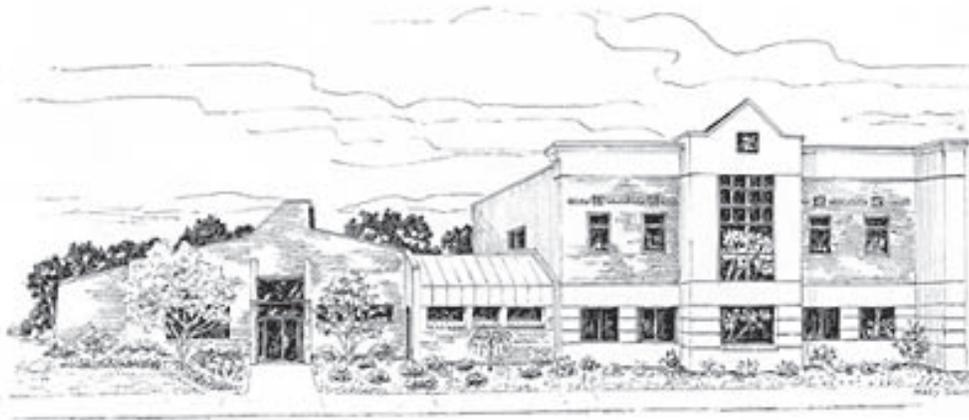




# Sturgis Bancorp, Inc.

## 2016 Annual Report



There's a  
**Difference**<sup>™</sup>

March 27, 2017

On behalf of the Directors and employees of Sturgis Bancorp, Inc. and Sturgis Bank & Trust Company, I am pleased to provide a copy of our 2016 Annual Report. In this Annual Report you will find many key ratios and measures of performance. I encourage you to study this information and participate as a shareholder. If you do not understand information contained in this Annual Report, or have suggestions, do not hesitate to contact me or our CFO Brian Hoggatt at (269)651-9345.

The Bank's performance continues to improve. Earnings are higher and credit quality is in line with peers. The Bank completed integration of its first whole bank acquisition with the purchase of West Michigan Savings Bank in Bangor. This acquisition added \$35 million to the Bank's total assets during 2015. This addition enhances the Bank's market presence in Van Buren County and is in-line with the Bank's Strategic plan to expand our market presence in markets adjacent to our current footprint. There continues to be a great deal of economic uncertainty and the Bank has diversified both its loan and investment portfolios over the last several years to mitigate concentrations of credit in any one industry or market. The largest concern for many banks less than \$1.0 billion in assets is the ever increasing Regulatory burden that has been placed on the entire industry by the Dodd/Frank Act. We remain hopeful the new administration will be successful at rolling back some of the burden imposed on small banks by this Act. Total assets under management for the year ended December 31, 2016 totaled \$972 million, including Oak Mortgage, Oakleaf Financial Services and the Bank's trust department. This provides the Bank with a diverse income stream and allows overhead to be spread over a larger base.

Our Bank continues to be focused on growing shareholder value, being a responsible corporate citizen, and providing a work environment based on integrity and service. We look forward to our continuing role as the leading financial institution in St. Joseph County, Michigan and growing our presence in the Van Buren, Kalamazoo, Calhoun, and Branch County markets.

I wish to thank the members of our Board of Directors for their guidance and counsel. I also wish to recognize the talented staff of Sturgis Bank & Trust Company for their hard work and dedication to you, our shareholders.

In closing I would ask each of you to consider our products and services when choosing your financial service provider. After all, you are contributing to your own success, while receiving top-notch service, when you do business with your community Bank. Thank you for your continuing support and investment in Sturgis Bancorp, Inc.

I hope to see you at our annual meeting.

Sincerely,



Eric L. Eishen President/CEO

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## SELECTED FINANCIAL DATA

	(Dollars in Thousands)				
	<u>At December 31,</u>				
	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>
Total assets	\$398,629	\$368,559	\$312,445	\$304,980	\$317,045
Cash and investment securities	72,409	64,055	31,197	37,363	33,286
Loans and loans held for sale, net	267,960	255,405	238,087	235,583	250,781
Mortgage -backed securities (1)	22,928	15,500	10,263	-	-
Allowance for loan losses	3,242	3,213	3,437	4,146	5,138
Deposits	297,767	284,039	234,290	229,020	234,923
Short-term borrowings	10,800	7,000	-	-	-
Long-term borrowings	50,380	40,812	44,218	44,585	52,440
Stockholders' equity	34,727	32,612	30,350	28,535	26,924
Book Value per share	16.65	15.70	14.66	13.89	13.21
Shares outstanding	2,085,991	2,077,791	2,069,891	2,055,025	2,038,395

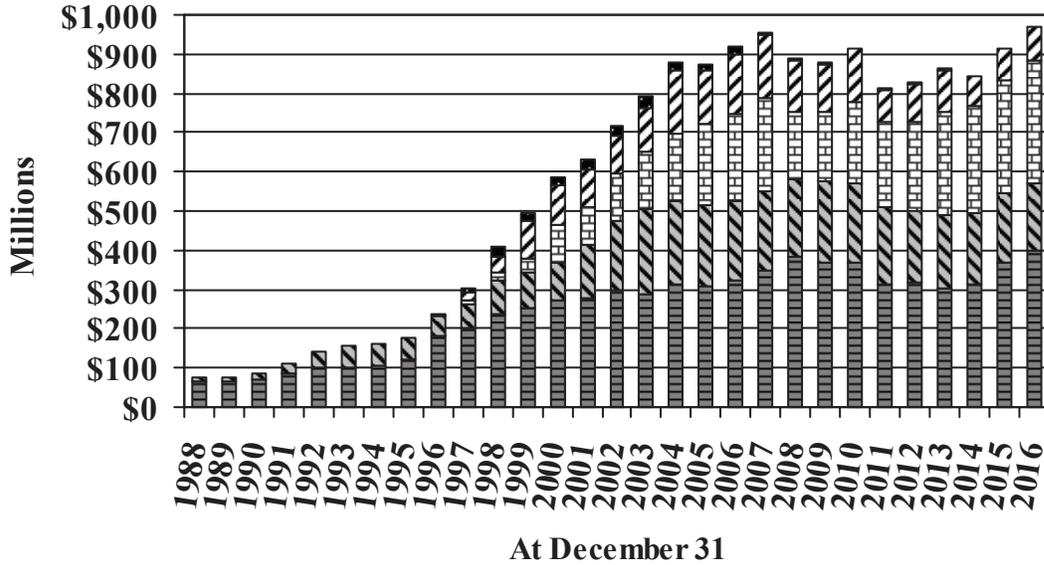
	(Dollars in Thousands)				
	<u>Year Ended December 31,</u>				
	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>
Interest income	\$14,132	\$12,630	\$11,737	\$11,922	\$12,679
Interest expense	1,816	1,881	2,094	2,578	3,035
Provision (benefit) for loan losses	357	(219)	104	(489)	545
Noninterest income	5,201	6,041	5,201	5,336	4,728
Noninterest expense	13,840	14,103	12,410	13,291	11,457
Provision for income taxes	658	446	448	251	504
Net income (loss)	2,662	2,460	1,882	1,627	1,866
Earnings (loss) per share (basic and diluted)	1.28	1.19	0.91	0.80	0.92
Cash dividends per share	0.42	0.14	0.09	-	-
Dividend payout ratio	32.83%	11.80%	9.86%	-	-
Equity/Assets ratio	8.69%	8.85%	9.71%	9.36%	8.49%
Return on assets	0.69%	0.70%	0.60%	0.52%	0.59%
Return on equity	8.09%	7.86%	6.46%	5.87%	7.18%

Weighted average shares outstanding:

Basic and diluted	2,080,789	2,073,004	2,061,666	2,045,430	2,028,547
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(1) This amount includes the carrying value of mortgage-backed securities and collateralized mortgage obligations. For information regarding fair values, see NOTE 2 - SECURITIES in the financial statements.

### Gross Assets Managed



■	<b>Commercial deposits swept to outside mutual fund</b>
▨	<b>Trust accounts</b>
▤	<b>Oakleaf Financial Services, Inc.</b>
▩	<b>Loans sold with servicing retained</b>
■	<b>Bancorp total assets</b>

The graph shows resumption of growth, after the economic interruption of 2008, and illustrates the stability of relationships for the Company since 1988. Each of these relationships indicates a point of contact with customers.

Acquisitions with related deposits assumed are shown below:

Seller Name	Date	Branch Locations	Total Deposits
First Federal of Michigan	March 12, 1988	Three Rivers	\$10,354,773
Fidelity Federal	June 29, 1990	Three Rivers	3,068,392
Standard Federal Bank	July 6, 1991	Sturgis	9,755,357
Great Lakes Bancorp	March 15, 1996	Coldwater and South Haven	24,016,569
KeyBank	December 8, 1997	Bronson and Constantine	16,883,609
First of America Bank	September 11, 1998	Centreville, Climax, Covert, and South Haven	45,140,000
West Michigan Savings Bank	April 6, 2015	Bangor	32,605,860

## **CORPORATE REVIEW**

On December 11, 2001, the shareholders of Sturgis Bank & Trust Company (the “Bank”) approved the reorganization of the Bank to become a wholly owned subsidiary of Sturgis Bancorp, Inc. (the “Bancorp”), a financial holding company. This reorganization was effective January 1, 2002. As a result, historical information in this Annual Report for periods before the January 1, 2002 effective date relate to the Bank. Throughout this Annual Report Sturgis Bancorp, Inc. will be referred to as Bancorp and Sturgis Bank & Trust Company will be referred to as the Bank.

The Bank, a Michigan savings bank, was founded in 1905 as a state chartered mutual building and loan. The original mission of the Bank was to promote personal savings and provide financing for the purchase of homes. Today we remain committed to the same objectives by offering consumer, educational, and property improvement loans, along with a large selection of investment opportunities to our community.

All commercial loan segments of the Bank grew in 2016. Although the Bank's primary business has historically been and will continue to be the origination of first mortgage loans on 1-4 family unit homes, it has implemented strategies in the last few years that have also increased commercial real estate and small business loans within its primary market area.

The Bank has its main office in Sturgis and branch offices in Bangor, Bronson, Centreville, Climax, Colon, South Haven, Sturgis, Three Rivers and White Pigeon, Michigan. The Bank's market area includes all of St. Joseph County and parts of Allegan, Branch, Calhoun, Cass, Hillsdale, Kalamazoo, and Van Buren Counties in Michigan.

In 2012, the Bancorp converted from a financial holding company to a bank holding company under the Bank Holding Company Act of 1956, as amended. In 2014, the Bancorp converted back to a financial holding company.

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

## Forward Looking Statements

This report contains statements that constitute forward-looking statements. These statements appear in several places in this report and include statements regarding intent, belief, outlook, objectives, efforts, estimates or expectations of Bancorp, primarily with respect to future events and the future financial performance of Bancorp. Any such forward-looking statements are not guarantees of future events or performance and involve risks and uncertainties, and actual results may differ materially from those in the forward-looking statement. Factors that could cause a difference between an ultimate actual outcome and a preceding forward-looking statement include, but are not limited to, changes in interest rates and interest rate relationships; demand for products and services; the degree of competition by traditional and non-traditional competitors; changes in banking laws and regulations; changes in tax laws; changes in prices, levies, and assessments; the impact of technological advances; government and regulatory policy changes; the outcome of any pending and future litigation and contingencies; trends in consumer behavior and ability to repay loans; and changes of the world, national and local economies. Bancorp undertakes no obligation to update, amend or clarify forward-looking statements as a result of new information, future events, or otherwise.

## Results of Operations

Bancorp reported net income for the year ended December 31, 2016 of \$2.7 million, or \$1.28 per share compared to net income of \$2.5 million, \$1.19 per share, for the year ended December 31, 2015. The primary component of the increase in net income was an increase in net interest income. The provision for loan losses was \$357,000 in 2016, compared to (\$219,000) in 2015. Net interest income increased 14.6% to \$12.3 million, from \$10.7 million for 2015. The increase in net interest income is primarily due to \$16.5 million increase in average net interest-earning assets. The tax equivalent net interest margin was 3.76% in 2016, compared to 3.62% in 2015.

## Interest Income

Interest income increased \$1.5 million to \$14.1 million in 2016 from \$12.6 million in 2015. This increase is primarily due to the \$39.2 million increase in average interest-earning assets to \$342.7 million. The average interest rate earned on interest-earning assets decreased to 4.12% in 2016 from 4.16% in 2015. The average interest rate earned on loans increased to 4.72% in 2016 from 4.68% in 2015. This increase in the average interest rate earned on loans is primarily due to new loans at the higher 2016 market rates and adjustable-rate loans repricing higher. Most commercial loans are priced on a variable basis and the expansion of related non-interest bearing commercial deposit accounts helps to reduce the average funding costs.

## **Interest Expense**

Interest expense decreased \$65,000 to \$1.8 million in 2016 from \$1.9 million in 2015. This was primarily due to the decrease in the average interest rates paid on interest-bearing liabilities to 0.65% in 2016 from 0.74% in 2015. Most of that decrease was on borrowed funds, due to FHLB advances that matured in the fourth quarter of 2015. The average rate paid on deposit accounts also decreased to 0.29% in 2016 from 0.32% in 2015. Average interest-bearing liabilities increased \$22.8 million to \$277.4 million in 2016 from \$254.6 million in 2015.

## **Net Interest Income**

Net interest income for the year ended December 31, 2016 was \$12.3 million compared to \$10.7 million for the year ended December 31, 2015, an increase of \$1.6 million. This increase was caused primarily by the increase in average interest-earning assets. The net interest margin increased to 3.59% in 2016 from 3.54% in 2015, and the tax equivalent net interest margin increased to 3.76% in 2016 from 3.62% in 2015.

*Average Balances, Interest Rates and Yields.* Net interest income is affected by the difference (“interest rate spread”) between rates of interest earned on interest-earning assets and rates of interest paid on interest-bearing liabilities and the relative amounts of interest-bearing liabilities and interest-earning assets. When the total of interest-earning assets approximates or exceeds the total of interest-bearing liabilities, any positive interest rate spread will generate net interest income. Financial institutions have traditionally used interest rate spreads as a measure of net interest income. Another indication of an institution’s net interest income is its “net yield on interest-earning assets” or “net interest margin,” which is net interest income divided by average interest-earning assets. The Bank’s net interest margin for 2016 was 3.59%, compared to 3.54% in 2015. The Bank has generally positioned itself for net interest income to increase with rising interest rates, with most loans adjusting with changes in related indices. The Bank’s interest-earning assets reprice at a faster pace than interest-bearing liabilities. A benefit to the positive gap strategy is the protection from unusually high market interest rates. The most significant risk to the positive gap strategy is decreases in market interest rates.

(In thousands)  
Average Balances and Interest Rates  
Year Ended December 31,

	2016			2015		
	Average Outstanding Balance	Interest Earned/Paid	Yield/Rate	Average Outstanding Balance	Interest Earned/Paid	Yield/Rate
<b>Interest-Earning Assets:</b>						
Loans (1, 3)	\$ 262,651	\$ 12,458	4.74%	\$ 248,890	\$ 11,658	4.68%
Mortgage-backed securities (2)	17,611	940	5.34%	10,514	296	2.81%
Investment securities (3)	39,606	436	1.10%	19,613	406	2.07%
Interest-bearing deposits	22,811	298	1.31%	24,449	270	1.11%
Total interest-earning assets	<u>\$ 342,679</u>	<u>\$ 14,132</u>	<u>4.12%</u>	<u>\$ 303,466</u>	<u>\$ 12,630</u>	<u>4.16%</u>
<b>Interest-Bearing Liabilities:</b>						
Deposits	\$ 230,165	\$ 676	0.29%	\$ 209,703	\$ 669	0.32%
FHLB advances and repurchase agreements	47,229	1,140	2.41%	44,933	1,212	2.70%
Total interest-bearing liabilities	<u>\$ 277,394</u>	<u>\$ 1,816</u>	<u>0.65%</u>	<u>\$ 254,636</u>	<u>\$ 1,881</u>	<u>0.74%</u>
Net interest income		<u>\$ 12,316</u>			<u>\$ 10,749</u>	
Interest rate spread			<u>3.47%</u>			<u>3.42%</u>
Net interest-earning assets	<u>\$ 65,286</u>			<u>\$ 48,830</u>		
Net interest margin			<u>3.59%</u>			<u>3.54%</u>

(1) Interest on loans includes fees. Nonaccrual loans and loans held for sale have been included in the average balances of loans.

(2) Mortgage backed securities includes collateralized mortgage obligations

(3) Yield on loans and investment securities is reported on an actual and not a tax equivalent basis

*Rate/Volume Analysis.* The following table sets forth certain information regarding changes in interest income and interest expense of Bancorp for the periods indicated. For each category of interest-earning asset and interest-bearing liability, information is provided on changes attributable to: (i) changes in volume (change in volume multiplied by the prior year rate) and (ii) changes in rate (change in rate multiplied by the prior year volume). Rate/volume variances have been allocated proportionately to the change due to rate and the change due to volume.

	(In thousands)					
	<u>Year Ended December 31,</u> <u>2016 vs 2015</u>			<u>Year Ended December 31,</u> <u>2015 vs 2014</u>		
	<u>Increase (Decrease) Due To:</u>			<u>Increase (Decrease) Due To:</u>		
	<u>Volume</u>	<u>Rate</u>	<u>Total</u>	<u>Volume</u>	<u>Rate</u>	<u>Total</u>
Interest Income:						
Loans	\$ 651	\$ 149	\$ 800	\$ 579	\$ (21)	\$ 558
Mortgage-backed securities	276	369	645	129	24	153
Investment securities	281	(251)	30	315	(159)	156
Interest-bearing deposits	(19)	46	27	7	20	27
Total interest-earning assets	<u>1,189</u>	<u>313</u>	<u>1,502</u>	<u>1,030</u>	<u>(136)</u>	<u>894</u>
Interest Expense:						
Deposits	63	(56)	7	77	(236)	(149)
FHLB advances and borrowings	60	(132)	(72)	14	(77)	(63)
Total interest-bearing liabilities	<u>123</u>	<u>(188)</u>	<u>(65)</u>	<u>91</u>	<u>(303)</u>	<u>(212)</u>
Net Interest Income	<u>\$ 1,066</u>	<u>\$ 501</u>	<u>\$ 1,567</u>	<u>\$ 939</u>	<u>\$ 167</u>	<u>\$ 1,106</u>

## Provision for Loan Losses

The provision for loan losses was \$357,000 for the year ended December 31, 2016, compared to a benefit of \$219,000 for the year ended December 31, 2015. The provision for loan losses was based upon management's assessment of relevant factors, including types and amounts of non-performing loans, historical and anticipated loss experience on such types of loans, and economic conditions. Loans charged off during 2016, net of recoveries, were \$328,000. Net charge-offs were at a historical low of \$5,000 in 2015, primarily due to two large commercial recoveries.

The recorded investment in nonperforming loans decreased to \$1.3 million at December 31, 2016 from \$3.9 million at December 31, 2015. At December 31, 2016, the Bank had another \$8.5 million of troubled debt restructured loans in addition to the nonperforming loans, compared to \$7.8 million at December 31, 2015. The Bank restructures loans when such restructures are expected to minimize the Bank's losses on the loans.

The allowance for loan losses as a percentage of total loans decreased to 1.19% in 2016 from 1.25% in 2015. This decrease is primarily due to Management's assessment of credit losses and exposure on loans specifically analyzed. Management monitors the increasing exposure to commercial lending and economic developments in the Bank's market area, among other factors, in determining appropriate provisions to the allowance for loan losses.

## **Noninterest Income**

Noninterest income was \$5.2 million in 2016, compared to \$6.0 million in 2015. The Bank received \$700,000 of death benefit in excess of recorded cash value from bank-owned life insurance in 2015. Investment brokerage commission income decreased \$494,000 to \$1.6 million in 2016, primarily due to mid-Summer conversion from LPL to Raymond James. The decrease in first-year revenue and related transition expenses are partially offset by \$748,000 of unearned income on December 31, 2016, which will be recognized into income through 2021.

## **Noninterest Expense**

Noninterest expense was \$13.8 million in 2016, compared to \$14.1 million in 2015. The Bank incurred \$825,000 pre-tax expenses in 2015 related to the acquisition of another Bank. The largest component of noninterest expense is salaries and employee benefits, which increased \$262,000. This increase is primarily due to full-year salaries and employee benefits for the acquired Bank location, health insurance, and other employee benefits. Real estate owned expense decreased \$317,000 in 2016 to \$224,000, including \$69,000 to write down values to market prices, compared to \$354,000 of similar write-downs to 2015 values. Management actively minimizes noninterest expense, although certain noninterest expenses are outside of Management's direct control.

The effective federal income tax rate was 19.8% in 2016 and 15.3% in 2015.

## **Financial Condition**

*General.* Bancorp's total assets at December 31, 2016 were \$398.6 million compared to \$368.6 million at December 31, 2015. Most of the increase was in securities, although loans also grew significantly.

*Loans.* Net loans increased to \$266.9 million at December 31, 2016 from \$253.8 million at December 31, 2015. The largest loan segment is residential mortgages, which decreased \$1.1 million. The Bank generally sells long-term, fixed rate, residential mortgages in the secondary market. The primary buyers of these loans are Federal Home Loan Mortgage Corporation (FHLMC) and FHLB. Commercial real estate loans and other commercial loans increased to \$122.5 million, or 45.4% of gross loans on December 31, 2016 from \$108.2 million, or 42.1% of gross loans, at December 31, 2015. The proceeds from sales of loans were \$21.1 million for the years ended December 31, 2016 and 2015. The mortgage loans originated for sale (\$20.3 million in 2016 and \$20.7 million in 2015) were primarily funded by the secondary mortgage market sales. The decision to sell most fixed-rate mortgages with original maturities of 10-years or greater protects the Bank from the interest rate risk inherent in holding these longer term, fixed-rate loans, and provides a source of liquidity to fund loan demand. Reductions in market interest rates generally increase the pace of refinance activity in the residential loan portfolio.

At December 31, 2016, outstanding commitments to originate loans were \$11.5 million and \$38.1 million on fixed and variable-rate loans, respectively. Bancorp also had \$980,000 of

commercial letters of credit, which are not expected to be drawn. Of the loan commitments, Management expects \$6.9 million to be disbursed for new loans during the first half of 2017. The additional loan commitments are unused lines of credit, which may be drawn at any time by the borrower. These loan commitments will be funded by interest-bearing deposits, maturing assets, and additional FHLB borrowings, if required.

Loans serviced for others were \$173.7 million and \$174.6 million at December 31, 2016 and 2015, respectively. This servicing portfolio includes \$162.9 million of residential mortgages originated by the Bank and sold in the secondary mortgage market with servicing retained by the Bank. The Bank also services \$10.9 million of commercial loans originated by the Bank and sold to other financial institutions. Management believes retaining servicing provides the Bank with a competitive advantage in its market, because many consumers have discovered the difficulties encountered when loan servicing is sold. The retention of servicing also allows the Bank to cross-sell other banking products and services to these customers. The retention of servicing requires the Bank to keep a higher staffing level than if the servicing would be sold. The value of the right to service is appraised quarterly and any temporary impairment of the value of servicing rights is recognized quarterly. The originated mortgage servicing rights asset required a valuation allowance of \$201,000 at December 31, 2016. The Bank will continue to monitor the valuation of the servicing rights asset. If subsequent analysis shows changes in the appraised impairment, the valuation allowance will be adjusted to match the impairment.

Bancorp has no purchased mortgage servicing portfolio.

The following table provides an analysis of the allowance for loan losses:

	(Dollars in thousands)	
	<u>Year Ended December 31,</u>	
	<u>2016</u>	<u>2015</u>
Ratio of net charge-offs during the period to average loans outstanding during the period	0.13%	0.00%
Allowance for loan losses to total loans	1.19%	1.25%
Nonperforming assets to total assets	0.47%	1.22%
Allowance for loan losses to nonperforming assets	172.39%	71.56%

Loans in nonaccrual status at December 31, 2016 were \$917,000, down from \$3.1 million at December 31, 2015. The following table presents the aggregate amount of troubled asset categories (principal balances of loans and carrying amount for real estate owned) as of the dates indicated:

	(Dollars in thousands)	
	<u>December 31,</u>	
	<u>2016</u>	<u>2015</u>
Past due – 90 days or greater	\$ 277	\$ 589
Nonaccrual loans	917	3,074
Real estate owned	687	827
Total nonperforming assets	<u>1,881</u>	<u>4,490</u>
Restructured assets	8,272	7,809
Total troubled assets	<u>\$10,153</u>	<u>\$12,299</u>
Ratio of troubled assets to total loans	<u>3.76%</u>	<u>4.78%</u>
Ratio of troubled assets to total assets	<u>2.55%</u>	<u>3.34%</u>

*Interest-earning Deposits in Banks.* Interest-bearing deposits in banks were \$16.1 million at December 31, 2016, compared to \$16.8 million at December 31, 2015, a decrease of \$737,000.

*Securities – Available for sale.* Investment securities available for sale were \$32.4 million at December 31, 2016 and \$27.6 million at December 31, 2015. The increase in 2016 was primarily in mortgage-backed securities.

*Securities – Held-to-maturity.* Investment securities held to maturity were \$33.8 million at December 31, 2016 and \$19.2 million at December 31, 2015. The increase in 2016 was primarily in state and political obligations.

*Deposits and Borrowed Funds.* Deposits were \$297.8 million at December 31, 2016 compared to \$284.0 million at December 31, 2015, an increase of \$13.7 million. Interest-bearing deposits increased to \$232.3 million at December 31, 2016 from \$219.0 million at December 31, 2015. The increase in interest-bearing deposits includes \$1.9 million increase in brokered deposits to \$9.6 million at December 31, 2016. Non-brokered jumbo certificates (with balances greater than \$100,000) remained unchanged at \$13.0 million at December 31, 2016 and December 31, 2015. The Bank uses brokered and jumbo certificates as sources of liquidity. Interest-bearing transaction savings accounts and checking accounts increased \$13.6 million, or 8.1%, from December 31, 2015 to December 31, 2016. Transaction savings accounts and checking accounts represented 60.9% of deposits at December 31, 2016, compared to 59.1% of deposits at December 31, 2015. Bank management is actively attempting to increase core deposit account relationships. Transaction savings accounts and checking accounts provide relatively inexpensive funding for future growth, compared to alternative certificates of deposit

and borrowed funds at higher interest rates. The Bank offers competitive rates on its time deposits, and uses jumbo certificates, brokered certificates, or borrowed funds, when that strategy is expected to enhance net interest income.

The Bank has an available line of credit with FHLB which provides for advances up to \$10.0 million, which matures in May 2017. The Bank anticipates renewal of the line of credit at maturity. All borrowings from FHLB are collateralized by certain residential and commercial mortgage loans, along with mortgage backed securities and CMO's.

All of the Bank's \$58.8 million of FHLB advances mature in 2017, although the Bank anticipates renewing most of them at maturity. The Bank has \$27.5 million of the FHLB advances swapped to longer-term funding. (See NOTE 18 - DERIVATIVES.) At December 31, 2016, Bancorp also had \$2.3 million outstanding on an amortizing loan with another financial institution, compared to \$2.8 million outstanding at December 31, 2015. The loan requires amortizing payments quarterly on a 7-year schedule, with final balloon payoff at maturity in July 2018. Bancorp anticipates refinance of the loan at maturity.

### **Capital Resources**

The stockholders' equity of Bancorp was \$34.7 million at December 31, 2016 compared to \$32.6 million at December 31, 2016, an increase of \$2.1 million, or 6.49%. The primary component of this increase was retained earnings. Cash dividends of \$873,000 and \$291,000 were paid in 2016 and 2015, respectively. The stockholders' equity was 8.71% of total assets at December 31, 2016. Management continues to monitor and evaluate the best capital structure of Bancorp. A structure that provides sufficient capital to fund future growth, yet maximizes earnings per share, is deemed optimal. Management does not project a need for capital beyond what can be provided by retained earnings.

The Federal Reserve Board ("FRB")'s risk-based capital guidelines are inapplicable to Bancorp, due to Bancorp qualifying as a "small bank holding company". However, if Bancorp's total assets exceed \$1.0 billion, the guidelines will then apply to Bancorp. The guidelines require that financial holding companies with over \$1.0 billion in total assets maintain capital no less than that required by their subsidiary bank(s).

Management deems the current capitalization level adequate for current and anticipated strategies. Management does not expect Bancorp to grow in the foreseeable future to the \$1.0 billion asset level.

### **Asset/Liability Management**

The primary component of Bancorp's earnings is net interest income of the Bank. The Bank's asset/liability management strategy is to maximize net interest income over time by reducing the impact of fluctuating interest rates. This is accomplished by matching the mix and maturities of its assets and liabilities. At the same time, the Bank's asset/liability strategies for managing interest rate risk must also accommodate customer demands for particular types of

deposit and loan products. The Bank uses asset/liability management techniques in an attempt to maintain a profitable mix of financial assets and liabilities, provide deposit and loan products that meet the needs of its market area, and maintain control over interest rate risk resulting from changes in interest rates.

Net interest income, the primary component of the Bank’s net income, is derived from the difference or “spread” between the yield on interest-earning assets and the cost of interest-bearing liabilities. The Bank has sought to reduce its exposure to changes in interest rates by matching more closely the effective maturities and repricings of its interest-sensitive assets and liabilities. At the same time, the Bank’s asset/liability management strategies must also accommodate customer demands for particular types of deposit and loan products.

While much of the Bank’s asset/liability management efforts involve strategies that manage the rate sensitivity of its loans and investments, such as the sale of long-term fixed rate loans, originations of adjustable rate loans and purchases of adjustable rate mortgage-backed securities or relatively short average life fixed-rate investments, it also uses techniques to manage the rate sensitivity of its deposits and borrowed money. Those techniques include attracting longer-term certificates of deposit at rates lower than borrowing rates, when the market will permit. The Bank emphasizes core deposits, which are less sensitive to changes in interest rates, and borrowing through long-term FHLB advances or brokered certificates of deposit. The Bank’s asset/liability management strategy adjusts, when market interest rates and customer demand change.

The Bank measures its exposure to interest rate fluctuations primarily by using a computer modeling software designed for financial institutions, such as the Bank. The model uses assumptions which Management believes are reasonable for the analysis. These assumptions include (but are not limited to) prepayment and decay rates. Because of the Bank’s smaller loan population, these assumptions are based on national statistics and may not reflect the Bank’s own experience. It allows the Bank to simulate its asset-liability sensitivity based on the interest rate risk identified. The analysis estimates the changes in the market value of the Bank’s equity using immediate and permanent interest rate change scenarios ranging from +4% to –4%, in 1% increments from current market rates. The software also allows simulation for unlimited additional market interest rate scenarios. At December 31, 2016, the following table illustrates the simulated interest rate sensitivity of the Bank’s consolidated equity to immediate and permanent changes in market interest rates.

<u>(in Thousands of Dollars)</u>	
Book value of Bank’s equity	\$36,880
4% increase in market rates	34,118
3% increase in market rates	38,582
2% increase in market rates	42,889
1% increase in market rates	47,354
No change (current market value of equity)	51,221
1% decrease in market rates	N/A
2% decrease in market rates	N/A

3% decrease in market rates	N/A
4% decrease in market rates	N/A

As the table shows, the Bank’s estimated market value of equity remains relatively stable when interest rates rise. Market rate decreases are not relevant because resulting rates would be below 0%. That indicates that the Bank is able to withstand fluctuations in market interest rates without posing a significant threat to either the Bank’s stockholders’ equity or the federal deposit insurance system, and therefore, the Bank can be deliberate in its actions to adjust the asset-liability mix. The Bank would meet the regulatory minimum capital requirements in all of the interest-rate scenarios.

The Bank has an Asset-Liability Management Committee (ALCO) that meets as needed. The purpose of this Committee is to communicate, coordinate, and monitor asset-liability management procedures. The Committee establishes and monitors the volume and mix of both assets and funding sources. The objective is to manage assets and funding sources to produce results consistent with the Bank’s liquidity requirements, capital adequacy, growth, and profitability goals. To accomplish this objective, the ALCO uses internal budget variance reports, forecasts for changes in interest rates and consumer deposit activity, as well as forecasts of loan demand in each of the Bank’s loan types, investment maturities and new investment alternatives, and various other internal and external reports.

**Effect of Interest Rate Fluctuations**

Bancorp’s consolidated results of operations depend, to a large extent, on the Bank’s level of net interest income, which is the difference between interest income earned on its loan and investment portfolios versus the interest paid on deposits and borrowed funds. If the cost of funds increases faster than the yield on its interest-earning assets, net interest income will be reduced.

Bancorp measures its interest rate risk primarily using simulation analysis. This analysis is prepared by the Chief Financial Officer and reviewed by the ALCO. ALCO is comprised of the Chief Executive Officer, Chief Financial Officer, Executive Vice President and Senior Officers of the Bank. Bancorp’s Board of Directors reviews quarterly reports that estimate Bancorp’s sensitivity to changes in interest rates. Sensitivity is estimated for net interest income and market value of portfolio equity.

While Bancorp uses various tools to monitor interest rate risk, it is unable to predict future fluctuations in interest rates or the specific impact thereof. The market value of most of Bancorp’s financial assets is sensitive to fluctuations in market interest rates. Fixed-rate investments and mortgage loans decline in value as interest rates rise. Adjustable-rate investments and loans generally have less market value volatility than fixed-rate assets.

**Liquidity**

Bancorp maintains certain levels of liquid assets (the most liquid of which are cash and investment securities) in order to meet demands from loan commitments, deposit withdrawals

and other obligations. Bancorp manages liquidity by maintaining a portion of its liquid assets in overnight accounts and by staggering maturities in its portfolio of investment securities. The primary sources of liquidity are loan repayments, loan sales, maturing investments, deposit accounts, and other borrowed funds, such as FHLB borrowings.

Through recent volatile equity markets, deposit customers have been attracted to Bank deposits from uninsured alternatives, such as money market accounts or other investments. If market interest rates remain historically low, Management expects depositors might unwisely look to more risky investments than Bank deposits to increase their return.

### Contractual Obligations

The long-term debt obligations consist of certificates of deposit, advances from the Federal Home Loan Bank, and a loan from another financial institution. The following schedule represents only scheduled principal payments as of December 31, 2016.

	Payments Due by Period (in thousands)				
	<u>Total</u>	<u>Less than 1 year</u>	<u>1 – 3 years</u>	<u>4 – 5 Years</u>	<u>After 5 Years</u>
Certificates of deposit	\$ 50,825	\$27,145	\$20,704	\$2,901	\$ 75
FHLB advances	58,800	31,300	-	-	(1) 27,500
Other borrowings	<u>2,380</u>	<u>433</u>	<u>1,947</u>	<u>-</u>	<u>-</u>
Total contractual obligations	\$112,005	\$58,878	\$22,651	\$2,901	(1) \$27,575

(1) The Bank has \$27,500 FHLB short-term advances swapped with another financial institution for final swap maturities in 2022 and 2026.

### Off-balance Sheet Activities

*Other Commercial Credits* – The Bank is a party to credit related financial instruments with off-balance sheet risks in the normal course of business to meet the financing needs of its customers. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized on the balance sheet of the Bank.

Commitments to extend credit are agreements to lend to a customer, as long as there are no violations of any condition established in the contract. Commitments for equity lines of credit or overdraft protection may expire without being drawn. Therefore, total commitments do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on Management's credit evaluation of the customer and the related loans. Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are collateralized, may not contain a specified maturity date and may be drawn to the total extent of the Bank's commitment.

Commercial and standby letters of credit are a conditional commitment issued by the Bank to guarantee the performance of a customer to a third party. The letters of credit are primarily used

to support public and private borrowing arrangements. All letters of credit have expiration dates within one year.

At December 31, 2016, the Bank had total commitments to originate loans of \$11.5 million and \$38.1 million on fixed rate and variable rate loans, respectively.

All of the commercial credits are underwritten using the commercial loan underwriting guidelines.

*Collateral Requirements* – To reduce credit risks related to the use of credit-related financial instruments, the Bank might deem it necessary to obtain collateral. The amount and nature of the collateral obtained are based on the Bank’s credit evaluation of the borrower and related loans. Collateral secured varies, but may include cash, investment securities, accounts receivable, inventory, property, plant and equipment and real estate. Although these items are used to secure loans, they are not included on the balance sheet of Bancorp.

*Legal Contingencies* – Various legal claims arise from time to time in the normal course of business which, in the opinion of Management, will have no material effect on Bancorp’s consolidated financial statements.

### **Impact of Inflation**

The majority of assets and liabilities of financial institutions are monetary in nature. Generally, changes in interest rates have a more significant impact on earnings of the Bank than inflation. Although influenced by inflation, changes in rates do not necessarily move in either the same magnitude or direction as changes in the price of goods and services. Inflation could impact the growth of total assets, creating a need to increase equity capital at a higher rate to maintain an adequate equity to assets ratio, which in turn reduces the amount of earnings available for cash dividends. Through 2016 and 2015, inflation did not have a material impact on the Bancorp.

**DIRECTORS OF BANCORP – December 31, 2016**

Kimberlee Bontrager	President/Owner of Locey CPA, LLC
Eric L. Eishen	President and Chief Executive Officer, Sturgis Bancorp, Inc and Sturgis Bank & Trust Company
David L. Franks	President and Chief Executive Officer, Oak Press Solutions Inc.
Donald L. Frost	Chairman of the Board Chief Executive Officer, LTi Printing, Inc.
Michael R. Frost	President, LTi Printing, Inc.
Jeffrey M. Mohney	Owner, A. W. Ayres Agency, Inc.
John T. Wiedlea	President, Automation Plus, Inc.

**OFFICERS OF BANCORP**

Eric L. Eishen	President, Chief Executive Officer
Ronald W. Scheske	Vice President
Brian P. Hoggatt	Chief Financial Officer, Secretary/Treasurer

**DIRECTORS OF THE BANK – DECEMBER 31, 2016**

Kimberlee Bontrager	President/Owner of Locey CPA, LLC Retained Counsel
Eric L. Eishen	President and Chief Executive Officer
David L. Franks	President and Chief Executive Officer, Oak Press Solutions Inc.
Donald L. Frost	Chairman of the Bank Board Chief Executive Officer, LTi Printing, Inc.
Michael R. Frost	President, LTi Printing, Inc.
Jeffrey M. Mohney	Owner, A. W. Ayres Agency, Inc.
John T. Wiedlea	President, Automation Plus, Inc.

**OFFICERS OF THE BANK – DECEMBER 31, 2016**

Eric L. Eishen	President, Chief Executive Officer
Steven G. Gage	Senior Vice President, Commercial Lending
Brian P. Hoggatt	Senior Vice President, Chief Financial Officer, Treasurer
Jason J. Hyska	Senior Vice President, Retail Lending
Tracey L. Parker	Senior Vice President, Chief Credit Officer
Ronald W. Scheske	Executive Vice President, Chief Operating Officer
Christine M. Moline	First Vice President, Private Banking Officer
Jose D. Albarran	Vice President
Robby S. Beachy	Vice President
Sandra J. Cagle	Vice President
Debora L. Capman	Vice President, Senior Trust Officer
Emily D. Frohriep	Vice President, Human Resources
Kurt A. Inman	Vice President, Director of Marketing
John D. Johnson	Vice President
Margaret M. Kunce	Vice President, Compliance BSA/OFAC Officer
Heather J. Myers	Corporate Secretary
Matthew D. Scheske	Vice President
Elizabeth M. Weinberg	Vice President
Camille M. Wilson	Vice President
Tamera J. De Mara	Assistant Vice President
Joel T. Fowler	Assistant Vice President
Trudy R. Gloy	Assistant Vice President
Mary F. Hooley	Assistant Vice President
Stephen E. Merchant	Assistant Vice President
Pamela A. Norgan	Assistant Vice President
Tammy K. Smith	Assistant Vice President

**BANK CORPORATE INFORMATION**

<u>Location</u>	<u>Address</u>	<u>City, ST ZIP</u>	<u>Telephone</u>	<u>Fax</u>
Sturgis (Main Office)	113-125 East Chicago Road	Sturgis, MI 49091	(269) 651-9345	(269) 651-5512 (269) 651-8263 (269) 865-5902
Sturgis–Trust Dept.	113-125 East Chicago Road	Sturgis, MI 49091	(269) 651-1380	(269) 659-6848
<u>Branch Offices</u>				
Bangor	232 West Monroe	Bangor, MI 49013	(269) 427-7941	(269) 427-5313
Bronson	863 West Chicago Road	Bronson, MI 49028	(517) 369-7322	(517) 369-2347
Centreville	158 West Main	Centreville, MI 49032	(269) 467-8525	(269) 467-4180
Climax	125 North Main	Climax, MI 49034	(269) 746-4256	(269) 746-4108
Colon	110 South Blackstone Street	Colon, MI 49040	(269) 432-3229	(269) 432-2971
South Haven	1121 LaGrange Street	South Haven, MI 49090	(269) 637-8444	(269) 637-5560
South Haven	365 Center Street	South Haven, MI 49090	(269)-637-6644	(269) 637-6645
Sturgis	1001 South Centerville Road	Sturgis, MI 49091	(269) 651-9379	(269) 651-1514
Sturgis	1501 East Chicago Road	Sturgis, MI 49091	(269) 651-9345	(269) 651-5609
Three Rivers	115 North Main Street	Three Rivers, MI 49093	(269) 273-8481	(269) 273-1732
White Pigeon	122 West Chicago Road	White Pigeon, MI 49099	(269) 483-9668	(269) 483-2725
<u>Loan Production Office</u>				
Portage	1210 W. Milham Road	Portage, MI 49024	(269) 659-1303	(269) 585-5961
Oakleaf Financial Services	113-125 East Chicago Road	Sturgis, MI 49091	(269) 651-2475	(269) 651-7273

## MARKET INFORMATION

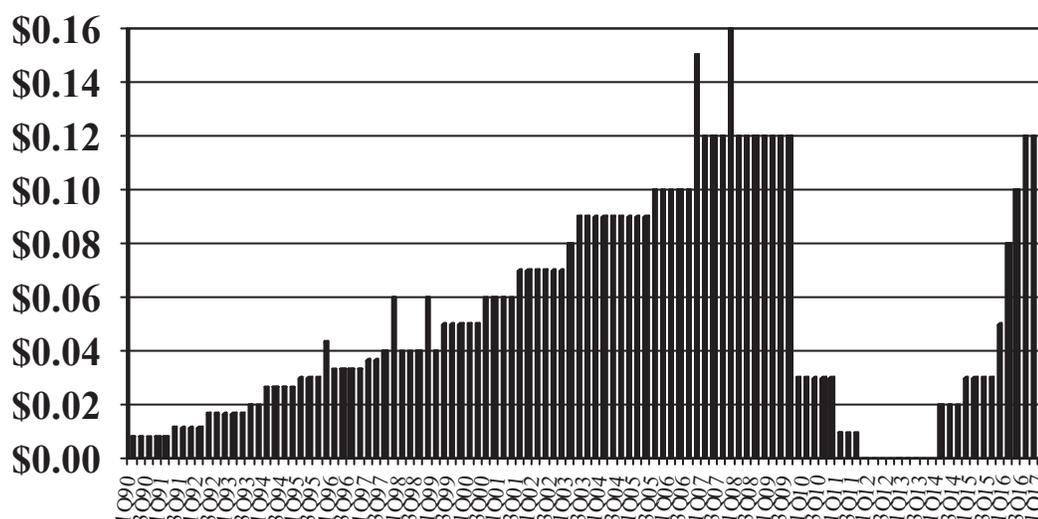
Shares of common stock of Bancorp were held by 102 holders of record as of December 31, 2016. Bancorp's shares are traded on the OTCQX network under the symbol of "STBI". Trading activity has been infrequent.

The range of high and low trade prices for each quarterly period during the past two years is presented below:

	<u>Year ended December 31,</u>			
	<u>2016</u>		<u>2015</u>	
	<u>High</u>	<u>Low</u>	<u>High</u>	<u>Low</u>
First quarter	\$15.50	\$11.68	\$13.00	\$ 8.70
Second quarter	12.50	11.45	11.00	10.06
Third quarter	12.41	10.25	10.90	9.60
Fourth quarter	11.00	9.85	10.49	9.73

The trade prices listed above are based on actual transactions obtained from public Internet sources obtained by Bancorp.

## Cash Dividends Per Share



On December 11, 2001, the shareholders of the Bank approved the reorganization of the Bank to become a wholly owned subsidiary of Sturgis Bancorp, Inc., a financial holding company. Sturgis Bancorp, Inc. was a financial holding company under the Bank Holding Company Act of 1956, as amended. This reorganization was approved at a special meeting of the shareholders of the Bank on December 11, 2001. Bancorp received all of the various federal and state regulatory approvals for this reorganization. In 2012, Bancorp converted to a bank holding company under the Bank Holding Company Act of 1956, as amended. In 2014, Bancorp converted back to a financial holding company.

This reorganization became effective as of the opening of business on January 1, 2002. Bancorp is a legal entity separate and distinct from its subsidiaries. Substantially all of Bancorp’s revenues result from dividends paid to it by the Bank and from earnings on investments. There are statutory and regulatory requirements applicable to the payment of dividends by the Bank to Bancorp, as well as by Bancorp to its shareholders.

Under the Michigan Savings Bank Act, Bancorp may not declare a cash dividend or a dividend of any kind except out of net income then on hand after deducting all losses and bad debts, and then only if it will have a surplus amounting to not less than 20% of its capital after the payment of the dividend. Moreover, the Bank may not declare or pay any cash dividend or dividend in kind until the cumulative dividends on its preferred stock, if any, have been paid in full. Further, if the surplus of the Bank is at any time less than the amount of its capital, before the declaration of a cash dividend or dividend in kind, it must transfer to surplus not less than 10% of its net income for the preceding 6 months (in the case of quarterly or semi-annual dividends) or the preceding two consecutive 6 month periods (in the case of annual dividends).

Pursuant to the Michigan Business Corporation Act, Bancorp may not make distributions to its shareholders if, after giving effect to the distribution, the corporation would not be able to pay its debts as they become due in the usual course of business, or the corporation's total assets would be less than the sum of its total liabilities plus, unless the corporation's articles of incorporation permit otherwise, the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

The payment of dividends by Bancorp and its subsidiaries may also be affected or limited by other factors, such as the requirements to maintain adequate capital above regulatory guidelines. In addition, if, in the opinion of the applicable regulatory authority, a bank under its jurisdiction is engaged in or is about to engage in an unsafe or unsound practice (which, depending on the financial condition of the Bank, could include the payment of dividends), such authority may require, after notice and hearing, that such bank cease and desist from such practice or prohibit the payment of future dividends. The Federal Reserve has indicated that paying dividends that deplete a bank's capital base to an inadequate level would be an unsafe and unsound banking practice. The Federal Reserve, the FDIC and the Division of Financial Institutions of the Michigan Department of Consumer & Industry Services Office of Financial and Insurance Services have issued policy statements which provide that bank holding companies and insured banks should generally only pay dividends out of current operating earnings.

#### **INDEPENDENT AUDITORS**

Bancorp employed the accounting firm of Crowe Horwath LLP as Independent Auditors for the years ended December 31, 2016 and December 31, 2015. There have been no disagreements on accounting or financial disclosure matters within these time periods.

## INDEPENDENT AUDITOR'S REPORT

Board of Directors and Shareholders  
Sturgis Bancorp, Inc.  
Sturgis, Michigan

**Report on the Financial Statements**

We have audited the accompanying consolidated financial statements of Sturgis Bancorp, Inc., which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for the years then ended, and the related notes to the financial statements.

***Management's Responsibility for the Financial Statements***

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

***Auditor's Responsibility***

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

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

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

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(Continued)

**Opinion**

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Sturgis Bancorp, Inc. as of December 31, 2016 and 2015, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*Crowe Horwath LLP*

Crowe Horwath LLP

South Bend, Indiana  
March 22, 2017

STURGIS BANCORP, INC.  
CONSOLIDATED BALANCE SHEETS  
December 31, 2016 and 2015  
(Amounts in thousands, except share and per share data)

	<u>2016</u>	<u>2015</u>
<b>ASSETS</b>		
Cash and due from banks	\$ 8,150	\$ 10,786
Other short-term investments	<u>4,963</u>	<u>5,084</u>
Total cash and cash equivalents	13,113	15,870
Interest-earning deposits in banks	16,068	16,805
Securities - available for sale	32,387	27,635
Securities - held to maturity (fair value of \$32,973 and \$19,643)	33,769	19,245
Federal Home Loan Bank stock, at cost	3,117	2,632
Loans held for sale, at fair value	1,089	1,575
Loans, net of allowance of \$3,242 and \$3,213	266,871	253,830
Premises and equipment, net	8,360	8,114
Goodwill	5,834	5,834
Core deposit intangibles	259	320
Originated mortgage servicing rights	1,216	1,349
Real estate owned	687	827
Bank-owned life insurance	9,998	9,735
Accrued interest receivable	1,407	1,183
Other assets	<u>4,454</u>	<u>3,605</u>
Total assets	<u>\$ 398,629</u>	<u>\$ 368,559</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Liabilities		
Deposits		
Noninterest-bearing	\$ 65,455	\$ 65,041
Interest-bearing	<u>232,312</u>	<u>218,998</u>
Total deposits	297,767	284,039
Federal Home Loan Bank advances and other borrowings	61,180	47,812
Accrued interest payable	243	243
Other liabilities	<u>4,712</u>	<u>3,853</u>
Total liabilities	363,902	335,947
Stockholders' equity		
Preferred stock - \$1 par value: authorized - 1,000,000 shares issued and outstanding - 0 shares		-
Common stock - \$1 par value: authorized - 9,000,000 shares issued and outstanding 2,085,991 shares at December 31, 2016 and 2,077,791 at December 31, 2015	2,086	2,078
Additional paid-in capital	7,367	7,277
Retained earnings	25,234	23,445
Accumulated other comprehensive income (loss)	<u>40</u>	<u>(188)</u>
Total stockholders' equity	<u>34,727</u>	<u>32,612</u>
Total liabilities and stockholders' equity	<u>\$ 398,629</u>	<u>\$ 368,559</u>

See accompanying notes to consolidated financial statements.

STURGIS BANCORP, INC.  
CONSOLIDATED STATEMENTS OF INCOME  
Years ended December 31, 2016 and 2015  
(Amounts in thousands, except share and per share data)

	<u>2016</u>	<u>2015</u>
Interest income		
Loans	\$ 12,458	\$ 11,658
Investment securities:		
Taxable	661	521
Tax-exempt	909	316
Dividends	<u>104</u>	<u>135</u>
Total interest income	14,132	12,630
Interest expense		
Deposits	676	669
Borrowed funds	<u>1,140</u>	<u>1,212</u>
Total interest expense	<u>1,816</u>	<u>1,881</u>
<b>Net interest income</b>	12,316	10,749
Provision (benefit) for loan losses	<u>357</u>	<u>(219)</u>
<b>Net interest income after provision (benefit) for loan losses</b>	11,959	10,968
Noninterest income:		
Service charges and other fees	1,003	967
Interchange income	728	669
Investment brokerage commission income	1,603	2,097
Mortgage banking activities	686	700
Trust fee income	462	426
Earnings on cash value of bank-owned life insurance	263	973
Gain on sale of real estate owned	196	113
Gain (loss) on securities	1	(2)
Net gain on cash flow hedges	99	-
Other income	<u>160</u>	<u>98</u>
Total noninterest income	5,201	6,041
Noninterest expenses:		
Salaries and employee benefits	8,010	7,748
Occupancy and equipment	1,698	1,601
Interchange expenses	424	376
Data processing	772	872
Professional services	268	513
Real estate owned expense	224	541
Advertising	232	187
FDIC premiums	235	258
Other expenses	<u>1,977</u>	<u>2,007</u>
Total noninterest expenses	<u>13,840</u>	<u>14,103</u>
<b>Income before income tax expense</b>	3,320	2,906
Income tax expense	<u>658</u>	<u>446</u>
<b>Net income</b>	<u>\$ 2,662</u>	<u>\$ 2,460</u>
Earnings per share	\$ 1.28	\$ 1.19

See accompanying notes to consolidated financial statements.

STURGIS BANCORP, INC.  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
Years ended December 31, 2016 and 2015  
(Amounts in thousands, except share and per share data)

	<u>2016</u>	<u>2015</u>
Net income	\$ 2,662	\$ 2,460
Other comprehensive income (loss):		
Unrealized holding gain (loss) arising during the period	(372)	28
Reclassification adjustment for (gains) losses recognized on securities	(1)	2
Tax effect	<u>127</u>	<u>(10)</u>
Net of tax	(246)	20
Change in post-retirement obligation	14	47
Reclassification adjustment for amortization of prior service cost and net (gain) loss included in net periodic pension cost	10	29
Tax effect	<u>(8)</u>	<u>(26)</u>
Net of tax	16	50
Unrealized gain (loss) on cash flow hedge	763	(58)
Reclassification adjustment for (gains) losses recognized in net income	(99)	-
Tax effect	<u>(206)</u>	<u>-</u>
Net of tax	<u>458</u>	<u>(58)</u>
Total other comprehensive income (loss)	<u>228</u>	<u>12</u>
Comprehensive income	<u>\$ 2,890</u>	<u>\$ 2,472</u>

See accompanying notes to consolidated financial statements.

STURGIS BANCORP, INC.  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
Years ended December 31, 2016 and 2015  
(Amounts in thousands, except share and per share data)

	<u>Common Stock</u>	<u>Additional Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total Stockholders' Equity</u>
<b>Balance – January 1, 2015</b>	\$ 2,070	\$ 7,204	\$ 21,276	\$ (200)	\$ 30,350
Net income for the year ended December 31, 2015	-	-	2,460	-	2,460
Other comprehensive income, net of tax effect of \$36	-	-	-	12	12
Common stock issued (7,900 shares)	8	73	-	-	81
Cash dividends (\$0.14 per share)	<u>-</u>	<u>-</u>	<u>(291)</u>	<u>-</u>	<u>(291)</u>
<b>Balance – December 31, 2015</b>	2,078	7,277	23,445	(188)	32,612
Net income for the year ended December 31, 2016	-	-	2,662	-	2,662
Other comprehensive income, net of tax effect of \$87	-	-	-	228	228
Common stock issued (8,200 shares)	8	90	-	-	98
Cash dividends (\$0.42 per share)	<u>-</u>	<u>-</u>	<u>(873)</u>	<u>-</u>	<u>(873)</u>
<b>Balance – December 31, 2016</b>	<u>\$ 2,086</u>	<u>\$ 7,367</u>	<u>\$ 25,234</u>	<u>\$ 40</u>	<u>\$ 34,727</u>

See accompanying notes to consolidated financial statements.

STURGIS BANCORP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
Years ended December 31, 2016 and 2015  
(Amounts in thousands)

	<u>2016</u>	<u>2015</u>
<b>Cash flows from operating activities</b>		
Net income	\$ 2,662	\$ 2,460
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation	535	515
Amortization of mortgage servicing rights	323	325
Amortization of core deposit intangible	61	45
Provision (benefit) for loan losses	357	(219)
Accretion and amortization of securities	504	258
Gain on sale of fixed assets	-	(5)
Gain on sale of loans	(620)	(555)
Proceeds from the sale of loans held for sale	21,141	21,149
Loans originated for sale	(20,307)	(20,731)
Impairment of mortgage servicing rights	83	17
(Gain) loss on sale of real estate owned	(196)	(113)
Write-down of real estate owned	69	354
(Gain) loss on available for sale securities	(1)	2
Earnings on cash value of bank-owned life insurance	(263)	(973)
Changes in assets and liabilities:		
Decrease in accrued interest and other assets	(337)	(307)
Increase (decrease) in accrued interest and other liabilities	859	(132)
Net cash provided by operating activities	4,870	2,090
<b>Cash flows from investing activities</b>		
Net change in interest-earning deposits in banks	737	(230)
Maturities of securities available-for-sale	1,425	2,500
Principal reduction on securities available-for-sale	2,983	1,117
Purchase of securities available-for-sale	(9,895)	(15,937)
Sales of securities available-for-sale	-	8,891
Principal reductions on securities held-to-maturity	671	3,889
Purchase of securities held-to-maturity	(15,425)	(17,408)
Purchase of USDA Government-guaranteed loans	(1,162)	-
Net (increase) decrease in loans	(13,463)	(6,674)
Proceeds from sale of real estate owned	1,037	1,242
Proceeds from redemption of FHLB stock	-	777
Purchase of FHLB stock	(485)	-
Proceeds from life insurance benefits	-	1,046
Cash and cash equivalents received in bank acquisition, net of \$3,300 paid	-	2,816
Proceeds from sale of premises and equipment	-	5
Additions to premises and equipment, net	(371)	(830)
Net cash provided by (used in) investing activities	(33,948)	(18,796)

(Continued)

STURGIS BANCORP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
Years ended December 31, 2016 and 2015  
(Amounts in thousands)

	<u>2016</u>	<u>2015</u>
<b>Cash flows from financing activities</b>		
Net increase (decrease) in deposits	\$ 13,728	\$ 17,143
Repayment of FHLB advances and other borrowings	(78,932)	(52,406)
Proceeds from FHLB and other borrowings	92,300	56,000
Cash dividends paid on common stock	(873)	(291)
Issuance of common stock	<u>98</u>	<u>81</u>
Net cash provided by (used in) financing activities	<u>26,321</u>	<u>20,527</u>
Net change in cash and cash equivalents	(2,757)	3,821
Cash and cash equivalents - beginning of year	<u>15,870</u>	<u>12,049</u>
<b>Cash and cash equivalents - end of year</b>	<u>\$ 13,113</u>	<u>\$ 15,870</u>
Supplemental information		
Cash paid (refunded) for:		
Interest	\$ 1,815	\$ 1,878
Income taxes	512	351
Fair value of assets purchased in bank acquisition (Note 17)	-	35,794
Fair value of liabilities assumed in bank acquisition (Note 17)	-	33,219
Noncash investing and financing activities		
Loans transferred to real estate owned	1,185	622
Loans transferred to other assets	40	-
Other real estate transferred to premises and equipment	410	-

See accompanying notes to consolidated financial statements.

STURGIS BANCORP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2016 and 2015  
(Amounts in thousands, except share and per share data)

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**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Basis of Presentation and Consolidation: The consolidated financial statements include the accounts of Sturgis Bancorp, Inc. (Bancorp), Sturgis Bank & Trust Company (Bank) and the Bank's wholly owned subsidiaries. The Bank's wholly owned subsidiaries include Oakleaf Financial Services, Inc., Oak Mortgage, LLC, and First Michiana Development Corporation of Sturgis, Inc. All significant intercompany transactions and balances have been eliminated in consolidation.

The Bank, which has been in continuous operation since 1905, formed Bancorp on January 1, 2002 via an equal exchange of common stock of Bank for common stock of Bancorp.

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

Nature of Operations: Bancorp operates predominantly in the southwestern portion of Michigan's Lower Peninsula. Its primary services include accepting deposits, making commercial and mortgage loans, engaging in mortgage banking activities, and providing investment brokerage advisory services.

Significant Group Concentrations of Credit Risk: Most of Bancorp's activities are with customers located within southwestern Michigan. Note 2 discusses the types of securities in which Bancorp invests. Note 3 discusses the types of lending in which Bancorp engages. Bancorp's loan portfolio is concentrated in residential and commercial mortgage loans. Bancorp does not have any significant concentrations to any one industry or customer.

Subsequent Events: Bancorp has evaluated subsequent events for recognition and disclosure through March 22, 2017, which is the date the financial statements were available to be issued.

Cash Flows: For the purpose of the consolidated statements of cash flows, cash and cash equivalents include cash and balances due from banks, federal funds sold, and other short-term time and investment accounts at the Federal Home Loan Bank, all of which mature within 90 days. Net cash flows are reported for customer loan and deposit transactions, interest bearing deposits in banks, other short term investment, and repurchase agreements.

Interest-Earning Deposits in Banks: Interest-earning deposits in banks mature within five years and are carried at cost.

Securities: Debt securities that management has the positive intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost. Securities not classified as held to maturity are classified as available for sale and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held to maturity and available for sale securities below their cost, that are deemed to be other than temporary, are reflected in earnings as realized losses. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

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(Continued)

STURGIS BANCORP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2016 and 2015  
(Amounts in thousands, except share and per share data)

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**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Management evaluates securities for other-than-temporary impairment (“OTTI”) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. In determining OTTI for debt securities, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Bancorp has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

Federal Home Loan Bank Stock: Bancorp’s minimum investment in the stock of the Federal Home Loan Bank of Indianapolis (FHLB) is an amount equal to at least 1.0% of the unpaid principal balances of Bancorp’s residential mortgage loans or 0.3% of its total assets, whichever is greater. Purchases and sales of stock are made directly with the FHLB at par value. The stock is recorded at cost and classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value.

Loans Held for Sale: Loans originated and intended for sale in the secondary market are carried at fair value. The fair value includes the servicing value of the loans as well as any accrued interest. Net unrealized losses, if any, are recognized in a valuation allowance by charges to income.

Mortgage loans held for sale are generally sold with servicing rights retained. Gains and losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the related loans sold. The carrying value of mortgage loans sold is reduced by the amount allocated to the servicing right.

Loans: Bancorp grants mortgage, commercial, and consumer loans to customers. Loans are reported at their outstanding unpaid principal balances, adjusted for amounts charged off, nonaccrual interest paid, the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment to the related loan yield using the interest method. Recorded investment in loans includes unpaid principal balances, adjusted for amounts charged off, nonaccrual interest paid, unamortized deferred fees and costs, accrued interest receivable, and negative escrow balances.

The accrual of interest on loans is discontinued at the time the loan is 90 days delinquent, unless the credit is well-secured and in the process of collection. Past due status is based on the contractual terms of the loan. In all cases, if collection of principal and interest is considered doubtful, loans are placed on nonaccrual, charged off, or charged down to the fair value of collateral.

When a loan is placed in nonaccrual status, all interest accrued but not collected is reversed against interest income. Interest payments received on loans in nonaccrual status are accounted for as reductions to the carrying value of the principal. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

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(Continued)

STURGIS BANCORP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2016 and 2015  
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**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Allowance for Loan Losses: The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance, when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision with any new information.

The allowance consists of specific and general components. The specific components relate to loans that are classified as impaired. For such loans, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors.

A loan is considered impaired, based on current information and events, when it is probable Bancorp will be unable to collect the scheduled payments of principal or interest in accordance with the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls are not generally classified as impaired. 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 length of the delay, reasons for the delay, the borrower's prior payment history, and the amount of the shortfall in relation to the amount due and collateral value. Impairment on a loan is generally measured on a loan-by-loan basis for commercial, commercial real estate, and residential troubled debt restructurings.

Large groups of homogenous loans, such as consumer and residential mortgages, are collectively evaluated for impairment. Accordingly, Bancorp does not separately identify individual consumer and residential mortgage loans for impairment disclosures.

The general component of the allowance for loan losses covers non-impaired loans and is based on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by Bancorp. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. The following portfolio segments have been identified:

Commercial - Loans to businesses that are sole proprietorships, partnerships, limited liability companies and corporations. These loans are for commercial, industrial, or professional purposes. The risk characteristics of these loans vary based on the borrower's business and industry as repayment is typically dependent on cash flows generated from the underlying business.

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(Continued)

STURGIS BANCORP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2016 and 2015  
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**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Commercial Real Estate and Commercial Construction - Loans to individuals or businesses that are secured by improved and unimproved vacant land, farmland, commercial real property, multifamily residential properties, and all other conforming, nonresidential properties. The risk characteristics are similar to commercial loans, but these loan segments may also be dependent on real estate sales or rental income. For commercial construction, proceeds may be used for land acquisition, development or construction.

Consumer - Term loans or lines of credit for the purchase of consumer goods, vehicles or home improvement. The risk characteristics of this loan segment vary depending on the type of collateral but general repayment is expected from an individual continuing to generate a cash flow that supports the calculated payment obligation.

Residential and Residential Construction - Loans to purchase or refinance single family residences. The risks associated with these segments are similar to the risks for consumer loans regarding individual payment obligations however the underlying collateral is the real estate. Real estate is subject to changes in market valuation and can be unstable for a variety of reasons. For residential construction, proceeds may be used for land acquisition, development, or construction of residential properties.

Home equity – Loans to purchase consumer goods or home improvements. The risks associated with this segment are similar to residential loans, however typically these loans are secured by second lien positions in real estate.

For the commercial and commercial real estate portfolio segments, the historical loss is tracked by year of charge off. Grades are assigned to each commercial and commercial real estate loan by accessing information about the specific borrower's situation and the estimated collateral values. The description of the loan grade criteria is included in Note 3.

Loans, for which the terms have been modified, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired. Troubled debt restructurings are separately identified for impairment disclosures and are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral.

For troubled debt restructurings that subsequently default, the Bancorp determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

Servicing: Servicing rights are recognized separately when they are acquired through sales of loans. When mortgage loans are sold, servicing rights are initially recorded at fair value with the income statement effect recorded in gains on sales of loans. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses. Bancorp compares the valuation model inputs and results to published industry data in order to validate the model results and assumptions. All classes of servicing assets are subsequently measured using the amortization method which requires servicing rights to be amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans.

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(Continued)

STURGIS BANCORP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2016 and 2015  
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**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to carrying amount. Impairment is determined by stratifying rights into groupings based on predominant risk characteristics, such as interest rate, loan type and investor type. Impairment is recognized through a valuation allowance for individual groupings, to the extent that fair value is less than the carrying amount. Changes in valuation allowances are reported with mortgage banking activities on the income statement. The fair values of servicing rights are subject to significant fluctuations as a result of changes in estimated and actual prepayment speeds and default rates and losses.

Servicing fee income, which is reported on the income statement as mortgage banking activities, is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal and are recorded as income when earned. The amortization of mortgage servicing rights is netted against loan servicing fee income. Servicing fees totaled \$435 and \$446 for the years ended December 31, 2016 and 2015 respectively. Late fees and ancillary fees related to loan servicing were not material for presentation.

Transfers of Financial Assets: Transfers of financial assets are accounted for as sales, when control over the assets has been relinquished. Control over transferred assets is deemed to be surrendered when the assets have been isolated from Bancorp, the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and Bancorp does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Premises and Equipment: Land is carried at cost. Premises and equipment are carried at cost, less accumulated depreciation computed on the straight-line method over the estimated useful lives of the assets. Buildings and related components are depreciated with useful lives ranging from 5 to 50 years. Furniture, fixtures and equipment are depreciated with useful lives ranging from 3 to 15 years.

Real Estate Owned: Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value at the date of foreclosure, less costs to sell when acquired, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less costs to sell. Revenue and expenses from operations and changes in the valuation allowance are included in real estate owned expense.

Bank-Owned Life Insurance: Bancorp has purchased life insurance policies on certain key officers. Bank-owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

Goodwill: Generally, intangible assets that meet certain criteria are recognized and subsequently amortized over their estimated useful lives. Goodwill with indefinite lives are not amortized. However, such assets are tested for impairment at least annually thereafter. The impairment test is generally performed in the fourth quarter of each year. There has been no impairment of goodwill.

Long-Term Assets: Premises and equipment and other long-term assets are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value.

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(Continued)

STURGIS BANCORP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2016 and 2015  
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**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Loan Commitments and Related Financial Instruments: Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

Derivatives: The Company began entering into cash flow hedge agreements in 2015. For each cash flow hedge, the gain or loss on the derivative is reported in other comprehensive income and is reclassified into earnings in the same period during which the hedged transaction affects earnings. Changes in the fair value of derivatives that are not highly effective in hedging the changes in expected cash flows of the hedged item are recognized immediately in current earnings.

Net cash settlements on derivatives that qualify for hedge accounting are recorded in interest income or interest expense, based on the item being hedged. Cash flows on hedges are classified in the cash flow statement the same as the cash flows of the items being hedged.

The Company formally documents the relationship between hedged items, as well as the risk-management objective and the strategy for undertaking hedge transactions at the inception of the hedging relationship. This documentation includes linking cash flow hedges to specific liabilities on the balance sheet or to specific firm commitments or forecasted transactions. The Company also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivative instruments that are used are highly effective in offsetting changes in cash flows of the hedged items. The Company discontinues hedge accounting when it determines that the derivative is no longer effective in offsetting changes in the cash flows of the hedged item, the derivative is settled or terminates, a hedged forecasted transaction is no longer probable, a hedged firm commitment is no longer firm, or treatment of the derivative as a hedge is no longer appropriate or intended.

When hedge accounting is discontinued, subsequent changes in fair value of the derivative are recorded as non-interest income. When a cash flow hedge is discontinued but the hedged cash flow or forecasted transactions are still expected to occur, gains or losses that were accumulated in other comprehensive income are amortized into earnings over the same periods which the hedged transactions will affect earnings.

Income Taxes: Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the various temporary differences between the book and the tax bases of the various balance sheet assets and liabilities. This method gives current recognition to changes in tax rates and laws. When necessary, valuation allowances are established to reduce deferred tax assets to the amount expected to be realized.

A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded.

Bancorp recognizes interest and/or penalties related to income tax matters in income tax expense.

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(Continued)

STURGIS BANCORP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

Earnings Per Share: Basic earnings per share represents income available to common stockholders divided by the weighted average number of common shares outstanding during the period. Diluted earnings per share includes outstanding additional common shares that would have been outstanding, if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. As of December 31, 2016 and 2015, there were no dilutive common shares. As of December 31, 2016 and 2015, weighted average shares used in computing earnings per share were 2,080,789 and 2,073,004.

Common stock issuances: The Company issues common stock to directors for their board service. Shares are issued on a quarterly basis in accordance with the amount of annual director fees established annually. Shares of 8,200 and 7,900 were issued for directors fees in 2016 and 2015, respectively, and vested immediately upon issuance. Expense associated with the issuance of stock for director fees is reflected in the consolidated income statement in other expense and was \$98 and \$81 for 2016 and 2015, respectively.

Comprehensive Income (loss): Comprehensive income (loss) consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on securities available for sale, changes in the fair value of cash flow hedges, and changes in the post retirement benefit obligation, which are also recognized as separate components of equity.

Loss Contingencies: Loss contingencies, including claims and legal action arising in the normal course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there are now such matters that will have a material effect on Bancorp's consolidated financial statements.

Fair Value of Financial Instruments: Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in a separate note. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

Adoption of New Accounting Standards:

New Accounting Standards Not Yet Effective: In June 2016, FASB issued guidance to replace the incurred loss model with an expected loss model, which is referred to as the current expected credit loss (CECL) model. The CECL model is applicable to the measurement of credit losses on financial assets measured at amortized cost, including loan receivables, held to maturity debt securities, and reinsurance receivables. It also applies to off-balance sheet credit exposures not accounted for as insurance (loan commitments, standby letters of credit, financial guarantees, and other similar instruments) and net investments in leases recognized by a lessor. For debt securities with other-than-temporary impairment, the guidance will be applied prospectively. For all other assets within the scope of CECL, a cumulative-effect adjustment will be recognized in retained earnings as of the beginning of the first reporting period in which the guidance is effective. The standard will be effective for fiscal years beginning after December 15, 2020, including interim periods within those years. Early adoption is permitted for fiscal years beginning after December 15, 2019. The Company is still evaluating the impact of adopting this standard on the Company's operating results and financial condition.

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(Continued)

STURGIS BANCORP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2016 and 2015  
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**NOTE 2 – SECURITIES**

The amortized cost and fair value of securities with gross unrealized / unrecognized gains and losses follow:

	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Fair Value
<u>2016</u>				
Available-for-sale securities:				
U. S. government sponsored entities and agencies	\$ 2,115	\$ 3	\$ -	\$ 2,118
State and political subdivisions	11,765	89	(50)	11,804
Mortgage-backed securities-residential	5,986	-	(173)	5,813
Mortgage-backed securities-commercial	6,584	6	(80)	6,510
Collateralized mortgage obligations	<u>6,238</u>	<u>-</u>	<u>(96)</u>	<u>6,142</u>
Total available-for-sale	<u>\$ 32,688</u>	<u>\$ 98</u>	<u>\$ (399)</u>	<u>\$ 32,387</u>
Held-to-maturity securities:				
State and political subdivisions	\$ 29,306	\$ 28	\$ (784)	\$ 28,550
Collateralized mortgage obligations	<u>4,463</u>	<u>57</u>	<u>(97)</u>	<u>4,423</u>
Total held-to-maturity	<u>\$ 33,769</u>	<u>\$ 85</u>	<u>\$ (881)</u>	<u>\$ 32,973</u>
<u>2015</u>				
Available-for-sale securities:				
U. S. government sponsored entities and agencies	\$ 1,658	\$ 1	\$ (5)	\$ 1,654
State and political subdivisions	12,206	206	(11)	12,401
Mortgage-backed securities-residential	3,921	-	(48)	3,873
Mortgage-backed securities-commercial	4,026	4	-	4,030
Collateralized mortgage obligations	<u>5,752</u>	<u>1</u>	<u>(76)</u>	<u>5,677</u>
Total available-for-sale	<u>\$ 27,563</u>	<u>\$ 212</u>	<u>\$ (140)</u>	<u>\$ 27,635</u>
Held-to-maturity securities:				
State and political subdivisions	\$ 17,325	\$ 311	\$ (4)	\$ 17,632
Collateralized mortgage obligations	<u>1,920</u>	<u>91</u>	<u>-</u>	<u>2,011</u>
Total held-to-maturity	<u>\$ 19,245</u>	<u>\$ 402</u>	<u>\$ (4)</u>	<u>\$ 19,643</u>

Securities with an amortized cost of \$23,399 (fair value of \$23,029) were pledged at December 31, 2016 to secure FHLB advances. Securities with an amortized cost of \$1,987 (fair value of \$1,977) were pledged at December 31, 2016 to secure derivatives. Securities with an amortized cost of \$14,463 (fair value of \$14,451) were pledged at December 31, 2015 to secure FHLB advances. Securities with an amortized cost of \$981 (fair value of \$972) were pledged at December 31, 2015 to secure derivatives.

(Continued)

STURGIS BANCORP, INC.  
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**NOTE 2 – SECURITIES** (Continued)

The amortized cost and fair value of securities by contractual maturity at December 31, 2016 are shown below. Actual and 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. Securities not due at a single maturity date are shown separately.

	Held-to-Maturity		Available-for-Sale	
	Amortized <u>Cost</u>	Fair <u>Value</u>	Amortized <u>Cost</u>	Fair <u>Value</u>
Due in one year or less	\$ -	\$ -	\$ 1,075	\$ 1,076
Due after one through five years	148	148	2,262	2,255
Due after five through ten years	2,356	2,299	5,639	5,677
Due after ten years	26,802	26,103	4,904	4,914
Mortgage-backed securities and CMO's	<u>4,463</u>	<u>4,423</u>	<u>18,808</u>	<u>18,465</u>
	<u>\$ 33,769</u>	<u>\$ 32,973</u>	<u>\$ 32,688</u>	<u>\$ 32,387</u>

Securities with unrealized losses at year end 2016 and 2015, aggregated by investment category and length of time that individual securities have been in an unrealized loss position, are as follows:

<u>Description</u>	<u>Less than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>Unrealized Loss</u>
<u>2016</u>						
Available-for-sale securities:						
States and political subdivisions	\$ 4,246	\$ (50)	\$ -	\$ -	\$ 4,246	\$ (50)
Mortgage-backed securities - residential	5,813	(173)	-	-	5,813	(173)
Mortgage-backed securities - commercial	3,113	(80)	-	-	3,113	(80)
Collateralized mortgage obligations	<u>6,142</u>	<u>(96)</u>	<u>-</u>	<u>-</u>	<u>6,142</u>	<u>(96)</u>
Total available-for-sale	<u>\$ 19,314</u>	<u>\$ (399)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 19,314</u>	<u>\$ (399)</u>
Held-to-maturity						
States and political subdivisions	\$ 24,816	\$ (784)	\$ -	\$ -	\$ 24,816	\$ (784)
Collateralized mortgage obligations	<u>2,958</u>	<u>(97)</u>	<u>-</u>	<u>-</u>	<u>2,958</u>	<u>(97)</u>
Total held-to-maturity	<u>\$ 27,774</u>	<u>\$ (881)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 27,774</u>	<u>\$ (881)</u>

(Continued)

STURGIS BANCORP, INC.  
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**NOTE 2 – SECURITIES** (Continued)

<u>Description</u>	<u>Less than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>Unrealized Loss</u>
<u>2015</u>						
Available-for-sale securities:						
U. S. government sponsored entities and agencies	\$ 1,154	\$ (5)	\$ -	\$ -	\$ 1,154	\$ (5)
States and political subdivisions	807	(11)	-	-	807	(11)
Mortgage-backed securities - residential	3,873	(48)	-	-	3,873	(48)
Collateralized mortgage obligations	<u>5,210</u>	<u>(76)</u>	<u>-</u>	<u>-</u>	<u>5,210</u>	<u>(76)</u>
Total available-for-sale	<u>\$ 11,044</u>	<u>\$ (140)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 11,044</u>	<u>\$ (140)</u>
Held-to-maturity						
States and political subdivisions	<u>\$ 603</u>	<u>\$ (4)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 603</u>	<u>\$ (4)</u>

Unrealized losses have not been recognized into income because the securities are of high credit quality, management does not intend to sell, it is not more likely than not that management would be required to sell the securities prior to their anticipated recovery, and the decline in fair value is largely due to changes in market interest rates. The fair value is expected to recover as the securities approach their maturity date and/or market rates decline.

For the years ended December 31, 2016 and 2015, there were securities sales of \$0 and \$8,891, respectively, with gross gains of \$0 and gross losses of \$0 recognized in 2016, and gross gains of \$13 and gross losses of \$(15) recognized in 2015. One bond was called with unaccreted discount balance of \$1, which was recognized in 2016.

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**NOTE 3 – LOANS**

A summary of the balances of loans follows:

	<u>2016</u>	<u>2015</u>
Residential loans:		
Residential	\$ 99,395	\$ 100,417
Home equity	38,248	39,192
Residential construction	<u>5,047</u>	<u>4,228</u>
Total residential loans	142,690	143,837
Commercial real estate loans:		
Commercial real estate	80,552	75,892
Commercial construction	<u>4,077</u>	<u>1,242</u>
Total commercial real estate loans	84,629	77,134
Commercial loans	37,883	31,052
Consumer loans	<u>4,757</u>	<u>4,925</u>
	269,959	256,948
Less:		
Allowance for loan losses	3,242	3,213
Add:		
Deferred loan origination and other costs, net of fees	<u>154</u>	<u>95</u>
Loans, net	<u>\$ 266,871</u>	<u>\$ 253,830</u>

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(Continued)

STURGIS BANCORP, INC.  
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**NOTE 3 – LOANS** (Continued)

The following table presents the activity in the allowance for loan losses by portfolio segment for the years ended December 31, 2016 and 2015:

	<u>Residential</u>	<u>Home Equity</u>	<u>Residential Construction</u>	<u>Commercial Real Estate</u>	<u>Commercial Construction</u>	<u>Commercial</u>	<u>Consumer</u>	<u>Total</u>
<u>December 31, 2016</u>								
Allowance for loan losses:								
Beginning balance	\$ 1,299	\$ 381	\$ 50	\$ 1,302	\$ 5	\$ 174	\$ 2	\$ 3,213
Provision for loan losses	116	108	(42)	28	2	109	36	357
Loans charged-off	(149)	(99)	-	(35)	-	(51)	(42)	(376)
Recoveries	-	9	1	12	-	13	13	48
Total ending allowance balance	<u>\$ 1,266</u>	<u>\$ 399</u>	<u>\$ 9</u>	<u>\$ 1,307</u>	<u>\$ 7</u>	<u>\$ 245</u>	<u>\$ 9</u>	<u>\$ 3,242</u>
<u>December 31, 2015</u>								
Allowance for loan losses:								
Beginning balance	\$ 1,482	\$ 468	\$ 10	\$ 1,312	\$ -	\$ 145	\$ 20	\$ 3,437
Provision (benefit) for loan losses	(178)	(51)	40	82	5	(104)	(13)	(219)
Loans charged-off	(10)	(54)	-	(253)	-	(27)	(13)	(357)
Recoveries	5	18	-	161	-	160	8	352
Total ending allowance balance	<u>\$ 1,299</u>	<u>\$ 381</u>	<u>\$ 50</u>	<u>\$ 1,302</u>	<u>\$ 5</u>	<u>\$ 174</u>	<u>\$ 2</u>	<u>\$ 3,213</u>

(Continued)

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**NOTE 3 – LOANS** (Continued)

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and class and based on impairment method as of December 31, 2016 and 2015:

	<u>Residential</u>	<u>Home Equity</u>	<u>Residential Construction</u>	<u>Commercial Real Estate</u>	<u>Commercial Construction</u>	<u>Commercial</u>	<u>Consumer</u>	<u>Total</u>
<b>2016</b>								
Allowance for loan losses:								
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$ 115	\$ 6	\$ -	\$ 501	\$ -	\$ -	\$ -	\$ 622
Collectively evaluated for impairment	1,151	393	9	806	7	245	9	2,620
Acquired with deteriorated credit quality	-	-	-	-	-	-	-	-
Total ending allowance balance	<u>\$ 1,266</u>	<u>\$ 399</u>	<u>\$ 9</u>	<u>\$ 1,307</u>	<u>\$ 7</u>	<u>\$ 245</u>	<u>\$ 9</u>	<u>\$ 3,242</u>
Loans:								
Loans individually evaluated for impairment	\$ 4,917	\$ 94	\$ -	\$ 4,611	\$ -	\$ 87	\$ 8	\$ 9,717
Loans collectively evaluated for impairment	94,138	38,510	5,056	76,456	4,077	38,052	4,741	261,030
Loans acquired with deteriorated credit quality	<u>203</u>	<u>-</u>	<u>-</u>	<u>76</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>279</u>
Total ending recorded investment in loans	<u>\$ 99,258</u>	<u>\$ 38,604</u>	<u>\$ 5,056</u>	<u>\$ 81,143</u>	<u>\$ 4,077</u>	<u>\$ 38,139</u>	<u>\$ 4,749</u>	<u>\$ 271,026</u>
<b>2015</b>								
Allowance for loan losses:								
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$ 108	\$ 7	\$ -	\$ 545	\$ -	\$ 1	\$ -	\$ 661
Collectively evaluated for impairment	1,191	374	50	757	5	173	2	2,552
Acquired with deteriorated credit quality	-	-	-	-	-	-	-	-
Total ending allowance balance	<u>\$ 1,299</u>	<u>\$ 381</u>	<u>\$ 50</u>	<u>\$ 1,302</u>	<u>\$ 5</u>	<u>\$ 174</u>	<u>\$ 2</u>	<u>\$ 3,213</u>
Loans:								
Loans individually evaluated for impairment	\$ 5,766	\$ 149	\$ -	\$ 6,394	\$ -	\$ 131	\$ 12	\$ 12,452
Loans collectively evaluated for impairment	94,247	39,382	4,238	69,979	1,226	31,144	4,907	245,123
Loans acquired with deteriorated credit quality	<u>218</u>	<u>-</u>	<u>-</u>	<u>64</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>282</u>
Total ending recorded investment in loans	<u>\$ 100,231</u>	<u>\$ 39,531</u>	<u>\$ 4,238</u>	<u>\$ 76,437</u>	<u>\$ 1,226</u>	<u>\$ 31,275</u>	<u>\$ 4,919</u>	<u>\$ 257,857</u>

(Continued)

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**NOTE 3 – LOANS** (Continued)

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2016 and 2015. For purposes of this disclosure, unpaid principal balance has been reduced by partial charge offs, if any.

	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Average Recorded Investment	Interest Income Recognized	Cash basis Interest Income Recognized
<u>2016</u>						
With no related allowance recorded:						
Residential	\$ 3,358	\$ 3,369	\$ -	\$ 3,457	\$ 172	\$ 172
Home equity	-	-	-	-	-	-
Commercial real estate	402	419	-	452	16	16
Commercial	87	87	-	84	5	5
Consumer	-	-	-	-	-	-
	<u>3,847</u>	<u>3,875</u>	<u>-</u>	<u>3,993</u>	<u>193</u>	<u>193</u>
With an allowance recorded:						
Residential	1,543	1,548	115	1,564	67	67
Home equity	93	94	6	99	5	5
Commercial real estate	3,972	4,192	501	4,269	119	119
Commercial	-	-	-	-	-	-
Consumer	8	8	-	10	1	1
	<u>5,616</u>	<u>5,842</u>	<u>622</u>	<u>5,942</u>	<u>192</u>	<u>192</u>
	<u>\$ 9,463</u>	<u>\$ 9,717</u>	<u>\$ 622</u>	<u>\$ 9,935</u>	<u>\$ 385</u>	<u>\$ 385</u>
<u>2015</u>						
With no related allowance recorded:						
Residential	\$ 4,889	\$ 4,908	\$ -	\$ 4,993	\$ 232	\$ 232
Home equity	57	57	-	59	3	3
Commercial real estate	1,979	2,039	-	2,097	83	83
Commercial	89	91	-	83	4	4
Consumer	-	-	-	-	-	-
	<u>7,014</u>	<u>7,095</u>	<u>-</u>	<u>7,232</u>	<u>322</u>	<u>322</u>
With an allowance recorded:						
Residential	851	858	108	879	37	37
Home equity	92	92	7	95	5	5
Commercial real estate	4,100	4,355	545	3,958	117	117
Commercial	40	40	1	41	2	2
Consumer	12	12	-	14	1	1
	<u>5,095</u>	<u>5,357</u>	<u>661</u>	<u>4,987</u>	<u>162</u>	<u>162</u>
	<u>\$ 12,109</u>	<u>\$ 12,452</u>	<u>\$ 661</u>	<u>\$ 12,219</u>	<u>\$ 484</u>	<u>\$ 484</u>

(Continued)

STURGIS BANCORP, INC.  
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**NOTE 3 – LOANS** (Continued)

The following table presents the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of December 31, 2016 and 2015:

	<u>2016</u>		<u>2015</u>	
	Loans Past Due Over 90 Days Still		Loans Past Due Over 90 Days Still	
	<u>Nonaccrual</u>	<u>Accruing</u>	<u>Nonaccrual</u>	<u>Accruing</u>
Residential	\$ 507	\$ 220	\$ 357	\$ 479
Home equity	23	-	69	38
Commercial real estate	404	111	2,875	75
Consumer	<u>-</u>	<u>-</u>	<u>-</u>	<u>7</u>
Total	<u>\$ 934</u>	<u>\$ 331</u>	<u>\$ 3,301</u>	<u>\$ 599</u>

The following table presents the aging of the recorded investment in past due loans as of December 31, 2016 and 2015 by class of loans:

	<u>30-59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>Greater than 90 Days Past Due</u>	<u>Total Past Due</u>	<u>Loans not Past Due</u>	<u>Total</u>
<u>2016</u>						
Residential	\$ 719	\$ 760	\$ 271	\$ 1,750	\$ 97,508	\$ 99,258
Home equity	127	172	-	299	38,305	38,604
Residential construction	-	-	-	-	5,056	5,056
Commercial real estate	66	-	111	177	80,966	81,143
Commercial construction	-	-	-	-	4,077	4,077
Commercial	-	-	-	-	38,139	38,139
Consumer	<u>17</u>	<u>31</u>	<u>-</u>	<u>48</u>	<u>4,701</u>	<u>4,749</u>
Total recorded investment	<u>\$ 929</u>	<u>\$ 963</u>	<u>\$ 382</u>	<u>\$ 2,274</u>	<u>\$ 268,752</u>	<u>\$ 271,026</u>
<u>2015</u>						
Residential	\$ 948	\$ 965	\$ 492	\$ 2,405	\$ 97,826	\$ 100,231
Home equity	185	41	83	309	39,222	39,531
Residential construction	-	-	-	-	4,238	4,238
Commercial real estate	59	79	139	277	76,160	76,437
Commercial construction	-	-	-	-	1,226	1,226
Commercial	-	16	-	16	31,259	31,275
Consumer	<u>32</u>	<u>22</u>	<u>7</u>	<u>61</u>	<u>4,858</u>	<u>4,919</u>
Total recorded investment	<u>\$ 1,224</u>	<u>\$ 1,123</u>	<u>\$ 721</u>	<u>\$ 3,068</u>	<u>\$ 254,789</u>	<u>\$ 257,857</u>

(Continued)

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**NOTE 3 – LOANS** (Continued)

**Troubled Debt Restructurings:**

Bancorp has allocated \$611 and \$651 of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of December 31, 2016 and 2015. Bancorp has committed to lend \$6 as of December 31, 2016 and \$22 as of December 31, 2015 to customers with outstanding loans that are classified as troubled debt restructurings.

During the years ended December 31, 2016 and 2015, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; or an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk.

Modifications involving a reduction of the stated interest rate of the loan were for periods ranging from 1 years to 30 years. Modifications involving an extension of the maturity date were for periods ranging from 1 year to 30 years.

The following table presents loans by class modified as troubled debt restructurings that occurred during the years ended December 31, 2016 and 2015:

	<u>Number of Loans</u>	<u>Pre-Modification Outstanding Recorded Investment</u>	<u>Post-Modification Outstanding Recorded Investment</u>
<u>2016</u>			
Troubled Debt Restructurings:			
Residential	1	\$ 85	\$ 85
Commercial real estate	<u>1</u>	<u>99</u>	<u>99</u>
Total	<u>2</u>	<u>\$ 184</u>	<u>\$ 184</u>

The troubled debt restructurings described above increased the allowance for loan losses by \$2 and resulted in charge offs of \$0 during the year ended December 31, 2016.

	<u>Number of Loans</u>	<u>Pre-Modification Outstanding Recorded Investment</u>	<u>Post-Modification Outstanding Recorded Investment</u>
<u>2015</u>			
Troubled Debt Restructurings:			
Residential	1	\$ 116	\$ 116
Commercial real estate	<u>1</u>	<u>146</u>	<u>146</u>
Total	<u>2</u>	<u>\$ 262</u>	<u>\$ 262</u>

The troubled debt restructurings described above increased the allowance for loan losses by \$47 and resulted in charge offs of \$0 during the year ended December 31, 2015.

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(Continued)

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**NOTE 3 – LOANS** (Continued)

The following table presents loans by class modified as troubled debt restructurings for which there was a payment default within the twelve months following the modification during the years ended December 31, 2016 and 2015:

	<u>2016</u>		<u>2015</u>	
	<u>Number of Loans</u>	<u>Recorded Investment</u>	<u>Number of Loans</u>	<u>Recorded Investment</u>
Residential	1	\$ 108	1	\$ 119
Home equity	-	-	-	-
Commercial real estate	1	92	-	-
Commercial	-	-	1	20
	<u>2</u>	<u>\$ 200</u>	<u>2</u>	<u>\$ 139</u>

A loan is considered to be in payment default once it is 30 days contractually past due under the modified terms.

The troubled debt restructurings that subsequently defaulted described above did not materially increase the allowance for loan losses during the years ended December 31, 2016 or 2015. These did not result in material charge offs during the years ended December 31, 2016 or 2015.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under Bancorp's internal underwriting policy.

**Credit Quality Indicators:**

Bancorp categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. Bancorp analyzes loans individually by classifying the loans as to credit risk. This analysis includes loans with an outstanding balance greater than \$250 and non-homogeneous loans, such as commercial and commercial real estate loans, unless such loans have a government guaranty. This analysis is performed on a quarterly basis. Bancorp uses the following definitions for risk ratings:

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

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

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

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(Continued)

STURGIS BANCORP, INC.  
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**NOTE 3 – LOANS** (Continued)

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans. Loans listed as not rated are either less than \$250 or are included in groups of homogeneous loans. Management monitors loans reported to be not rated by segregating between performing and nonperforming loans, which generally uses delinquency statistics. As of December 31, 2016 and 2015, and based on the most recent analysis performed, the risk category of loans (recorded investment) is as follows:

	<u>Pass</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Not Rated</u>	<u>Total</u>
<u>2016</u>						
Residential	\$ 11,746	\$ 1,231	\$ 3,975	\$ -	\$ 82,306	\$ 99,258
Home equity	2,422	-	89	-	36,093	38,604
Residential construction	182	-	-	-	4,874	5,056
Commercial real estate	73,648	4,439	3,056	-	-	81,143
Commercial construction	4,077	-	-	-	-	4,077
Commercial	26,543	1,719	-	-	9,877	38,139
Consumer	<u>356</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>4,393</u>	<u>4,749</u>
Total	<u>\$ 118,974</u>	<u>\$ 7,389</u>	<u>\$ 7,120</u>	<u>\$ -</u>	<u>\$ 137,543</u>	<u>\$ 271,026</u>
<u>2015</u>						
Residential	\$ 12,683	\$ 1,345	\$ 6,038	\$ -	\$ 80,165	\$ 100,231
Home equity	3,478	95	217	-	35,741	39,531
Residential construction	227	-	-	-	4,011	4,238
Commercial real estate	62,186	8,176	6,075	-	-	76,437
Commercial construction	1,226	-	-	-	-	1,226
Commercial	17,924	3,387	-	-	9,964	31,275
Consumer	<u>453</u>	<u>18</u>	<u>37</u>	<u>-</u>	<u>4,411</u>	<u>4,919</u>
Total	<u>\$ 98,177</u>	<u>\$ 13,021</u>	<u>\$ 12,367</u>	<u>\$ -</u>	<u>\$ 134,292</u>	<u>\$ 257,857</u>

**Purchased Credit Impaired Loans:**

The Company has purchased loans (Note 17), for which there was, at acquisition, evidence of deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. The carrying amount of these loans is as follows:

	<u>2016</u>	<u>2015</u>
Residential	\$ 367	\$ 431
Commercial real estate	<u>245</u>	<u>248</u>
Outstanding balance	<u>\$ 612</u>	<u>\$ 679</u>
Carrying amount, net of allowance \$0	\$ 256	\$ 280

Accretable yield, or income expected to be collected, is as follows:

	<u>2016</u>	<u>2015</u>
Balance at January 1	\$ 65	\$ -
New loans purchased	-	104
Accretion of income	(18)	(2)
Disposals	<u>-</u>	<u>(37)</u>
Balance at December 31	<u>\$ 47</u>	<u>\$ 65</u>

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**NOTE 3 – LOANS** (Continued)

For those purchased credit impaired loans disclosed above, the Company did not increase the allowance for loan losses in 2016 or 2015. No allowances for loan losses were reserved during 2016 or 2015.

Purchased credit impaired loans purchased during the year ended December 31, 2015, for which it was probable at acquisition that all contractually required payments would not be collected, are as follows:

Contractually required payments receivable of loans purchased during the year:	
Residential	\$ 799
Commercial real estate	256
Consumer	<u>19</u>
	<u>\$ 1,074</u>
Cash flows expected to be collected at acquisitions	\$ 629
Fair value of acquired loans at acquisition	525

**NOTE 4 – PREMISES AND EQUIPMENT**

A summary of the cost and accumulated depreciation of premises and equipment follows:

	<u>2016</u>	<u>2015</u>
Land	\$ 1,454	\$ 1,454
Land improvements	247	226
Office buildings	10,305	9,855
Furniture, fixtures and equipment	5,864	5,616
Leasehold improvements	113	113
Construction in progress	<u>46</u>	<u>1</u>
Total premises and equipment	18,029	17,265
Less accumulated depreciation	<u>(9,669)</u>	<u>(9,151)</u>
Net carrying amount	<u>\$ 8,360</u>	<u>\$ 8,114</u>

Depreciation expense for the years ended December 31, 2016 and 2015 amounted to \$535 and \$515, respectively.

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(Continued)

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**NOTE 5 – SERVICING**

Loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balance of mortgages and other loans serviced for others approximated \$173,724 and \$174,560 at December 31, 2016 and 2015, respectively.

The fair values of the rights to service these loans were \$1,407 and \$1,647 at December 31, 2016 and 2015. The fair value of servicing rights at December 31, 2016 was determined using a discount rate of 10% and prepayment speeds ranging from 101 PSA to 216 PSA. The fair value of servicing rights at December 31, 2015 was determined using a discount rate of 9% and prepayment speeds ranging from 77 PSA to 251 PSA.

The following summarizes the activity in mortgage servicing rights and the related valuation allowance:

	<u>2016</u>	<u>2015</u>
Mortgage servicing rights:		
Balance at beginning of year	\$ 1,349	\$ 1,413
Mortgage servicing rights capitalized	273	278
Mortgage servicing rights amortized	(323)	(325)
Change in valuation allowance	<u>(83)</u>	<u>(17)</u>
Balance at end of year	<u>\$ 1,216</u>	<u>\$ 1,349</u>
Valuation allowance:		
Balance at beginning of year	\$ 118	\$ 101
Additions	121	34
Reductions	<u>(38)</u>	<u>(17)</u>
Balance at end of year	<u>\$ 201</u>	<u>\$ 118</u>

**NOTE 6 – EQUITY AND LIMITED PARTNERSHIP INVESTMENTS**

The Bancorp has various equity and limited partnership investments. The following table summarizes the Bancorp's investments recorded as of December 31, 2016 and 2015:

Investment	Year Invested	Ownership %	December 31, 2016			December 31, 2015		
			Asset (a)	Unfunded Commitment (b)	Amortization/ Impairment (c)	Asset (a)	Unfunded Commitment (b)	Amortization/ Impairment (c)
TGap	2003	1.23%	\$ 63	\$ -	\$ 3	\$ 66	\$ -	\$ 37
TGap 2	2008	.95	219	43	18	237	55	2
Great Lakes XX	2010	4.878	277	19	104	381	20	33
Great Lakes XX-2	2012	4.546	319	19	63	382	21	27
Great Lakes XX-3	2014	7.692	<u>899</u>	<u>539</u>	<u>66</u>	<u>965</u>	<u>837</u>	<u>35</u>
Totals			<u>\$ 1,777</u>	<u>\$ 620</u>	<u>\$ 254</u>	<u>\$ 2,031</u>	<u>\$ 933</u>	<u>\$ 134</u>

(Continued)

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**NOTE 6 – EQUITY AND LIMITED PARTNERSHIP INVESTMENTS** (Continued)

- (a) Investments are included in other assets on the consolidated balance sheets at December 31, 2016 and 2015.
- (b) Unfunded commitments are included in other liabilities on the consolidated balance sheets at December 31, 2016 and 2015.
- (c) Amortization / impairment expense of \$21 and \$39 is included in other noninterest expense on the consolidated income statements for the years ended December 31, 2016 and 2015. Amortization / impairment expense of \$233 and \$95 for the years ended December 31, 2016 and 2015 is included in income tax expense.

The TGap investments represent investments in venture capital limited partnerships that mostly invest in medical research companies. Bancorp anticipates receiving income in the future from the sale of these medical research companies to a third party. There were no distributions from the venture capital limited partnerships in 2016 and 2015.

The Great Lakes investments represent interests in limited partnerships operating in St. Joseph County, Michigan. The limited partnerships were formed to rehabilitate and operate multi-family housing units. All income, expenses and tax credits will be allocated to Bancorp based upon ownership percentage. As an investor, Bancorp is able to exercise influence over operating and financial policies of the management through provisions of the partnership agreements that require a majority approval of the limited partners. At such time as the projects are sold, the limited partners will receive a share of the net proceeds proportionate to each limited partner's outstanding capital balance. Under the terms of the limited partnership agreements, Bancorp is allocated tax losses and affordable housing federal income tax credits.

Bancorp's share of tax credits generated by the above partnerships totaled \$173 in 2016 and \$134 in 2015.

**NOTE 7 – DEPOSITS**

Interest-bearing deposit balances at December 31 are summarized as follows:

	<u>2016</u>	<u>2015</u>
Savings accounts	\$ 89,642	\$ 85,746
NOW accounts	91,845	82,128
Time:		
\$250,000 and over	3,709	3,317
Under \$250,000	<u>47,116</u>	<u>47,807</u>
	<u>\$ 232,312</u>	<u>\$ 218,998</u>

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**NOTE 7 – DEPOSITS** (Continued)

At December 31, 2016, the scheduled maturities of time deposits are as follows:

Maturing in the Year Ending <u>December 31,</u>	<u>Under \$250,000</u>	<u>\$250,000 and Over</u>
2017	\$ 25,473	\$ 1,672
2018	10,601	340
2019	8,066	1,697
2020	1,646	-
2021	1,255	-
Thereafter	<u>75</u>	<u>-</u>
	<u>\$ 47,116</u>	<u>\$ 3,709</u>

**NOTE 8 – FEDERAL HOME LOAN BANK ADVANCES AND OTHER BORROWINGS**

The Bank had advances from the Federal Home Loan Bank of Indianapolis (FHLB) of \$58,800 at December 31, 2016, which mature through 2017. Of that total, the Bank has entered into interest rate swaps on \$27,500 of advances which will swap the risk of increases in LIBOR for fixed rates ranging from 1.565% to 1.77% through 2026, as the Bank expects to have FHLB advances of at least this amount through that date. The Bank had advances from the Federal Home Loan Bank of Indianapolis (FHLB) of \$45,000 at December 31, 2015, which mature through 2017. Of that total, the Bank had an interest rate swap on \$17,500 of advances which swapped the variable interest rates for a fixed rate of 1.77% through 2022. At December 31, 2016, the interest rates on the advances ranged from 0.82% to 2.97%. At December 31, 2015, the interest rates on the advances ranged from 0.48% to 2.97%. The advances are subject to prepayment penalties as defined in the credit policy of FHLB.

The Bank has an available six-month line of credit with the FHLB which provides for advances up to \$10,000 and matures in May 2017. There were no balances outstanding on this line of credit at December 31, 2016 or 2015.

The advances and 6-month line of credit are collateralized by performing non-employee residential and commercial mortgage loans. The unpaid principal balance of pledged loans was approximately \$72,335 and \$70,166 at December 31, 2016 and 2015, respectively.

Annual payments of FHLB advances are as follows:

2017	\$ 58,800
2018	-
2019	<u>-</u>
	<u>\$ 58,800</u>

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**NOTE 8 – FEDERAL HOME LOAN BANK ADVANCES AND OTHER BORROWINGS** (Continued)

At December 31, 2016 and 2015, the Bank had a \$4,000 term loan outstanding with a financial institution. The balloon maturity was refinanced in July 2015 with 7-year amortization and balloon maturity in July 2018. The outstanding balance of the loan was \$2,380 and \$2,812 at December 31, 2016 and 2015, respectively. The interest rate on the loan at December 31, 2016 was 3.75%, variable with Prime and 3.50%, variable with Prime at December 31, 2015.

**NOTE 9 – FEDERAL INCOME TAXES**

Sturgis Bancorp, Inc. and Subsidiaries file a consolidated federal income tax return. The following is a summary of the provision for income taxes for the two years ended December 31:

	<u>2016</u>	<u>2015</u>
Current expense	\$ 756	\$ 523
Deferred expense	<u>(98)</u>	<u>(77)</u>
	<u>\$ 658</u>	<u>\$ 446</u>

A reconciliation of the difference between total federal income tax expense and the amount computed by applying the statutory tax rates to income before income taxes is as follows:

	<u>2016</u>	<u>2015</u>
Amount computed at statutory rate	\$ 1,129	\$ 988
Tax-exempt income from Bank-owned life insurance	(89)	(331)
Tax-exempt interest income	(389)	(163)
Low-income housing tax credits	(173)	(131)
Other, net	<u>180</u>	<u>83</u>
	<u>\$ 658</u>	<u>\$ 446</u>

The components of the net deferred tax asset (liability) are as follows:

	<u>2016</u>	<u>2015</u>
Deferred tax assets:		
Allowance for loan losses	\$ 547	\$ 428
Unfunded pension liability	83	92
Deferred compensation	415	369
Low-Income housing tax credits	381	486
Alternative minimum tax credits	110	94
Nonaccrual interest income	200	177
Other real estate	16	77
Unrealized loss on available-for sale securities	103	-
Other	<u>97</u>	<u>71</u>
	1,952	1,794

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(Continued)

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**NOTE 9 – FEDERAL INCOME TAXES (Continued)**

	<u>2016</u>	<u>2015</u>
Deferred tax liabilities:		
Deferred loan fees	\$ (56)	\$ (37)
Mortgage servicing rights	(415)	(462)
Amortization of goodwill	(1,685)	(1,660)
Depreciation	(184)	(226)
FHLB stock dividends	(89)	(89)
Unrealized gain on available-for-sale securities	-	(24)
Cash flow hedge	(206)	-
Other	<u>(86)</u>	<u>(74)</u>
	<u>(2,721)</u>	<u>(2,572)</u>
 Net deferred tax asset (liability)	 <u>\$ (769)</u>	 <u>\$ (778)</u>

At December 31, 2016, Bancorp has a low income housing tax credit carryforward of \$381 that begins to expire if unused in the year 2031. The AMT credits do not expire.

Bancorp and its subsidiaries are subject to U.S. federal income tax as well as income tax to the state of Indiana. Bancorp is no longer subject to examination by taxing authorities for years before 2013.

There were no unrecognized tax benefits at December 31, 2016 and Bancorp does not expect the total amount of unrecognized tax benefits to significantly increase or decrease in the next twelve months.

For the years ended 2016 and 2015, interest and penalties related to income tax matters were not material.

**NOTE 10 – RETIREMENT BENEFITS**

The Bancorp participates in the Pentegra Defined Benefit Plan for Financial Institutions (Pentegra DB Plan), which is a tax-qualified, multi-employer defined benefit pension plan, covering substantially all of the officers and employees of the Bank and its subsidiaries. The defined benefit plan provided benefits to all full-time employees with one year of service, based on basic compensation and years of service. Bancorp contributions are determined by the Plan and generally represent the normal cost of the Plan. Specific Plan assets and accumulated benefit information for Bancorp's portion of the fund are not available. Under the Employee Retirement Income Security Act (ERISA), a contributor to a multi-employer pension plan may be liable in the event of complete or partial withdrawal for the benefit payments guaranteed under ERISA. Bancorp has no present intention to withdraw from the fund, although Bancorp froze future benefits to participants effective March 2, 2011. The Pentegra DB Plan's Employee Identification Number is 13-5645888 and the Plan Number is 333.

The Pentegra DB Plan is a single plan under Internal Revenue Code Section 413(c) and, as a result, all of the assets stand behind all of the liabilities. Accordingly, under the Pentegra DB Plan, contributions made by a participating employer may be used to provide benefits to participants of other participating employers. Total contributions received by the Pentegra DB Plan, as reported on Form 5500, for the plan years ended June 30, 2015 and 2014 totaled \$163,138 and \$190,751, respectively.

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**NOTE 10 – RETIREMENT BENEFITS** (Continued)

Employer contributions and administrative expenses charged to operations for the years ended December 31, 2016 and 2015 totaled \$255 and \$321, respectively. Bancorp contributions for 2016 and 2015 were not more than 5% of the total contributions made to the Pentegra DB Plan. There are no collective bargaining agreements in place that require contributions to the plan. The funded status of the plan as of July 1, 2016 and 2015 was 104.59% and 107.19%, respectively.

The Bancorp sponsors a non-qualified defined benefit (DB) to provide supplemental retirement benefits for certain executives. These benefits include pre-retirement disability and death benefits, as well as post-retirement payments for 15 years. The following table sets forth the DB activity and other information as of and for the years ended December 31, 2016 and 2015.

	<u>2016</u>	<u>2015</u>
Plan assets at fair value	\$ -	\$ -
Projected benefit obligation	<u>1,462</u>	<u>1,349</u>
Underfunded status	<u>\$ (1,462)</u>	<u>\$ (1,349)</u>
Accumulated benefit obligation	\$ 1,097	\$ 991
Components of Net Periodic Benefit Cost:		
	<u>2016</u>	<u>2015</u>
Service cost	\$ 53	\$ 55
Interest cost	60	54
Amortization of prior service cost	10	10
Amortization of net (gain) loss	<u>14</u>	<u>19</u>
Net periodic benefit cost	137	138
Net (gain) loss	(14)	(47)
Amortization of prior service cost and net (gain) loss	<u>(10)</u>	<u>(29)</u>
Total recognized in other comprehensive income	<u>(24)</u>	<u>(76)</u>
Total recognized in net periodic benefit cost and other comprehensive income	<u>\$ 113</u>	<u>\$ 62</u>

Amounts reported in accumulated other comprehensive income at December 31 consist of:

	<u>2016</u>	<u>2015</u>
Net actuarial loss (gain)	\$ 146	\$ 160
Prior service cost	<u>99</u>	<u>109</u>
	<u>\$ 245</u>	<u>\$ 269</u>
Actuarial assumptions:		
Weighted average discount rate	4.39%	4.39%
Increase in future compensation levels	2.25	2.25

The Bancorp does not expect to contribute to the plan in 2017.

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**NOTE 10 – RETIREMENT BENEFITS** (Continued)

The estimated net loss and prior service cost for the plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost during the year ending December 31, 2016 are not significant.

To fund the DB obligation and other employee benefits, Bancorp has purchased insurance policies on the lives of certain officers of the Bank. Bancorp is owner and beneficiary of these policies. At December 31, 2016 and 2015, the cash value of all bank-owned life insurance policies was \$9,998 and \$9,735, respectively. The cash value is available to fund future benefit obligations. There were no supplemental retirement benefits paid by the DB during 2016 or 2015. The Bancorp does not anticipate paying benefits in connection with this plan over the next three years, with \$26 anticipated to be paid in 2020 and \$46 anticipated to be paid in 2021. The projected benefit obligation of \$1,462 in 2016 and \$1,349 in 2015 was included in other liabilities.

**NOTE 11 – MINIMUM REGULATORY CAPITAL REQUIREMENTS**

The Bank is subject to various regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet minimum capital requirements can initiate regulatory action. The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. Banks (Basil III rules) became effective for the Bank on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. Under the Basel III rules, the Company must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer is being phased in from 0.0% for 2015 to 2.50% by 2019. The capital conservation buffer for 2016 is 0.625%. The net unrealized gains or losses carried in other comprehensive income is not included in computing regulatory capital. Management believes as of December 31, 2016, the Bank met all capital adequacy requirements to which the Bank is subject.

Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these items are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. At year-end 2016 and 2015, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category

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**NOTE 11 – MINIMUM REGULATORY CAPITAL REQUIREMENTS (Continued)**

The Bank's actual capital amounts and ratios at December 31, 2016 and 2015 were as follows:

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio (1)	Amount	Ratio
<u>December 31, 2016</u>						
Total capital (to risk weighted assets)	\$ 35,595	14.1%	\$ 20,218	8.0%	\$ 25,273	10.0%
Tier 1 capital (to risk weighted assets)	32,434	12.8	15,164	6.0	20,218	8.0
Common Equity Tier 1 (CET1) (to risk weighted assets)	32,434	12.8	11,373	4.5	16,427	6.5
Tier 1 capital (to adjusted total assets)	32,434	8.3	15,595	4.0	19,494	5.0
<u>December 31, 2015</u>						
Total capital (to risk weighted assets)	\$ 34,046	14.8%	\$ 18,409	8.0%	\$ 23,011	10.0%
Tier 1 capital (to risk weighted assets)	31,165	13.5	13,807	6.0	18,409	8.0
Common Equity Tier 1 (CET1) (to risk weighted assets)	31,165	13.5	10,355	4.5	14,957	6.5
Tier 1 capital (to adjusted total assets)	31,165	8.7	14,402	4.0	18,002	5.0

(1) Excludes the capital conservation buffer.

**Dividend Restrictions** - Bancorp's primary source of funds for dividend payments is dividends received from the Bank. Banking regulations limit the amount of dividends that may be paid without prior approval of regulatory agencies. Under these regulations, the amount of dividends that may be paid in any calendar year is limited to the current year's net profits, combined with the retained net profits of the preceding two years, subject to the capital requirements described in this Note. During 2016, the Bank could, without prior approval, declare dividends of \$3,173 plus any 2016 net profits retained to date of the dividend declaration.

**NOTE 12 – OFF-BALANCE-SHEET ACTIVITIES**

**Credit-Related Financial Instruments:** Bancorp is a party to credit-related financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit and commercial letters of credit. To various degrees, such commitments involve elements of credit and interest rate risk in excess of the amount recognized on the consolidated balance sheet.

Bancorp's exposure to credit loss is represented by the contractual amount of the commitments. Bancorp follows the same credit policies in making commitments as it does for on-balance-sheet instruments.

At December 31, 2016 and 2015, the following financial instruments with credit risk were outstanding:

	<u>2016</u>	<u>2015</u>
Commitments to grant loans	\$ 7,708	\$ 18,166
Unfunded commitments under lines of credit	41,884	38,769
Commercial and standby letters of credit	980	1,230

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**NOTE 12 – OFF-BALANCE-SHEET ACTIVITIES (Continued)**

Commitments to extend credit are agreements to lend to a customer, as long as there are no violations of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of fees. These commitments, especially related to equity lines of credit, may expire without being drawn. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral secured by Bancorp is based on management's credit evaluation of the customer.

Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. The equity and commercial lines of credit are collateralized, may not have a specified maturity date, and may be drawn to the full extent of Bancorp's commitment.

Commercial and standby letters of credit are conditional commitments issued by Bancorp to guarantee the performance of a customer to a third party. The letters of credit are primarily used to support public and private borrowing arrangements. All letters of credit issued by Bancorp have expiration dates within one year.

**NOTE 13 – RELATED PARTY TRANSACTIONS**

In the ordinary course of business, Bancorp has granted loans to principal officers, directors and affiliates. A summary of the related party loan transactions for the years ended December 31, 2016 and 2015 is as follows:

	<u>2016</u>	<u>2015</u>
Related party loans - beginning of the year	\$ 2,430	\$ 2,616
Advances	46	561
Changes in related parties	-	(97)
Principal repayments	<u>(207)</u>	<u>(650)</u>
Related party loans – end of the year	<u>\$ 2,269</u>	<u>\$ 2,430</u>

Deposits from related parties held by the Bank at December 31, 2016 and 2015 approximated \$8,529 and \$671, respectively. The increase was primarily due to additional related parties in 2016.

A former director of Bancorp was a stockholder in a law firm that provides legal counsel to Bancorp and its subsidiaries. Legal fees and disbursements to the law firm totaled \$105 and \$184 for 2016 and 2015, respectively.

**NOTE 14 – FAIR VALUE OF FINANCIAL INSTRUMENTS**

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

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**NOTE 14 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)**

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

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Securities: The fair values of securities are determined by matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs).

Loans held for sale: The fair value of loans held for sale is based upon binding quotes from third party investors. (Level 2 inputs).

Impaired Loans: The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments can be significant and typically result in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, resulting in a Level 3 fair value classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

Real Estate Owned: Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals which are updated no less frequently than annually. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments can be significant and typically result in a Level 3 classification of the inputs for determining fair value. Real estate owned properties are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

Appraisals for both collateral-dependent impaired loans and real estate owned are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Bancorp. Once received, an officer reviews the assumptions and approaches utilized in the appraisal as well as the overall resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics. On an annual basis, the Bancorp compares the actual selling price of collateral that has been sold to the most recent appraised value to determine what additional adjustment should be made to the appraisal value to arrive at fair value.

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**NOTE 14 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)**

Derivatives (Cash Value Hedges): The fair values of derivatives are based on valuation models using observable market data as of the measurement date (Level 2). Our derivatives are traded in an over-the-counter market where quoted market prices are not always available. Therefore the fair values of derivatives are determined using quantitative models that utilize multiple market inputs. The inputs will vary based on the type of derivative, but could include interest rates, prices and indices to generate continuous yield or pricing curves, prepayment rates, and volatility factors to value the position. The majority of market inputs are actively quoted and can be validated through external sources, including brokers, market transactions and third-party pricing services.

Assets and liabilities measured at fair value on a recurring basis, including financial assets and liabilities for which the Bancorp has elected the fair value option, are summarized below:

	Carrying Value	Fair Value Measurements at December 31, 2016 Using:		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets				
U. S. government sponsored entities and agencies	\$ 2,118	\$ -	\$ 2,118	\$ -
State and political subdivision	11,804	-	11,804	-
Mortgage-backed securities - residential	5,813	-	5,813	-
Mortgage-backed securities - commercial	6,510	-	6,510	-
Collateralized mortgage obligations	<u>6,142</u>	<u>-</u>	<u>6,142</u>	<u>-</u>
Total investment securities available-for-sale	<u>\$ 32,387</u>	<u>\$ -</u>	<u>\$ 32,387</u>	<u>\$ -</u>
Loans held for sale	\$ 1,089	\$ -	\$ 1,089	\$ -
Cash flow hedges	705	-	705	-

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**NOTE 14 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)**

	Carrying Value	Fair Value Measurements at December 31, 2015 Using:		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Financial Assets</b>				
U. S. government sponsored entities and agencies	\$ 1,654	\$ -	\$ 1,654	\$ -
State and political subdivision Mortgage-backed securities - residential	12,401	-	12,401	-
Mortgage-backed securities - commercial	3,873	-	3,873	-
Collateralized mortgage obligations	4,030	-	4,030	-
	<u>5,677</u>	<u>-</u>	<u>5,677</u>	<u>-</u>
 Total investment securities available-for-sale	 <u>\$ 27,635</u>	 <u>\$ -</u>	 <u>\$ 27,635</u>	 <u>\$ -</u>
 Loans held for sale	 \$ 1,575	 \$ -	 \$ 1,575	 \$ -
 Cash flow hedges	 (58)		 (58)	 -

Financial Instruments Recorded Using Fair Value Option

The Bancorp has elected the fair value option for loans held for sale. These loans are intended for sale and the Bancorp believes the fair value is the best indicator of the resolution of these loans. Interest income is recorded based on the contractual terms of the loan and in accordance with the Bancorp's policy on loans held for investment. None of these loans are 90 days or more past due or on nonaccrual as of December 31, 2016 and 2015.

As of December 31, 2016 and 2015, the aggregate fair value, contractual balance (including accrued interest), and gain or loss was as follows:

	<u>2016</u>	<u>2015</u>
Aggregated fair value	\$ 1,089	\$ 1,575
Contractual balance	1,074	1,554
Gain	15	21

The total amount of gains and losses from changes in fair value included in earnings for the years ended December 31, 2016 and 2015 for loans held for sale were:

	<u>2016</u>	<u>2015</u>
Interest income	\$ 6	\$ 2
Interest expense	-	-
Change in fair value	(4)	2

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**NOTE 14 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)**

Assets measured at fair value on a non-recurring basis are summarized below:

	Carrying Value	Fair Value Measurements at December 31, 2016 Using:		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Real estate owned:				
Residential	\$ 555	\$ -	\$ -	\$ 555
Commercial real estate	132	-	-	132

	Carrying Value	Fair Value Measurements at December 31, 2015 Using:		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Real estate owned:				
Residential	\$ 687	\$ -	\$ -	\$ 687
Commercial real estate	140	-	-	140

Other Financial Instruments

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for Bancorp's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The following methods and assumptions were used by Bancorp in estimating fair value disclosures for financial instruments unless previously described:

Cash and Cash Equivalents: The carrying amounts of cash and short-term instruments approximate fair values.

Interest-earning Deposits in Banks: The carrying amounts of interest-earning deposits maturing within 90 days approximate their fair values. Fair values of other interest-earning deposits are estimated using discounted cash flow analyses based on current rates for similar types of deposits.

FHLB stock: It was not practicable to estimate the fair value of FHLB stock due to restrictions on its transferability.

(Continued)

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**NOTE 14 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)**

Loans Receivable: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values, as adjusted for estimated credit losses. Fair values for other loans (e.g., commercial real estate and investment property mortgage loans, commercial and industrial loans) are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for non-performing loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

Deposits: The fair values disclosed for demand deposits (e.g., interest and non-interest checking, savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

FHLB Advances and Other Borrowings: The carrying amount of short-term FHLB advances, federal funds purchased, and other borrowings is a reasonable estimate of their fair value due to their variable interest rates and short-term maturities. The estimated fair value of long-term FHLB is determined by discounting the future cash flows of outstanding advances using rates currently available on advances from the FHLB with similar characteristics.

Accrued Interest: The carrying amounts of accrued interest approximate fair value.

Off-Balance-Sheet Instruments: Fair values for off-balance-sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of off-balance sheet items is not considered material.

The estimated fair values and related carrying or notional amounts of Bancorp's financial instruments that are not previously presented are as follows:

	<u>2016</u>		<u>2015</u>	
	<u>Carrying Amount</u>	<u>Estimated Fair Value</u>	<u>Carrying Amount</u>	<u>Estimated Fair Value</u>
<b>Financial assets:</b>				
Cash and cash equivalents	\$ 13,113	\$ 13,113	\$ 15,870	\$ 15,870
Interest-earning deposits in banks	16,068	16,129	16,805	16,877
Securities – held to maturity	33,769	32,973	19,245	19,643
FHLB stock	3,117	N/A	2,632	N/A
Loans in portfolio, net (including impaired)	266,871	263,873	253,830	251,671
Accrued interest receivable	1,407	1,407	1,183	1,183
<b>Financial liabilities:</b>				
Deposits	\$ 297,767	\$ 282,242	\$ 284,039	\$ 272,253
FHLB advances and other borrowings	61,180	61,485	47,812	48,417
Accrued interest payable	243	243	243	243

(Continued)

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**NOTE 15 – GOODWILL AND INTANGIBLE ASSETS**

Impairment exists when a reporting unit's carrying value of goodwill exceeds its fair value, which is determined through an impairment test that is performed at least annually or more frequently if events and circumstances exist that indicate that a goodwill impairment test should be performed. The Bancorp performed a qualitative assessment to determine if it was more likely than not that the fair value of the reporting unit exceeds its carrying value, including goodwill at December 31, 2016. The results of the qualitative assessment indicated that the fair value of the reporting unit exceeded its carrying amount. Consequently, no additional impairment testing was necessary. The Company acquired \$725 of goodwill during 2015 (Note 17).

The Company recognized \$365 of core deposit intangibles acquired in 2015 (Note 17), which was amortized by \$61 during 2016 and \$45 during 2015. Therefore core deposit intangibles as of December 31, 2016 and 2015 were \$259 and \$320, respectively.

**NOTE 16 – ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)**

The following tables present changes in accumulated other comprehensive income (loss) by component, net of tax, for the years ended December 31, 2016 and 2015:

	Unrealized Gains and (Losses) On Cash Flow Hedges	Unrealized Gains and (Losses) On Available- for-Sale Securities	Defined Benefit Pension Items	Total
<u>2016</u>				
Beginning balance	\$ (58)	\$ 48	\$ (178)	\$ (188)
Other comprehensive income before reclassification	523	(246)	-	277
Amounts reclassified from accumulated other comprehensive income	<u>(65)</u>	<u>-</u>	<u>16</u>	<u>(49)</u>
Net current period other comprehensive income (loss)	<u>458</u>	<u>(246)</u>	<u>16</u>	<u>228</u>
Ending balance	<u>\$ 400</u>	<u>\$ (198)</u>	<u>\$ (162)</u>	<u>\$ 40</u>
<u>2015</u>				
Beginning balance	\$ -	\$ 28	\$ (228)	\$ (200)
Other comprehensive income before reclassification	(58)	21	31	(6)
Amounts reclassified from accumulated other comprehensive income	<u>-</u>	<u>(1)</u>	<u>19</u>	<u>18</u>
Net current period other comprehensive income (loss)	<u>(58)</u>	<u>20</u>	<u>50</u>	<u>12</u>
Ending balance	<u>\$ (58)</u>	<u>\$ 48</u>	<u>\$ (178)</u>	<u>\$ (188)</u>

(Continued)

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**NOTE 16 – ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)** (Continued)

Amounts reclassified from accumulated other comprehensive income for cash flow hedges, available-for-sale securities and the pension are recorded in other income, gain (loss) on securities, and salaries and employee benefits in the consolidated statements of income, respectively.

**NOTE 17 - ACQUISITION**

On April 6, 2015, the Company acquired 100% of the outstanding common shares of West Michigan Savings Bank ("WMSB") in Bangor, Michigan, in an all-cash transaction. The Company recognized \$365 of core deposit intangible and \$725 in goodwill, related to this acquisition. The Company incurred \$1.0 million of pre-tax expense (\$672 after tax), including \$825 (\$555 after tax) recorded in 2015. The majority of the transaction expenses were related to professional services, data processing termination and conversion, pension termination, and severance pay. All of the goodwill is expected to be deductible for income tax purposes.

The following table summarizes the amounts of assets acquired and liabilities assumed recognized at the acquisition date:

Cash consideration paid	\$ 3,300
Cash and cash equivalents	6,116
Securities	17,393
Loans	11,188
Premises and equipment	295
Core deposit intangibles	365
Real estate owned	80
Other assets	<u>357</u>
Total assets acquired	35,794
Deposits	32,606
Other liabilities	<u>613</u>
Total liabilities assumed	<u>33,219</u>
Goodwill	<u>\$ 725</u>

**NOTE 18 - DERIVATIVES**

The Company utilizes interest rate swap agreements as part of its asset liability management strategy to help manage its interest rate risk position. The notional amount of the interest rate swaps does not represent amounts exchanged by the parties. The amount exchanged is determined by reference to the notional amount and the other terms of the individual interest rate swap agreements.

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(Continued)

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**NOTE 18 – DERIVATIVES** (Continued)

The Company had two interest rate swaps with a notional amount of \$27,500 as of December 31, 2016, and had one interest rate swap with a notional amount of \$17,500 as of December 31, 2015. Both interest rate swaps were designated as cash flow hedges of Federal Home Loan Bank advances and were determined to be highly effective during all periods presented. Aggregate ineffectiveness resulted in a \$99 net gain on cash flow hedges in 2016 and \$0 in 2015. The aggregate fair value of the hedges is recorded in other assets at 2016 and other liabilities at 2015 with changes in fair value recorded in other comprehensive income (loss) up to the fair value of related swapped advances and in income for any excess. The amount included in accumulated other comprehensive income (loss) would be reclassified to current earnings should the hedges no longer be considered effective. The Company expects the hedges to remain highly effective during the remaining term of the swaps.

Summary information about the interest-rate swaps designated as a cash flow hedges as of year-end is as follows:

	<u>2016</u>	<u>2015</u>
Notional amounts	\$27,500	\$17,500
Weighted average pay rates	1.565% to 1.770%	1.770%
Weighted average receive rates	One and three-month LIBOR	One-month LIBOR
Weighted average maturity	7.2 years	6.8 years
Unrealized gains (losses)	\$606	\$(58)

Interest expense recorded on these hedge transaction totaled \$257 and \$33 during 2016 and 2015 and are reported as a component of interest expense on borrowed funds.

# Sturgis Bancorp, Inc.

## Directors

Donald L. Frost, Chairman of the Board  
Kimberlee Bontrager  
Eric L. Eishen  
David L. Franks  
Michael R. Frost  
Jeffrey M. Mohny  
John T. Wiedlea

## Executive Officers

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Brian P. Hoggatt, CFO, Treasurer  
Ronald W. Scheske, Executive Vice President, COO

# Sturgis Bank & Trust Company

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David L. Franks  
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Tammy K. Smith, Assistant Vice President  
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**Sturgis Bank  
& Trust Company**

113-125 E. Chicago Rd  
Sturgis, MI 49091

[www.sturgisbank.com](http://www.sturgisbank.com)

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