

MIDDLEFIELD BANC CORP  
Form 10-Q  
August 07, 2018

**UNITED STATES  
SECURITIES AND  
EXCHANGE  
COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

(Mark  
One)

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

For the quarterly  
period ended June 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  
001-36613

**Middlefield Banc Corp.**  
(Exact Name of Registrant  
as Specified in its Charter)

Ohio 34-1585111  
State or I.R.S.  
Other Employer  
Jurisdiction Identification  
of No.



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.

**Class: Common Stock, without par value**  
Outstanding at August 7, 2018: **3,233,924**

---

MIDDLEFIELD BANC CORP.

INDEX

Part I – Financial Information

Item 1. Financial Statements (unaudited)

Consolidated Balance Sheet as of June 30, 2018 and December 31, 2017	3
Consolidated Statement of Income for the Three and Six Months ended June 30, 2018 and 2017	4
Consolidated Statement of Comprehensive Income for the Three and Six Months ended June 30, 2018 and 2017	5
Consolidated Statement of Changes in Stockholders' Equity for the Six Months ended June 30, 2018	6
Consolidated Statement of Cash Flows for the Six Months ended June 30, 2018 and 2017	7
Notes to Unaudited Consolidated Financial Statements	9

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	32
---	----

Item 3. Quantitative and Qualitative Disclosures about Market Risk	41
--	----

Item 4. Controls and Procedures	42
---------------------------------	----

Part II – Other Information

Item 1. Legal Proceedings	43
---------------------------	----

Item 1a. Risk Factors	43
-----------------------	----

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	43
---	----

Item 3. Defaults by the Company on its Senior Securities	43
--	----

Item 4. Mine Safety Disclosures	43
---------------------------------	----

Item 5. Other Information	43
---------------------------	----

Item 6. Exhibits and Reports on Form 8-K	43
--	----

Signatures

48

Exhibit 31.1

Exhibit 31.2

Exhibit 32

2

---

## MIDDLEFIELD BANC CORP.

## CONSOLIDATED BALANCE SHEET

(Dollar amounts in thousands, except share data)

(Unaudited)

	June 30, 2018	December 31, 2017
<b>ASSETS</b>		
Cash and due from banks	\$42,451	\$39,886
Federal funds sold	28,795	-
Cash and cash equivalents	71,246	39,886
Equity securities, at fair value	656	-
Investment securities available for sale, at fair value	100,028	95,283
Loans held for sale	1,132	463
Loans	943,674	923,213
Less allowance for loan and lease losses	7,502	7,190
Net loans	936,172	916,023
Premises and equipment, net	12,978	11,853
Goodwill	15,071	15,071
Core deposit intangibles	2,571	2,749
Bank-owned life insurance	15,862	15,652
Other real estate owned	181	212
Accrued interest receivable and other assets	10,182	9,144
<b>TOTAL ASSETS</b>	<b>\$1,166,079</b>	<b>\$1,106,336</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing demand	\$207,791	\$192,438
Interest-bearing demand	92,116	83,990
Money market	137,572	150,277
Savings	204,408	208,502
Time	290,359	242,987
Total deposits	932,246	878,194
Short-term borrowings	87,833	74,707
Other borrowings	18,996	29,065
Accrued interest payable and other liabilities	4,288	4,507
<b>TOTAL LIABILITIES</b>	<b>1,043,363</b>	<b>986,473</b>
<b>STOCKHOLDERS' EQUITY</b>		

Edgar Filing: MIDDLEFIELD BANC CORP - Form 10-Q

Common stock, no par value; 10,000,000 shares authorized, 3,619,843 and 3,603,881 shares issued; 3,233,678 and 3,217,716 shares outstanding	85,544	84,859
Retained earnings	51,121	47,431
Accumulated other comprehensive (loss) income	(431 )	1,091
Treasury stock, at cost; 386,165 shares	(13,518 )	(13,518 )
TOTAL STOCKHOLDERS' EQUITY	122,716	119,863
 TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	 \$1,166,079	 \$1,106,336

See accompanying notes to unaudited consolidated financial statements.

## MIDDLEFIELD BANC CORP.

## CONSOLIDATED STATEMENT OF INCOME

(Dollar amounts in thousands, except per share data)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
<b>INTEREST AND DIVIDEND INCOME</b>				
Interest and fees on loans	\$11,234	\$9,916	\$22,288	\$19,096
Interest-bearing deposits in other institutions	115	92	234	141
Federal funds sold	7	1	21	4
Investment securities:				
Taxable interest	170	223	339	441
Tax-exempt interest	550	630	1,075	1,267
Dividends on stock	53	40	112	152
Total interest and dividend income	12,129	10,902	24,069	21,101
<b>INTEREST EXPENSE</b>				
Deposits	1,973	1,227	3,613	2,352
Short-term borrowings	192	273	468	450
Other borrowings	118	125	240	265
Total interest expense	2,283	1,625	4,321	3,067
<b>NET INTEREST INCOME</b>	<b>9,846</b>	<b>9,277</b>	<b>19,748</b>	<b>18,034</b>
Provision for loan losses	210	170	420	335
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>9,636</b>	<b>9,107</b>	<b>19,328</b>	<b>17,699</b>
<b>NONINTEREST INCOME</b>				
Service charges on deposit accounts	472	449	925	918
Investment securities gains on sale, net	-	-	-	488
Gain on equity securities	13	-	31	-
Earnings on bank-owned life insurance	98	98	210	207
Gain on sale of loans	117	231	121	465
Other income	305	211	504	422
Total noninterest income	1,005	989	1,791	2,500
<b>NONINTEREST EXPENSE</b>				
Salaries and employee benefits	3,866	3,203	7,845	6,899



Edgar Filing: MIDDLEFIELD BANC CORP - Form 10-Q

Occupancy expense	472	433	1,008	921
Equipment expense	201	266	434	547
Data processing costs	402	588	879	908
Ohio state franchise tax	244	186	359	372
Federal deposit insurance expense	150	135	300	203
Professional fees	327	423	772	796
Advertising expense	230	164	458	412
Software amortization expense	155	80	305	162
Core deposit intangible amortization	87	103	178	175
Merger expense	-	307	-	694
Other expense	929	816	1,870	1,882
Total noninterest expense	7,063	6,704	14,408	13,971
Income before income taxes	3,578	3,392	6,711	6,228
Income taxes	481	885	1,009	1,621
NET INCOME	\$3,097	\$2,507	\$5,702	\$4,607
EARNINGS PER SHARE				
Basic	\$0.96	\$0.84	\$1.77	\$1.62
Diluted	0.96	0.83	1.76	1.61
DIVIDENDS DECLARED PER SHARE	\$0.28	\$0.27	\$0.61	\$0.54

See accompanying notes to unaudited consolidated financial statements.

## MIDDLEFIELD BANC CORP.

## CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(Dollar amounts in thousands)

(Unaudited)

	Three Months Ended June 30, 2018		Six Months Ended June 30, 2017	
Net income	\$3,097	\$2,507	\$5,702	\$4,607
Other comprehensive (loss) gain:				
Net unrealized holding (loss) gain on available-for-sale investment securities	(73 )	1,186	(1,985)	1,417
Tax effect	15	(403 )	417	(481 )
Reclassification adjustment for investment securities gains included in net income	-	-	-	(488 )
Tax effect	-	-	-	166
Total other comprehensive (loss) gain	(58 )	783	(1,568)	614
Comprehensive income	\$3,039	\$3,290	\$4,134	\$5,221

See accompanying notes to unaudited consolidated financial statements.

## MIDDLEFIELD BANC CORP.

## CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

(Dollar amounts in thousands, except share and per share data)

(Unaudited)

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders' Equity
Balance, December 31, 2017	\$ 84,859	\$ 47,431	\$ 1,091	\$(13,518)	\$ 119,863
Change in accounting principle for adoption of ASU 2016-01		141	(141)	)	-
Change in accounting principle for adoption of ASU 2018-02		(187)	187	)	-
Net income		5,702			5,702
Other comprehensive loss			(1,568)	)	(1,568)
Dividend reinvestment and purchase plan (5,902 shares)	301				301
Stock options exercised (4,500 shares)	104				104
Stock-based compensation expense (5,560 shares)	280				280
Cash dividends (\$0.61 per share)		(1,966)			(1,966)
Balance, June 30, 2018	\$ 85,544	\$ 51,121	\$ (431)	\$(13,518)	\$ 122,716

See accompanying notes to unaudited consolidated financial statements.

## MIDDLEFIELD BANC CORP.

## CONSOLIDATED STATEMENT OF CASH FLOWS

(Dollar amounts in thousands)

(Unaudited)

	Six Months Ended June 30,	
	2018	2017
<b>OPERATING ACTIVITIES</b>		
Net income	\$5,702	\$4,607
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Provision for loan losses	420	335
Investment securities gains on sale, net	-	(488 )
Gain on equity securities	(31 )	-
Depreciation and amortization of premises and equipment, net	457	535
Software amortization expense	305	162
Amortization of premium and discount on investment securities, net	208	220
Accretion of deferred loan fees, net	(564 )	(295 )
Amortization of core deposit intangibles	178	175
Stock-based compensation expense	280	-
Origination of loans held for sale	(6,694 )	(10,035 )
Proceeds from sale of loans	6,146	3,866
Gain on sale of loans	(121 )	(148 )
Origination of student loans held for sale	-	(222,526)
Proceeds from sale of student loans	-	225,956
Gain on sale of student loans	-	(317 )
Earnings on bank-owned life insurance	(210 )	(207 )
Deferred income tax	132	(245 )
Net (gain) loss on other real estate owned	5	(158 )
(Increase) decrease in accrued interest receivable	(7 )	102
Increase in accrued interest payable	83	56
Other, net	(1,268 )	(4,208 )
Net cash provided by (used in) operating activities	5,021	(2,613 )
<b>INVESTING ACTIVITIES</b>		
Investment securities available for sale:		
Proceeds from repayments and maturities	2,304	7,364
Proceeds from sale of securities	-	2,678
Purchases	(9,862 )	-
Increase in loans, net	(20,005)	(64,390 )
Proceeds from the sale of other real estate owned	26	1,463
Purchase of bank-owned life insurance	-	(4 )

Edgar Filing: MIDDLEFIELD BANC CORP - Form 10-Q

Purchase of premises and equipment	(1,582 )	(518 )
Purchase of restricted stock	(90 )	(899 )
Redemption of restricted stock	-	795
Acquisition, net of cash paid	-	5,431
Net cash used in investing activities	(29,209)	(48,080 )
<b>FINANCING ACTIVITIES</b>		
Net increase in deposits	54,052	18,805
Increase (decrease) in short-term borrowings, net	13,126	(4,971 )
Repayment of other borrowings	(10,069)	(91 )
Proceeds from other borrowings	-	30,000
Proceeds from common stock issued	-	15,377
Stock options exercised	104	-
Proceeds from dividend reinvestment and purchase plan	301	272
Cash dividends	(1,966 )	(1,623 )
Net cash provided by financing activities	55,548	57,769
Increase in cash and cash equivalents	31,360	7,076
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	39,886	32,495
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$71,246	\$39,571

See accompanying notes to unaudited consolidated financial statements.

	Six Months Ended June 30,	
	2018	2017
<b>SUPPLEMENTAL INFORMATION</b>		
Cash paid during the year for:		
Interest on deposits and borrowings	\$4,238	\$3,011
Income taxes	1,075	3,555
Noncash investing transactions:		
Transfers from loans to other real estate owned	\$-	\$1,021
Common stock issued in business acquisition	-	20,995
Transfer of equity securities from investment securities available for sale, at fair value	(625 )	-
Acquisition of Liberty Bank, N.A.		
Noncash assets acquired		
Loans	\$-	\$195,388
Loans held for sale	-	5,953
Premises and equipment, net	-	325
Accrued interest receivable	-	440
Bank-owned life insurance	-	1,681
Core deposit intangible	-	3,087
Other assets	-	997
Goodwill	-	10,740
Total noncash assets acquired	-	218,611
Liabilities assumed		
Time deposits	-	(30,744 )
Deposits other than time deposits	-	(167,300)
Accrued interest payable	-	(47 )
Deferred taxes	-	(1,134 )
Other liabilities	-	(2,754 )
Total liabilities assumed	-	(201,979)
Liberty stock acquired in business combination	-	(1,068 )
Net noncash assets acquired	\$-	\$15,564
Cash and cash equivalents acquired, net	\$-	\$5,431

See accompanying notes to unaudited consolidated financial statements.

MIDDLEFIELD BANC CORP.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 1 - BASIS OF PRESENTATION**

The consolidated financial statements of Middlefield Banc Corp. ("Company") include its bank subsidiary, The Middlefield Banking Company ("MBC" or "Middlefield Bank"), and a nonbank asset resolution subsidiary EMORECO, Inc. All significant inter-company items have been eliminated.

The accompanying unaudited financial statements have been prepared in accordance with U.S. generally accepted accounting principles and the instructions for Form 10-Q and Article 10 of Regulation S-X. In management's opinion, the financial statements include all adjustments, consisting of normal recurring adjustments, that the Company considers necessary to fairly state the Company's financial position and the results of operations and cash flows. The consolidated balance sheet at *December 31, 2017*, has been derived from the audited financial statements at that date but does *not* include all of the necessary informational disclosures and footnotes as required by U.S. generally accepted accounting principles. The accompanying financial statements should be read in conjunction with the financial statements and notes thereto included with the Company's Form 10-K for the year ended *December 31, 2017*. The results of the Company's operations for any interim period are *not* necessarily indicative for the results of the Company's operations for any other interim period or for a full fiscal year.

Recent Accounting Pronouncements –

In *January 2016*, the FASB issued ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. This Update applies to all entities that hold financial assets or owe financial liabilities and is intended to provide more useful information on the recognition, measurement, presentation, and disclosure of financial instruments. Among other things, this Update (a) requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (b) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (c) eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are *not* public business entities; (d) eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (e) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (f) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the

financial statements; and (g) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. For public business entities, the amendments in this Update are effective for fiscal years beginning after *December 15, 2017*, including interim periods within those fiscal years. For all other entities, including *not-for-profit* entities and employee benefit plans within the scope of Topics 960 through 965 on plan accounting, the amendments in this Update are effective for fiscal years beginning after *December 15, 2018*, and interim periods within fiscal years beginning after *December 15, 2019*. All entities that are *not* public business entities *may* adopt the amendments in this Update earlier as of the fiscal years beginning after *December 15, 2017*, including interim periods within those fiscal years. In *February 2018*, the FASB issued ASU No. 2018-03 which includes technical corrections and improvements to clarify the guidance in ASU No. 2016-01. On *January 1, 2018*, the Company adopted ASU 2016-01 which resulted in a reclassification of \$141,000 between accumulated other comprehensive income and retained earnings on the Consolidated Balance Sheet and Consolidated Statement of Changes in Stockholders' Equity.

In *February 2016*, the FASB issued ASU 2016-02, *Leases (Topic 842)*. The standard requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. A short-term lease is defined as *one* in which (a) the lease term is *12* months or less and (b) there is *not* an option to purchase the underlying asset that the lessee is reasonably certain to exercise. For short-term leases, lessees *may* elect to recognize lease payments over the lease term on a straight-line basis. For public business entities, the amendments in this Update are effective for fiscal years beginning after *December 15, 2018*, and interim periods within those years. For all other entities, the amendments in this Update are effective for fiscal years beginning after *December 15, 2019*, and for interim periods within fiscal years beginning after *December 15, 2020*. The amendments should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently assessing the practical expedients it *may* elect at adoption, but does *not* anticipate the amendments will have a significant impact on the financial statements. Based on the Company's preliminary analysis of its current portfolio, the impact to the Company's balance sheet is estimated to result in less than a *1* percent increase in assets and liabilities. The Company also anticipates additional disclosures to be provided at adoption.



In June 2016, the FASB issued ASU 2016-13, *Financial Instruments - Credit Losses: Measurement of Credit Losses on Financial Instruments* (“CECL”), which changes the impairment model for most financial assets. This Update is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The underlying premise of the Update is that financial assets measured at amortized cost should be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. The allowance for credit losses should reflect management’s current estimate of credit losses that are expected to occur over the remaining life of a financial asset. The income statement will be effected for the measurement of credit losses for newly recognized financial assets, as well as the expected increases or decreases of expected credit losses that have taken place during the period. ASU 2016-13 is effective for annual and interim periods beginning after *December 15, 2019*, and early adoption is permitted for annual and interim periods beginning after *December 15, 2018*. With certain exceptions, transition to the new requirements will be through a cumulative effect adjustment to opening retained earnings as of the beginning of the *first* reporting period in which the guidance is adopted. Management is currently evaluating the impact of the adoption of this guidance on the Company’s consolidated financial statements. Management will oversee the implementation of CECL and is currently in the process of implementing a software solution to assist in the adoption of this ASU. Management plans to run the current incurred loss model and the CECL model concurrently for 12 months prior to the adoption of this guidance on *January 1, 2020*.

In February 2018, the FASB issued ASU 2018-02, *Income Statement – Reporting Comprehensive Income (Topic 220)*, to allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act. Consequently, the amendments eliminate the stranded tax effects resulting from the Tax Cuts and Jobs Act and will improve the usefulness of information reported to financial statement users. The amendments in this Update are effective for all entities for fiscal years beginning after *December 15, 2018*, and interim periods within those fiscal years. Early adoption of the amendments in this Update is permitted, including adoption in any interim period, (1) for public business entities for reporting periods for which financial statements have *not* yet been issued and (2) for all other entities for reporting periods for which financial statements have *not* yet been made available for issuance. The amendments in this Update should be applied either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act is recognized. On *January 1, 2018*, the Company adopted this standard which resulted in a reclassification of \$187,000 between accumulated other comprehensive income and retained earnings on the Consolidated Balance Sheet and Consolidated Statement of Changes in Stockholders’ Equity.

In February 2018, the FASB issued ASU 2018-03, *Technical Corrections and Improvements to Financial Instruments—Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities*, to clarify certain aspects of the guidance issued in ASU 2016-01. (1) An entity measuring an equity security using the measurement alternative *may* change its measurement approach to a fair value method in accordance with Topic 820, Fair Value Measurement, through an irrevocable election that would apply to that security and all identical or similar investments of the same issuer. Once an entity makes this election, the entity should measure all future purchases of identical or similar investments of the same issuer using a fair value method in accordance with Topic 820. (2) Adjustments made under the measurement alternative are intended to reflect the fair value of the security as of the date that the observable transaction for a similar security took place. (3) Remeasuring the entire value of forward contracts and purchased options is required when observable transactions occur on the underlying equity securities. (4) When the fair value option is elected for a financial liability, the guidance in paragraph 825-10- 45-5 should be applied, regardless of whether the fair value option was elected under either Subtopic 815-15, Derivatives and

Hedging—Embedded Derivatives, or 825-10, Financial Instruments—Overall. (5) Financial liabilities for which the fair value option is elected, the amount of change in fair value that relates to the instrument specific credit risk should *first* be measured in the currency of denomination when presented separately from the total change in fair value of the financial liability. Then, both components of the change in the fair value of the liability should be remeasured into the functional currency of the reporting entity using end-of-period spot rates. (6) The prospective transition approach for equity securities without a readily determinable fair value in the amendments in Update 2016-01 is meant only for instances in which the measurement alternative is applied. An insurance entity subject to the guidance in Topic 944, Financial Services— Insurance, should apply a prospective transition method when applying the amendments related to equity securities without readily determinable fair values. An insurance entity should apply the selected prospective transition method consistently to the entity’s entire population of equity securities for which the measurement alternative is elected. For public business entities, the amendments in this Update are effective for fiscal years beginning after *December 15, 2017*, and interim periods within those fiscal years beginning after *June 15, 2018*. Public business entities with fiscal years beginning between *December 15, 2017*, and *June 15, 2018*, are *not* required to adopt these amendments until the interim period beginning after *June 15, 2018*, and public business entities with fiscal years beginning between *June 15, 2018*, and *December 15, 2018*, are *not* required to adopt these amendments before adopting the amendments in Update 2016-01. For all other entities, the effective date is the same as the effective date in Update 2016-01. All entities *may* early adopt these amendments for fiscal years beginning after *December 15, 2017*, including interim periods within those fiscal years, as long as they have adopted Update 2016-01. The Company is currently evaluating the impact the adoption of the standard will have on the Company’s financial position or results of operations.

ASU 2018-04, *Investments – Debt Securities (Topic 320) and Regulated Operations (Topic 980)* - Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 117 and SEC Release No. 33-9273, ASU 2018-04 supersedes various SEC paragraphs and adds an SEC paragraph pursuant to the issuance of Staff Accounting Bulletin No. 117. This Update is *not* expected to have a significant impact on the Company's financial statements.

In June 2018, the FASB issued ASU 2018-07, *Compensation – Stock Compensation (Topic 718)*, which simplified the accounting for nonemployee share-based payment transactions. The amendments in this update expand the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from nonemployees. The amendments in this Update improve the following areas of nonemployee share-based payment accounting; (a) the overall measurement objective, (b) the measurement date, (c) awards with performance conditions, (d) classification reassessment of certain equity-classified awards, (e) calculated value (nonpublic entities only), and (f) intrinsic value (nonpublic entities only). The amendments in this Update are effective for public business entities for fiscal years beginning after *December 15, 2018*, including interim periods within that fiscal year. For all other entities, the amendments are effective for fiscal years beginning after *December 15, 2019*, and interim periods within fiscal years beginning after *December 15, 2020*. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

ASU 2018-10, *Codification Improvements to Topic 842, Leases*, represents changes to clarify, correct errors in, or make minor improvements to the Codification. The amendments in this ASU affect the amendments in ASU 2016-02, which are *not* yet effective, but for which early adoption upon issuance is permitted. For entities that early adopted Topic 842, the amendments are effective upon issuance of this ASU, and the transition requirements are the same as those in Topic 842. For entities that have *not* adopted Topic 842, the effective date and transition requirements will be the same as the effective date and transition requirements in Topic 842. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

## **NOTE 2 – REVENUE RECOGNITION**

Effective *January 1, 2017*, the Company adopted ASU 2014-09 *Revenue from Contracts with Customers-Topic 606* and all subsequent ASUs that modified ASC 606. The implementation of the new standard had *no* material impact to the measurement or recognition of revenue of prior periods and did *not* require any cumulative effect adjustment for adoption.

Management determined that the primary sources of revenue, which emanate from interest income on loans and investments, along with noninterest revenue resulting from investment security gains, gains on the sale of loans, and BOLI income, are *not* within the scope of ASC 606. As a result, *no* changes were made during the period related to these sources of revenue, which cumulatively comprise 93.1% of the total revenue of the Company.

The main types of noninterest income within the scope of the standard are as follows:

Service charges on deposit accounts – The Company has contracts with its deposit customers where fees are charged if the account balance falls below predetermined levels defined as compensating balances. These agreements can be cancelled at any time by either the Company or the deposit customer. Revenue from these transactions is recognized on a monthly basis as the Company has an unconditional right to the fee consideration. The Company also has transaction fees related to specific transactions or activities resulting from a customer request or activity that include overdraft fees, online banking fees, and other transaction fees. All of these fees are attributable to specific performance obligations of the Company where the revenue is recognized at a defined point in time, which is completion of the requested service/transaction.

Gains (losses) on sale of other real estate owned – Gains and losses are recognized at the completion of the property sale when the buyer obtains control of the real estate and all of the performance obligations of the Company have been satisfied. Evidence of the buyer obtaining control of the asset include transfer of the property title, physical possession of the asset, and the buyer obtaining control of the risks and rewards related to the asset. In situations where the Company agrees to provide financing to facilitate the sale, additional analysis is performed to ensure that the contract for sale identifies the buyer and seller, the asset to be transferred, payment terms, and that the contract has a true commercial substance and that collection of amounts due from the buyer is reasonable. In situations where financing terms are *not* reflective of current market terms, the transaction price is discounted impacting the gain/loss and the carrying value of the asset.

The following table depicts the disaggregation of revenue derived from contracts with customers to depict the nature, amount, timing, and uncertainty of revenue and cash flows:

	For the Three Months		For the Six Months	
	Ended June 30, 2018	2017	Ended June 30, 2018	2017
Noninterest Income (Dollar amounts in thousands)				
Service charges on deposit accounts:				
Overdraft fees	\$197	\$182	\$390	\$374
ATM banking fees	214	205	415	319
Service charges and other fees	61	62	120	225
Investment securities gains on sale, net <sup>(a)</sup>	-	-	-	488
Equity securities, unrealized gains <sup>(a)</sup>	13	-	31	-
Earnings on bank-owned life insurance <sup>(a)</sup>	98	98	210	207
Gain on sale of loans <sup>(a)</sup>	117	231	121	465
Other income	305	211	504	422
Total noninterest income	\$1,005	\$989	\$1,791	\$2,500

(a) *Not* within scope of ASC 606

### NOTE 3 - STOCK-BASED COMPENSATION

The Company had *no* unvested stock options outstanding as of *June 30, 2018* and *2017*.

Stock option activity during the *six* months ended *June 30* is as follows:

	Shares	Weighted- average Exercise Price Per Share
Outstanding, January 1	19,750	\$ 20.94

Exercised	<i>(6,000 )</i>	<i>23.00</i>
Outstanding, June 30	<i>13,750</i>	<i>\$ 20.05</i>
Exercisable, June 30	<i>13,750</i>	<i>\$ 20.05</i>

12

---

The following table presents the activity during the *six* months ended *June 30, 2018* related to awards of restricted stock:

	Shares	Weighted- average Grant Date Fair Value Per Share
Nonvested at January 1, 2018	14,601	\$ 35.14
Granted	9,952	48.20
Forfeited	(223 )	35.31
Vested	(3,905 )	33.61
Nonvested at June 30, 2018	20,425	\$ 41.80
Expected to vest at June 30, 2018	10,473	\$ 35.71

The Company recognizes restricted stock forfeitures in the period they occur.

Share-based compensation expense of \$91,000 and \$45,000 was recognized for the *three*-month periods ended *June 30, 2018* and *2017*, respectively. Share-based compensation expense of \$136,000 and \$90,000 was recognized for the *six*-month periods ended *June 30, 2018* and *2017*, respectively.

The expected remaining compensation expense that will be recognized on restricted stock totals \$141,000, of which \$70,000 will be recognized in *2018* and \$71,000 will be recognized in *2019*.

**NOTE 4 - EARNINGS PER SHARE**

The Company provides dual presentation of basic and diluted earnings per share. Basic earnings per share is calculated by dividing net income by the average shares outstanding. Diluted earnings per share adds the dilutive effects of stock options and restricted stock to average shares outstanding.

The following table sets forth the composition of the weighted-average common shares (denominator) used in the basic and diluted earnings-per-share computation.

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2018	2017	2018	2017
Weighted-average common shares outstanding	3,611,891	3,386,616	3,609,174	3,227,184
Average treasury stock shares	(386,165 )	(386,165 )	(386,165 )	(386,165 )
Weighted-average common shares and common stock equivalents used to calculate basic earnings per share	3,225,726	3,000,451	3,223,009	2,841,019
Additional common stock equivalents (stock options and restricted stock) used to calculate diluted earnings per share	14,603	13,689	15,227	13,139
Weighted-average common shares and common stock equivalents used to calculate diluted earnings per share	3,240,329	3,014,140	3,238,236	2,854,158

Options to purchase 13,750 shares of common stock, at prices ranging from \$17.55 to \$23.00, were outstanding during the *three* and *six* months ended *June 30, 2018*. Also outstanding were 20,425 shares of restricted stock. *None* of the outstanding options or restricted stock were anti-dilutive.

Options to purchase 21,375 shares of common stock, at prices ranging from \$17.55 to \$37.48, were outstanding during the *three* and *six* months ended *June 30, 2017*. Also outstanding were 9,975 shares of restricted stock. *None* of the outstanding options or restricted stock were anti-dilutive.

**NOTE 5 - FAIR VALUE MEASUREMENTS**



Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for an asset or liability in an orderly transaction between market participants at the measurement date. GAAP establishes a fair value hierarchy that prioritizes the use of inputs used in valuation methodologies into the following levels:

Level I: Quoted prices are available in active markets for identical assets or liabilities as of the reported date.

Pricing inputs are other than the quoted prices in active markets, which are either directly or indirectly Level observable as of the reported date. The nature of these assets and liabilities includes items for which quoted II: prices are available but traded less frequently and items that are fair valued using other financial instruments, the parameters of which can be directly observed.

Level III: Assets and liabilities that have little to *no* pricing observability as of the reported date. These items do *not* have *two*-way markets and are measured using management's best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation.

The following tables present the assets measured on a recurring basis on the Consolidated Balance Sheet at their fair value by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

(Dollar amounts in thousands)	June 30, 2018			Total
	Level I	Level II	Level III	
Assets measured on a recurring basis:				
U.S. government agency securities	\$-	\$7,988	\$ -	\$7,988
Obligations of states and political subdivisions	-	75,397	-	75,397
Mortgage-backed securities in government-sponsored entities	-	16,643	-	16,643
Total debt securities	-	100,028	-	100,028
Equity securities in financial institutions	406	250	-	656
Total	\$406	\$100,278	\$ -	\$100,684

(Dollar amounts in thousands)	December 31, 2017			Total
	Level I	Level II	Level III	
Assets measured on a recurring basis:				
U.S. government agency securities	\$-	\$8,719	\$ -	\$8,719
Obligations of states and political subdivisions	-	67,429	-	67,429
Mortgage-backed securities in government-sponsored entities	-	18,510	-	18,510
Total debt securities	-	94,658	-	94,658
Equity securities in financial institutions	375	250	-	625
Total	\$375	\$94,908	\$ -	\$95,283

Investment Securities Available for Sale - The Company obtains fair values from an independent pricing service which represent quoted prices for similar assets, fair values determined by pricing models using a market approach that considers observable market data, such as interest rate volatilities, LIBOR yield curve, credit spreads and prices from market makers and live trading systems (Level II).

Equity Securities - Equity securities that are traded on a national securities exchange are valued at their last reported sales price as of the measurement date. Equity securities traded in the over-the-counter ("OTC") markets and listed securities for which *no* sale was reported on that date are generally valued at their last reported "bid" price if held long, and last reported "ask" price if sold short. To the extent equity securities are actively traded and valuation adjustments are *not* applied, they are categorized in Level I of the fair value hierarchy. Equity securities traded on inactive markets

or valued by reference to similar instruments are generally categorized in Level II of the fair value hierarchy. Equity securities are carried at fair value through net income at *June 30, 2018*.

The following tables present the assets measured on a nonrecurring basis on the Consolidated Balance Sheet at their fair value by level within the fair value hierarchy. Collateral-dependent impaired loans are carried at fair value if they have been charged down to fair value or if a specific valuation allowance has been established. A new cost basis is established at the time a property is initially recorded in OREO. OREO properties are carried at fair value if a devaluation has been taken to the property's value subsequent to the initial measurement. *No* such devaluation occurred in the *six* months ended *June 30, 2018*.

(Dollar amounts in thousands)	June 30, 2018			Total
	Level I	Level II	Level III	
Assets measured on a non-recurring basis:				
Impaired loans	\$ -	\$-	\$1,134	\$1,134

(Dollar amounts in thousands)	December 31, 2017			Total
	Level I	Level II	Level III	
Assets measured on a non-recurring basis:				
Impaired loans	\$ -	\$-	\$3,072	\$3,072
Other real estate owned	-	-	32	32

**Impaired Loans** – The Company has measured impairment on collateral-dependent impaired loans generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent *third*-party appraisals of the properties. In some cases, management *may* adjust the appraised value due to the age of the appraisal, changes in market conditions, or observable deterioration of the property since the appraisal was completed. Additionally, management makes estimates about expected costs to sell the property which are also included in the net realizable value. If the fair value of the collateral-dependent loan is less than the carrying amount of the loan, a specific reserve for the loan is made in the allowance for loan losses or a charge-off is taken to reduce the loan to the fair value of the collateral (less estimated selling costs) and the loan is included in the above table as a Level III measurement. If the fair value of the collateral exceeds the carrying amount of the loan, then the loan is *not* included in the above table as it is *not* currently being carried at its fair value. The fair values in the above table exclude estimated selling costs of \$419,000 at *June 30, 2018*.

**Other Real Estate Owned (OREO)** – OREO is carried at the lower of cost or fair value, which is measured at the date of foreclosure. If the fair value of the collateral exceeds the carrying amount of the loan, *no* charge-off or adjustment is necessary, the loan is *not* considered to be carried at fair value, and is therefore *not* included in the above table. If the fair value of the collateral is less than the carrying amount of the loan, management will charge the loan down to its estimated realizable value. The fair value of OREO is based on the appraised value of the property, which is generally unadjusted by management and is based on comparable sales for similar properties in the same geographic region as the subject property, and is included in the above table as a Level II measurement. In some cases, management *may* adjust the appraised value due to the age of the appraisal, changes in market conditions, or observable deterioration of

the property since the appraisal was completed. In these cases, the loans are categorized in the above table as a Level III measurement since these adjustments are considered to be unobservable inputs. Income and expenses from operations and further declines in the fair value of the collateral subsequent to foreclosure are included in net expenses from OREO.

The following tables present additional quantitative information about assets measured at fair value on a nonrecurring basis and for which the Company uses Level III inputs to determine fair value:

Quantitative Information about Level III Fair Value Measurements

(Dollar amounts in thousands)

	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range (Weighted Average)
June 30, 2018				
Impaired loans	\$ 1,134	Appraisal of collateral (1)	Appraisal adjustments (2)	0% to 100% (47.49%)

Quantitative Information about Level III Fair Value Measurements

(Dollar amounts in thousands)

	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range (Weighted Average)
December 31, 2017				
Impaired loans	\$ 3,072	Appraisal of collateral (1)	Appraisal adjustments (2)	0% to 86.1% (13.8%)
Other real estate owned	\$ 32	Appraisal of collateral (1)	Appraisal adjustments (2)	0% to 10.0%

(1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various level III inputs which are *not* identifiable, less any associated allowance.

Appraisals *may* be adjusted by management for qualitative factors such as economic conditions and estimated (2) liquidation expenses. The range and weighted average of liquidation expenses and other appraisal adjustments are presented as a percent of the appraisal.

The estimated fair value of the Company's financial instruments *not* recorded at fair value on a recurring basis is as follows:

	June 30, 2018			Total Fair Value
	Carrying Value	Level I	Level II	
(Dollar amounts in thousands)				

Financial assets:

Edgar Filing: MIDDLEFIELD BANC CORP - Form 10-Q

Cash and cash equivalents <sup>(1)</sup>	\$71,246	\$71,246	\$-	\$-	\$71,246
Loans held for sale	1,132	-	1,132	-	1,132
Net loans	936,172	-	-	925,076	925,076
Bank-owned life insurance <sup>(1)</sup>	15,862	15,862	-	-	15,862
Federal Home Loan Bank stock <sup>(1)</sup>	3,679	3,679	-	-	3,679
Accrued interest receivable <sup>(1)</sup>	3,295	3,295	-	-	3,295
Financial liabilities:					
Deposits	\$932,246	\$641,887	\$-	\$287,358	\$929,245
Short-term borrowings <sup>(1)</sup>	87,833	87,833	-	-	87,833
Other borrowings	18,996	-	-	18,990	18,990
Accrued interest payable <sup>(1)</sup>	661	661	-	-	661

(1) This financial instrument is carried at cost at June 30, 2018, which approximates the fair value of the instrument.

	December 31, 2017				Total Fair Value
	Carrying Value	Level I	Level II	Level III	
(Dollar amounts in thousands)					
Financial assets:					
Cash and cash equivalents	\$39,886	\$39,886	\$-	\$-	\$39,886
Loans held for sale	463	-	463	-	463
Net loans	916,023	-	-	913,323	913,323
Bank-owned life insurance	15,652	15,652	-	-	15,652
Federal Home Loan Bank stock	3,589	3,589	-	-	3,589
Accrued interest receivable	3,288	3,288	-	-	3,288
Financial liabilities:					
Deposits	\$878,194	\$635,207	\$-	\$242,020	\$877,227
Short-term borrowings	74,707	74,707	-	-	74,707
Other borrowings	29,065	-	-	29,069	29,069
Accrued interest payable	578	578	-	-	578

#### NOTE 6 – ACCUMULATED OTHER COMPREHENSIVE INCOME

The following tables present the changes in accumulated other comprehensive income (“AOCI”) by component net of tax for the *three* and *six* months ended *June 30, 2018* and *2017*, respectively:

(Dollars in thousands)	Unrealized gains on available-for-sale securities
	(a)
Balance as of March 31, 2018	\$ (373 )
Other comprehensive loss before reclassification	(58 )
Balance at June 30, 2018	\$ (431 )
Balance as of December 31, 2017	\$ 1,091
Other comprehensive loss before reclassification	(1,568 )
Change in accounting principle, ASC 2016-01 <sup>(b)</sup>	(141 )
Change in accounting principle, ASC 2018-02 <sup>(b)</sup>	187



Period change	(1,522	)
Balance at June 30, 2018	\$ (431	)

	Unrealized gains on
(Dollars in thousands)	available-for-sale securities
	(a)
Balance as of March 31, 2017	\$ 1,032
Other comprehensive income before reclassification	783
Amount reclassified from accumulated other comprehensive income	-
Period change	783
Balance at June 30, 2017	\$ 1,815
Balance as of December 31, 2016	\$ 1,201
Other comprehensive income before reclassification	936
Amount reclassified from accumulated other comprehensive income	(322 )
Period change	614
Balance at June 30, 2017	\$ 1,815

(a) All amounts are net of tax. Amounts in parentheses indicate debits to AOCI.

Reclassifications are the result of the adoption of ASUs 2016-01 and 2018-02 effective for the Company (b)beginning *January 1, 2018*. The reclassifications are presented within the Consolidated Statement of Changes in Stockholders' Equity for the affected transitional periods.

The following tables present significant amounts reclassified from or to each component of AOCI:

	Amount Reclassified from Accumulated Other Comprehensive Income <i>For the Six Months Ended</i>	Affected Line Item in the Statement Where  <i>Net Income is</i>
(Dollars in thousands)		
Details about other comprehensive income	June 30, 2018	June 30, 2017  Presented
Unrealized gains on available-for-sale securities	\$ -	\$ 488
(a)	-	(166 )
	\$ -	\$ 322
		Investment securities gains on sale, net Income taxes

(a) For unrealized gains on available-for-sale securities, amounts in parentheses indicate expenses and other amounts indicate income.

There were *no* amounts reclassified to or from AOCI for the *three* months ended *June 30, 2018* and *June 30, 2017*.

**NOTE 7 – INVESTMENT AND EQUITY SECURITIES**

The amortized cost and fair values of investment securities are as follows:

(Dollar amounts in thousands)	June 30, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government agency securities	\$8,052	\$ 43	\$ (107)	) \$7,988
Obligations of states and political subdivisions:				
Taxable	503	11	-	514
Tax-exempt	74,767	786	(670)	) 74,883
Mortgage-backed securities in government-sponsored entities	17,249	44	(650)	) 16,643
Total	\$100,571	\$ 884	\$ (1,427)	) \$100,028

(Dollar amounts in thousands)	December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government agency securities	\$8,664	\$ 126	\$ (71)	) \$8,719
Obligations of states and political subdivisions:				
Taxable	504	8	-	512
Tax-exempt	65,408	1,547	(38)	) 66,917
Mortgage-backed securities in government-sponsored entities	18,640	157	(287)	) 18,510
Total debt securities	93,216	1,838	(396)	) 94,658
Equity securities in financial institutions	415	210	-	625
Total	\$93,631	\$ 2,048	\$ (396)	) \$95,283

The Company held *one* equity investment without a readily determinable fair value at *June 30, 2018*. For both year-to-date and life-to-date, the equity had an amortized cost of \$250,000, with *no* impairment or observable price changes.

The Company recognized net gains on equity investments of \$13,000 and \$31,000, respectively, for the *three* and *six* months ended *June 30, 2018*. *No* net gains on sold equity securities were realized during those periods.



The amortized cost and fair value of debt securities at *June 30, 2018*, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers *may* have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollar amounts in thousands)	Amortized Cost	Fair Value
Due in one year or less	\$ 5,676	\$ 5,729
Due after one year through five years	6,202	6,267
Due after five years through ten years	12,267	12,156
Due after ten years	76,426	75,876
Total	\$ 100,571	\$ 100,028

Proceeds from the sales of investment securities and the gross realized gains and losses are as follows:

(Dollar amounts in thousands)	For the Three Months Ended June 30, 2018	For the Six Months Ended June 30, 2018
Proceeds from sales	\$- \$2,678	\$- \$2,678
Gross realized gains	- -	- 488 <sup>(1)</sup>
Gross realized losses	- -	- -

<sup>(1)</sup> Prior to the acquisition of Liberty Bank, N.A., the Company held an equity interest in Liberty which was re-measured at fair value on the acquisition date and resulted in a gain of \$488,000. This gain was recorded in Equity Securities, Unrealized Gains on the consolidated Income Statement for the *six* months ended *June 30, 2017*.

Investment securities with an approximate carrying value of \$67.9 million and \$57.9 million at *June 30, 2018* and *December 31, 2017*, respectively, were pledged to secure deposits and for other purposes as required by law.

The following tables show the Company's gross unrealized losses and fair value, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position.

Edgar Filing: MIDDLEFIELD BANC CORP - Form 10-Q

(Dollar amounts in thousands)	June 30, 2018					
	Less than Twelve Months		Twelve Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. government agency securities	\$495	\$ (13 )	\$3,816	\$ (94 )	\$4,311	\$ (107 )
Obligations of states and political subdivisions:						
Tax-exempt	27,247	(571 )	2,713	(99 )	29,960	(670 )
Mortgage-backed securities in government-sponsored entities	4,905	(209 )	8,520	(441 )	13,425	(650 )
Total	\$32,647	\$ (793 )	\$15,049	\$ (634 )	\$47,696	\$ (1,427 )

(Dollar amounts in thousands)	December 31, 2017					
	Less than Twelve Months		Twelve Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. government agency securities	\$557	\$ (4 )	\$4,036	\$ (67 )	\$4,593	\$ (71 )
Obligations of states and political subdivisions:						
Tax-exempt	1,009	(6 )	2,784	(32 )	3,793	(38 )
Mortgage-backed securities in government-sponsored entities	5,698	(71 )	8,734	(216 )	14,432	(287 )
Total	\$7,264	\$ (81 )	\$15,554	\$ (315 )	\$22,818	\$ (396 )

There were 87 securities considered temporarily impaired at *June 30, 2018*.

On a quarterly basis, the Company performs an assessment to determine whether there have been any events or economic circumstances indicating that a security with an unrealized loss has suffered other-than-temporary impairment (“OTTI”). A debt security is considered impaired if the fair value is less than its amortized cost basis at the reporting date. The Company assesses whether the unrealized loss is other than temporary.

OTTI losses are recognized in earnings when the Company has the intent to sell the debt security or it is more likely than *not* that it will be required to sell the debt security before recovery of its amortized cost basis. However, even if the Company does *not* expect to sell a debt security, it must evaluate expected cash flows to be received and determine if a credit loss has occurred.

An unrealized loss is generally deemed to be other than temporary and a credit loss is deemed to exist if the present value of the expected future cash flows is less than the amortized cost basis of the debt security. As a result, the credit loss of an OTTI is recorded as a component of investment securities gains (losses) in the accompanying Consolidated Statement of Income, while the remaining portion of the impairment loss is recognized in other comprehensive income, provided the Company does *not* intend to sell the underlying debt security and it is “more likely than *not*” that the Company will *not* have to sell the debt security prior to recovery.

Debt securities issued by U.S. government agencies, U.S. government-sponsored enterprises, and state and political subdivisions accounted for 100% of the total available-for-sale portfolio as of *June 30, 2018* and *no* credit losses are expected, given the explicit and implicit guarantees provided by the U.S. federal government and the lack of prolonged unrealized loss positions within the obligations of the state and political subdivisions security portfolio. The Company considers the following factors in determining whether a credit loss exists and the period over which the debt security is expected to recover:



- The length of time and the extent to which the fair value has been less than the amortized cost basis.
- Changes in the near-term prospects of the underlying collateral of a security such as changes in default rates, loss severity given default and significant changes in prepayment assumptions;
- The level of cash flows generated from the underlying collateral supporting the principal and interest payments of the debt securities; and,
- Any adverse change to the credit conditions and liquidity of the issuer, taking into consideration the latest information available about the overall financial condition of the issuer, credit ratings, recent legislation and government actions affecting the issuer's industry and actions taken by the issuer to deal with the present economic climate.

For the *six* months ended *June 30, 2018* and *2017*, there were *no* available-for-sale debt securities with an unrealized loss that suffered OTTI. Management does *not* believe any individual unrealized loss as of *June 30, 2018* or *December 31, 2017* represented an other-than-temporary impairment. The unrealized losses on debt securities are primarily the result of interest rate changes. These conditions will *not* prohibit the Company from receiving its contractual principal and interest payments on these debt securities. The fair value of these debt securities is expected to recover as payments are received on these securities and they approach maturity. Should the impairment of any of these securities become other than temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income in the period the other-than-temporary impairment is identified.

**NOTE 8 - LOANS AND RELATED ALLOWANCE FOR LOAN AND LEASE LOSSES**

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

	June 30, 2018	December 31, 2017
Commercial and industrial	\$101,975	\$101,346
Real estate - construction	45,647	47,017
Real estate - mortgage:		
Residential	320,858	318,157
Commercial	457,050	437,947
Consumer installment	18,144	18,746
	943,674	923,213
Less: Allowance for loan and lease losses	(7,502 )	(7,190 )
Net loans	\$936,172	\$916,023

The amounts above include deferred loan origination costs of \$1.5 million at both *June 30, 2018* and *December 31, 2017*.

The Company's primary business activity is with customers located within its local Northeastern Ohio trade area, Geauga County, and contiguous counties. The Company also serves the central Ohio market with offices in Dublin, Sunbury and Westerville, Ohio. Commercial, residential, consumer, and agricultural loans are granted. Although the Company has a diversified loan portfolio, loans outstanding to individuals and businesses are dependent upon the local economic conditions in the Company's immediate trade area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff generally are reported at their outstanding unpaid principal balances net of the allowance for loan and lease losses. Interest income is recognized on the accrual method. The accrual of interest is discontinued on a loan when management believes, after considering economic and business conditions, the borrower's financial condition is such that collection of interest is doubtful. Interest payments received on nonaccrual loans are applied against the unpaid principal balance until nonaccrual status is restored.

Loan origination fees and certain direct loan origination costs are deferred with the net amount amortized over the contractual life of the loan as an adjustment of the related loan's yield.

The following tables summarize the primary segments of the loan portfolio and allowance for loan and lease losses (in thousands):

June 30, 2018	Commercial and industrial	Real estate- construction	Real Estate - Mortgage			Total
			Residential	Commercial	Consumer installment	
<b>Loans:</b>						
Individually evaluated for impairment	\$ 2,923	\$ -	\$ 2,652	\$ 6,209	\$ 3	\$ 11,787
Collectively evaluated for impairment	99,052	45,647	318,206	450,841	18,141	931,887
Total loans	\$ 101,975	\$ 45,647	\$ 320,858	\$ 457,050	\$ 18,144	\$ 943,674

December 31, 2017	Commercial and industrial	Real estate- construction	Real Estate - Mortgage			Total
			Residential	Commercial	Consumer installment	
<b>Loans:</b>						
Individually evaluated for impairment	\$ 3,627	\$ 44	\$ 2,824	\$ 5,610	\$ 4	\$ 12,109
Collectively evaluated for impairment	97,719	46,973	315,333	432,337	18,742	911,104
Total loans	\$ 101,346	\$ 47,017	\$ 318,157	\$ 437,947	\$ 18,746	\$ 923,213

June 30, 2018	Commercial and industrial	Real estate- construction	Real Estate - Mortgage		Consumer installment	Total
			Residential	Commercial		
<b>Allowance for loan and lease losses:</b>						
Ending allowance balance attributable to loans:						
Individually evaluated for impairment	\$ 879	\$ -	\$82	\$ 607	\$ 1	\$1,569
Collectively evaluated for impairment	301	89	1,661	3,754	128	5,933
Total ending allowance balance	\$ 1,180	\$ 89	\$1,743	\$ 4,361	\$ 129	\$7,502

December 31, 2017	Commercial and industrial	Real estate- construction	Real Estate - Mortgage		Consumer installment	Total
			Residential	Commercial		
<b>Allowance for loan and lease losses:</b>						
Ending allowance balance attributable to loans:						
Individually evaluated for impairment	\$ 694	\$ -	\$140	\$ 733	\$ -	\$1,567
Collectively evaluated for impairment	305	313	1,620	3,303	82	5,623
Total ending allowance balance	\$ 999	\$ 313	\$1,760	\$ 4,036	\$ 82	\$7,190

The Company's loan portfolio is segmented to a level that allows management to monitor risk and performance. The portfolio is segmented into Commercial and Industrial ("C&I"), Real Estate Construction, Real Estate - Mortgage which is further segmented into Residential and Commercial real estate ("CRE"), and Consumer Installment Loans. The C&I loan segment consists of loans made for the purpose of financing the activities of commercial customers. The residential mortgage loan segment consists of loans made for the purpose of financing the activities of residential homeowners. The commercial mortgage loan segment consists of loans made for the purpose of financing the activities of commercial real estate owners and operators. The consumer loan segment consists primarily of installment loans and overdraft lines of credit connected with customer deposit accounts. The increases in the allowance for loan loss for C&I, Residential, CRE, and Consumer Installment loan portfolios were partially offset by a decrease in the allowance for the Real Estate Construction portfolio.

Management evaluates individual loans in all of the commercial segments for possible impairment based on guidance established by the Board of Directors. Loans are considered to be impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in evaluating impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including

the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. The Company does *not* separately evaluate individual consumer and residential mortgage loans for impairment, unless such loans are part of a larger relationship that is impaired, or the loan was modified in a troubled debt restructuring.

Once the determination has been made that a loan is impaired, the determination of whether a specific allocation of the allowance is necessary is measured by comparing the recorded investment in the loan to the fair value of the loan using *one* of the following methods: (a) the present value of expected future cash flows discounted at the loan's effective interest rate; (b) the loan's observable market price; or (c) the fair value of the collateral less selling costs. The method is selected on a loan-by-loan basis, with management primarily utilizing the present value of expected cash flows. The evaluation of the need and amount of a specific allocation of the allowance and whether a loan can be removed from impairment status is made on a quarterly basis. The Company's policy for recognizing interest income on impaired loans does *not* differ from its overall policy for interest recognition.

The following tables present impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was *not* necessary (in thousands):

June 30, 2018  
Impaired Loans

	Recorded Investment	Unpaid <i>Principal</i> <i>Balance</i>	Related Allowance
With no related allowance recorded:			
Commercial and industrial	\$ 339	\$ 538	\$ -
Real estate - mortgage:			
Residential	1,812	2,085	-
Commercial	2,002	2,164	-
Total	\$ 4,153	\$ 4,787	\$ -
With an allowance recorded:			
Commercial and industrial	\$ 2,584	\$ 3,278	\$ 879
Real estate - mortgage:			
Residential	840	962	82
Commercial	4,207	4,319	607
Consumer installment	3	3	1
Total	\$ 7,634	\$ 8,562	\$ 1,569
Total:			
Commercial and industrial	\$ 2,923	\$ 3,816	\$ 879
Real estate - mortgage:			
Residential	2,652	3,047	82
Commercial	6,209	6,483	607
Consumer installment	3	3	1
Total	\$ 11,787	\$ 13,349	\$ 1,569

December 31, 2017

## Impaired Loans

	Recorded Investment	Unpaid <i>Principal</i> <i>Balance</i>	Related Allowance
With no related allowance recorded:			
Commercial and industrial	\$ 450	\$ 1,006	\$ -
Real estate - construction	44	44	-
Real estate - mortgage:			
Residential	1,685	1,904	-
Commercial	1,870	1,984	-
Consumer installment	4	4	-
Total	\$ 4,053	\$ 4,942	\$ -
With an allowance recorded:			
Commercial and industrial	\$ 3,177	\$ 3,888	\$ 694
Real estate - mortgage:			
Residential	1,139	1,179	140
Commercial	3,740	3,913	733
Total	\$ 8,056	\$ 8,980	\$ 1,567
Total:			
Commercial and industrial	\$ 3,627	\$ 4,894	\$ 694
Real estate - construction	44	44	-
Real estate - mortgage:			
Residential	2,824	3,083	140
Commercial	5,610	5,897	733
Consumer installment	4	4	-
Total	\$ 12,109	\$ 13,922	\$ 1,567

The tables above include troubled debt restructurings totaling \$3.1 million at *June 30, 2018* and \$5.4 million as of *December 31, 2017*.

The following tables present the average balance and interest income by class, recognized on impaired loans (in thousands):

For the Three Months Ended		For the Six Months Ended	
June 30, 2018		June 30, 2018	
Average	Interest	Average	Interest
Recorded Income		Recorded Income	

InvestmenRecognized InvestmenRecognized

Commercial and industrial	\$4,277	\$ 23	\$3,644	\$ 47
Real estate - construction	142	-	283	-
Real estate - mortgage:				
Residential	2,772	13	2,871	27
Commercial	6,464	51	6,583	102
Consumer installment	4	-	4	-
Total	\$13,659	\$ 87	\$13,385	\$ 176



	For the Three Months Ended		For the Six Months Ended	
	June 30, 2017		June 30, 2017	
	Average	Interest	Average	Interest
	Recorded Income		Recorded Income	
	Investmen	Recognized	Investmen	Recognized
Commercial and industrial	\$2,228	\$ 57	\$1,889	\$ 141
Real estate - construction	676	1	877	1
Real estate - mortgage:				
Residential	3,131	28	3,264	50
Commercial	8,643	95	8,223	183
Consumer installment	5	-	5	-
Total	\$14,683	\$ 181	\$14,258	\$ 375

Management uses a *nine*-point internal risk-rating system to monitor the credit quality of the overall loan portfolio. The *first five* categories are considered *not* criticized and are aggregated as Pass rated. The criticized rating categories utilized by management generally follow bank regulatory definitions. The Special Mention category includes assets that are currently protected but are potentially weak, resulting in an undue and unwarranted credit risk, but *not* to the point of justifying a Substandard classification. Loans in the Substandard category have well-defined weaknesses that jeopardize the liquidation of the debt and have a distinct possibility that some loss will be sustained if the weaknesses are *not* corrected. All loans greater than 90 days past due are considered Substandard. Any portion of a loan that has been charged off is placed in the Loss category.

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay a loan as agreed, the Company has a structured loan-rating process with several layers of internal and external oversight. Generally, consumer and residential mortgage loans are included in the Pass categories unless a specific action, such as bankruptcy, repossession, or death, occurs to raise awareness of a possible credit event. The Company's Commercial Loan Officers are responsible for the timely and accurate risk rating of the loans in their portfolios at origination and on an ongoing basis with the Chief Credit Officer ultimately responsible for accurate and timely risk ratings. The Credit Department performs an annual review of all commercial relationships with loan balances of \$500,000 or greater. Confirmation of the appropriate risk grade is included in the review on an ongoing basis. The Company engages an external consultant to conduct loan reviews on a semiannual basis. Generally, the external consultant reviews commercial relationships greater than \$250,000 and/or criticized relationships greater than \$125,000. Detailed reviews, including plans for resolution, are performed on loans classified as Substandard on a quarterly basis. Loans in the Special Mention and Substandard categories that are collectively evaluated for impairment are given separate consideration in the determination of the allowance.

The primary risk of commercial and industrial loans is the current economic uncertainties. C&I loans are, by nature, secured by less substantial collateral than real estate-secured loans. The primary risk of real estate construction loans

is potential delays and disputes during the completion process. The primary risk of residential real estate loans is current economic uncertainties along with the slow recovery in the housing market. The primary risk of commercial real estate loans is loss of income of the owner or occupier of the property and the inability of the market to sustain rent levels. Consumer installment loans historically have experienced higher delinquency rates. Consumer installments are typically secured by less substantial collateral than other types of credits.

The following tables present the classes of the loan portfolio summarized by the aggregate Pass and the criticized categories of Special Mention, Substandard and Doubtful within the internal risk-rating system (in thousands):

June 30, 2018	Pass	Special Mention	Substandard	Doubtful	Total Loans
Commercial and industrial	\$95,486	\$3,095	\$ 3,394	\$ -	\$101,975
Real estate - construction	44,289	1,358	-	-	45,647
Real estate - mortgage:					
Residential	315,277	706	4,875	-	320,858
Commercial	446,026	5,859	5,165	-	457,050
Consumer installment	17,969	-	175	-	18,144
Total	\$919,047	\$11,018	\$ 13,609	\$ -	\$943,674

December 31, 2017	Pass	Special Mention	Substandard	Doubtful	Total Loans
Commercial and industrial	\$95,621	\$1,942	\$ 3,783	\$ -	\$101,346
Real estate - construction	46,995	-	22	-	47,017
Real estate - mortgage:					
Residential	312,176	723	5,258	-	318,157
Commercial	424,225	9,164	4,558	-	437,947
Consumer installment	18,742	-	4	-	18,746
Total	\$897,759	\$11,829	\$ 13,625	\$ -	\$923,213

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due.

Nonperforming assets include nonaccrual loans, TDRs, loans 90 days or more past due, EMORECO assets, other real estate owned, and repossessed assets. A loan is classified as nonaccrual when, in the opinion of management, there are serious doubts about collectability of interest and principal. Accrual of interest is discontinued on a loan when management believes, after considering economic and business conditions, the borrower's financial condition is such that collection of principal and interest is doubtful. Payments received on nonaccrual loans are applied against the principal balance.

The following tables present the classes of the loan portfolio summarized by the aging categories of performing loans (in thousands):

Edgar Filing: MIDDLEFIELD BANC CORP - Form 10-Q

		30-59 Days Past Due	60-89 Days Past Due	90 Days+ Past Due	Total Past Due	Total Loans
June 30, 2018	Current					
Commercial and industrial	\$101,459	\$50	\$45	\$421	\$516	\$101,975
Real estate - construction	45,647	-	-	-	-	45,647
Real estate - mortgage:						
Residential	316,239	2,620	853	1,146	4,619	320,858
Commercial	456,006	67	-	977	1,044	457,050
Consumer installment	18,124	14	6	-	20	18,144
Total	\$937,475	\$2,751	\$904	\$2,544	\$6,199	\$943,674

28

---

		30-59 Days Past Due	60-89 Days Past Due	90 Days+ Past Due	Total Past Due	Total Loans
December 31, 2017	Current					
Commercial and industrial	\$99,633	\$1,607	\$29	\$77	\$1,713	\$101,346
Real estate - construction	47,017	-	-	-	-	47,017
Real estate - mortgage:						
Residential	314,866	1,977	227	1,087	3,291	318,157
Commercial	434,879	1,907	1	1,160	3,068	437,947
Consumer installment	18,736	10	-	-	10	18,746
Total	\$915,131	\$5,501	\$257	\$2,324	\$8,082	\$923,213

The following tables present the classes of the loan portfolio summarized by nonaccrual loans (in thousands):

		90+ Days Past Due and Accruing
June 30, 2018	Nonaccrual	
Commercial and industrial	\$ 1,411	\$ 15
Real estate - construction	-	-
Real estate - mortgage:		
Residential	3,843	-
Commercial	3,102	-
Consumer installment	1	-
Total	\$ 8,357	\$ 15

		90+ Days Past Due and Accruing
December 31, 2017	Nonaccrual	
Commercial and industrial	\$ 1,120	\$ -
Real estate - construction	-	-
Real estate - mortgage:		
Residential	4,002	-
Commercial	3,311	-
Consumer installment	-	-
Total	\$ 8,433	\$ -

Interest income that would have been recorded had these loans *not* been placed on nonaccrual status was \$654,000 for the six months ended June 30, 2018 and \$437,000 for the year ended December 31, 2017.

An allowance for loan and lease losses (“ALLL”) is maintained to absorb losses from the loan portfolio. The ALLL is based on management’s continuing evaluation of the risk characteristics and credit quality of the loan portfolio, assessment of current economic conditions, diversification and size of the portfolio, adequacy of collateral, past and anticipated loss experience, and the amount of nonperforming loans.

The Company’s methodology for determining the ALLL is based on the requirements of ASC Section 310-10-35 for loans individually evaluated for impairment (discussed above) and ASC Subtopic 450-20 for loans collectively evaluated for impairment, as well as the Interagency Policy Statements on the Allowance for Loan and Lease Losses and other bank regulatory guidance. The total of the *two* components represents the Company’s ALLL. Management also performs impairment analyses on TDRs, which *may* result in specific reserves.

Loans that are collectively evaluated for impairment are analyzed with general allowances being made as appropriate. For general allowances, historical loss trends are used in the estimation of losses in the current portfolio. These historical loss amounts are modified by other qualitative factors.

The classes described above, which are based on the purpose code assigned to each loan, provide the starting point for the ALLL analysis. Management tracks the historical net charge-off activity at the purpose code level. The historical charge-off factor was calculated using the last *twelve* consecutive historical quarters.

Management has identified a number of additional qualitative factors which it uses to supplement the historical charge-off factor because these factors are likely to cause estimated credit losses associated with the existing loan pools to differ from historical loss experience. The additional factors that are evaluated quarterly and updated using information obtained from internal, regulatory, and governmental sources are: national and local economic trends and conditions; levels of and trends in delinquency rates and nonaccrual loans; trends in volumes and terms of loans; effects of changes in lending policies; experience, ability, and depth of lending staff; value of underlying collateral; and concentrations of credit from a loan type, industry and/or geographic standpoint.

Management reviews the loan portfolio on a quarterly basis using a defined, consistently applied process in order to make appropriate and timely adjustments to the ALLL. When information confirms all or part of specific loans to be uncollectible, these amounts are promptly charged off against the ALLL.

The following tables summarize the primary segments of the loan portfolio and the activity within those segments (in thousands):

	Commercial and industrial	Real estate- construction	Real estate- residential mortgage	Real estate- commercial mortgage	Consumer installment	Total
ALLL balance at December 31, 2017	\$ 999	\$ 313	\$ 1,760	\$ 4,036	\$ 82	\$7,190
Charge-offs	(9 )	-	(74 )	(111 )	(135 )	(329 )
Recoveries	140	17	29	-	35	221
Provision	50	(241 )	28	436	147	420
ALLL balance at June 30, 2018	\$ 1,180	\$ 89	\$ 1,743	\$ 4,361	\$ 129	\$7,502

	Commercial and industrial	Real estate- construction	Real estate- residential mortgage	Real estate- commercial mortgage	Consumer installment	Total
--	---------------------------------	------------------------------	--	--	-------------------------	-------

Edgar Filing: MIDDLEFIELD BANC CORP - Form 10-Q

ALLL balance at December 31, 2016	\$ 448	\$ 172	\$ 2,818	\$ 3,135	\$ 25	\$6,598
Charge-offs	(435 )	-	(74 )	(19 )	(154 )	(682 )
Recoveries	144	22	14	-	174	354
Provision	456	8	(991 )	896	(34 )	335
ALLL balance at June 30, 2017	\$ 613	\$ 202	\$ 1,767	\$ 4,012	\$ 11	\$6,605

	Commercial and industrial	Real estate- construction	Real estate- residential mortgage	Real estate- commercial mortgage	Consumer installment	Total
ALLL balance at March 31, 2018	\$ 1,256	\$ 92	\$ 1,782	\$ 4,323	\$ 98	\$7,551
Charge-offs	-	-	(74 )	(111 )	(130 )	(315 )
Recoveries	29	-	10	-	17	56
Provision	(105 )	(3 )	25	149	144	210
ALLL balance at June 30, 2018	\$ 1,180	\$ 89	\$ 1,743	\$ 4,361	\$ 129	\$7,502

	Commercial and industrial	Real estate- construction	Real estate- residential mortgage	Real estate- commercial mortgage	Consumer installment	Total
ALLL balance at March 31, 2017	\$ 616	\$ 186	\$ 2,523	\$ 3,378	\$ 17	\$6,720
Charge-offs	(415 )	-	(7 )	-	(52 )	(474 )
Recoveries	65	6	7	-	111	189
Provision	347	10	(756 )	634	(65 )	170
ALLL balance at June 30, 2017	\$ 613	\$ 202	\$ 1,767	\$ 4,012	\$ 11	\$6,605



The negative provision allocated to real estate construction loans in the amount of \$241,000 for the six-month period ended June 30, 2018 is due to the historical loss rate for the real estate construction pool changing to -0.127% from 0.775% in the first quarter of 2018.

The ALLL balance for real estate-commercial mortgage loans as of June 30, 2018 is an increase of 8.7% from the balance as of June 30, 2017, due to a greater amount of unallocated loans assigned to this classification.

The negative provision allocated to residential real estate loans in the amount of \$991,000 for the six-month period ended June 30, 2017 is largely due to the payoff of a large residential credit during that period.

The following tables summarize troubled debt restructurings (in thousands):

Troubled Debt Restructurings	For the Three Months Ended June 30, 2018			Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
	Number of Contracts				
	Term Modification	Other	Total		
Residential real estate	1	-	1	\$ 113	\$ 113

Troubled Debt Restructurings	For the Six Months Ended June 30, 2018			Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
	Number of Contracts				
	Term Modification	Other	Total		
Residential real estate	2	-	2	160	160

Troubled Debt Restructurings	For the Three Months Ended June 30, 2017			Pre-Modification Outstanding Recorded	Post-Modification Outstanding Recorded
	Number of Contracts				
	Term Modification	Other	Total		

Edgar Filing: MIDDLEFIELD BANC CORP - Form 10-Q

	Modification			Investment	Investment
Commercial and industrial	-	1	1	\$ 904	\$ 905
Residential real estate	1	-	1	7	7

For the Six Months Ended

June 30, 2017

Troubled Debt Restructurings	Number of Contracts			Pre-Modification Outstanding Recorded	Post-Modification Outstanding Recorded
	Term Modification	Other	Total	Investment	Investment
Commercial and industrial	1	1	2	\$ 954	\$ 955
Residential real estate	2	-	2	10	10

The following table summarizes TDR modifications within the previous 12 months for which there was a payment default during the *three-month* and *six-month* periods ended *June 30, 2018* and *June 30, 2017*, respectively (in thousands):

Troubled Debt Restructurings subsequently defaulted	For the Six Months Ended June 30, 2018	
	Number of	Recorded
Residential real estate	2	\$ 215

One contract, with a recorded investment of \$33,000, subsequently defaulted in the *six* months ended *June 30, 2017*. There were *no* other subsequent defaults of troubled debt restructurings for the *three* months ended *June 30, 2018* and *June 30, 2017*.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis provides further detail to the financial condition and results of operations of the Company. The MD&A should be read in conjunction with the notes and financial statements presented in this report.

The information contained or incorporated by reference in this report on Form 10-Q contain forward-looking statements, including certain plans, expectations, goals, and projections, which are subject to numerous assumptions, risks, and uncertainties. Actual results could differ materially from those contained or implied by such statements for a variety of factors, including: changes in economic conditions; movements in interest rates; competitive pressures on product pricing and services; success and timing of business strategies; the nature, extent, and timing of government actions and reforms; and extended disruption of vital infrastructure. All forward-looking statements included in this report on Form 10-Q are based on information available at the time of the report. Middlefield Banc Corp. assumes no obligation to update any forward-looking statement.

### CHANGES IN FINANCIAL CONDITION

**General.** The Company's total assets ended the June 30, 2018 quarter at \$1.17 billion, an increase of \$59.7 million from December 31, 2017. For the same time period, cash and cash equivalents increased \$31.4 million, or 78.6%, while net loans increased \$20.2 million, or 2.2%. Total liabilities increased \$56.9 million or 5.8%, while stockholders' equity increased \$2.9 million, or 2.4%.

**Cash and cash equivalents.** Cash and cash equivalents increased \$31.4 million, or 78.6%, to \$71.3 million at June 30, 2018 from \$39.9 million at December 31, 2017. Deposits from customers into savings and checking accounts, loan and securities repayments, and proceeds from borrowed funds typically increase these accounts. Decreases result from customer withdrawals, new loan originations, purchases of investment securities and repayments of borrowed funds. Included in the increase to cash and cash equivalents is an increase in federal funds sold of \$28.8 million, or 100.0%, which is the result of a strategic initiative to increase on-balance-sheet liquidity as of June 30, 2018.

**Investment securities.** Investment securities available for sale on June 30, 2018 totaled \$100.0 million, an increase of \$4.7 million, or 5.0%, from \$95.3 million at December 31, 2017. Included in this net increase is a reclassification from investment securities available for sale to equity securities of \$625,000 in accordance with the adoption ASU 2016-01 on January 1, 2018. During this period the Company recorded repayments, calls, and maturities of \$2.3 million. Securities purchased were \$9.9 million and there were no securities sold during this period. The Company recorded \$31,000 in gains on equity securities as of June 30, 2018 on the Company's Consolidated Statement of Income and Consolidated Statement of Cash Flows. This gain is the result of remeasurements of fair value of the

equity securities held during this six-month period.

**Loans receivable.** The loans receivable category consists primarily of single-family mortgage loans used to purchase or refinance personal residences located within the Company's market area, commercial and industrial loans and commercial real estate loans used to finance properties that are used in the borrowers' businesses or to finance investor-owned rental properties, and to a lesser extent, construction and consumer loans. Net loans receivable increased \$20.2 million, or 2.2%, to \$936.2 million as of June 30, 2018 from \$916.0 million at December 31, 2017 due to strategic growth goals. Included in the total increase for loans receivable were increases in the commercial real estate and residential portfolios of \$19.1 million, or 4.4%, and \$2.7 million, or 0.9%, respectively. Also included in the total increase to loans receivable was a decrease in the real estate – construction portfolio of \$1.4 million or 2.9%.

The Company's Mortgage Banking operation generates loans for sale to FHLMC. Loans held for sale on June 30, 2018 totaled \$1.1 million, an increase of \$669,000, or 144.5%, from December 31, 2017. This increase is the result of more funded loans being held in the warehouse at quarter end.

**Student Lending.** Through its acquisition of Liberty Bank, N.A., on January 12, 2017, MBC acquired Liberty's private student loan business. These loans provided qualified borrowers with the ability to finance the costs associated with obtaining a degree and to refinance their existing student loans. Pursuant to loan origination agreements with student loan originating and servicing companies, MBC made student loans to qualified students and sold those loans, without recourse and with servicing released, into the secondary market. Gains on the sales of these loans as well as interest income earned while held by MBC are included in the Consolidated Statement of Income. The lending program changed near the end of 2017, requiring the Company to expand to "in-school" lending and extending the Company's carrying period, both of which increased the risk profile. The Company therefore has ceased the origination of new student loans.

**Allowance for Loan and Lease Losses and Asset Quality.** The allowance for loan and lease losses increased \$312,000, or 4.3%, to \$7.5 million at June 30, 2018 from \$7.2 million at December 31, 2017. For the three months ended June 30, 2018, net loan charge-offs totaled \$259,000, or 0.11% of average loans, compared to net charge-offs of \$285,000, or 0.13%, for the same period in 2017. To maintain the allowance for loan and lease losses, the Company recorded a provision for loan loss of \$210,000 in the three-month period ended June 30, 2018. For the six months ended June 30, 2018, net loan charge-offs totaled \$108,000, or 0.02% of average loans, compared to net charge-offs of \$328,000, or 0.08%, for the same period in 2017. To maintain the allowance for loan and lease losses, the Company recorded a provision for loan loss of \$420,000 in the six-month period ended June 30, 2018.

Management analyzes the adequacy of the allowance for loan and lease losses regularly through reviews of the performance of the loan portfolio considering economic conditions, changes in interest rates and the effect of such changes on real estate values, and changes in the amount and composition of the loan portfolio. The allowance for loan and lease losses is a significant estimate that is particularly susceptible to changes in the near term. Management's analysis includes a review of all loans designated as impaired, historical loan loss experience, the estimated fair value of the underlying collateral, economic conditions, current interest rates, trends in the borrower's industry and other factors that management believes warrant recognition in providing for an appropriate allowance for loan and lease losses. Future additions or reductions to the allowance for loan and lease losses will be dependent on these factors. Additionally, the Company uses an outside party to conduct an independent review of commercial and commercial real estate loans that is designed to validate management conclusions of risk ratings and the appropriateness of the allowance allocated to these loans. The Company uses the results of this review to help determine the effectiveness of policies and procedures and to assess the adequacy of the allowance for loan and lease losses allocated to these types of loans. Management believes the allowance for loan and lease losses is appropriately stated at June 30, 2018. Based on the variables involved and management's judgments about uncertain outcomes, the determination of the allowance for loan and lease losses is considered a critical accounting policy.

**Nonperforming assets.** Nonperforming assets includes nonaccrual loans, troubled debt restructurings (TDRs), loans 90 days or more past due, EMORECO assets, other real estate, and repossessed assets. Real estate owned is written down to fair value at its initial recording and continually monitored for changes in fair value. A loan is classified as nonaccrual when, in the opinion of management, there are serious doubts about collectability of interest and principal. Accrual of interest is discontinued on a loan when management believes, after considering economic and business conditions, the borrower's financial condition is such that collection of principal and interest is doubtful. Payments received on nonaccrual loans are applied against principal until doubt about collectability ceases. TDRs are those loans which the Company, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower that the Company would not otherwise consider. The Company has 43 TDRs accruing interest with a balance of \$4.7 million as of June 30, 2018. A TDR that yields a market interest rate at the time of restructuring and is in compliance with its modified terms is no longer reported as TDR in calendar years after the year in which the restructuring took place. To be in compliance with its modified terms, a loan that is a TDR must not be in nonaccrual status and must be current or less than 30 days past due on its contractual principal and interest payments under the modified repayment terms. Nonperforming loans decreased \$6.4 million, or 35.9%, to \$11.4 million as of June 30, 2018 from \$17.8 million as of March 31, 2018 mostly due to the payoff of a \$6.0 million loan that was previously classified as a TDR. Nonperforming loans secured by real estate totaled \$10.5 million as of June 30, 2018, an increase of \$400,000 from \$10.1 million at December 31, 2017.

Edgar Filing: MIDDLEFIELD BANC CORP - Form 10-Q

Asset Quality History

(Dollar amounts in thousands)	6/30/2018	3/31/2018	12/31/2017	9/30/2017	6/30/2017
Nonperforming loans	\$ 11,423	\$ 17,818	\$ 13,415	\$ 14,401	\$ 16,402
Other real estate owned	181	212	212	557	650
Nonperforming assets	\$ 11,604	\$ 18,030	\$ 13,627	\$ 14,958	\$ 17,052
Allowance for loan and lease losses	7,502	7,551	7,190	6,852	6,605
<b>Ratios</b>					
Nonperforming loans to total loans	1.21 %	1.91 %	1.45 %	1.64 %	1.89 %
Nonperforming assets to total assets	1.00 %	1.63 %	1.23 %	1.38 %	1.59 %
Allowance for loan and lease losses to total loans	0.79 %	0.81 %	0.78 %	0.78 %	0.76 %
Allowance for loan and lease losses to nonperforming loans	65.67 %	42.38 %	53.60 %	47.58 %	40.27 %

A major factor in determining the appropriateness of the allowance for loan and lease losses is the type of collateral which secures the loans. Of the total nonperforming loans at June 30, 2018, 91.9% were secured by real estate. Although this does not insure against all losses, the real estate typically provides for at least partial recovery, even in a distressed-sale and declining-value environment. The Company's objective is to minimize the future loss exposure of the Company.

The allowance for loan and lease losses to total loans ratio increased from 0.78% as of December 31, 2017 to 0.79% as of June 30, 2018. This increase is primarily due to a decrease in loans charged off during the six-month period ended June 30, 2018.

**Deposits.** The Company considers various sources when evaluating funding needs, including but not limited to deposits, which are a significant source of funds, totaling \$932.3 million or 89.7% of the Company's total funding sources at June 30, 2018. Total deposits increased \$54.1 million, or 6.2%, at June 30, 2018 from \$878.2 million at December 31, 2017. The total increase in deposits is primarily related to increases in time, noninterest-bearing demand, and interest-bearing demand deposits of \$47.4 million or 19.5%, \$15.4 million or 8.0%, and \$8.1 million or 9.7%, respectively. These increases were partially offset by decreases in money market and savings deposits of \$12.7 million or 8.5%, and \$4.1 million or 2.0%, respectively, at June 30, 2018.

**Borrowed funds.** The Company uses short-term and long-term borrowings as another source of funding for asset growth and liquidity needs. These borrowings primarily include FHLB advances, junior subordinated debt, short-term borrowings from other banks, federal funds purchased, and repurchase agreements. Short-term borrowings increased \$13.1 million, or 17.6%, to \$87.8 million as of June 30, 2018. Other borrowings decreased \$10.1 million, or 34.6%, to \$19.0 million as of June 30, 2018 from \$29.1 million as of December 31, 2017. This decrease is due to the reduction of FHLB borrowings during the six-month period ending June 30, 2018, resulting from increases in funds from deposit accounts, which allowed the Company to repay a significant portion of the outstanding short-term debt.

**Stockholders' equity.** Stockholders' equity increased \$2.9 million, or 2.4%, to \$122.7 million at June 30, 2018 from \$119.9 million at December 31, 2017. This growth was the result of increases in retained earnings and common stock of \$3.7 million and \$685,000, respectively. The change in retained earnings is due to the year-to-date net income offset by dividends paid and the change in common stock is due to regular stock grants and dividend reinvestment and purchase plan distributions. The increase in stockholders' equity at June 30, 2018 is partially offset by a decrease in AOCI of \$1.5 million due to fair value adjustments of available-for-sale securities, and the adoption of accounting standard updates made effective for periods beginning after December 15, 2017, which resulted in a net reclassification of \$46,000 between retained earnings and AOCI.

## RESULTS OF OPERATIONS

**General.** Net income for the three months ended June 30, 2018, was \$3.1 million, a \$590,000 or 23.5% increase from the amount earned during the same period in 2017. Diluted earnings per share for the quarter increased to \$0.96, compared to \$0.83 from the same period in 2017. Net income for the six months ended June 30, 2018, was \$5.7 million, a \$1.1 million or 23.8% increase from the amount earned during the same period in 2017. Diluted earnings per share increased to \$1.76, compared to \$1.61 from the same period in 2017.

The Company's annualized return on average assets ("ROA") and return on average equity ("ROE") for the quarter were 1.11% and 10.08%, respectively, compared with 0.94% and 9.34% for the same period in 2017. The Company's ROA and ROE for the six-month period were 1.03% and 9.42%, respectively, compared with 0.89% and 9.05% for the same period in 2017.

**Net interest income.** Net interest income, the primary source of revenue for the Company, is determined by the interest rate spread, which is defined as the difference between income on earning assets and the cost of funds supporting those assets, and the relative amounts of interest-earning assets and interest-bearing liabilities. Management periodically adjusts the mix of assets and liabilities, as well as the rates earned or paid on those assets and liabilities, in order to manage and improve net interest income. The level of interest rates and changes in the amount and composition of interest-earning assets and liabilities affect the Company's net interest income. Management's goal is to maintain a balance between steady net interest income growth and the risks associated with interest rate fluctuations.

Net interest income for the three months ended June 30, 2018 totaled \$9.9 million, an increase of 6.1% from that reported in the comparable period of 2017. The net interest margin was 3.76% for the second quarter of 2018, down from the 3.80% reported for the same quarter of 2017. Net interest income for the six months ended June 30, 2018 totaled \$19.8 million, an increase of 9.5% from that reported in the comparable period of 2017. The net interest margin was 3.79% for the six-month period ended June 30, 2018, down from the 3.82% reported for the comparable period of 2017.

**Interest and dividend income.** Interest and dividend income increased \$1.2 million, or 11.3%, for the three months ended June 30, 2018, compared to the same period in the prior year. This is attributable to an increase in interest and fees on loans of \$1.3 million, partially offset by a decrease in interest earned on investment securities of \$133,000. Interest and dividend income increased \$3.0 million, or 14.1%, for the six months ended June 30, 2018, compared to the same period in the prior year. This is attributable to an increase in interest and fees on loans of \$3.2 million, partially offset by a decrease in interest earned on investment securities of \$294,000.

Interest and fees earned on loans receivable increased \$1.3 million, or 13.3%, for the three months ended June 30, 2018, compared to the same period in the prior year. This is attributable to an increase in average loan balances of \$79.8 million, accompanied by a 17 basis point increase in the average yield to 4.84%. Interest and fees earned on loans receivable increased \$3.2 million, or 16.7%, for the six months ended June 30, 2018, compared to the same period in the prior year. This is attributable to an increase in average loan balances of \$105.1 million, accompanied by a 17 basis point increase in the average yield to 4.83%.



Net interest earned on securities decreased by \$133,000 for the three months ended June 30, 2018 when compared to the same period in the prior year. The average balance of investment securities decreased \$14.3 million, or 13.2%, while the 3.68% yield on the investment portfolio decreased by 66 basis points, from 4.34%, for the same period in the prior year. Net interest earned on securities decreased by \$294,000 for the six months ended June 30, 2018 when compared to the same period in the prior year. The average balance of investment securities decreased \$16.0 million, or 14.5%, while the 3.64% yield on the investment portfolio decreased by 68 basis points, from 4.32%, for the same period in the prior year. The decreases in yields are mostly due to the decrease in corporate tax rates which lowered the tax equivalent adjustments used to calculate the yield on tax-exempt securities.

**Interest expense.** Interest expense increased \$658,000, or 40.5%, for the three months ended June 30, 2018, compared to the same period in the prior year. The increase is attributable to increases in the average balances of certificates of deposit, and savings deposits of \$42.1 million or 17.1%, and \$34.1 million or 18.8%, respectively, and was partially offset by a decrease in the average balance of money market deposits of \$18.1 million or 11.4%. This increase was accompanied by increases in costs of 112, 43, 39, and 29 basis points for the average balances of borrowings, money market deposits, certificates of deposit, and savings deposits, respectively. The overall increase in deposits was utilized to pay down borrowings, the average balance of which decreased by \$60.6 million, or 55.8%. Interest expense increased \$1.3 million, or 40.9%, for the six months ended June 30, 2018, compared to the same period in the prior year. The increase is attributable to increases in the average balances of savings deposits, and certificates of deposit of \$35.2 million or 19.5%, and \$34.0 million or 14.4%, respectively, and was partially offset by a decrease in the average balance of money market deposits of \$11.2 million or 7.1%. This increase was accompanied by increases in costs of 66, 39, 32, and 26 basis points for the average balances of borrowings, money market deposits, certificates of deposit, and savings deposits, respectively. The overall increase in deposits was utilized to pay down borrowings, the average balance of which decreased by \$37.9 million, or 34.4%.

**Provision for loan losses.** The provision for loan losses represents the charge to income necessary to adjust the allowance for loan and lease losses to an amount that represents management's assessment of the estimated probable incurred credit losses inherent in the loan portfolio. Each quarter management performs a review of estimated probable incurred credit losses in the loan portfolio. Based on this review, a provision for loan losses of \$210,000 was recorded for the quarter ended June 30, 2018, an increase of \$40,000, or 23.5% from the quarter ended June 30, 2017. A provision for loan losses of \$420,000 was recorded for the six-month period ended June 30, 2018, compared to \$335,000 in the same period in 2017. Nonperforming loans were \$11.4 million, or 1.2% of total loans at June 30, 2018 compared with \$16.4 million, or 1.9% at June 30, 2017. For the three months ended June 30, 2018, net loan charge-offs totaled \$259,000, or 0.11% of average loans, compared to net charge-offs of \$285,000, or 0.13%, for the second quarter of 2017. For the six months ended June 30, 2018, net loan charge-offs totaled \$108,000, or 0.02% of average loans, compared to net charge-offs of \$328,000, or 0.08%, for the same period in 2017.

**Noninterest income.** Noninterest income increased \$16,000 for the three months ended June 30, 2018 over the comparable 2017 period. This increase was the result of increases in other income, service charges on deposit accounts, and gains on equity securities of \$94,000, \$23,000, and \$13,000, respectively. This increase is net of a decrease in gains on sales of loans of \$114,000 due to the Company ceasing the origination of student lending as of December 31, 2017. Noninterest income decreased \$709,000 for the six months ended June 30, 2018 over the comparable 2017 period. This decrease is largely the result of decreases in net investment security gains on sale of \$488,000 and gains on sales of loans of \$344,000. The decrease in net investment securities gains on sale is due to the Company having liquidated its investment in Liberty stock during its acquisition in the first quarter of 2017. The decrease in gains of sales of loans is largely due to the Company ceasing the origination of student lending as of December 31, 2017.

**Noninterest expense.** Noninterest expense of \$7.1 million for the second quarter 2018 was 5.4%, or \$359,000 more than the second quarter of 2017. Salaries and employee benefits and other expenses increased \$663,000 or 20.7%, and \$113,000 or 13.8%, respectively. These increases were partially offset by decreases in data processing costs and merger expenses of \$186,000 or 31.6% and \$307,000, respectively. The salary increase is mostly due to annual pay

adjustments. Noninterest expense of \$14.4 million for the six-month period ended June 30, 2018 was 3.1%, or \$437,000 more than the same period in 2017. Salaries and employee benefits and software amortization expense increased \$946,000 or 13.7%, and \$143,000 or 88.3%, respectively. These increases were partially offset by decreases in equipment expense and merger expenses of \$113,000 or 20.7% and \$694,000, respectively. The salary increase is mostly due to annual pay adjustments and the increase in software amortization expense is due to an increase in capitalized expenses compared to the same period in the prior year.

**Provision for income taxes.** The Company recognized \$481,000 in income tax expense, which reflected an effective tax rate of 13.4% for the three months ended June 30, 2018, as compared to \$885,000 with an effective tax rate of 26.1% for the comparable 2017 period. The Company recognized \$1.0 million in income tax expense, which reflected an effective tax rate of 15.0% for the six months ended June 30, 2018, as compared to \$1.6 million with an effective tax rate of 26.0% for the comparable 2017 period. The decreases in the provisions are directly correlated to the decrease in corporate tax rates applied to the increase in net income before taxes.

**Average Balance Sheet and Yield/Rate Analysis.** The following table sets forth, for the periods indicated, information concerning the total dollar amounts of interest income from interest-earning assets and the resultant average yields, the total dollar amounts of interest expense on interest-bearing liabilities and the resultant average costs, net interest income, interest rate spread and the net interest margin earned on average interest-earning assets. For purposes of this table, average balances are calculated using monthly averages and the average loan balances include nonaccrual loans and exclude the allowance for loan and lease losses, and interest income includes accretion of net deferred loan fees. Yields on tax-exempt securities (tax exempt for federal income tax purposes) are shown on a fully tax-equivalent basis utilizing a federal tax rate of 21% and 34% for the periods ended June 30, 2018 and 2017, respectively. Yields and rates have been calculated on an annualized basis utilizing monthly interest amounts.

(Dollars in thousands)	For the Three Months Ended June 30,							
	2018				2017			
	Average Balance	Interest	Average Yield/Cost		Average Balance	Interest	Average Yield/Cost	
Interest-earning assets:								
Loans receivable	\$931,504	\$11,234	4.84	%	\$851,754	\$9,916	4.67	%
Investment securities (3)	94,460	720	3.68	%	108,774	853	4.34	%
Interest-bearing deposits with other banks	40,904	175	1.72	%	52,077	133	1.02	%
Total interest-earning assets	1,066,868	12,129	4.61	%	1,012,605	10,902	4.45	%
Noninterest-earning assets	53,653				58,632			
Total assets	\$1,120,521				\$1,071,237			
Interest-bearing liabilities:								
Interest-bearing demand deposits	\$96,358	\$71	0.30	%	\$90,337	\$66	0.29	%
Money market deposits	141,238	305	0.87	%	159,333	175	0.44	%
Savings deposits	215,639	309	0.57	%	181,547	127	0.28	%
Certificates of deposit	288,283	1,288	1.79	%	246,196	859	1.40	%
Borrowings	47,935	310	2.59	%	108,513	398	1.47	%
Total interest-bearing liabilities	789,453	2,283	1.16	%	785,926	1,625	0.83	%
Noninterest-bearing liabilities								
Other liabilities	207,840				177,696			
Stockholders' equity	123,228				107,615			
Total liabilities and stockholders' equity	\$1,120,521				\$1,071,237			
Net interest income		\$9,846				\$9,277		
Interest rate spread (1)			3.45	%			3.62	%
Net interest margin (2)			3.76	%			3.80	%
			135.14	%			128.84	%

Ratio of average interest-earning assets to  
average interest-bearing liabilities

---

(1) Interest rate spread represents the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities.

(2) Net interest margin represents net interest income as a percentage of average interest-earning assets.

(3) Tax-equivalent adjustments to calculate the yield on tax-exempt securities were \$146 and \$325 for the three months ended June 30, 2018 and 2017, respectively.

36

---

**Analysis of Changes in Net Interest Income.** The following table analyzes the changes in interest income and interest expense, between the three-month periods ended June 30, 2018 and 2017, in terms of: (1) changes in volume of interest-earning assets and interest-bearing liabilities and (2) changes in yields and rates. The table reflects the extent to which changes in the Company's interest income and interest expense are attributable to changes in rate (change in rate multiplied by prior period volume), changes in volume (changes in volume multiplied by prior period rate) and changes attributable to the combined impact of volume/rate (change in rate multiplied by change in volume). The changes attributable to the combined impact of volume/rate are allocated on a consistent basis between the volume and rate variances.

(Dollars in thousands)	2018 versus 2017		
	Increase (decrease) due to		
	Volume	Rate	Total
Interest-earning assets:			
Loans receivable	\$929	\$389	\$1,318
Investment securities	(155)	22	(133 )
Interest-bearing deposits with other banks	(28 )	70	42
Total interest-earning assets	746	481	1,227
Interest-bearing liabilities:			
Interest-bearing demand deposits	4	1	5
Money market deposits	(20 )	150	130
Savings deposits	24	158	182
Certificates of deposit	147	282	429
Borrowings	(222)	134	(88 )
Total interest-bearing liabilities	(67 )	725	658
Net interest income	\$813	\$(244)	\$569

**Average Balance Sheet and Yield/Rate Analysis.** The following table sets forth, for the periods indicated, information concerning the total dollar amounts of interest income from interest-earning assets and the resultant average yields, the total dollar amounts of interest expense on interest-bearing liabilities and the resultant average costs, net interest income, interest rate spread and the net interest margin earned on average interest-earning assets. For purposes of this table, average balances are calculated using monthly averages and the average loan balances include nonaccrual loans and exclude the allowance for loan and lease losses, and interest income includes accretion of net deferred loan fees. Yields on tax-exempt securities (tax exempt for federal income tax purposes) are shown on a fully tax-equivalent basis utilizing a federal tax rate of 21% and 34% for the periods ended June 30, 2018 and 2017, respectively. Yields and rates have been calculated on an annualized basis utilizing monthly interest amounts.

(Dollars in thousands)	For the Six Months Ended June 30,							
	2018			2017				
	Average Balance	Interest	Average Yield/Cost	Average Balance	Interest	Average Yield/Cost		
Interest-earning assets:								
Loans receivable	\$930,915	\$22,288	4.83	% \$825,812	\$19,096	4.66	%	
Investment securities (3)	94,074	1,414	3.64	% 110,073	1,708	4.32	%	
Interest-bearing deposits with other banks	41,552	367	1.78	% 50,613	297	1.18	%	
Total interest-earning assets	1,066,541	24,069	4.60	% 986,498	21,101	4.45	%	
Noninterest-earning assets	53,463			59,079				
Total assets	\$1,120,004			\$1,045,577				
Interest-bearing liabilities:								
Interest-bearing demand deposits	\$91,330	\$131	0.29	% \$86,262	\$117	0.27	%	
Money market deposits	145,779	608	0.84	% 156,943	349	0.45	%	
Savings deposits	215,597	575	0.54	% 180,444	251	0.28	%	
Certificates of deposit	270,093	2,299	1.72	% 236,079	1,635	1.40	%	
Borrowings	72,332	708	1.97	% 110,267	715	1.31	%	
Total interest-bearing liabilities	795,131	4,321	1.10	% 769,995	3,067	0.80	%	
Noninterest-bearing liabilities								
Other liabilities	202,758			172,907				
Stockholders' equity	122,115			102,675				
Total liabilities and stockholders' equity	\$1,120,004			\$1,045,577				
Net interest income		\$19,748			\$18,034			
Interest rate spread (1)			3.50	%		3.65	%	
Net interest margin (2)			3.79	%		3.82	%	
Ratio of average interest-earning assets to average interest-bearing liabilities			134.13	%		128.12	%	

(1) Interest rate spread represents the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities.

(2) Net interest margin represents net interest income as a percentage of average interest-earning assets.

(3) Tax-equivalent adjustments to calculate the yield on tax-exempt securities were \$286 and \$653 for the six months ended June 30, 2018 and 2017, respectively.





**Analysis of Changes in Net Interest Income.** The following table analyzes the changes in interest income and interest expense, between the six-month periods ended June 30, 2018 and 2017, in terms of: (1) changes in volume of interest-earning assets and interest-bearing liabilities and (2) changes in yields and rates. The table reflects the extent to which changes in the Company's interest income and interest expense are attributable to changes in rate (change in rate multiplied by prior period volume), changes in volume (changes in volume multiplied by prior period rate) and changes attributable to the combined impact of volume/rate (change in rate multiplied by change in volume). The changes attributable to the combined impact of volume/rate are allocated on a consistent basis between the volume and rate variances.

(Dollars in thousands)	2018 versus 2017		
	Increase (decrease) due to		
	Volume	Rate	Total
Interest-earning assets:			
Loans receivable	\$2,429	\$763	\$3,192
Investment securities	(343 )	49	(294 )
Interest-bearing deposits with other banks	(53 )	123	70
Total interest-earning assets	2,033	935	2,968
Interest-bearing liabilities:			
Interest-bearing demand deposits	7	7	14
Money market deposits	(25 )	284	259
Savings deposits	49	275	324
Certificates of deposit	236	428	664
Borrowings	(246 )	239	(7 )
Total interest-bearing liabilities	21	1,233	1,254
Net interest income	\$2,012	\$(298 )	\$1,714

## **LIQUIDITY**

Management's objective in managing liquidity is maintaining the ability to continue meeting the cash flow needs of banking customers, such as borrowings or deposit withdrawals, as well as the Company's own financial commitments. The principal sources of liquidity are net income, loan payments, maturing and principal reductions on securities and sales of securities available for sale, federal funds sold and cash and deposits with banks. Along with its liquid assets, the Company has additional sources of liquidity available to ensure that adequate funds are available as needed. These include, but are not limited to, the purchase of federal funds, and the ability to borrow funds under line of credit agreements with correspondent banks and a borrowing agreement with the Federal Home Loan Bank of Cincinnati, and the adjustment of interest rates to obtain depositors. Management believes the Company has the capital adequacy, profitability and reputation to meet the current and projected needs of its customers.

For the six months ended June 30, 2018, the adjustments to reconcile net income to net cash from operating activities consisted mainly of depreciation and amortization of premises and equipment, the provision for loan losses, net amortization of securities and net changes in other assets and liabilities. For a more detailed illustration of sources and uses of cash, refer to the Condensed Consolidated Statements of Cash Flows.

## **INFLATION**

Substantially all of the Company's assets and liabilities relate to banking activities and are monetary in nature. The consolidated financial statements and related financial data are presented in accordance with U.S. Generally Accepted Accounting Principles ("GAAP"). GAAP currently requires the Company to measure the financial position and results of operations in terms of historical dollars, with the exception of securities available for sale, impaired loans and other real estate loans that are measured at fair value. Changes in the value of money due to rising inflation can cause purchasing power loss.

Management's opinion is that movements in interest rates affect the financial condition and results of operations to a greater degree than changes in the rate of inflation. It should be noted that interest rates and inflation do affect each other, but do not always move in correlation with each other. The Company's ability to match the interest sensitivity of its financial assets to the interest sensitivity of its liabilities in its asset/liability management may tend to minimize the effect of changes in interest rates on the Company's performance.

## **REGULATORY MATTERS**

The Company is subject to the regulatory requirements of the Federal Reserve System as a bank holding company. The bank subsidiary is subject to regulations of the Federal Deposit Insurance Corporation (“FDIC”) and the Ohio Division of Financial Institutions.

The Federal Reserve Board and the FDIC have extensive authority to prevent and to remedy unsafe and unsound practices and violations of applicable laws and regulations by institutions and holding companies. The agencies may assess civil money penalties, issue cease-and-desist or removal orders, seek injunctions, and publicly disclose those actions. In addition, the Ohio Division of Financial Institutions possesses enforcement powers to address violations of Ohio banking law by Ohio-chartered banks.

## **REGULATORY CAPITAL REQUIREMENTS**

Financial institution regulators have established guidelines for minimum capital ratios for banks, thrifts and bank and thrift holding companies. The net unrealized gain or loss on available-for-sale securities is generally not included in computing regulatory capital. In order to avoid limitations on capital distributions, including dividend payments, Middlefield Bank and the Company must each hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer began on January 1, 2016 at 0.625% and increases ratably on each subsequent January 1 until it reaches 2.50% on January 1, 2019. Within the tabular presentation that follows is the adequately capitalized ratio plus capital conservation buffer that includes the fully phased-in 2.50% buffer.

Middlefield Bank and the Company met each of the well-capitalized ratio guidelines at June 30, 2018. The following table indicates the capital ratios for Middlefield Bank and Company at June 30, 2018 and December 31, 2017.

	As of June 30, 2018				
	Leverage	Tier 1	Common	Total	
		Risk		Risk	
		Based	Equity	Based	
		Tier 1			
The Middlefield Banking Company	9.56 %	10.74 %	10.74 %		11.51 %
Middlefield Banc Corp.	10.33 %	11.55 %	10.74 %		12.31 %
Adequately capitalized ratio	4.00 %	6.00 %	4.50 %		8.00 %
Adequately capitalized ratio plus fully phased-in capital conservation buffer	4.00 %	8.50 %	7.00 %		10.50 %
Well-capitalized ratio (Bank only)	5.00 %	8.00 %	6.50 %		10.00 %
	As of December 31, 2017				
	Leverage	Tier 1	Common	Total	
		Risk		Risk	
		Based	Equity	Based	
		Tier 1			

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

#### ASSET AND LIABILITY MANAGEMENT

The primary objective of the Company's asset and liability management function is to maximize the Company's net interest income while simultaneously maintaining an acceptable level of interest rate risk given the Company's operating environment, capital and liquidity requirements, performance objectives and overall business focus. The principal determinant of the exposure of the Company's earnings to interest rate risk is the timing difference between the re-pricing or maturity of interest-earning assets and the re-pricing or maturity of interest-bearing liabilities. The Company's asset and liability management policies are designed to decrease interest rate sensitivity primarily by shortening the maturities of interest-earning assets while at the same time extending the maturities of interest-bearing liabilities. The Board of Directors of the Company continues to believe in a strong asset/liability management process in order to insulate the Company from material and prolonged increases in interest rates.

The Company's Board of Directors has established an Asset and Liability Management Committee consisting of outside directors and senior management. This committee, which meets quarterly, generally monitors various asset and liability management policies and strategies.

### **Interest Rate Sensitivity Simulation Analysis**

The Company engages an external consultant to facilitate income simulation modeling on a quarterly basis. This modeling measures interest rate risk and sensitivity. The Asset and Liability Management Committee of the Company believes the various rate scenarios of the simulation modeling enables the Company to more accurately evaluate and manage the exposure of interest rate fluctuations on net interest income, the yield curve, various loan and mortgage-backed security prepayments, and deposit decay assumptions.

Earnings simulation modeling and assumptions about the timing and volatility of cash flows are critical in net portfolio equity valuation analysis. Particularly important are the assumptions driving mortgage prepayments and expected attrition of the core deposit portfolios. These assumptions are based on the Company's historical experience and industry standards and are applied consistently across all rate risk measures.

The Company has established the following guidelines for assessing interest rate risk:

Net interest income simulation (“NII”) - Projected net interest income over the next twelve months will not be reduced by more than 10% given a gradual shift (i.e., over 12 months) in interest rates of up to 200 basis points (+ or -) and assuming no balance sheet growth.

Portfolio equity simulation - Portfolio equity is the net present value of the Company’s existing assets and liabilities. The Company uses an Economic Value of Equity (“EVE”) analysis which shows the estimated changes in portfolio equity taking certain long-term shock rates into consideration. Given a 200 basis point immediate and permanent increase in market interest rates, portfolio equity may not correspondingly decrease or increase by more than 20% of stockholders’ equity. Given a 100 basis point immediate and permanent decrease in market interest rates, portfolio equity may not correspondingly decrease or increase by more than 10% of stockholders’ equity.

The following table presents the simulated impact of a 200 basis point upward or 100 basis point downward shift of market interest rates on net interest income, and the change in portfolio equity. This analysis was done assuming the interest-earning asset and interest-bearing liability levels at June 30, 2018 and December 31, 2017 remained constant. The impact of the market rate movements was developed by simulating the effects of rates changing gradually over a one-year period from the June 30, 2018 and December 31, 2017 levels for net interest income and portfolio equity. The impact of market rate movements was developed by simulating the effects of an immediate and permanent change in rates at June 30, 2018 and December 31, 2017 for portfolio equity:

	June 30, 2018		December 31, 2017	
	% Change in NII	% Change in EVE	% Change in NII	% Change in EVE
+200bp	(0.11)%	11.50 %	(1.06)%	13.50 %
-100bp	(2.07)%	(17.10 )%	(2.29)%	(21.30 )%

## CRITICAL ACCOUNTING ESTIMATES

The Company’s critical accounting estimates involving the more significant judgments and assumptions used in the preparation of the consolidated financial statements as of June 30, 2018, have remained unchanged from December 31, 2017.

## Item 4. Controls and Procedures

### Controls and Procedures Disclosure

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Corporation's reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

As of the end of the period covered by this quarterly report, an evaluation was carried out under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934). Based on their evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures are, to the best of their knowledge, effective to ensure that information required to be disclosed by the Corporation in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. Subsequent to the date of their evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that there were no significant changes in internal control or in other factors that could significantly affect the Company's internal controls, including any corrective actions with regard to significant deficiencies and material weaknesses.

A material weakness is a significant deficiency (as defined in Public Company Accounting Oversight Board Auditing Standard No. 2), or a combination of significant deficiencies, that results in there being more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis by management or employees in the normal course of performing their assigned functions.

Changes in Internal Control over Financial Reporting

There have not been any changes in the Company's internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) that occurred during the Company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

Item  
1. Legal Proceedings

None

Item  
1a. There are no material changes to the risk factors set forth in Part I, Item 1A, "Risk Factors," of the Company's Annual Report on Form 10-K for the year ended December 31, 2017. Please refer to that section for disclosures regarding the risks and uncertainties related to the Company's business.

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

None

Item  
3. Defaults by the Company on its Senior Securities

None

Item  
4. Mine Safety Disclosures

N/A

Item  
5. Other information

None

Item  
6. Exhibits

**Exhibit list for Middlefield Banc Corp.'s Form 10-Q Quarterly Report for the Period Ended March 31, 2018**



<b>Exhibit Number</b>	<b>Description</b>	<b>Location</b>
3.1	<u>Second Amended and Restated Articles of Incorporation of Middlefield Banc Corp., as amended</u>	Incorporated by reference to Exhibit 3.1 of Middlefield Banc Corp.'s Annual Report on Form 10-K for the Fiscal Year Ended December 31, 2005, filed on March 29, 2006
3.2	<u>Regulations of Middlefield Banc Corp.</u>	Incorporated by reference to Exhibit 3.2 of Middlefield Banc Corp.'s registration statement on Form 10 filed on April 17, 2001
4	<u>Specimen stock certificate</u>	Incorporated by reference to Exhibit 4 of Middlefield Banc Corp.'s registration statement on Form 10 filed on April 17, 2001

43

---

4.1	<u>Amended and Restated Trust Agreement, dated as of December 21, 2006, between Middlefield Banc Corp., as Depositor, Wilmington Trust Company, as Property trustee, Wilmington Trust Company, as Delaware Trustee, and Administrative Trustees</u>	Incorporated by reference to Exhibit 4.1 of Middlefield Banc Corp.'s Form 8-K Current Report filed on December 27, 2006
4.2	<u>Junior Subordinated Indenture, dated as of December 21, 2006, between Middlefield Banc Corp. and Wilmington Trust Company</u>	Incorporated by reference to Exhibit 4.2 of Middlefield Banc Corp.'s Form 8-K Current Report filed on December 27, 2006
4.3	<u>Guarantee Agreement, dated as of December 21, 2006, between Middlefield Banc Corp. and Wilmington Trust Company</u>	Incorporated by reference to Exhibit 4.3 of Middlefield Banc Corp.'s Form 8-K Current Report filed on December 27, 2006
10.1.0*	<u>2017 Omnibus Equity Plan</u>	Incorporated by reference to Middlefield Banc Corp.'s definitive proxy statement for the 2017 Annual Meeting of Shareholders, Appendix A, filed on April 4, 2017
10.1.1*	<u>2007 Omnibus Equity Plan</u>	Incorporated by reference to Middlefield Banc Corp.'s definitive proxy statement for the 2008 Annual Meeting of Shareholders, Appendix A, filed on April 7, 2008
10.2*	<u>Severance Agreement between Middlefield Banc Corp. and Thomas G. Caldwell, dated January 7, 2008</u>	Incorporated by reference to Exhibit 10.2 of Middlefield Banc Corp.'s Form 8-K Current Report filed on January 9, 2008
10.3*	<u>Severance Agreement between Middlefield Banc Corp. and James R. Heslop, II, dated January 7, 2008</u>	Incorporated by reference to Exhibit 10.3 of Middlefield Banc Corp.'s Form 8-K Current Report filed on January 9, 2008
10.4	<u>Federal Home Loan Bank of Cincinnati Agreement for Advances and Security Agreement dated September 14, 2000</u>	Incorporated by reference to Exhibit 10.4 of Middlefield Banc Corp.'s registration statement on Form 10 filed on April 17, 2001
10.4.1*	<u>Severance Agreement between Middlefield Banc Corp. and Teresa M. Hetrick, dated January 7, 2008</u>	Incorporated by reference to Exhibit 10.4.1 of Middlefield Banc Corp.'s Form 8-K Current Report filed on January 9, 2008
10.4.2	[reserved]	
10.4.3*	<u>Severance Agreement between Middlefield Banc Corp. and Donald L. Stacy, dated January 7, 2008</u>	Incorporated by reference to Exhibit 10.4.3 of Middlefield Banc Corp.'s Form 8-K Current Report filed on January 9, 2008



10.4.4*	<u>Severance Agreement between Middlefield Banc Corp. and Alfred F. Thompson Jr., dated January 7, 2008</u>	Incorporated by reference to Exhibit 10.4.4 of Middlefield Banc Corp.'s Form 8-K Current Report filed on January 9, 2008
10.5	[reserved]	
10.6*	<u>Amended Director Retirement Agreement with Richard T. Coyne</u>	Incorporated by reference to Exhibit 10.6 of Middlefield Banc Corp.'s Form 8-K Current Report filed on January 9, 2008
10.7*	<u>Amended Director Retirement Agreement with Frances H. Frank</u>	Incorporated by reference to Exhibit 10.7 of Middlefield Banc Corp.'s Form 8-K Current Report filed on January 9, 2008
10.8	[reserved]	
10.9	[reserved]	
10.10*	<u>Director Retirement Agreement with Donald D. Hunter</u>	Incorporated by reference to Exhibit 10.10 of Middlefield Banc Corp.'s Annual Report on Form 10-K for the Year Ended December 31, 2001, filed on March 28, 2002
10.11*	<u>Director Retirement Agreement with Martin S. Paul</u>	Incorporated by reference to Exhibit 10.11 of Middlefield Banc Corp.'s Annual Report on Form 10-K for the Year Ended December 31, 2001, filed on March 28, 2002
10.12	[reserved]	
10.13	[reserved]	
10.14*	<u>Executive Survivor Income Agreement (aka DBO agreement [death benefit only]) with Donald L. Stacy</u>	Incorporated by reference to Exhibit 10.14 of Middlefield Banc Corp.'s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004
10.15*	<u>DBO Agreement with Jay P. Giles</u>	Incorporated by reference to Exhibit 10.15 of Middlefield Banc Corp.'s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004
10.16*	<u>DBO Agreement with Alfred F. Thompson Jr.</u>	Incorporated by reference to Exhibit 10.16 of Middlefield Banc Corp.'s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004

10.17*	<u>DBO Agreement with Teresa M. Hetrick</u>	Incorporated by reference to Exhibit 10.18 of Middlefield Banc Corp.'s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004
10.18 *	<u>Executive Deferred Compensation Agreement with Jay P. Giles</u>	Incorporated by reference to Exhibit 10.18 of Middlefield Banc Corp.'s Annual Report on Form 10-K for the Year Ended December 31, 2011, filed on March 20, 2012
10.19	[reserved]	
10.20*	<u>DBO Agreement with James R. Heslop, II</u>	Incorporated by reference to Exhibit 10.20 of Middlefield Banc Corp.'s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004
10.21*	<u>DBO Agreement with Thomas G. Caldwell</u>	Incorporated by reference to Exhibit 10.21 of Middlefield Banc Corp.'s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004
10.22*	<u>Annual Incentive Plan</u>	Incorporated by reference to Exhibit 10.22 of Middlefield Banc Corp.'s Form 8-K Current Report filed on June 12, 2012
10.22.1*	<u>Annual Incentive Plan 2017 Award Summary</u>	Incorporated by reference to Middlefield Banc Corp.'s Form 8-K current Report filed on March 14, 2017
10.23*	<u>Amended Executive Deferred Compensation Agreement with Thomas G. Caldwell</u>	Incorporated by reference to Exhibit 10.23 of Middlefield Banc Corp.'s Form 8-K Current Report filed on May 9, 2008
10.24*	<u>Amended Executive Deferred Compensation Agreement with James R. Heslop, II</u>	Incorporated by reference to Exhibit 10.24 of Middlefield Banc Corp.'s Form 8-K Current Report filed on May 9, 2008
10.25*	<u>Amended Executive Deferred Compensation Agreement with Donald L. Stacy</u>	Incorporated by reference to Exhibit 10.25 of Middlefield Banc Corp.'s Form 8-K Current Report filed on May 9, 2008
10.26*	<u>Executive Variable Benefit Deferred Compensation Agreement with James R. Heslop, II</u>	Incorporated by reference to Exhibit 10.26 of Middlefield Banc Corp.'s Form 8-K Current Report filed on July 11, 2018
10.27*	<u>Executive Variable Benefit Deferred Compensation Agreement with Donald L. Stacy</u>	Incorporated by reference to Exhibit 10.27 of Middlefield Banc Corp.'s Form 8-K Current Report filed on July 11, 2018

10.28*	<u>Executive Deferred Compensation Agreement with Charles O. Moore</u>	filed herewith
10.29*	<u>Form of conditional stock award under the 2007 Omnibus Equity Plan</u>	Incorporated by reference to Exhibit 10.29 of Middlefield Banc Corp.'s Form 8-K Current Report filed on March 4, 2016
10.29.1	<u>Form of conditional stock award under the 2017 Omnibus Equity Plan</u>	Incorporated by reference to Exhibit 10.29 of Middlefield Banc Corp.'s Form 8-K Current Report filed on July 24, 2017
31.1	<u>Rule 13a-14(a) certification of Chief Executive Officer</u>	filed herewith
31.2	<u>Rule 13a-14(a) certification of Chief Financial Officer</u>	filed herewith
32	<u>Rule 13a-14(b) certification</u>	filed herewith
99.1	<u>Form of Indemnification Agreement with directors of Middlefield Banc Corp. and with executive officers of Middlefield Banc Corp. and The Middlefield Banking Company</u>	Incorporated by reference to Exhibit 99.1 of Middlefield Banc Corp.'s registration statement on Form 10, Amendment No. 1, filed on June 14, 2001
101.INS**	XBRL Instance	furnished herewith
101.SCH**	XBRL Taxonomy Extension Schema	furnished herewith
101.CAL**	XBRL Taxonomy Extension Calculation	furnished herewith
101.DEF**	XBRL Taxonomy Extension Definition	furnished herewith
101.LAB**	XBRL Taxonomy Extension Labels	furnished herewith
101.PRE**	XBRL Taxonomy Extension Presentation	furnished herewith

\* management contract or compensatory plan or arrangement

\*\* XBRL information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.



**SIGNATURES**

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

MIDDLEFIELD BANC CORP.

Date: August 7, 2018

By: /s/ Thomas G. Caldwell

Thomas G. Caldwell

President and Chief Executive Officer



Date: August 7, 2018

By: /s/ Donald L. Stacy

Donald L. Stacy

Principal Financial and Accounting Officer