

Annual Report

2015



In town. In touch.



Evolution? **Revolution.**

In just a little more than a decade, 1st State Bank has evolved from a dream to a prominent player in the Great Lakes Bay business community. In part, this success has been achieved by promoting our self as the bank that's "In town. In touch." through a variety of marketing executions such as print advertising, direct mail and occasional support from radio and outdoor billboards.

The media marketplace has made dramatic shifts. Local news sites, newspapers and direct mail campaigns have become virtually non-existent or too costly. 1st State Bank has reached a new point in our evolution, and in the evolution of the marketplace. It is time for our advertising to evolve as well. For 1st State Bank it's not only evolutionary, but somewhat revolutionary.

During 2015, 1st State Bank began using online network advertising. This allows us to place ads on many online sites based on the demographic profile of our audience: business owners, professionals and managers. Our newly designed landing pages provide viewers who click through an online ad the ability to learn more about 1st State Bank and view live-action video messages.



We've also gone Social! Staying better connected with customers and spreading information through various individual networks will accelerate our message. Social media is friendly, focused on friends, acquaintances, and friends of friends. It provides the opportunity to develop stronger relationships and give our customers an easy, efficient way to tell us what is happening with their businesses. Social media is the fastest growing means of referring business.

Visit our new microsite at InTownInTouch.com

Follow and connect with 1st State Bank on Facebook, LinkedIn, and Twitter.





To Our Shareholders,

Although the banking world experienced significant change in 2015, it was a stable year for 1st State Bank. Our focus was to improve earnings incrementally across many areas of the Bank. This was accomplished through increased Interest Income due to solid loan growth. Interest Expense decreased as we replaced more expensive borrowings with customer deposits. Greater mortgage origination and growth in new accounts led to an increase in Other Income. We also held Operating Expenses under budget. All these items allowed the Bank to improve earnings by 14.6% year-over-year. One of 2015's highlights was redeeming the remaining \$1 million of preferred shares owned by the Department of Treasury's Small Business Lending Fund.

Our 2016 plan projects a continued increase in earnings through incremental improvements across all areas of the Bank. We will maintain the pursuit of increased market share in Bay County and the Public Funds markets. We made service enhancements to continue increasing our Business Charge Card portfolio. The mortgage business has grown to the point where we are looking for another mortgage loan officer. We will be adding that position sometime in the second quarter of 2016.

The banking environment is ever changing. Bank mergers move decision making further from our region. Branch closings disrupt customers' banking relationships, and branch office conversions to new owners change the accounts and services customers have become accustomed to. I expect that this type of activity will continue in our region.

We will soon celebrate our 12th year in business. While that doesn't seem long for a bank, we are becoming the sign of stability compared to the rest of the industry. We have been profitable for the last eight years. We founded the RUBY Award celebrating recipients for 11 years and have been in Bay City for 10 years. I am proud that we have created a solid, dependable bank that you can trust will be here for you and our community for years to come.

Stock transactions in 2015 totaled 37,119 shares in 11 trades. The average price of traded shares was \$10.66, up from \$10.06 in 2014, a 6% increase. Book value at year end 2015 was \$12.23, compared to \$11.48 at year end 2014. Our third party stock evaluation for 2015 is \$11.50 versus \$11.00 in 2014. The latest trade was for \$11.00.

1st State Bank will continue to be In Town. In Touch.

Sincerely,

A handwritten signature in black ink that reads "Rick Goedert". The signature is written in a cursive, flowing style.

Rick Goedert
President and CEO

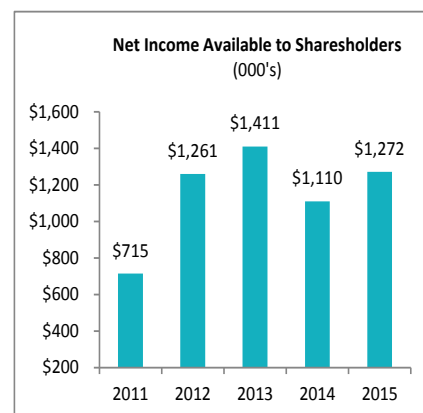
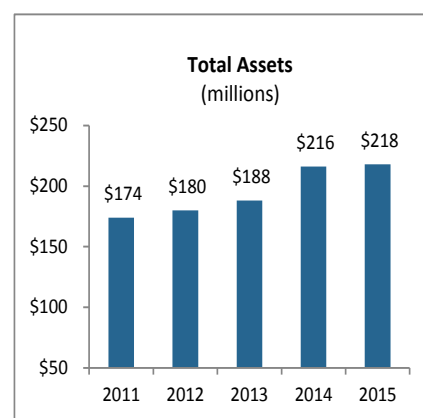
2015 FINANCIAL REPORT

Earnings for Valley Financial Group and 1st State Bank improved to \$1,272,000 in 2015, eclipsing 2014's results of \$1,110,000 by 14.6% or \$162,000. Growth in the loan portfolio and increased mortgage origination income were the primary contributors to the rise in earnings. 2015's net interest income increased by \$438,000, or 6.4% over 2014, provided primarily by a \$13.7 million increase in the Company's loan portfolio. In addition, gains from mortgage loans originated for sale were \$407,000 in 2015 versus \$297,000 in 2014. The Company's return on average assets ratio was .60% in 2015 versus .57% in 2014.

While the Company's balance sheet increased year-end 2015 over year-end 2014 by a modest 1.2%, changes in the mix of the balance sheet assisted the growth in net interest income. As mentioned above, the Company experienced solid loan growth of 9.5% in 2015. Loan growth was essentially funded by a comparable decrease in lower yielding interest bearing balances in banks and investments. Total deposits increased only \$1.2 million from year-end 2014 to 2015 as growth in non-interest bearing deposits of \$16.7 million were offset by a \$15.5 million decline in interest bearing deposits. In September of 2015, the Company redeemed its remaining \$1 million of preferred stock, marking the end of participation in the Small Business Lending Fund program. Please review the Consolidated Selected Financial Data for additional information regarding Valley's financial performance.

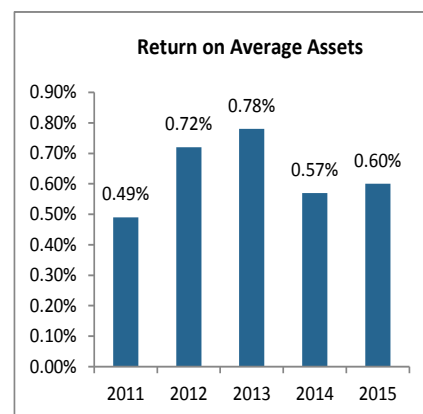
CONSOLIDATED BALANCE SHEETS

	<u>12/31/2015</u>	<u>12/31/2014</u>
Assets		
Cash and cash equivalents	\$ 33,211,870	\$ 42,513,217
Investments	16,616,109	18,573,386
Loans, net of reserve for loan losses	157,313,674	143,640,032
Premises and equipment, net	7,265,664	7,453,997
Repossessed assets	2,007,691	1,770,646
Other assets	1,962,381	1,896,563
Total Assets	<u>\$218,377,389</u>	<u>\$215,847,841</u>
Liabilities and Shareholders' Equity		
Interest bearing deposits	\$ 115,035,533	\$ 130,484,084
Non-interest bearing deposits	72,360,024	55,695,780
Borrowed funds	9,500,000	9,341,788
Other liabilities	2,006,272	1,121,495
Total Liabilities	<u>198,901,829</u>	<u>196,643,147</u>
Total Shareholders' Equity	<u>19,475,560</u>	<u>19,204,694</u>
Total Liabilities and Shareholders' Equity	<u>\$218,377,389</u>	<u>\$215,847,841</u>



CONSOLIDATED STATEMENTS OF INCOME

	Year ended December 31	
	<u>2015</u>	<u>2014</u>
Interest Income	\$8,044,274	\$7,959,219
Interest Expense	726,874	1,079,440
Net Interest Income	7,317,400	6,879,779
Provision for loan losses	330,000	310,000
Net Interest Income After Provision for Loan Losses	6,987,400	6,569,779
Other Income	1,001,532	794,081
Other Expense	6,039,585	5,637,608
Income Before Federal Income Tax	1,949,347	1,726,252
Federal Income tax expense	669,700	596,800
Net Income	<u>\$1,279,647</u>	<u>\$1,129,452</u>
Preferred stock dividends	7,222	18,972
Net Income Available to Common Shareholders	<u>\$1,272,425</u>	<u>\$1,110,480</u>



SELECTED FINANCIAL DATA

This unaudited table sets forth selected historical consolidated financial information derived from our audited consolidated financial statements for the five years ended December 31, 2015.

Dollars in thousands, except per share data

	<u>2015</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>
Net Income	\$1,280	\$1,129	\$1,431	\$1,281	\$825
Net Income Available to Common Shareholders	1,272	1,110	1,411	1,261	715

Balance Sheet Data (December 31)

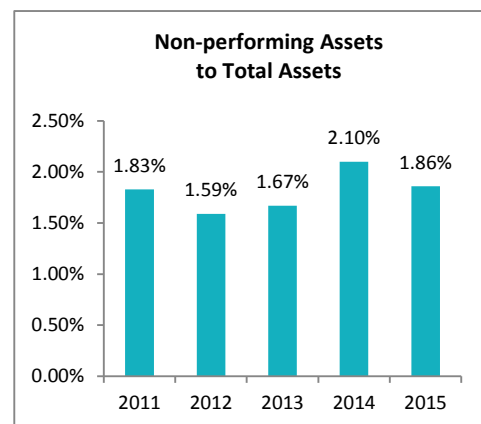
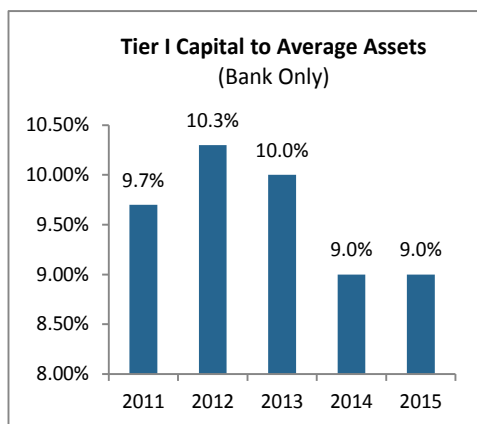
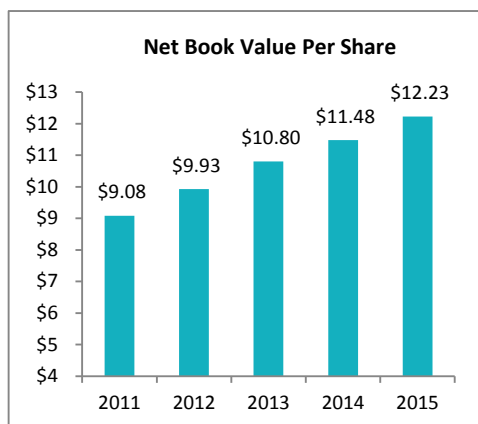
Total Assets	\$218,377	\$215,848	\$188,404	\$180,168	\$173,762
Total Loans	159,465	145,685	142,596	137,305	135,446
Total Deposits	187,396	186,180	154,804	141,652	133,352
Total Shareholders' Equity	19,476	19,205	19,040	17,655	16,314
Tier I Capital to Average Assets (Bank Only)	8.96%	9.04%	9.96%	10.26%	9.67%
Net Book Value per Common Share	\$12.23	\$11.48	\$10.80	\$9.93	\$9.08

Performance Ratios

Return on Average Assets	0.60%	0.57%	0.78%	0.72%	0.49%
Return on Average Common Equity	6.79%	6.41%	8.73%	8.37%	5.12%
Net Interest Margin	3.55%	3.56%	3.72%	3.77%	3.71%
Net Income per Average Common Share	\$0.80	\$0.71	\$0.91	\$0.80	\$0.45

Asset Quality Measures

Net Loan Charge-offs	\$224	\$303	\$430	\$206	\$138
Net Loan Charge-offs to Average Total Loans	0.15%	0.21%	0.31%	0.15%	0.11%
Allowance for Loan Losses to Total Loans	1.35%	1.40%	1.43%	1.52%	1.38%
Non-performing Assets to Total Assets	1.86%	2.10%	1.67%	1.59%	1.83%



BOARD OF DIRECTORS

Michael D. Bierlein – Bierlein Companies, Inc.

Mitzi M. Dimitroff – RDS Management

Joseph R. Fabiano II – Fabiano Brothers, Inc.

David M. Hall – Crimiel Publications

Michael L. Hanisko – Weinlander Fitzhugh

Scott L. Holman – Bay Cast, Inc.

Phillip L. List – Chairman of the Board – On Line Realtors

Terry R. Niederstadt – 1st State Bank (Retired)

James J. Shinnors – Shinnors & Cook

Lynn R. Wolgast – Wolgast Development, LLC

Rick Goedert – 1st State Bank

Richard T. Watson – Director Emeritus

STAFF

Tricia Armstrong

Loan Specialist

Denise Avery

Vice President

Deposit Services

Tania Beverly

Personal Banker

Maureen Brinker

Administrative Assistant

David Brown

Asst. Vice President

Business Lender

Allison Caister

Marketing Coordinator

Jessica Callaghan

Personal Banker

Steven Canole

Sr. Vice President

Business Lender

Brittany Chrcek

Loan Specialist

Todd Clements

Sr. Vice President

Business Lender

Michael Colby

Exec. Vice President

Business Lending Manager

Brenda Demo

BSA & Compliance Officer

Dennis Dinauer

Mortgage Officer

Downtown Bay City Office Manager

Angela Dixon

Wilder Road Office Manager

Samantha Dore

Mortgage Processor & Personal Banker

Kevin Fraser

Controller

Rick Goedert

President & CEO

Katherine Hamel

Lending Office Professional

Timothy Harrigan

Information Systems

Support Specialist

Carly Jankowiak

Personal Banker

Christine Juarez

Personal Banker

Ed Keating

Sr. Vice President

Business Lender

Jesse Kendall

Credit Analyst

Jessica Krause

Personal Banker

Barbara Kwapis

Personal Banker

Craig Loree

Vice President

Information Systems Officer

Debra Mazur

Mortgage Officer

James Milroy

Exec. Vice President & CFO

Teresa Mitchell

Deposit Operations Specialist

Jamie Myers

Personal Banker

Maria Ortega

Deposit Operations Specialist

James Papajesk

Sr. Vice President

Credit Manager & Business Lender

Kirsten Parks

Personal Loan Administration

Vicki Pavlik

Cash Management

Relationship Manager

Becke Popour

State Street Office Manager

Kelsey Primeau

Personal Banker

Jennifer Shepard

Personal Banker

Abigail Skowronski

Personal Banker

Anne Smith

Main Office Manager

Jeff Southcott

Sr. Vice President

Deposits & Personal Lending Manager

Hillary Stockel

Credit Analyst

Audrey Thomas

Deposit Operations Clerk

Allyson VanderHaar

Personal Banker

Dawn Walny

Personal Banker

Mary Weinstein

Mortgage Processor

Brittney Welke

Credit Analyst

Bridget Windy

Accounting Operations Specialist

Margo Winieckie

Sr. Vice President

Deposit Relationships & Marketing

LOCATIONS



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5425 State Street
Saginaw, MI 48603
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601 N. Madison Avenue
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