minimum	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to risk weighted assets)	\$ 197,706	12.50%	\$ 126,554	8.00%	N/A	N/A
Tier 1 Capital (to risk weighted assets)	181,566	11.48%	94,915	6.00%	N/A	N/A
Common Equity Tier 1 Capital (to risk weighted assets)	168,566	10.66%	71,186	4.50%	N/A	N/A
Tier 1 Capital (to average assets)	181,566	10.15%	71,557	4.00%	N/A	N/A

(dollars in thousands)	Actual		For capital adequacy purposes minimum		December 31, 2017 To be well capitalized under prompt corrective action provisions minimum	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to risk weighted assets)	\$ 178,665	13.27%	\$ 107,749	8.00%	N/A	N/A
Tier 1 Capital (to risk weighted assets)	163,142	12.11%	80,812	6.00%	N/A	N/A
Common Equity Tier 1 Capital (to risk weighted assets)	150,142	11.15%	60,609	4.50%	N/A	N/A
Tier 1 Capital (to average assets)	163,142	10.26%	63,573	4.00%	N/A	N/A

The ability of the Company to pay cash dividends is dependent upon receiving cash in the form of dividends from the Bank. The dividends that may be paid by the Bank to the Company are subject to legal limitations and regulatory capital requirements.

Effect of Inflation and Changing Prices

The effect of relative purchasing power over time due to inflation has not been taken into account in our consolidated financial statements. Rather, our financial statements have been prepared on an historical cost basis in accordance with generally accepted accounting principles.

Unlike most industrial companies, our assets and liabilities are primarily monetary in nature. Therefore, the effect of changes in interest rates will have a more significant impact on our performance than will the effect of changing prices and inflation in general. In addition, interest rates may generally increase as the rate of inflation increases, although not necessarily in the same magnitude. As discussed previously, we seek to manage the relationships between interest sensitive assets and liabilities in order to protect against wide rate fluctuations, including those resulting from inflation.

Off-Balance Sheet Risk

Commitments to extend credit are agreements to lend money to a client as long as the client has not violated any material condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of a fee. At September 30, 2018, unfunded commitments to extend credit were \$390.5 million, of which \$135.1 million was at fixed rates and \$255.4 million was at variable rates. At December 31, 2017, unfunded commitments to extend credit were \$310.6 million, of which approximately \$85.2 million was at fixed rates and \$225.4 million was at variable rates. A significant portion of the unfunded commitments related to consumer equity lines of credit. Based on historical experience, we anticipate that a significant portion of these lines of credit will not be funded. We evaluate each client's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by us upon extension of credit, is based on our credit evaluation of the borrower. The type of collateral varies but may include accounts receivable, inventory, property, plant and equipment, and commercial and residential real estate.

At September 30, 2018 and December 31, 2017, there were commitments under letters of credit for \$9.4 million and \$6.3 million, respectively. The credit risk and collateral involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Since most of the letters of credit are expected to expire without being drawn upon, they do not necessarily represent future cash requirements.

A portion of our business is to originate mortgage loans that will be sold in the secondary market to investors. Loan types that we originate include conventional loans, jumbo loans and other governmental agency loan products. We adhere to the legal lending limits and guidelines as set forth by the various governmental agencies and investors to whom we sell loans. Under a "best efforts" selling procedure, we make our best effort to process, fund, and deliver the loan to a particular investor. If the loan fails to fund, there is no immediate cost to us, as the market risk has been transferred to the investor. In the event of a customer loan default, we may be required to reimburse the investor.

Except as disclosed in this report, we are not involved in off-balance sheet contractual relationships, unconsolidated related entities that have off-balance sheet arrangements or transactions that could result in liquidity needs or other commitments that significantly impact earnings.

Market Risk and Interest Rate Sensitivity

Market risk is the risk of loss from adverse changes in market prices and rates, which principally arises from interest rate risk inherent in our lending, investing, deposit gathering, and borrowing activities. Other types of market risks, such as foreign currency exchange rate risk and commodity price risk, do not generally arise in the normal course of our business.

Edgar Filing: SOUTHERN FIRST BANCSHARES INC - Form 10-Q

We actively monitor and manage our interest rate risk exposure in order to control the mix and maturities of our assets and liabilities utilizing a process we call asset/liability management. The essential purposes of asset/liability management are to ensure adequate liquidity and to maintain an appropriate balance between interest sensitive assets and liabilities in order to minimize potentially adverse impacts on earnings from changes in market interest rates. Our asset/liability management committee ("ALCO") monitors and considers methods of managing exposure to interest rate risk. We have both an internal ALCO consisting of senior management that meets at various times during each month and a board ALCO that meets monthly. The ALCOs are responsible for maintaining the level of interest rate sensitivity of our interest sensitive assets and liabilities within board-approved limits.

As of September 30, 2018, the following table summarizes the forecasted impact on net interest income using a base case scenario given upward and downward movements in interest rates of 100, 200, and 300 basis points based on forecasted assumptions of prepayment speeds, nominal interest rates and loan and deposit repricing rates. Estimates are based on current economic conditions, historical interest rate cycles and other factors deemed to be relevant. However, underlying assumptions may be impacted in future periods which were not known to management at the time of the issuance of the Consolidated Financial Statements. Therefore, management's assumptions may or may not prove valid. No assurance can be given that changing economic conditions and other relevant factors impacting our net interest income will not cause actual occurrences to differ from underlying assumptions. In addition, this analysis does not consider any strategic changes to our balance sheet which management may consider as a result of changes in market conditions.

Interest rate scenario	Change in net interest income from base
Up 300 basis points	(2.83)%
Up 200 basis points	(1.09)%
Up 100 basis points	(0.04)%
Base	-
Down 100 basis points	(3.57)%
Down 200 basis points	(6.02)%
Down 300 basis points	(5.85)%

Critical Accounting Policies

We have adopted various accounting policies that govern the application of accounting principles generally accepted in the United States and with general practices within the banking industry in the preparation of our financial statements. Our significant accounting policies are described in the footnotes to our audited consolidated financial statements as of December 31, 2017, as filed in our Annual Report on Form 10-K.

Certain accounting policies involve significant judgments and assumptions by us that have a material impact on the carrying value of certain assets and liabilities. We consider these accounting policies to be critical accounting policies. The judgment and assumptions we use are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Our Critical Accounting Policies are the allowance for loan losses, fair value of financial instruments, other-than-temporary impairment analysis, other real estate owned, and income taxes. Because of the nature of the judgment and assumptions we make, actual results could differ from these judgments and estimates that could have a material impact on the carrying values of our assets and liabilities and our results of operations.

Accounting, Reporting, and Regulatory Matters

See Note 1 – Nature of Business and Basis of Presentation in the accompanying condensed notes to consolidated financial statements included elsewhere in this report for details of recently issued accounting pronouncements and their expected impact on our consolidated financial statements.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on the consolidated financial statements upon adoption.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

See Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations – Market Risk and Interest Rate Sensitivity.

Item 4. CONTROLS AND PROCEDURES.

Evaluation of Disclosure Controls and Procedures

Management, including our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed in the reports we file and submit under the Exchange Act is (i) recorded, processed, summarized and reported as and when required and (ii) accumulated and communicated to our management, including our Chief Executive Officer and the Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There has been no change in the Company's internal control over financial reporting during the three months ended September 30, 2018, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS.

We are a party to claims and lawsuits arising in the course of normal business activities. Management is not aware of any material pending legal proceedings against the Company which, if determined adversely, would have a material adverse impact on our financial position, results of operations or cash flows.

Item 1A RISK FACTORS.

Investing in shares of our common stock involves certain risks, including those identified and described in Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2017, as well as cautionary statements contained in this Form 10-Q, including those under the caption "Cautionary Warning Regarding Forward-Looking Statements" set forth in Part 1, Item 2 of this Form 10-Q, risks and matters described elsewhere in this Form 10-Q, and in our other filings with the SEC.

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

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

None.

Item 3. DEFAULTS UPON SENIOR SECURITIES.

None.

Item 4. MINE SAFETY DISCLOSURES.

Not applicable.

Item 5. OTHER INFORMATION.

None.

Item 6. EXHIBITS.

The exhibits required to be filed as part of this Quarterly Report on Form 10-Q are listed in the Index to Exhibits attached hereto and are incorporated herein by reference.

SIGNATURES

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

SOUTHERN FIRST BANCSHARES, INC.
Registrant

Date: November 1, 2018 /s/R. Arthur Seaver, Jr.
R. Arthur Seaver, Jr.
Chief Executive Officer (Principal Executive
Officer)

Date: November 1, 2018 /s/Michael D. Dowling
Michael D. Dowling
Chief Financial Officer (Principal Financial and
Accounting Officer)

INDEX TO EXHIBITS

Exhibit Number	Description
<u>31.1</u>	<u>Rule 13a-14(a) Certification of the Principal Executive Officer.</u>
<u>31.2</u>	<u>Rule 13a-14(a) Certification of the Principal Financial Officer.</u>
<u>32</u>	<u>Section 1350 Certifications.</u>

The following materials from the Quarterly Report on Form 10-Q of Southern First Bancshares, Inc. for the quarter ended September 30, 2018, formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Comprehensive Income, (iv) Consolidated Statement of Changes in Shareholders' Equity, (v) Consolidated Statements of Cash Flows and (vi) Notes to Unaudited Consolidated Financial Statements.

101
47
