

SHORE BANCSHARES INC  
Form 10-K  
March 15, 2019

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-K**

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

For the Year Ended December 31, 2018

Commission File No. 0-22345

**SHORE BANCSHARES, INC.**

(Exact name of registrant as specified in its charter)

Maryland 52-1974638  
(State or Other Jurisdiction of (I.R.S. Employer  
Incorporation or Organization) Identification No.)

28969 Information Lane, Easton, Maryland 21601

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(Address of Principal Executive Offices) (Zip Code)

Registrant's Telephone Number, Including Area Code: (410) 763-7800

Securities Registered pursuant to Section 12(b) of the Act:

|   |  |
|---|--|
| Title of Each Class:                    | Name of Each Exchange on Which Registered: |
| Common stock, par value \$.01 per share | Nasdaq Global Select Market                |

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
" Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 16(d) of the Act. " Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days Yes  No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K "

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

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

Emerging growth company

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

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter: \$ 237,212,761.

The number of shares outstanding of the registrant's common stock as of the latest practicable date: 12,779,809 as of February 28, 2019.

### **Documents Incorporated by Reference**

Certain information required by Part III of this annual report is incorporated therein by reference to the definitive proxy statement for the 2019 Annual Meeting of Stockholders.

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### Cautionary note regarding forward-looking statements

This Annual Report on Form 10-K of Shore Bancshares, Inc. (the “Company” and “we,” “our” or “us” on a consolidated basis) contains forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. These forward looking statements represent plans, estimates, objectives, goals, guidelines, expectations, intentions, projections and statements of our beliefs concerning future events, business plans, expected operating results and the assumptions upon which those statements are based. In some cases, you can identify these forward-looking statements by words like “may,” “will,” “should,” “expect,” “plan,” “anticipate,” “intend,” “believe,” “estimate,” “predict,” “potential,” or the negative of those words and other comparable terminology, although not all forward-looking statements contain these words. Forward-looking statements are not a guarantee of future performance or results, and will not necessarily be accurate indications of the times at, or by, which such performance or results will be achieved. We caution that the forward-looking statements are based largely on our expectations and information available at the time the statements are made and are subject to a number of known and unknown risks and uncertainties that are subject to change based on factors which are in many instances, beyond our control. Actual results, performance or achievements could differ materially from those contemplated, expressed, or implied by the forward-looking statements. You should bear this in mind when reading this annual report and not place undue reliance on these forward-looking statements. The following factors, among others, could cause our financial performance to differ materially from that expressed in such forward-looking statements:

· general economic conditions, whether national or regional, and conditions in the lending markets in which we participate that may have an adverse effect on the demand for our loans and other products, our credit quality and related levels of nonperforming assets and loan losses, and the value and salability of the real estate that we own or that is the collateral for our loans;

- results of examinations of us by our regulators, including the possibility that our regulators may, among other things, require us to increase our reserve for loan losses or to write-down assets;
- our ability to prudently manage our growth and execute our strategy;
- impairment of our goodwill and intangible assets;

· the disposition of the insurance subsidiaries that occurred during the fourth quarter of 2018 may adversely impact our revenue and profitability to the extent we are unable to replace their revenues or realize the expected cost savings of this transaction;

· changing bank regulatory conditions, policies or programs, whether arising as new legislation or regulatory initiatives, that could lead to restrictions on activities of banks generally, or our subsidiary banks in particular, more restrictive regulatory capital requirements, increased costs, including deposit insurance premiums, regulation or prohibition of certain income producing activities or changes in the secondary market for loans and other products;

- changes in market rates and prices may adversely impact the value of securities, loans, deposits and other financial instruments and the interest rate sensitivity of our balance sheet;
  
- our liquidity requirements could be adversely affected by changes in our assets and liabilities;
  
- the effect of legislative or regulatory developments, including changes in laws concerning taxes, banking, securities, insurance and other aspects of the financial services industry;
  
- competitive factors among financial services organizations, including product and pricing pressures and our ability to attract, develop and retain qualified banking professionals;
  
- the growth and profitability of non-interest or fee income being less than expected;
  
- the effect of changes in accounting policies and practices, as may be adopted by the Financial Accounting Standards Board, the Securities and Exchange Commission (the “SEC”), the Public Company Accounting Oversight Board and other regulatory agencies; and
  
- the effect of fiscal and governmental policies of the United States federal government.

You should also consider carefully the Risk Factors contained in Item 1A of Part I of this annual report, which address additional factors that could cause our actual results to differ from those set forth in the forward-looking statements and could materially and adversely affect our business, operating results and financial condition. The risks discussed in this annual report are factors that, individually or in the aggregate, management believes could cause our actual results to differ materially from expected and historical results. You should understand that it is not possible to predict or identify all such factors. Consequently, you should not consider such disclosures to be a complete discussion of all potential risks or uncertainties.

The forward-looking statements speak only as of the date on which they are made, and, except to the extent required by federal securities laws, we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

## **PART I**

### **Item 1. Business.**

#### **BUSINESS**

##### **General**

The Company was incorporated under the laws of Maryland on March 15, 1996 and is a financial holding company registered under the Bank Holding Company Act of 1956, as amended (the “BHC Act”). The Company is the largest independent financial holding company located on the Eastern Shore of Maryland. The Company, through its subsidiary, provides commercial banking products and services, including trust, wealth management and financial planning services. The Company and Shore United Bank (the “Bank”) are Affirmative Action/Equal Opportunity Employers.

##### **Recent Transactions**

On December 31, 2018, the Company sold the assets and activities of its insurance business, The Avon-Dixon Agency, LLC (“Avon”), a Maryland limited liability company, with two specialty lines, trading as Elliot Wilson Insurance (Trucking) and Jack Martin & Associates (Marine). The Company received net proceeds from the sale of \$25.2 million. In addition, the Company discontinued operations of its insurance premium finance business, Mubell, LLC (“Mubell”), a Maryland limited liability company which it plans to sell or dispose of in the next year. Additional details related to the sale of Avon and the discontinuing operations of Mubell can be located in Note 2 to the Company’s Consolidated Financial Statements included in Item 8 of Part II of this annual report.

On May 19, 2017, the Bank purchased three branches from Northwest Bank (“NWBI”) located in Arbutus, Elkridge, and Owings Mills, Maryland. Pursuant to the transaction, the Bank acquired \$122.9 million in loans and \$212.5 million in deposits, as well as the branch premises and equipment. In connection with its purchase of the branches from NWBI, the Bank received a cash payment from NWBI of \$64.0 million, which was net of a premium paid on deposits of \$17.2 million. Total acquisition costs totaled \$18.2 million. This acquisition provided the Bank with the opportunity to enhance its footprint in Maryland by extending its branch network across the Eastern Shore to the greater Baltimore area communities of Elkridge, Owings Mills and Arbutus. Additional details related to the purchase of branches from NWBI can be located in Note 3 to the Company’s Consolidated Financial Statements included in Item 8 of Part II of this annual report.

## **Banking Products and Services**

The Bank is a Maryland chartered commercial bank with trust powers that can trace its origin to 1876. The Bank currently operates 21 full service branches, 23 ATMs, 2 loan production offices, and provides a full range of commercial and consumer banking products and services to individuals, businesses, and other organizations in Baltimore City, Baltimore County, Howard County, Kent County, Queen Anne's County, Caroline County, Talbot County and Dorchester County in Maryland, Kent County, Delaware and in Accomack County, Virginia. The Bank's deposits are insured up to applicable legal limits by the Federal Deposit Insurance Corporation (the "FDIC").

The Bank is an independent community bank that serves businesses and individuals in their respective market areas. Services offered are essentially the same as those offered by larger regional institutions that compete with the Bank. Services provided to businesses include commercial checking, savings, certificates of deposit and overnight investment sweep accounts. The Bank offers all forms of commercial lending, including secured and unsecured loans, working capital loans, lines of credit, term loans, accounts receivable financing, real estate acquisition and development, construction loans and letters of credit. Merchant credit card clearing services are available as well as direct deposit of payroll, internet banking and telephone banking services.

Services to individuals include checking accounts, various savings programs, mortgage loans, home improvement loans, installment and other personal loans, credit cards, personal lines of credit, automobile and other consumer financing, safe deposit boxes, debit cards, 24-hour telephone banking, internet banking, mobile banking, and 24-hour automatic teller machine services. The Bank also offers nondeposit products, such as mutual funds and annuities, and discount brokerage services to their customers. Additionally, the Bank has Saturday hours and extended hours on certain evenings during the week for added customer convenience.



*Lending Activities*

The Bank originates secured and unsecured loans for business purposes. Commercial loans are typically secured by real estate, accounts receivable, inventory, equipment and/or other assets of the business. Commercial loans generally involve a greater degree of credit risk than one to four family residential mortgage loans. Repayment is often dependent upon the successful operation of the business and may be affected by adverse conditions in the local economy or real estate market. The financial condition and cash flow of commercial borrowers is therefore carefully analyzed during the loan approval process, and continues to be monitored by obtaining business financial statements, personal financial statements and income tax returns. The frequency of this ongoing analysis depends upon the size and complexity of the credit and collateral that secures the loan. It is also the Bank's general policy to obtain personal guarantees from the principals of the commercial loan borrowers.

The Bank's commercial real estate loans are primarily secured by land for residential and commercial development, agricultural purpose properties, service industry buildings such as restaurants and motels, retail buildings and general purpose business space. The Bank attempts to mitigate the risks associated with these loans through thorough financial analyses, conservative underwriting procedures, including loan to value ratio standards, obtaining additional collateral, closely monitoring construction projects to control disbursement of funds on loans, and management's knowledge of the local economy in which the Bank lends.

The Bank provides residential real estate construction loans to builders and individuals for single family dwellings. Residential construction loans are usually granted based upon "as completed" appraisals and are secured by the property under construction. Additional collateral may be taken if loan to value ratios exceed 80%. Site inspections are performed to determine pre-specified stages of completion before loan proceeds are disbursed. These loans typically have maturities of six to 12 months and may have fixed or variable rate features. Permanent financing options for individuals include fixed and variable rate loans with three- and five-year balloon features and one-, three- and five-year adjustable rate mortgage loans. The risk of loss associated with real estate construction lending is controlled through conservative underwriting procedures such as loan to value ratios of 80% or less at origination, obtaining additional collateral when prudent, and closely monitoring construction projects to control disbursement of funds on loans.

The Bank originates fixed and variable rate residential mortgage loans. As with any consumer loan, repayment is dependent upon the borrower's continuing financial stability, which can be adversely impacted by job loss, divorce, illness, or personal bankruptcy, among other factors. Underwriting standards recommend loan to value ratios not to exceed 80% at origination based on appraisals performed by approved appraisers. The Bank relies on title insurance to protect their lien priorities and protect the property securing the loans by requiring fire and casualty insurance.

A variety of consumer loans are offered to customers, including home equity loans, credit cards and other secured and unsecured lines of credit and term loans. Careful analysis of an applicant's creditworthiness is performed before granting credit, and ongoing monitoring of loans outstanding is performed in an effort to minimize risk of loss by identifying problem loans early.

#### *Deposit Activities*

The Bank offers a full array of deposit products including checking, savings and money market accounts, and regular and IRA certificates of deposit. The Bank also offers the CDARS program, providing up to \$50 million of FDIC insurance to our customers. In addition, we offer our commercial customers packages which include cash management services and various checking opportunities and cash sweep products.

#### *Trust Services*

The Bank has a trust department through which it offers trust, asset management and financial planning services to customers within our market areas using the trade name Wye Financial & Trust.

## **Seasonality**

Management does not believe that our business activities are seasonal in nature.

## **Employees**

At February 28, 2019, we employed 292 persons, of which 278 were employed on a full-time basis. None of our employees are represented by any collective bargaining unit or are a party to a collective bargaining agreement. Management of the Company considers its employee relations to be excellent.

## **COMPETITION**

Shore Bancshares, Inc. and the Bank operate in a highly competitive environment. Our competitors include community banks, commercial banks, credit unions, thrifts, mortgage banking companies, credit card issuers, investment advisory firms, brokerage firms, mutual fund companies and e-commerce and other internet-based companies. We compete on a local and regional basis for banking and investment products and services.

The primary factors when competing in the financial service market include personalized services, the quality and range of products and services, interest rates on loans and deposits, lending services, price, customer convenience, and our ability to attract and retain experienced employees.

To compete in our market areas, we utilize multiple media channels including print, online, social media, television, radio, direct mail, e-mail and digital signage. Our employees also play a significant role in maintaining existing relationships with customers while establishing new relationships to grow all areas of our businesses.

## **SUPERVISION AND REGULATION**

The following is a summary of the material regulations and policies applicable to us and is not intended to be a comprehensive discussion. Changes in applicable laws and regulations may have a material effect on our business,

financial condition and results of operations.

## **General**

The Company is a financial holding company registered with the Board of Governors of the Federal Reserve System (the “FRB”) under the BHC Act and, as such, is subject to the supervision, examination and reporting requirements of the BHC Act and the regulations of the FRB.

The Bank is a Maryland chartered commercial bank subject to the banking laws of Maryland and to regulation by the Commissioner of Financial Regulation of Maryland, who is required by statute to make at least one examination in each calendar year (or at 18-month intervals if the Commissioner determines that an examination is unnecessary in a particular calendar year). The primary federal regulator of the Bank is the FRB. The deposits of the Bank are insured by the FDIC, so certain laws and regulations administered by the FDIC also govern their deposit taking operations. In addition to the foregoing, the Bank is subject to numerous state and federal statutes and regulations that affect the business of banking generally.

Nonbank affiliates of the Company are subject to examination by the FRB, and, as affiliates of the Bank, may be subject to examination by the Bank’s regulators from time to time.

## **Regulation of Financial Holding Companies**

In November 1999, the Gramm-Leach-Bliley Act (the “GLB Act”) was signed into law. The GLB Act revised the BHC Act and repealed the affiliation provisions of the Glass-Steagall Act of 1933, which, taken together, limited the securities, insurance and other non-banking activities of any company that controls an FDIC insured financial institution. Under the GLB Act, a bank holding company can elect, subject to certain qualifications, to become a “financial holding company.” The GLB Act provides that a financial holding company may engage in a full range of financial activities, including insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities, with new expedited notice procedures. The Company is a financial holding company.

Under FRB policy, the Company is expected to act as a source of strength to the bank, and the FRB may charge the Company with engaging in unsafe and unsound practices for failure to commit resources to the Bank when required. This support may be required at times when the Company may not have the resources to provide the support. Under the prompt corrective action provisions, if a controlled bank is undercapitalized, then the regulators could require the bank holding company to guarantee the bank’s capital restoration plan. In addition, if the FRB believes that a company’s activities, assets or affiliates represent a significant risk to the financial safety, soundness or stability of a controlled bank, then the FRB could require the bank holding company to terminate the activities, liquidate the assets

or divest the affiliates. The regulators may require these and other actions in support of controlled banks even if such actions are not in the best interests of the bank holding company or its stockholders. Because the Company is a bank holding company, it is viewed as a source of financial and managerial strength for any controlled depository institutions, like the Bank.

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), which made sweeping changes to the financial regulatory landscape that impacts all financial institutions, including the Company and the Bank. The Dodd-Frank Act directs federal bank regulators to require that all companies that directly or indirectly control an insured depository institution serve as sources of financial strength for the institution. The term “source of financial strength” is defined under the Dodd-Frank Act as the ability of a company to provide financial assistance to its insured depository institution subsidiaries in the event of financial distress. The appropriate federal banking agency for such a depository institution may require reports from companies that control the insured depository institution to assess their abilities to serve as sources of strength and to enforce compliance with the source-of-strength requirements. The appropriate federal banking agency may also require a holding company to provide financial assistance to a bank with impaired capital. Under this requirement, the Company could be required to provide financial assistance to the Bank should it experience financial distress.

In addition, under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (“FIRREA”), depository institutions insured by the FDIC can be held liable for any losses incurred by, or reasonably anticipated to be incurred by, the FDIC in connection with (i) the default of a commonly controlled FDIC-insured depository institution or (ii) any assistance provided by the FDIC to a commonly controlled FDIC-insured depository institution in danger of default. Accordingly, in the event that any insured subsidiary of the Company causes a loss to the FDIC, other insured subsidiaries of the Company could be required to compensate the FDIC by reimbursing it for the estimated amount of such loss. Such cross guaranty liabilities generally are superior in priority to obligations of a financial institution to its stockholders and obligations to other affiliates.

### **Federal Regulation of Banks**

Federal and state banking regulators may prohibit the institutions over which they have supervisory authority from engaging in activities or investments that the agencies believe are unsafe or unsound banking practices. These banking regulators have extensive enforcement authority over the institutions they regulate to prohibit or correct activities that violate law, regulation or a regulatory agreement or which are deemed to be unsafe or unsound practices. Enforcement actions may include the appointment of a conservator or receiver, the issuance of a cease and desist order, the termination of deposit insurance, the imposition of civil money penalties on the institution, its directors, officers, employees and institution-affiliated parties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the removal of or restrictions on directors, officers, employees and institution-affiliated parties, and the enforcement of any such mechanisms through restraining orders or other court actions.

The Bank is subject to the provisions of Section 23A and Section 23B of the Federal Reserve Act. Section 23A limits the amount of loans or extensions of credit to, and investments in, the Company and its nonbank affiliates by the Bank. Section 23B requires that transactions between the Bank and the Company and its nonbank affiliates be on terms and under circumstances that are substantially the same as with non-affiliates.

The Bank is also subject to certain restrictions on extensions of credit to executive officers, directors, and principal stockholders or any related interest of such persons, which generally require that such credit extensions be made on substantially the same terms as are available to third parties dealing with the Bank and not involve more than the normal risk of repayment. Other laws tie the maximum amount that may be loaned to any one customer and its related interests to capital levels.

As part of the Federal Deposit Insurance Company Improvement Act of 1991 (“FDICIA”), each federal banking regulator adopted non-capital safety and soundness standards for institutions under its authority. These standards include internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, and compensation, fees and benefits. An institution that fails to meet those standards may be required by the agency to develop a plan acceptable to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions. The Company, on behalf of the Bank, believes that the Bank meets substantially all standards that have been adopted. FDICIA also imposes capital standards on insured depository institutions.

The Community Reinvestment Act (“CRA”) requires that, in connection with the examination of financial institutions within their jurisdictions, the federal banking regulators evaluate the record of the financial institution in meeting the credit needs of their communities including low and moderate income neighborhoods, consistent with the safe and sound operation of those banks. These factors are also considered by all regulatory agencies in evaluating mergers, acquisitions and applications to open a branch or facility. As of the date of its most recent examination report, the Bank has a CRA rating of “Satisfactory.”

The Bank is also subject to a variety of other laws and regulations with respect to the operation of their businesses, including, but not limited to, the Truth in Lending Act, the Truth in Savings Act, the Equal Credit Opportunity Act, the Electronic Funds Transfer Act, the Fair Housing Act, the Home Mortgage Disclosure Act, the Fair Debt Collection Practices Act, the Fair Credit Reporting Act, Expedited Funds Availability (Regulation CC), Reserve Requirements (Regulation D), Privacy of Consumer Information (Regulation P), Margin Stock Loans (Regulation U), the Right To Financial Privacy Act, the Flood Disaster Protection Act, the Homeowners Protection Act, the Servicemembers Civil Relief Act, the Real Estate Settlement Procedures Act, the Telephone Consumer Protection Act, the CAN-SPAM Act, the Children’s Online Privacy Protection Act, and the John Warner National Defense Authorization Act.

## **The Dodd-Frank Act**

The Dodd-Frank Act significantly changed the bank regulatory structure and affected the lending, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires the FRB to set minimum capital levels for bank holding companies that are as stringent as those required for insured depository institutions. The legislation also establishes a floor for capital of insured depository institutions and directs the federal banking regulators to implement new leverage and capital requirements. The new leverage and capital requirements must take into account off-balance sheet activities and other risks, including risks relating to securitized products and derivatives. Pursuant to the Dodd-Frank Act, the FDIC has backup enforcement authority over a depository institution holding company, such as the Company, if the conduct or threatened conduct of such holding company poses a risk to the Deposit Insurance Fund (“DIF”), although such authority may not be used if the holding company is generally in sound condition and does not pose a foreseeable and material risk to the DIF. In addition, the Dodd-Frank Act contains a wide variety of provisions (many of which are not yet effective) affecting the regulation of depository institutions, including restrictions related to mortgage originations, risk retention requirements as to securitized loans and the establishment of the Consumer Financial Protection Bureau (“CFPB”).

The Dodd-Frank Act will increase our regulatory compliance burden and costs and may restrict the financial products and services we offer to our customers. In particular, the Dodd-Frank Act will require us to invest significant management attention and resources so that we can evaluate the impact of this law and its regulations and make any necessary changes to our product offerings and operations. These impacts may be material.

On February 3, 2017, President Trump signed an executive order calling for his administration to review existing U.S. financial laws and regulations, including the Dodd-Frank Act, in order to determine their consistency with a set of “core principles” of financial policy. The core financial principles identified in the executive order include the following: empowering Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth; preventing taxpayer-funded bailouts; fostering economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry; enabling American companies to be competitive with foreign firms in domestic and foreign markets; advancing American interests in international financial regulatory negotiations and meetings; and restoring public accountability within Federal financial regulatory agencies and “rationalizing” the Federal financial regulatory framework.

Although the order does not specifically identify any existing laws or regulations that the administration considers to be inconsistent with the core principles, areas that the mandated agency report may ultimately identify for reform include the Volcker Rule; any “fiduciary” standard applicable to investment advisers and broker-dealers; and the powers, structure and funding arrangements of the Financial Stability Oversight Council, the Office of Financial Research, the prudential bank regulators, the SEC, U.S. Commodity Futures Trading Commission, and CFPB. While some changes can be implemented by the regulatory agencies themselves, implementing much of the anticipated agenda of changes would require legislation from Congress.



In 2017, both the House of Representatives and the Senate introduced legislation that would repeal or modify provisions of the Dodd-Frank Act and significantly impact financial services regulation. Although the bills vary in content, certain key aspects include revisions to rules related to mortgage loans, delayed implementation of rules related to the Home Mortgage Disclosure Act, and reform and simplification of certain Volcker Rule requirements.

In conjunction with the executive order, President Trump also issued a memorandum to the Department of Labor (“DOL”) on the fiduciary rule, delaying the rule’s effectiveness and requiring further analysis. DOL must postpone the application of the rule for 180 days beyond its originally scheduled effective date of April 10, 2017, and must prepare an economic and legal analysis of the likely impact of the rule. If this analysis concludes that the rule will harm investors, disrupt the retirement services industry, increase litigation (and therefore the price of retirement services), be undermined as the result of certain exemptions, or violate any statute (including the Administrative Procedure Act) or that the rule is inconsistent with Administration policy, then DOL must propose rescission of or revisions to the rule. On November 17, 2017, the DOL announced a further transition period (ending in mid-2019) for key provisions of the fiduciary rule in order to allow the DOL to continue its analysis in response to the executive order and memorandum.

## **Regulatory Capital Requirements**

### ***General***

FDICIA established a system of prompt corrective action to resolve the problems of undercapitalized institutions. Under this system, the federal banking regulators are required to rate supervised institutions on the basis of five capital categories: “well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized,” and “critically undercapitalized;” and to take certain mandatory actions (and are authorized to take other discretionary actions) with respect to institutions in the three undercapitalized categories. The severity of the actions will depend upon the category in which the institution is placed. A depository institution is “well capitalized” if it has a total risk based capital ratio of 10% or greater, a Tier 1 risk based capital ratio of 6% or greater, and a leverage ratio of 5% or greater and is not subject to any order, regulatory agreement, or written directive to meet and maintain a specific capital level for any capital measure. An “adequately capitalized” institution is defined as one that has a total risk based capital ratio of 8% or greater, a Tier 1 risk based capital ratio of 4% or greater and a leverage ratio of 4% or greater (or 3% or greater in the case of a bank with a composite CAMEL rating of 1).

FDICIA generally prohibits a depository institution from making any capital distribution, including the payment of cash dividends, or paying a management fee to its holding company if the depository institution would thereafter be undercapitalized. Undercapitalized depository institutions are subject to growth limitations and are required to submit capital restoration plans. For a capital restoration plan to be acceptable, the depository institution's parent holding company must guarantee (subject to certain limitations) that the institution will comply with such capital restoration plan.

Significantly undercapitalized depository institutions may be subject to a number of other requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized and requirements to reduce total assets and stop accepting deposits from correspondent banks. Critically undercapitalized depository institutions are subject to the appointment of a receiver or conservator; generally within 90 days of the date such institution is determined to be critically undercapitalized.

As of December 31, 2018, the Bank was categorized as "well capitalized." For more information regarding the capital condition of the Company, see Note 18 to the Consolidated Financial Statements appearing in Item 8 of Part II of this annual report.

### ***Basel III***

In December 2010, the Basel Committee on Banking Supervision (BCBS), an international forum for cooperation on banking supervisory matters, announced the "Basel III" capital standards, which substantially revised the existing capital requirements for banking organizations. Modest revisions were made in June 2011. On July 2, 2013, the Federal Reserve adopted a final rule for the Basel III capital framework. The requirements in the rule began to phase in on January 1, 2015 for the Company. The requirements in the rule will be fully phased in by January 1, 2019.

The rule imposes higher risk-based capital and leverage requirements than those currently in place. Specifically, the rule imposes the following minimum capital requirements: (1) a new common equity Tier 1 risk-based capital ratio of 4.5%; (2) a Tier 1 risk-based capital ratio of 6% (increased from the previous 4% requirement); (3) a total risk-based capital ratio of 8% (unchanged from the previous requirement); and (4) a leverage ratio of 4%.

Under the rule, Tier 1 capital has been redefined to include two components: Common Equity Tier 1 capital and additional Tier 1 capital. The new and highest form of capital, Common Equity Tier 1 capital, consists solely of common stock (plus related surplus), retained earnings, accumulated other comprehensive income, and limited amounts of minority interests that are in the form of common stock. Additional Tier 1 capital includes other perpetual instruments historically included in Tier 1 capital, such as non-cumulative perpetual preferred stock. The rule permits

bank holding companies with less than \$15 billion in total consolidated assets to continue to include trust preferred securities and cumulative perpetual preferred stock issued before May 19, 2010 in Tier 1 capital, but not in Common Equity Tier 1 capital, subject to certain restrictions. Tier 2 capital consists of instruments that previously qualified in Tier 2 capital plus instruments that the rule has disqualified from Tier 1 capital treatment.

In addition, in order to avoid restrictions on capital distributions or discretionary bonus payments to executives, a covered banking organization must maintain a "capital conservation buffer" on top of its minimum risk-based capital requirements. This buffer must consist solely of Tier 1 Common Equity, but the buffer applies to all three measurements (Common Equity Tier 1, Tier 1 capital and total capital). The capital conservation buffer will be phased in incrementally over time, becoming fully effective on January 1, 2019, and will consist of an additional amount of common equity equal to 2.5% of risk-weighted assets.

The previous capital rules required certain deductions from or adjustments to capital. The new rule retains many of these deductions and adjustments and also provides for new ones. As a result, deductions from Common Equity Tier 1 capital will be required for goodwill (net of associated deferred tax liabilities); intangible assets such as non-mortgage servicing assets and purchased credit card relationships (net of associated deferred tax liabilities); deferred tax assets that arise from net operating loss and tax credit carryforwards (net of any related valuation allowances and net of deferred tax liabilities); any gain on sale in connection with a securitization exposure; any defined benefit pension fund net asset (net of any associated deferred tax liabilities) held by a bank holding company (this provision does not apply to a bank or savings association); the aggregate amount of outstanding equity investments (including retained earnings) in financial subsidiaries; and identified losses.

Additionally, the new rule provides for the deduction of three categories of assets: (i) deferred tax assets arising from temporary differences that cannot be realized through net operating loss carrybacks (net of related valuation allowances and of deferred tax liabilities), (ii) mortgage servicing assets (net of associated deferred tax liabilities) and (iii) investments in more than 10% of the issued and outstanding common stock of unconsolidated financial institutions (net of associated deferred tax liabilities). The amount in each category that exceeds 10% of Common Equity Tier 1 capital must be deducted from Common Equity Tier 1 capital. The remaining, non-deducted amounts are then aggregated, and the amount by which this total amount exceeds 15% of Common Equity Tier 1 capital must be deducted from Common Equity Tier 1 capital. Amounts of minority investments in consolidated subsidiaries that exceed certain limits and investments in unconsolidated financial institutions may also have to be deducted from the category of capital to which such instruments belong.

Accumulated other comprehensive income (AOCI) is presumptively included in Common Equity Tier 1 capital and often would operate to reduce this category of capital. The new rule provided a one-time opportunity at the end of the first quarter of 2015 for covered banking organizations to opt out of much of this treatment of AOCI and the Company has elected this option. The new rule also has the effect of increasing capital requirements by increasing the risk weights on certain assets, including high volatility commercial real estate, mortgage servicing rights not includable in Common Equity Tier 1 capital, equity exposures, and claims on securities firms, that are used in the denominator of the three risk-based capital ratios.



In September 2017, the federal bank regulators proposed to revise and simplify the capital treatment for certain deferred tax assets, mortgage servicing assets, investments in non-consolidated financial entities and minority interests for banking organizations, such as the Bank, that are not subject to the advanced approaches requirements. In November 2017, the federal banking regulators revised the Basel III Rules to extend the current transitional treatment of these items for non-advanced approaches banking organizations until the September 2017 proposal is finalized. The September 2017 proposal would also change the capital treatment of certain commercial real estate loans under the standardized approach, which we use to calculate our capital ratios.

In December 2017, the Basel Committee published standards that it described as the finalization of the Basel III post-crisis regulatory reforms (the standards are commonly referred to as “Basel IV”). Among other things, these standards revise the Basel Committee’s standardized approach for credit risk (including by recalibrating risk weights and introducing new capital requirements for certain “unconditionally cancellable commitments,” such as unused credit card lines of credit) and provides a new standardized approach for operational risk capital. Under the Basel framework, these standards will generally be effective on January 1, 2022, with an aggregate output floor phasing in through January 1, 2027. Under the current U.S. capital rules, operational risk capital requirements and a capital floor apply only to advanced approaches institutions, and not to us. The impact of Basel IV on us will depend on the manner in which it is implemented by the federal bank regulators.

*Community Bank Leverage Ratio.* As a result of the Economic Growth, Regulatory Relief, and Consumer Protection Act (“EGRRCPA”), the federal banking agencies were required to develop a Community Bank Leverage Ratio (the ratio of a bank’s tangible equity capital to average total consolidated assets) for banking organizations with assets of less than \$10 billion, such as the Bank. On November 21, 2018, the federal banking agencies invited public comment on their proposal to establish the Community Bank Leverage Ratio framework. Under the proposal, a community banking organization would be eligible to elect the Community Bank Leverage Ratio framework if it has less than \$10 billion in total consolidated assets, limited amounts of certain assets and off-balance sheet exposures, and a Community Bank Leverage Ratio greater than 9 percent. A qualifying community banking organization that has chosen the proposed framework would be automatically considered in compliance with the Basel III capital requirements and would be exempt from the complex Basel III risk-based capital calculations. Such a community banking organization would be considered to have met the capital ratio requirements to be “well capitalized” for the federal banking agencies’ Prompt Corrective Action rules provided it has a Community Bank Leverage Ratio greater than 9 percent. Because the proposal has not been finalized and a final rule has not been issued, it is difficult at this time to predict when or how this new capital ratio will ultimately be applied to community banking organizations or to predict the specific effects of the final rule.

## **Deposit Insurance**

The Bank is a member of the FDIC and pays an insurance premium on a quarterly basis. Deposits are insured by the FDIC through the DIF and such insurance is backed by the full faith and credit of the United States Government. Under the Dodd-Frank Act, a permanent increase in deposit insurance to \$250,000 was authorized. The coverage limit

is per depositor, per insured depository institution, for each account ownership category.

The Dodd-Frank Act also set a new minimum DIF reserve ratio at 1.35% of estimated insured deposits. The FDIC is required to attain this ratio by September 30, 2020. The Dodd-Frank Act required the FDIC to redefine the deposit insurance assessment base for an insured depository institution. Prior to the Dodd-Frank Act, an institution's assessment base has historically been its domestic deposits, with some adjustments. As redefined pursuant to the Dodd-Frank Act, an institution's assessment base is now an amount equal to the institution's average consolidated total assets during the assessment period minus average tangible equity. Institutions with \$1.0 billion or more in assets at the end of a fiscal quarter must report their average consolidated total assets on a daily basis and report their average tangible equity on an end-of-month balance basis. Institutions with less than \$1.0 billion in assets at the end of a fiscal quarter may opt to report average consolidated total assets and average tangible equity on a weekly and end-of-quarter basis, respectively.

The Federal Deposit Insurance Reform Act of 2005, which created the DIF, gave the FDIC greater latitude in setting the assessment rates for insured depository institutions which could be used to impose minimum assessments. Deposit insurance assessments are based on average consolidated total assets minus average tangible equity. Under the FDIC's risk-based assessment system, insured institutions with less than \$10 billion in assets are assigned to one of four risk categories based on supervisory evaluations, regulatory capital level, and certain other factors, with less risky institutions paying lower assessments. An institution's assessment rate depends upon the category to which it is assigned and certain other factors. The Bank expensed a total of \$804 thousand in FDIC insurance premiums during 2018. The FDIC has the flexibility to adopt actual deposit assessment rates that are higher or lower than the total base assessment rates adopted without notice and comment, if certain conditions are met.

DIF-insured institutions pay a Financing Corporation (“FICO”) assessment in order to fund the interest on bonds issued in the 1980s in connection with the failures in the thrift industry. For the fourth quarter of 2018, the FICO assessment was equal to 0.120 basis points computed on assets as required by the Dodd-Frank Act. These assessments will continue until the bonds mature in 2019.

The FDIC is authorized to conduct examinations of and require reporting by FDIC-insured institutions. It is also authorized to terminate a depository bank’s deposit insurance upon a finding by the FDIC that the bank’s financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices or has violated any applicable rule, regulation, order or condition enacted or imposed by the bank’s regulatory agency. The termination of deposit insurance for the Bank would have a material adverse effect on our earnings, operations and financial condition.

### **Bank Secrecy Act/Anti-Money Laundering**

The Bank Secrecy Act (“BSA”), which is intended to require financial institutions to develop policies, procedures, and practices to prevent and deter money laundering, mandates that every national bank have a written, board-approved program that is reasonably designed to assure and monitor compliance with the BSA.

The program must, at a minimum: (i) provide for a system of internal controls to assure ongoing compliance; (ii) provide for independent testing for compliance; (iii) designate an individual responsible for coordinating and monitoring day-to-day compliance; and (iv) provide training for appropriate personnel. In addition, state-chartered banks are required to adopt a customer identification program as part of its BSA compliance program. State-chartered banks are also required to file Suspicious Activity Reports when they detect certain known or suspected violations of federal law or suspicious transactions related to a money laundering activity or a violation of the BSA.

In addition to complying with the BSA, the Bank is subject to the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the “USA Patriot Act”). The USA Patriot Act is designed to deny terrorists and criminals the ability to obtain access to the United States’ financial system and has significant implications for depository institutions, brokers, dealers, and other businesses involved in the transfer of money. The USA Patriot Act mandates that financial service companies implement additional policies and procedures and take heightened measures designed to address any or all of the following matters: (i) customer identification programs; (ii) money laundering; (iii) terrorist financing; (iv) identifying and reporting suspicious activities and currency transactions; (v) currency crimes; and (vi) cooperation between financial institutions and law enforcement authorities.

### **Ability-to-Repay and Qualified Mortgage Rule**

Pursuant to the Dodd Frank Act, the CFPB issued a final rule on January 10, 2013 (effective on January 10, 2014), amending Regulation Z, as implemented by the Truth in Lending Act, that requires mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Mortgage lenders are required to determine consumers' ability to repay in one of two ways. The first alternative requires the mortgage lender to consider the following eight underwriting factors when making the credit decision: (i) current or reasonably expected income or assets; (ii) current employment status; (iii) the monthly payment on the covered transaction; (iv) the monthly payment on any simultaneous loan; (v) the monthly payment for mortgage-related obligations; (vi) current debt obligations, alimony, and child support; (vii) the monthly debt-to-income ratio or residual income; and (viii) credit history. Alternatively, the mortgage lender can originate "qualified mortgages," which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a "qualified mortgage" is a mortgage loan without negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years. In addition, to be a qualified mortgage the points and fees paid by a consumer cannot exceed three percent of the total loan amount. Qualified mortgages that are "higher-priced" (e.g. subprime loans) garner a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not "higher-priced" (e.g. prime loans) are given a safe harbor of compliance.



## The Tax Act

On December 22, 2017, the Tax Cuts and Jobs Act of 2017 (“the Tax Act”) was signed into law. The Tax Act includes a number of provisions that impact us, including the following:

**Tax Rate.** The Tax Act replaces the graduated corporate tax rates applicable under prior law, which imposed a maximum tax rate of 35%, with a reduced 21% flat tax rate. Although the reduced tax rate generally should be favorable to us by resulting in increased earnings and capital, it will decrease the value of our existing deferred tax assets. U.S. generally accepted accounting principles (“GAAP”) requires that the impact of the provisions of the Tax Act be accounted for in the period of enactment. As a result, the value of our deferred tax assets as of December 31, 2017 was reduced by approximately \$582 thousand.

**FDIC Insurance Premiums.** The Tax Act prohibits taxpayers with consolidated assets over \$50 billion from deducting any FDIC insurance premiums and prohibits taxpayers with consolidated assets between \$10 and \$50 billion from deducting the portion of their FDIC premiums equal to the ratio, expressed as a percentage, that (i) the taxpayer’s total consolidated assets over \$10 billion, as of the close of the taxable year, bears to (ii) \$40 billion.

**Employee Compensation.** A “publicly held corporation” is not permitted to deduct compensation in excess of \$1 million per year paid to certain employees. The Tax Act eliminates certain exceptions to the \$1 million limit applicable under prior law related to performance-based compensation, such as equity grants and cash bonuses that are paid only on the attainment of performance goals.

**Business Asset Expensing.** The Tax Act allows taxpayers immediately to expense the entire cost (instead of only 50%, as under prior law) of certain depreciable tangible property and real property improvements acquired and placed in service after September 27, 2017 and before January 1, 2023 (with an additional year for certain property). This 100% “bonus” depreciation is phased out proportionately for property placed in service on or after January 1, 2023 and before January 1, 2027 (with an additional year for certain property).

**Interest Expense.** The Tax Act limits a taxpayer’s annual deduction of business interest expense to the sum of (i) business interest income and (ii) 30% of “adjusted taxable income,” defined as a business’s taxable income without taking into account business interest income or expense, net operating losses, and, for 2018 through 2021, depreciation, amortization and depletion.

## Federal Securities Laws

The shares of the Company's common stock are registered with the SEC under Section 12(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and listed on the NASDAQ Global Select Market. The Company is subject to information reporting requirements, proxy solicitation requirements, insider trading restrictions and other requirements of the Exchange Act, including the requirements imposed under the Sarbanes-Oxley Act of 2002 and the rules of The NASDAQ Stock Market, LLC. Among other things, loans to and other transactions with insiders are subject to restrictions and heightened disclosure, directors and certain committees of the Board must satisfy certain independence requirements, and the Company is generally required to comply with certain corporate governance requirements.

### **Governmental Monetary and Credit Policies and Economic Controls**

The earnings and growth of the banking industry and ultimately of the Company are affected by the monetary and credit policies of governmental authorities, including the FRB. An important function of the FRB is to regulate the national supply of bank credit in order to control recessionary and inflationary pressures. Among the instruments of monetary policy used by the FRB to implement these objectives are open market operations in U.S. Government securities, changes in the federal funds rate, changes in the discount rate of member bank borrowings, and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth of bank loans, investments and deposits and may also affect interest rates charged on loans or paid for deposits. The monetary policies of the FRB authorities have had a significant effect on the operating results of commercial banks in the past and are expected to continue to have such an effect in the future. In view of changing conditions in the national economy and in the money markets, as well as the effect of actions by monetary and fiscal authorities, including the FRB, no prediction can be made as to possible future changes in interest rates, deposit levels, loan demand or their effect on the business and earnings of the Company and its subsidiaries.

### **AVAILABLE INFORMATION**

The Company maintains an Internet site at [www.shorebancshares.com](http://www.shorebancshares.com) on which it makes available, free of charge, its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to the foregoing as soon as reasonably practicable after these reports are electronically filed with, or furnished to, the SEC. In addition, stockholders may access these reports and documents on the SEC's web site at [www.sec.gov](http://www.sec.gov). The information on, or accessible through, our website or any other website cited in this Annual Report on Form 10-K is not part of, or incorporated by reference into, this Annual Report on Form 10-K and should not be relied upon in determining whether to make an investment decision.

**Item 1A. RISK FACTORS.**

An investment in our common stock involves significant risks. You should consider carefully the risk factors included below together with all of the information included in or incorporated by reference into this annual report, as the same may be updated from time to time by our future filings with the SEC under the Exchange Act, before making a decision to invest in our common stock. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also have a material adverse effect on our business, financial condition and results of operations. If any of the matters included in the following information about risk factors were to occur, our business, financial condition, results of operations, cash flows or prospects could be materially and adversely affected. In such case, you may lose all or a substantial part of your investment. To the extent that any of the information contained in this document constitutes forward-looking statements, the risk factors below should be reviewed as cautionary statements identifying important factors that could cause actual results to differ materially from those expressed in any forward-looking statements made by us or on our behalf. See “Cautionary note regarding forward-looking statements.”

## **Risks Relating to Our Business**

### **Changes in U.S. or regional economic conditions could have an adverse effect on our business, financial condition or results of operations.**

Our business activities and earnings are affected by general business conditions in the United States and in our local market area. These conditions include short-term and long-term interest rates, inflation, unemployment levels, consumer confidence and spending, fluctuations in both debt and equity capital markets, and the strength of the economy in the United States generally and in our market area in particular. In the late 2000's, the national economy experienced an extended recession, with rising unemployment levels, declines in real estate values and erosion in consumer confidence. Dramatic declines in the U.S. housing market during the recession, with falling home prices and higher levels of foreclosures, negatively affected the performance of mortgage loans and resulted in significant write-downs of asset values by many financial institutions. Although the housing sector has improved, real estate prices have rebounded and consumer confidence has shown improvement, historical trends indicate that a recession occurs every 8-10 years which could result in another economic downturn in the near future. A return to elevated levels of unemployment, declines in the values of real estate, or other events that affect household and/or corporate incomes could impair the ability of our borrowers to repay their loans in accordance with their terms and reduce demand for banking products and services.

### **A majority of our business is concentrated in Maryland and Delaware, a significant amount of which is concentrated in real estate lending, so a decline in the local economy and real estate markets could adversely impact our financial condition and results of operations.**

Because most of our loans are made to customers who reside on the Eastern Shore of Maryland and in Delaware, a decline in local economic conditions may have a greater effect on our earnings and capital than on the earnings and capital of larger financial institutions whose loan portfolios are geographically diverse. Further, a significant portion of our loan portfolio is secured by real estate, including construction and land development loans, all of which are in greater demand when interest rates are low and economic conditions are good. Accordingly, a decline in local economic conditions would likely have an adverse impact on our financial condition and results of operations, and the impact on us would likely be greater than the impact felt by larger financial institutions whose loan portfolios are geographically diverse. The Company has made strides to make our loan portfolio more diverse by expanding its footprint closer to the metropolitan area of Baltimore which during the last recession rebounded at a much faster pace than the more rural areas of Maryland. We cannot guarantee that any risk management practices that we implement to address our geographic and loan concentrations will be effective in preventing losses relating to our loan portfolio.

### **Our concentrations of commercial real estate loans could subject us to increased regulatory scrutiny and directives, which could force us to preserve or raise capital and/or limit our future commercial lending**

**activities.**

The FRB and the FDIC, along with the other federal banking regulators, issued guidance in December 2006 entitled “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices” directed at institutions that have particularly high concentrations of commercial real estate loans within their lending portfolios. This guidance suggests that these institutions face a heightened risk of financial difficulties in the event of adverse changes in the economy and commercial real estate markets. Accordingly, the guidance suggests that institutions whose concentrations exceed certain percentages of capital should implement heightened risk management practices appropriate to their concentration risk. Federal bank regulatory guidelines identify institutions potentially exposed to commercial real estate concentration risk as those that have (i) experienced rapid growth in commercial real estate lending, (ii) notable exposure to a specific type of commercial real estate, (iii) total reported loans for construction, land development and other land loans representing 100% or more of the institution’s capital, or (iv) total commercial real estate loans representing 300% or more of the institution’s capital if the outstanding balance of the institution’s commercial real estate loan portfolio has increased 50% or more during the prior 36 months. The guidance provides that banking regulators may require such institutions to reduce their concentrations and/or maintain higher capital ratios than institutions with lower concentrations in commercial real estate. Due to our emphasis on commercial real estate and construction lending, as of December 31, 2018, non-owner-occupied commercial real estate loans (including construction, land and land development loans) represented 297.7% of total risk-based capital. Construction, land and land development loans represent 84.5% of total risk-based capital. The commercial real estate portfolio has increased 96.9% during the prior 36 months. We may be subject to heightened supervisory scrutiny during future examinations and/or be required to maintain higher levels of capital as a result of our commercial real estate concentrations, which could require us to obtain additional capital, and may adversely affect shareholder returns. Management cannot predict the extent to which this guidance will impact our operations or capital requirements. Further, we cannot guarantee that any risk management practices we implement will be effective in preventing losses resulting from concentrations in our commercial real estate portfolio.

**Interest rates and other economic conditions will impact our results of operations.**

Our results of operations may be materially and adversely affected by changes in prevailing economic conditions, including declines in real estate values, rapid changes in interest rates and the monetary and fiscal policies of the federal government. Our results of operations are significantly impacted by the spread between the interest rates earned on assets and the interest rates paid on deposits and other interest-bearing liabilities (i.e., net interest income), including advances from the Federal Home Loan Bank (the “FHLB”) of Atlanta. Interest rate risk arises from mismatches (i.e., the interest sensitivity gap) between the dollar amount of repricing or maturing assets and liabilities. If more assets reprice or mature than liabilities during a falling interest rate environment, then our earnings could be negatively impacted. Conversely, if more liabilities reprice or mature than assets during a rising interest rate environment, then our earnings could be negatively impacted. Fluctuations in interest rates are not predictable or controllable. Changes in interest rates, particularly by the FRB, which implements national monetary policy in order to mitigate recessionary and inflationary pressures, also affect the value of our loans. In setting its policy, the FRB may utilize techniques such as: (i) engaging in open market transactions in United States government securities; (ii) setting the discount rate on member bank borrowings; and (iii) determining reserve requirements. These techniques may have an adverse effect on our deposit levels, net interest margin, loan demand or our business and operations. In addition, an increase in interest rates could adversely affect borrowers’ ability to pay the principal or interest on existing loans or reduce their desire to borrow more money. This may lead to an increase in our nonperforming assets, a decrease in loan originations, or a reduction in the value of and income from our loans, any of which could have a

material and negative effect on our results of operations.

Changes in market interest rates are affected by many factors beyond our control, including inflation, unemployment, money supply, international events, and events in world financial markets. We attempt to manage our risk from changes in market interest rates by adjusting the rates, maturity, re-pricing, and balances of the different types of interest-earning assets and interest-bearing liabilities, but interest rate risk management techniques are not exact. As a result, a rapid increase or decrease in interest rates could have an adverse effect on the net interest margin and results of operations. Changes in the market interest rates for types of products and services in various markets also may vary significantly from location to location and over time based upon competition and local or regional economic factors. At December 31, 2018, our interest rate sensitivity simulation model projected that net interest income would increase by 1.2% if interest rates immediately rose by 200 basis points. The results of an interest rate sensitivity simulation model depend upon a number of assumptions which may not prove to be accurate. There can be no assurance that we will be able to successfully manage interest rate risk.

**The Bank may experience credit losses in excess of its allowances, which would adversely impact our financial condition and results of operations.**

The risk of credit losses on loans varies with, among other things, general economic conditions, the type of loan being made, the creditworthiness of the borrower over the term of the loan and, in the case of a collateralized loan, the value and marketability of the collateral for the loan. Management at the Bank bases the allowance for credit losses upon, among other things, historical experience, an evaluation of economic conditions and regular reviews of delinquencies and loan portfolio quality. If management's assumptions and judgments prove to be incorrect and the allowance for credit losses is inadequate to absorb future losses, or if the bank regulatory authorities, as a part of their examination process, require the Bank to increase its allowance for credit losses, our earnings and capital could be significantly and adversely affected. Material additions to the allowance for credit losses at the Bank would result in a decrease in the Bank's net income and capital and could have a material adverse effect on our financial condition.

Although we believe that our allowance for credit losses is maintained at a level adequate to absorb any inherent losses in our loan portfolio, these estimates of loan losses are necessarily subjective and their accuracy depends on the outcome of future events.

While we strive to carefully monitor credit quality and to identify loans that may become nonperforming, at any time there are loans included in the portfolio that have not been identified as nonperforming or potential problem loans, but that will result in losses. We cannot be sure that we will be able to identify deteriorating loans before they become nonperforming assets, or that we will be able to limit losses on those loans that are identified. As a result, future additions to the allowance may be necessary.

Economic conditions and increased uncertainty in the financial markets could adversely affect our ability to accurately assess our allowance for credit losses. Our ability to assess the creditworthiness of our customers or to estimate the

values of our assets and collateral for loans will be reduced if the models and approaches we use become less predictive of future behaviors, valuations, assumptions or estimates. We estimate losses inherent in our loan portfolio, the adequacy of our allowance for credit losses and the values of certain assets by using estimates based on difficult, subjective, and complex judgments, including estimates as to the effects of economic conditions and how those economic conditions might affect the ability of our borrowers to repay their loans or the value of assets.

**Our investment securities portfolio is subject to credit risk, market risk and liquidity risk.**

As of December 31, 2018, we had classified 96% of our debt securities as available-for-sale pursuant to the Accounting Standards Codification (“ASC”) Topic 320 (“ASC 320”) of the Financial Accounting Standards Board (“FASB”) relating to accounting for investments. ASC 320 requires that unrealized gains and losses in the estimated value of the available-for-sale portfolio be “marked to market” and reflected as a separate item in stockholders’ equity (net of tax) as accumulated other comprehensive income (loss). The remaining debt securities are classified as held-to-maturity in accordance with ASC 320 and are stated at amortized cost. Equity securities are recorded at fair value with changes in fair value recorded in earnings.

In the past, gains on sales of investment securities have not been a significant source of income for us. There can be no assurance that future market performance of our investment portfolio will enable us to realize income from sales of securities. Stockholders’ equity will continue to reflect the unrealized gains and losses (net of tax) of these investments. There can be no assurance that the market value of our investment portfolio will not decline, causing a corresponding decline in stockholders’ equity.

The Bank is a member of the FHLB of Atlanta. A member of the FHLB system is required to purchase stock issued by the relevant FHLB bank based on how much it borrows from the FHLB and the quality of the collateral pledged to secure that borrowing. Accordingly, our investments include stock issued by the FHLB of Atlanta. These investments could be subject to future impairment charges and there can be no guaranty of future dividends.



Management believes that several factors will affect the market values of our investment portfolio. These risk factors include, but are not limited to, rating agency downgrades of the securities, defaults of the issuers of the securities, lack of market pricing of the securities, and instability in the credit markets. Lack of market activity with respect to some securities has, in certain circumstances, required us to base our fair market valuation on unobservable inputs. Any changes in these risk factors, in current accounting principles or interpretations of these principles could impact our assessment of fair value and thus the determination of other-than-temporary impairment of the securities in the investment securities portfolio. Investment securities that previously were determined to be other-than-temporarily impaired could require further write-downs due to continued erosion of the creditworthiness of the issuer. Write-downs of investment securities would negatively affect our earnings and regulatory capital ratios.

**Impairment of investment securities, goodwill, other intangible assets, or deferred tax assets could require charges to earnings, which could result in a negative impact on our results of operations.**

We are required to record a non-cash charge to earnings when management determines that an investment security is other-than-temporarily impaired. In assessing whether the impairment of investment securities is other-than-temporary, management considers the length of time and extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability to retain our investment in the security for a period of time sufficient to allow for any anticipated recovery in fair value in the near term.

Under current accounting standards, goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis or more frequently if an event occurs or circumstances change that reduce the fair value of a reporting unit below its carrying amount. Intangible assets other than goodwill are also subject to impairment tests at least annually. A decline in the price of the Company's common stock or occurrence of a triggering event following any of our quarterly earnings releases and prior to the filing of the periodic report for that period could, under certain circumstances, cause us to perform goodwill and other intangible assets impairment tests and result in an impairment charge being recorded for that period which was not reflected in such earnings release. In the event that we conclude that all or a portion of our goodwill or other intangible assets may be impaired, a non-cash charge for the amount of such impairment would be recorded to earnings. At December 31, 2018, we had recorded goodwill of \$17.5 million and other intangible assets of \$2.9 million, representing approximately 9.6% and 1.6% of stockholders' equity, respectively.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. Assessing the need for, or the sufficiency of, a valuation allowance requires management to evaluate all available evidence, both negative and positive, including the recent trend of quarterly earnings. Positive evidence necessary to overcome the negative evidence includes whether future taxable income in sufficient amounts and character within the carryback and carryforward periods is available under the tax law, including the use of tax planning strategies. When negative evidence (e.g., cumulative losses in recent years, history of operating loss or tax credit carry forwards expiring unused) exists, more positive evidence than negative evidence will be necessary. At December 31, 2018, our deferred tax assets were approximately \$5.1 million.

There was no valuation allowance for deferred taxes recorded at December 31, 2018 as management believes it is more likely than not that all of the deferred taxes will be realized because they were supported by positive evidence such as the expected generation of a sufficient level of future taxable income from operations and tax planning strategies.

The impact of each of these impairment matters could have a material adverse effect on our business, results of operations, and financial condition. See Notes 1 and 16 to the Consolidated Financial Statements included in Item 8 of Part II of this annual report for further information.

**Any changes in the Federal or State tax laws may negatively impact our financial performance.**

We are subject to changes in tax law that could increase the effective tax rate payable to the state or federal government. These law changes may be retroactive to previous periods and as a result, could negatively affect our current and future financial performance. On December 22, 2017, President Donald Trump signed into law "The Tax Act, which among other items reduces the federal corporate tax rate to 21% from 35% effective January 1, 2018. As a result, at December 31, 2017, the Company had to revalue its deferred tax assets which resulted in a write-down of approximately \$582 thousand which subsequently increased income tax expense by the same amount. Although this one-time adjustment negatively affected our 2017 earnings, the impact of a lower federal tax rate in 2018 had a positive impact on net income.

**Changes in accounting standards or interpretation of new or existing standards may affect how we report our financial condition and results of operations.**

From time to time the FASB and the SEC change accounting regulations and reporting standards that govern the preparation of the Company's financial statements. In addition, the FASB, SEC, bank regulators and the outside independent auditors may revise their previous interpretations regarding existing accounting regulations and the application of these accounting standards. These changes can be hard to predict and can materially impact how to record and report our financial condition and results of operations. In some cases, there could be a requirement to apply a new or revised accounting standard retroactively, resulting in the restatement of prior period financial statements.

**Our future success will depend on our ability to compete effectively in the highly competitive financial services industry.**

We face substantial competition in all phases of our operations from a variety of different competitors. We compete with commercial banks, credit unions, savings and loan associations, mortgage banking firms, consumer finance companies, securities brokerage firms, money market funds and other mutual funds, as well as other local and community, super-regional, national and international financial institutions that operate offices in our primary market areas and elsewhere. Our future growth and success will depend on our ability to compete effectively in this highly competitive financial services environment.

Many of our competitors are well-established, larger financial institutions and many offer products and services that we do not. Many have substantially greater resources, name recognition and market presence that benefit them in attracting business. Some of our competitors are not subject to the same regulations that are imposed on us, including credit unions that do not pay federal income tax, and, therefore, have regulatory advantage over us in accessing funding and in providing various services. While we believe we compete effectively with these other financial institutions in our primary markets, we may face a competitive disadvantage as a result of our smaller size, smaller asset base, lack of geographic diversification and inability to spread our marketing costs across a broader market. If we have to raise interest rates paid on deposits or lower interest rates charged on loans to compete effectively, our net interest margin and income could be negatively affected. Failure to compete effectively to attract new or to retain existing, clients may reduce or limit our net income and our market share and may adversely affect our results of operations, financial condition and growth.

**Our funding sources may prove insufficient to replace deposits and support our future growth.**

We rely on customer deposits, advances from the FHLB, and lines of credit at other financial institutions to fund our operations. Although we have historically been able to replace maturing deposits and advances if desired, no assurance can be given that we would be able to replace such funds in the future if our financial condition or the financial condition of the FHLB or market conditions were to change. Our financial flexibility will be severely constrained and/or our cost of funds will increase if we are unable to maintain our access to funding or if financing necessary to accommodate future growth is not available at favorable interest rates. Finally, if we are required to place greater reliance on more expensive funding sources to support future growth, our revenues may not increase proportionately to cover our costs. In this case, our profitability would be adversely affected.

In addition, the FRB has issued rules pursuant to the Dodd-Frank Act governing debit card interchange fees that apply to institutions with greater than \$10 billion in assets. Although we are not subject to these rules, market forces may effectively require all banks to adopt debit card interchange fee structures that comply with these rules, in which case our non-interest income for future periods could be materially and adversely affected.

**The loss of key personnel could disrupt our operations and result in reduced earnings.**

Our growth and profitability will depend upon our ability to attract and retain skilled managerial, marketing and technical personnel. Competition for qualified personnel in the financial services industry is intense, and there can be no assurance that we will be successful in attracting and retaining such personnel. Our current executive officers provide valuable services based on their many years of experience and in-depth knowledge of the banking industry. Due to the intense competition for financial professionals, these key personnel would be difficult to replace and an unexpected loss of their services could result in a disruption to the continuity of operations and a possible reduction in earnings.

**The recently completed sale of our Insurance Agency, Avon Dixon (“Avon”), could adversely affect our revenues and profitability.**

The sale of Insurance Agency, Avon Dixon, which we completed on December 31, 2018, involves significant risks. We may not be able to replace the revenues generated by Avon Dixon or achieve the cost savings and other efficiencies anticipated from this transaction. Other conditions outside of our control that could impact the Company's future financial results include, but are not limited to, the ability of the purchaser to successfully transition Avon's personnel.

**The cost savings that we estimate for mergers and acquisitions may not be realized.**

The success of our mergers and acquisitions may depend, in part, on the ability to realize the estimated cost savings from combining the acquired businesses with our existing operations. It is possible that the potential cost savings could turn out to be more difficult to achieve than anticipated. The cost savings estimates also depend on the ability to combine the businesses in a manner that permits those cost savings to be realized. If the estimates turn out to be incorrect or there is an inability to combine successfully, the anticipated cost savings may not be realized fully or at all or may take longer to realize than expected.

**Combining acquired businesses with the Bank may be more difficult, costly, or time-consuming than expected, or could result in the loss of customers.**

It is possible that the process of merger integration of acquired companies could result in the loss of key employees, the disruption of ongoing business or inconsistencies in standards, controls, procedures and policies that adversely affect the ability to maintain relationships with clients and employees or to achieve the anticipated benefits of the merger or acquisition. There also may be disruptions that cause the Bank to lose customers or cause customers to

withdraw their deposits. Customers may not readily accept changes to their banking arrangements or other customer relationships after the merger or acquisition.

**Our lending activities subject us to the risk of environmental liabilities.**

A significant portion of our loan portfolio is secured by real property. During the ordinary course of business, we may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, we may be liable for remediation costs, as well as for personal injury and property damage.

Environmental laws may require us to incur substantial expenses and may materially reduce the affected property's value or limit our ability to use or sell the affected property. In addition, future laws or more stringent interpretations of enforcement policies with respect to existing laws may increase our exposure to environmental liability. Although we have policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on our financial condition and results of operations.

**We may be subject to other adverse claims.**

We may from time to time be subject to claims from customers for losses due to alleged breaches of fiduciary duties, errors and omissions of employees, officers and agents, incomplete documentation, the failure to comply with applicable laws and regulations, or many other reasons. Also, our employees may knowingly or unknowingly violate laws and regulations. Management may not be aware of any violations until after their occurrence. This lack of knowledge may not insulate us or our subsidiaries from liability. Claims and legal actions may result in legal expenses and liabilities that may reduce our profitability and hurt our financial condition.

**We depend on the accuracy and completeness of information about customers and counterparties and our financial condition could be adversely affected if we rely on misleading information.**

In deciding whether to extend credit or to enter into other transactions with customers and counterparties, we may rely on information furnished to us by or on behalf of customers and counterparties, including financial statements and other financial information, which we do not independently verify. We also may rely on representations of customers and counterparties as to the accuracy and completeness of that information and, with respect to financial statements, on reports of independent auditors. For example, in deciding whether to extend credit to customers, we may assume that a customer's audited financial statements conform with U.S. GAAP and present fairly, in all material respects, the financial condition, results of operations and cash flows of the customer. Our financial condition and results of operations could be negatively impacted to the extent we rely on financial statements that do not comply with GAAP

or are materially misleading.

**Our exposure to operational, technological and organizational risk may adversely affect us.**

We are exposed to many types of operational risks, including reputation, legal and compliance risk, the risk of fraud or theft by employees or outsiders, unauthorized transactions by employees or operational errors, clerical or record-keeping errors, and errors resulting from faulty or disabled computer or telecommunications systems.

Certain errors may be repeated or compounded before they are discovered and successfully rectified. Our necessary dependence upon automated systems to record and process transactions may further increase the risk that technical system flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect. We may also be subject to disruptions of our operating systems arising from events that are wholly or partially beyond our control (for example, computer viruses or electrical or telecommunications outages), which may give rise to disruption of service to customers and to financial loss or liability. We are further exposed to the risk that our external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees as are we) and to the risk that our (or our vendors') business continuity and data security systems prove to be inadequate.

**Our information systems may experience an interruption or breach in security.**

We rely heavily on communications and information systems to conduct our business. We, our customers, and other financial institutions with which we interact, are subject to ongoing, continuous attempts to penetrate key systems by individual hackers, organized criminals, and in some cases, state-sponsored organizations. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer relationship management, general ledger, deposit, loan and other systems, misappropriation of funds, and theft of proprietary Company or customer data. While we have policies and procedures designed to prevent or limit the effect of the possible failure, interruption or security breach of our information systems, there can be no assurance that any such failure, interruption or security breach will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failure, interruption or security breach of our information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability.

**Security breaches and other disruptions could compromise our information and expose us to liability, which would cause our business and reputation to suffer.**

In the ordinary course of our business, we collect and store sensitive data, including intellectual property, our proprietary business information and that of our customers, suppliers and business partners, and personally identifiable information of our customers and employees, in our data centers and on our networks. The secure processing, maintenance and transmission of this information is critical to our operations and business strategy. Despite our security measures, our information technology and infrastructure may be vulnerable to attacks by hackers or breached due to employee error, malfeasance or other disruptions. Any such breach could compromise our networks and the information stored there could be accessed, publicly disclosed, lost or stolen. Any such access, disclosure or other loss of information could result in legal claims or proceedings, liability under laws that protect the privacy of personal information, and regulatory penalties, disrupt our operations and the services we provide to customers, damage our reputation, and cause a loss of confidence in our products and services, which could adversely affect our business, revenues and competitive position.

**Our reliance on third party vendors could expose us to additional cyber risk and liability.**

The operation of our business involves outsourcing of certain business functions and reliance on third-party providers, which may result in transmission and maintenance of personal, confidential, and proprietary information to and by such vendors. Although we require third-party providers to maintain certain levels of information security, such providers remain vulnerable to breaches, unauthorized access, misuse, computer viruses, or other malicious attacks that could ultimately compromise sensitive information possessed by our company. Although we contract to limit our liability in connection with attacks against third-party providers, we remain exposed to risk of loss associated with such vendors.

**We outsource certain aspects of our data processing to certain third-party providers which may expose us to additional risk.**

We outsource certain key aspects of our data processing to certain third-party providers. While we have selected these third-party providers carefully, we cannot control their actions. If our third-party providers encounter difficulties, including those which result from their failure to provide services for any reason or their poor performance of services, or if we have difficulty in communicating with them, our ability to adequately process and account for customer transactions could be affected, and our business operations could be adversely impacted. Replacing these third-party providers could also entail significant delay and expense.



Our third-party providers may be vulnerable to unauthorized access, computer viruses, phishing schemes and other security breaches. Threats to information security also exist in the processing of customer information through various other third-party providers and their personnel. We may be required to expend significant additional resources to protect against the threat of such security breaches and computer viruses, or to alleviate problems caused by such security breaches or viruses. To the extent that the activities of our third-party providers or the activities of our customers involve the storage and transmission of confidential information, security breaches and viruses could expose us to claims, regulatory scrutiny, litigation and other possible liabilities.

**We are dependent on our information technology and telecommunications systems and third-party servicers, and systems failures, interruptions or breaches of security could have an adverse effect on our financial condition and results of operations.**

Our business is highly dependent on the successful and uninterrupted functioning of our information technology and telecommunications systems and third-party servicers. We outsource many of our major systems, such as data processing and deposit processing systems. The failure of these systems, or the termination of a third-party software license or service agreement on which any of these systems is based, could interrupt our operations. Because our information technology and telecommunications systems interface with and depend on third-party systems, we could experience service denials if demand for such services exceeds capacity or such third-party systems fail or experience interruptions. If sustained or repeated, a system failure or service denial could result in a deterioration of our ability to provide customer service, compromise our ability to operate effectively, damage our reputation, result in a loss of customer business and/or subject us to additional regulatory scrutiny and possible financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

In addition, we provide our customers the ability to bank remotely, including online over the Internet. The secure transmission of confidential information is a critical element of remote banking. Our network could be vulnerable to unauthorized access, computer viruses, phishing schemes, spam attacks, human error, natural disasters, power loss and other security breaches. We may be required to spend significant capital and other resources to protect against the threat of security breaches and computer viruses, or to alleviate problems caused by security breaches or viruses. Further, we outsource some of the data processing functions used for remote banking, and accordingly we are dependent on the expertise and performance of our third-party providers. To the extent that our activities, the activities of our customers, or the activities of our third-party service providers involve the storage and transmission of confidential information, security breaches and viruses could expose us to claims, litigation and other possible liabilities. Any inability to prevent security breaches or computer viruses could also cause existing customers to lose confidence in our systems and could adversely affect our reputation, results of operations and ability to attract and maintain customers and businesses. In addition, a security breach could also subject us to additional regulatory scrutiny, expose us to civil litigation and possible financial liability and cause reputational damage.

**Technological changes affect our business, and we may have fewer resources than many competitors to invest in technological improvements.**

The financial services industry is undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to serving customers better, the effective use of technology may increase efficiency and may enable financial institutions to reduce costs. Our future success will depend, in part, upon our ability to use technology to provide products and services that provide convenience to customers and to create additional efficiencies in operations. We may need to make significant additional capital investments in technology in the future, and we may not be able to effectively implement new technology-driven products and services. Many of our competitors have substantially greater resources to invest in technological improvements.

**Risks Relating to the Regulation of our Industry**

**We operate in a highly regulated environment, which could restrain our growth and profitability.**

We are subject to extensive laws and regulations that govern almost all aspects of our operations. These laws and regulations, and the supervisory framework that oversees the administration of these laws and regulations, are primarily intended to protect depositors, the DIF and the banking system as a whole, and not shareholders and consumers. These laws and regulations, among other matters, affect our lending practices, capital structure, investment practices, dividend policy, operations and growth. Compliance with the myriad laws and regulations applicable to our organization can be difficult and costly. In addition, these laws, regulations and policies are subject to continual review by governmental authorities, and changes to these laws, regulations and policies, including changes in interpretation or implementation of these laws, regulations and policies, could affect us in substantial and unpredictable ways and often impose additional compliance costs. Further, any new laws, rules and regulations, such as the Dodd-Frank Act and regulatory capital rules, could make compliance more difficult or expensive. All of these laws and regulations, and the supervisory framework applicable to our industry, could have a material adverse effect on our business, financial condition and results of operations.

**Federal and state regulators periodically examine our business, and we may be required to remediate adverse examination findings.**

The FRB and the Commissioner periodically examine our business, including our compliance with laws and regulations. If, as a result of an examination, the FRB or the Commissioner were to determine that our financial condition, capital resource, asset quality, earnings prospects, management, liquidity or other aspects of any of our operations had become unsatisfactory, or that we were in violation of any law or regulation, it may take a number of

different remedial actions as it deems appropriate. These actions include the power to enjoin “unsafe or unsound” practices, to require affirmative action to correct any conditions resulting from any violation or practice, to issue an administrative order that can be judicially enforced, to direct an increase in our capital, to restrict our growth, to assess civil monetary penalties against our officers or directors, to remove officers and directors and, if it is concluded that such conditions cannot be corrected or there is an imminent risk of loss to depositors, to terminate our deposit insurance and place us into receivership or conservatorship. Any regulatory action against us could have a material adverse effect on our business, financial condition and results of operations.

**Our FDIC deposit insurance premiums and assessments may increase.**

The deposits of the Bank are insured by the FDIC up to legal limits and, accordingly, subject to the payment of FDIC deposit insurance assessments. The Bank’s regular assessments are determined by its risk classifications, which are based on its regulatory capital levels and the level of supervisory concern that it poses. High levels of bank failures since the beginning of the financial crisis and increases in the statutory deposit insurance limits have increased resolution costs to the FDIC and put significant pressure on the DIF. In order to maintain a strong funding position and restore the reserve ratios of the Deposit Insurance Fund, the FDIC increased deposit insurance assessment rates and charged a special assessment to all FDIC-insured financial institutions. Further increase in assessment rates or special assessments may occur in the future, especially if there are significant additional financial institution failures. Any future special assessments, increases in assessment rates or required prepayments in FDIC insurance premiums could reduce our profitability or limit our ability to pursue certain business opportunities, which could have a material adverse effect on our business, financial condition and results of operations.

**We are subject to numerous laws designed to protect consumers, including the Community Reinvestment Act and fair lending laws, and failure to comply with these laws could lead to a wide variety of sanctions.**

The Community Reinvestment Act, the Equal Credit Opportunity Act, the Fair Housing Act and other fair lending laws and regulations impose nondiscriminatory lending requirements on financial institutions. The Department of Justice and other federal agencies are responsible for enforcing these laws and regulations. A successful regulatory challenge to an institution's performance under the Community Reinvestment Act or fair lending laws and regulations could result in a wide variety of sanctions, including damages and civil money penalties, injunctive relief, restrictions on mergers and acquisition activity, restrictions on expansion and restrictions on entering new business lines. Private parties may also have the ability to challenge an institution's performance under fair lending laws in private class action litigation. Such actions could have a material adverse effect on our business, financial condition and results of operations.

**We are subject to evolving and extensive regulations and requirements. Our failure to adhere to these requirements or the failure or circumvention of our controls and procedures could seriously harm our business.**

We are subject to extensive regulation as a financial institution and are also required to follow the corporate governance and financial reporting practices and policies required of a company whose stock is registered under the Exchange Act and listed on the NASDAQ Global Select Market. Compliance with these requirements means we incur significant legal, accounting and other expenses. Compliance also requires a significant diversion of management time and attention, particularly with regard to disclosure controls and procedures and internal control over financial reporting. Although we have reviewed, and will continue to review, our disclosure controls and procedures in order to determine whether they are effective, our controls and procedures may not be able to prevent errors or frauds in the future.

Faulty judgments, simple errors or mistakes, or the failure of our personnel to adhere to established controls and procedures may make it difficult for us to ensure that the objectives of the control system will be met. A failure of our controls and procedures to detect other than inconsequential errors or fraud could seriously harm our business and results of operations.

**We face a risk of noncompliance and enforcement action with the BSA and other anti-money laundering statutes and regulations.**

The BSA, the USA PATRIOT Act of 2001 and other laws and regulations require financial institutions, among other duties, to institute and maintain an effective anti-money laundering program and file suspicious activity and currency transaction reports as appropriate. The federal Financial Crimes Enforcement Network is authorized to impose significant civil money penalties for violations of those requirements and has recently engaged in coordinated enforcement efforts with the individual federal banking regulators, as well as the U.S. Department of Justice, Drug Enforcement Administration and Internal Revenue Service. We are also subject to increased scrutiny of compliance with the rules enforced by the Office of Foreign Assets Control. If our policies, procedures and systems are deemed deficient, we would be subject to liability, including fines and regulatory actions, which may include restrictions on our ability to pay dividends and the necessity to obtain regulatory approvals to proceed with certain aspects of our business plan, including our acquisition plans. Failure to maintain and implement adequate programs to combat money laundering and terrorist financing could also have serious reputational consequences for us. Any of these results could have a material adverse effect on our business, financial condition and results of operations.

## **Risks Relating to the Company's Securities**

**Our common stock is not insured by any governmental entity.**

Our common stock is not a deposit account or other obligation of any bank and is not insured by the FDIC or any other governmental entity. Investment in our common stock is subject to risk, including possible loss.

**Our ability to pay dividends is limited by law and contract.**

The continued ability to pay dividends to shareholders depends in part on dividends from the Bank. The amount of dividends that the Bank may pay to the Company is limited by federal laws and regulations. The ability of the Bank to pay dividends is also subject to its profitability, financial condition and cash flow requirements. There is no assurance that the Bank will be able to pay dividends to the Company in the future. The decision may be made to limit the payment of dividends even when the legal ability to pay them exists, in order to retain earnings for other uses.

**The shares of our common stock are not heavily traded.**

Shares of our common stock are listed on the NASDAQ Global Select Market, but are not heavily traded. Securities that are not heavily traded can be more volatile than stock trading in an active public market. Stock price volatility may make it more difficult for you to resell your common stock when you want and at prices you find attractive. Our stock price can fluctuate significantly and may decline in response to a variety of factors including:

- Actual or anticipated variations in quarterly results of operations;
- Developments in our business or the financial sector generally;
- Recommendations by securities analysts;
- Operating and stock price performance of other companies that investors deem comparable to us;
- News reports relating to trends, concerns and other issues in the financial services industry;
- Perceptions in the marketplace regarding us or our competitors;
- New technology used or services offered by competitors;
- Significant acquisitions or business combinations, strategic partnerships, joint venture or capital commitments by or involving us or our competitors;
- Failure to integrate acquisitions or realize anticipated benefits from acquisitions;
- Regulatory changes affecting our industry generally or our business or operations; or
- Geopolitical conditions such as acts or threats of terrorism or military conflicts.

Management cannot predict the extent to which an active public market for the shares of the common stock will develop or be sustained in the future. Accordingly, holders of shares of our common stock may not be able to sell them at the volumes, prices, or times that they desire. General market fluctuations, industry factors and general economic and political conditions and events, such as economic slowdowns or recessions, interest rate changes or credit loss trends, could also cause our stock price to decrease regardless of operating results. We urge you to obtain current market quotations for our common stock when you consider investing in our common stock.

**Future sales of our common stock or other securities may dilute the value and adversely affect the market price of our common stock.**

In many situations, the board of directors has the authority, without any vote of our shareholders, to issue shares of authorized but unissued stock, including shares authorized and unissued under our equity incentive plans. In the future, additional securities may be issued, through public or private offerings, in order to raise additional capital. Any such issuance would dilute the percentage of ownership interest of existing shareholders and may dilute the per share book value of our common stock. In addition, option holders may exercise their options at a time when we would otherwise be able to obtain additional equity capital on more favorable terms.

**Our Articles of Incorporation and By-Laws and Maryland law may discourage a corporate takeover which may make it more difficult for stockholders to receive a change in control premium.**

Our Amended and Restated Articles of Incorporation, as supplemented (the “Charter”), and Amended and Restated By-Laws, as amended (the “By-Laws”), contain certain provisions designed to enhance the ability of the board of directors to deal with attempts to acquire control of us. The Charter and By-Laws provide for the classification of the board into three classes; directors of each class generally serve for staggered three-year periods. No director may be removed except for cause and then only by a vote of at least two-thirds of the total eligible stockholder votes. The Charter gives the board certain powers in respect of our securities. First, the board has the authority to classify and reclassify unissued shares of stock of any class or series of stock by setting, fixing, eliminating, or altering in any one or more respects the preferences, rights, voting powers, restrictions and qualifications of, dividends on, and redemption, conversion, exchange, and other rights of, such securities. Second, a majority of the board, without action by the stockholders, may amend the Charter to increase or decrease the aggregate number of shares of stock or the number of shares of stock of any class that we have authority to issue. The board could use these powers, along with its authority to authorize the issuance of securities of any class or series, to issue securities having terms favorable to management to persons affiliated with or otherwise friendly to management.

Maryland law also contains anti-takeover provisions that apply to us. The Maryland Business Combination Act generally prohibits, subject to certain limited exceptions, corporations from being involved in any “business combination” (defined as a variety of transactions, including a merger, consolidation, share exchange, asset transfer or

issuance or reclassification of equity securities) with any “interested shareholder” for a period of five years following the most recent date on which the interested shareholder became an interested shareholder. An interested shareholder is defined generally as a person who is the beneficial owner of 10% or more of the voting power of the outstanding voting stock of the corporation after the date on which the corporation had 100 or more beneficial owners of its stock or who is an affiliate or associate of the corporation and was the beneficial owner, directly or indirectly, of 10% or more of the voting power of the then outstanding stock of the corporation at any time within the two-year period immediately prior to the date in question and after the date on which the corporation had 100 or more beneficial owners of its stock. The Maryland Control Share Acquisition Act applies to acquisitions of “control shares,” which, subject to certain exceptions, are shares the acquisition of which entitle the holder, directly or indirectly, to exercise or direct the exercise of the voting power of shares of stock of the corporation in the election of directors within any of the following ranges of voting power: one-tenth or more, but less than one-third of all voting power; one-third or more, but less than a majority of all voting power or a majority or more of all voting power. Control shares have limited voting rights. The By-Laws exempt our capital securities from the Maryland Control Share Acquisition Act, but the board has the authority to eliminate the exemption without stockholder approval.

Although these provisions do not preclude a takeover, they may have the effect of discouraging, delaying or deferring a tender offer or takeover attempt that a stockholder might consider in his or her best interest, including those attempts that might result in a premium over the market price for the common stock. Such provisions will also render the removal of the board of directors and of management more difficult and, therefore, may serve to perpetuate current management. These provisions could potentially adversely affect the market price of our common stock.

**We may issue debt and equity securities that are senior to the common stock as to distributions and in liquidation, which could negatively affect the value of the common stock.**

In the future, we may increase our capital resources by entering into debt or debt-like financing or issuing debt or equity securities, which could include issuances of senior notes, subordinated notes, preferred stock or common stock. In the event of our liquidation, our lenders and holders of our debt or preferred securities would receive a distribution of our available assets before distributions to the holders of our common stock. Our decision to incur debt and issue securities in future offerings will depend on market conditions and other factors beyond our control. We cannot predict or estimate the amount, timing or nature of its future offerings and debt financings. Future offerings could reduce the value of shares of our common stock and dilute a stockholder’s interest in us.

**Item 1B. Unresolved Staff Comments.**

None.

**Item 2. Properties.**

Our offices are listed in the tables below. The address of the Company's main office is 28969 Information Lane in Easton, Maryland. The Company owns the real property at this location, which also houses the Executive, Operations, Information Technology, Human Resources, Audit and Finance departments of the Company and its subsidiaries.

***Shore United Bank***

|                              | <b>Branches</b>              |                                  |
|------------------------------|------------------------------|----------------------------------|
| Main Office                  | Elliott Road Branch          | Tred Avon Square Branch          |
| 18 East Dover Street         | 8275 Elliott Road            | 212 Marlboro Road                |
| Easton, Maryland 21601       | Easton, Maryland 21601       | Easton, Maryland 21601           |
| St. Michaels Branch          | Sunburst Branch              | Centreville Branch               |
| 1013 South Talbot Street     | 424 Dorchester Avenue        | 109 North Commerce Street        |
| St. Michaels, Maryland 21663 | Cambridge, Maryland 21613    | Centreville, Maryland 21617      |
| Route 213 South Branch       | Chester Branch               | Denton Branch                    |
| 2609 Centreville Road        | 300 Castle Marina Road       | 850 South 5 <sup>th</sup> Avenue |
| Centreville, Maryland 21617  | Chester, Maryland 21619      | Denton, Maryland 21629           |
| Grasonville Branch           | Stevensville Branch          | Tuckahoe Branch                  |
| 202 Pullman Crossing         | 408 Thompson Creek Road      | 22151 WES Street                 |
| Grasonville, Maryland 21638  | Stevensville, Maryland 21666 | Ridgely, Maryland 21660          |
| Washington Square Branch     | Felton Branch                | Milford Branch                   |
| 899 Washington Avenue        | 120 West Main Street         | 698-A North Dupont Boulevard     |
| Chestertown, Maryland 21620  | Felton, Delaware 19943       | Milford, Delaware 19963          |
| Camden Branch                | Dover Branch                 | Arbutus Branch                   |
| 4580 South DuPont Highway    | 800 S. Governors Avenue      | 1101 Maiden Choice Lane          |
| Camden, Delaware 19934       | Dover, Delaware 19904        | Baltimore, MD 21229              |



|                      |                        |                        |
|----------------------|------------------------|------------------------|
| Elkridge Branch      | Owings Mills Branch    | Onley Branch           |
| 6050 Marshalee Drive | 9612 Reisterstown Road | 25306 Lankford Highway |
| Elkridge, MD 21075   | Owings Mills, MD 21117 | Onley, VA 23418        |

**ATMs**

|                             |                             |
|-----------------------------|-----------------------------|
| Memorial Hospital at Easton | Talbottown                  |
| 219 South Washington Street | 218 North Washington Street |
| Easton, Maryland 21601      | Easton, Maryland 21601      |

**Offices**

|   |                                     |                                     |
|---|-------------------------------------|-------------------------------------|
| Division Office - Wye Financial & Trust | Loan Production Office – Middletown | Loan Production Office – Ocean City |
| 16 North Washington Street, Suite 1     | 651 North Broad Street              | 9748 Stephen Decatur Highway        |
| Easton, Maryland 21601                  | Suite 201                           | Unit 104                            |
|   | Middletown, Delaware 19709          | Ocean City, Maryland 21842          |

The Bank owns the real property on which all of its Maryland offices are located, except that it operates under leases at its St. Michaels branch and the office of Wye Financial and Trust in Easton. The Bank leases the real property on which all of its Delaware offices are located, except that it owns the real property on which the Camden and Dover Branches are located. The Bank operates under a lease at its Onley branch in Virginia. For information about rent expense for all leased premises, see Note 6 to the Consolidated Financial Statements appearing in Item 8 of Part II of this annual report.

**Item 3. Legal Proceedings.**

We are at times, in the ordinary course of business, subject to legal actions. Management, upon the advice of counsel, believes that losses, if any, resulting from current legal actions will not have a material adverse effect on our financial condition or results of operations.

**Item 4. Mine Safety Disclosures.**

This item is not applicable.

**PART II****Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.****MARKET PRICE, HOLDERS AND CASH DIVIDENDS**

The shares of the Company’s common stock are listed on the NASDAQ Global Select Market under the symbol “SHBI”. As of February 28, 2018, the Company had approximately 1,285 registered holders of record. The high and low sales prices for the shares of common stock of the Company, as reported on the NASDAQ Global Select Market, and the cash dividends declared on those shares for each quarterly period of 2018 and 2017 are set forth in the table below.

|                | 2018                |          |                   | 2017                |          |                   |
|----------------|---------------------|----------|-------------------|---------------------|----------|-------------------|
|                | Price Range<br>High | Low      | Dividends<br>Paid | Price Range<br>High | Low      | Dividends<br>Paid |
| First Quarter  | \$ 19.80            | \$ 16.28 | \$ 0.07           | \$ 17.92            | \$ 14.64 | \$ 0.05           |
| Second Quarter | 20.09               | 17.92    | 0.08              | 17.53               | 15.17    | 0.05              |
| Third Quarter  | 19.84               | 16.63    | 0.08              | 17.34               | 15.97    | 0.05              |
| Fourth Quarter | 18.32               | 12.95    | 0.09              | 18.49               | 15.74    | 0.07              |
|                |                     |          | \$ 0.32           |                     |          | \$ 0.22           |

On February 28, 2018, the closing sales price for the shares of common stock as reported on the NASDAQ Global Select Market was \$15.75 per share.

Shareholders received quarterly cash common stock dividends totaling \$4.1 million in 2018 and \$2.8 million in 2017. Dividends have increased from 2017 due to the Company’s improved operating results. As a general matter, the payment of dividends is at the discretion of the Company’s Board of Directors, based on such factors as operating results, financial condition, capital adequacy, regulatory requirements, and stockholder return. The Company’s ability to pay dividends is limited by federal banking and state corporate law and is generally dependent on the ability of the Bank to declare dividends to the Company. For more information regarding these dividend limitations, see “Risk Factors - Our ability to pay dividends is limited by law and contract”.

The transfer agent for the Company’s common stock is:

Broadridge

51 Mercedes Way

Edgewood, NY 11717

Investor Relations: 1-800-353-0103

E-mail for investor inquiries: [shareholder@broadridge.com](mailto:shareholder@broadridge.com) .

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

**EQUITY COMPENSATION PLAN INFORMATION**

The following table contains information about these equity compensation plans as of December 31, 2018.

| <b>Plan Category</b>                                       | Number of securities to be issued upon exercise of outstanding options, warrants and rights (a) | Weighted-average exercise price of outstanding options, warrants, and rights (b) | Number of securities remaining available for future issuance under equity compensation plans [excluding securities reflected in column (a)] (c) |
|--|---|--|---|
| Equity compensation plans approved by security holders (1) | 27,249  | \$ 9.68  | 652,167   |
| Equity compensation plans not approved by security holders | -   | -  | -   |
| <b>Total</b>   | <b>27,249</b>   | <b>\$ 9.68</b>   | <b>652,167</b>  |

In addition to stock options and stock appreciation rights, the 2016 Plan permits the grant of stock awards, stock units, and performance units, and the shares available for issuance shown in column (c) may be granted pursuant to such awards. Subject to the anti-dilution provisions of the Omnibus Plan, the maximum number of shares of restricted stock that may be granted to any participant in any calendar year is 50,000; the maximum number of restricted stock units that may be granted to any one participant in any calendar year is 30,000; and the maximum dollar value of performance units that may be granted to any one participant in any calendar year is \$1,000,000. As of December 31, 2018, the Company has granted 197,809 shares of restricted stock and 106,494 in restricted stock units that are not reflected in column (a) of this table.

All other information required by this item is incorporated herein by reference to the section of the Company's definitive proxy statement to be filed in connection with the 2019 Annual Meeting of Stockholders entitled "Beneficial Ownership of Common Stock".

**Item 6. Selected Financial Data**

Not required.



## **Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations.**

The following discussion compares the Company’s financial condition at December 31, 2018 to its financial condition at December 31, 2017 and the results of operations for the years ended December 31, 2018 and 2017. This discussion should be read in conjunction with the Consolidated Financial Statements and the Notes thereto appearing in Item 8 of Part II of this annual report.

### **PERFORMANCE OVERVIEW**

The Company recorded net income of \$25.00 million for 2018 and net income of \$11.26 million for 2017. The Company sold the assets and activities of its retail insurance business, Avon Dixon, LLC (“Avon”) on December 31, 2018 for net proceeds of \$25.2 million and a net gain after tax of \$8.2 million. In addition, the Company discontinued operations of its insurance premium finance company, Mubell, LLC (“Mubell”), which it intends to dispose of in the next year. Excluding the sale and activity of Avon and Mubell (discontinued operations), the Company reported net income of \$15.76 million for 2018 for continuing operations. The basic and diluted income per share was \$1.96 which comprised of \$1.24 from continuing operations and \$0.72 from discontinued operations for 2018 and \$0.73 from continuing operations and \$0.16 from discontinued operations for 2017. When comparing 2018 to 2017, earnings were significantly improved due to increases in net interest income and noninterest income, partially offset by an increase in noninterest expenses.

Total assets were \$1.483 billion at December 31, 2018, a \$89.2 million, or 6.4%, increase when compared to the \$1.394 billion at December 31, 2017. The primary factors contributing to the increase were increases in gross loans of \$101.8 million and interest-bearing deposits with other banks of \$40.6 million, partially offset by decreases of \$42.5 million in investment securities which was utilized to fund loan growth and \$11.2 million in total assets due to the sale of Avon.

Total deposits increased \$9.6 million, or less than 1% to \$1.212 billion at December 31, 2018. The increase was due to increases in rates paid on core deposits as well as a new insured cash sweep (“ICS”) product for customers. Total stockholders’ equity increased \$19.4 million, or 11.9%, to \$183.2 million, or 12.35% of total assets at December 31, 2018. The increase in total stockholders’ equity was primarily due to current year earnings and the sale of Avon.

### **CRITICAL ACCOUNTING POLICIES**

The Company’s consolidated financial statements are prepared in accordance with GAAP and follow general practices within the industries in which it operates. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial

statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently result in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based on quoted market prices, collateral value or are provided by other third-party sources, when available.

The most significant accounting policies that the Company follows are presented in Note 1 to the Consolidated Financial Statements. These policies, along with the disclosures presented in the notes to the financial statements and in this discussion, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has determined that the accounting policies with respect to the allowance for credit losses, goodwill and other intangible assets, deferred tax assets, and fair value are critical accounting policies. These policies are considered critical because they relate to accounting areas that require the most subjective or complex judgments, and, as such, could be most subject to revision as new information becomes available.

The allowance for credit losses represents management's estimate of credit losses inherent in the loan portfolio as of the balance sheet date. Determining the amount of the allowance for credit losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the consolidated balance sheets. Note 1 to the Consolidated Financial Statements describes the methodology used to determine the allowance for credit losses. A discussion of the factors driving changes in the amount of the allowance for credit losses is included in the Asset Quality - Provision for Credit Losses and Risk Management section below.

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Other intangible assets represent purchased assets that also lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset or liability. Goodwill and other intangible assets are required to be recorded at fair value at inception. Determining fair value is subjective, requiring the use of estimates, assumptions and management judgment. Goodwill and other intangible assets with indefinite lives are tested at least annually for impairment, usually during the third quarter, or on an interim basis if circumstances dictate. Intangible assets that have finite lives are amortized over their estimated useful lives and also are subject to impairment testing. Impairment testing requires that the fair value of each of the Company's reporting units be compared to the carrying amount of its net assets, including goodwill. If the fair value of a reporting unit is less than book value, an expense may be required to write down the related goodwill or purchased intangibles to record an impairment loss. As of December 31, 2018, the Company had only one banking reporting unit.





Deferred tax assets and liabilities are determined by applying the applicable federal and state income tax rates to cumulative temporary differences. These temporary differences represent differences between financial statement carrying amounts and the corresponding tax bases of certain assets and liabilities. Deferred taxes result from such temporary differences. A valuation allowance, if needed, reduces deferred tax assets to the expected amount most likely to be realized. Realization of deferred tax assets is dependent on the generation of a sufficient level of future taxable income, recoverable taxes paid in prior years and tax planning strategies. The Company evaluates all positive and negative evidence before determining if a valuation allowance is deemed necessary regarding the realization of deferred tax assets.

The Company measures certain financial assets and liabilities at fair value, with the measurements made on a recurring or nonrecurring basis. Significant financial instruments measured at fair value on a recurring basis are investment securities. Impaired loans and other real estate owned are significant financial instruments measured at fair value on a nonrecurring basis. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. In determining fair value, the Company is required to maximize the use of observable inputs and minimize the use of unobservable inputs, reducing subjectivity.

## **RECENT ACCOUNTING PRONOUNCEMENTS AND DEVELOPMENTS**

Note 1 to the Consolidated Financial Statements discusses new accounting policies that the Company adopted during 2018 and the expected impact of accounting policies recently issued or proposed but not yet required to be adopted. To the extent the adoption of new accounting standards materially affects our financial condition, results of operations or liquidity, the impacts are discussed in the applicable section(s) of this discussion and Notes to the Consolidated Financial Statements.

## **RESULTS OF OPERATIONS**

### **Net Interest Income and Net Interest Margin**

Net interest income remains the most significant factor affecting our results of operations. Net interest income represents the excess of interest and fees earned on total average earning assets (loans, investment securities, federal funds sold and interest-bearing deposits with other banks) over interest owed on average interest-bearing liabilities (deposits and borrowings). Tax-equivalent net interest income is net interest income adjusted for the tax-favored status of income from certain loans and investments. As shown in the table below, tax-equivalent net interest income for 2018 was \$50.7 million. This represented a \$5.0 million, or 10.9%, increase from 2017, and net interest income increased \$7.3 million, or 19.0%, for 2017 when compared to 2016. The increase in net interest income when comparing 2018 to 2017 was primarily the result of higher average balances on loans. Although the yields on loans remained unchanged between 2018 and 2017, the funding of loan growth with lower yielding assets, coupled with higher yielding investment securities resulted in a higher overall yield on earning assets. The increase when

comparing 2017 to 2016 was due to higher average balances on loans and lower rates paid on time deposits. When comparing 2018 to 2017, interest income increased \$8.0 million while interest expense increased \$3.0 million. When comparing 2017 to 2016, interest income increased \$7.2 million while interest expense decreased \$130 thousand.

Our net interest margin (i.e., tax-equivalent net interest income divided by average earning assets) represents the net yield on earning assets minus the cost of liabilities. The net interest margin is managed through loan and deposit pricing and asset/liability strategies. The net interest margin was 3.74% for 2018 and 3.76% for 2017. The net interest margin decreased when comparing 2018 to 2017 due to the significant increase in the average balance of loans, higher yields on investment securities, offset by increases in rates paid on deposits and an increase in short and long-term borrowings. The net interest margin increased when comparing 2017 to 2016 due to an increase in the average balance of loans and lower rates paid on interest-bearing deposits. The net interest spread, which is the difference between the average yield on earning assets and the rate paid for interest-bearing liabilities, was 3.57% for 2018, 3.67% for 2017 and 3.46% for 2016.

The following table sets forth the major components of net interest income, on a tax-equivalent basis, for the years ended December 31, 2018, 2017, and 2016.

|  | 2018            |              |            | 2017            |              |            | 2016            |              |            |
|--|-----------------|--------------|------------|-----------------|--------------|------------|-----------------|--------------|------------|
|  | Average Balance | Interest (1) | Yield/Rate | Average Balance | Interest (1) | Yield/Rate | Average Balance | Interest (1) | Yield/Rate |
| (Dollars in thousands)                     |                 |              |            |                 |              |            |                 |              |            |
| <b>Earning assets</b>                      |                 |              |            |                 |              |            |                 |              |            |
| Loans (2) (3)                              | \$1,153,169     | \$51,446     | 4.46 %     | \$983,484       | \$43,857     | 4.46 %     | \$825,475       | \$37,349     | 4.52 %     |
| <b>Investment securities:</b>              |                 |              |            |                 |              |            |                 |              |            |
| Taxable                                    | 189,879         | 4,289        | 2.26       | 201,792         | 3,847        | 1.91       | 196,026         | 3,195        | 1.63       |
| Tax-exempt                                 | -               | -            | -          | 87              | 5            | 5.42       | 210             | 11           | 5.30       |
| Federal funds sold                         | -               | -            | -          | -               | -            | -          | 1,764           | 6            | 0.34       |
| Interest-bearing deposits                  | 14,707          | 286          | 1.94       | 30,819          | 334          | 1.08       | 56,479          | 289          | 0.51       |
| Total earning assets                       | 1,357,755       | 56,021       | 4.13 %     | 1,216,182       | 48,043       | 3.95 %     | 1,079,954       | 40,850       | 3.78 %     |
| Cash and due from banks                    | 17,327          |              |            | 15,896          |              |            | 15,844          |              |            |
| Other assets                               | 71,110          |              |            | 64,854          |              |            | 53,899          |              |            |
| Allowance for credit losses                | (10,278 )       |              |            | (9,181 )        |              |            | (8,555 )        |              |            |
| Total assets                               | \$1,435,914     |              |            | \$1,287,751     |              |            | \$1,141,142     |              |            |
| <b>Interest-bearing liabilities</b>        |                 |              |            |                 |              |            |                 |              |            |
| Demand deposits                            | \$215,600       | 700          | 0.32 %     | \$210,139       | 415          | 0.20 %     | \$194,062       | 234          | 0.12 %     |
| Money market and savings deposits          | 378,344         | 1,024        | 0.27       | 339,971         | 417          | 0.12       | 265,323         | 347          | 0.13       |
| Brokered deposits                          | 14,844          | 315          | 2.12       | -               | -            | -          | -               | -            | -          |
| Certificates of deposit, \$100,000 or more | 98,331          | 654          | 0.67       | 118,723         | 605          | 0.51       | 127,468         | 819          | 0.64       |
| Other time deposits                        | 146,492         | 838          | 0.57       | 152,959         | 805          | 0.53       | 148,671         | 989          | 0.67       |
| Interest-bearing deposits                  | 853,611         | 3,531        | 0.41       | 821,792         | 2,242        | 0.27       | 735,524         | 2,389        | 0.32       |
| Short-term borrowings                      | 77,311          | 1,636        | 2.12       | 4,525           | 31           | 0.68       | 5,753           | 14           | 0.24       |
| Long-term debt                             | 3,616           | 105          | 2.89       | -               | -            | -          | -               | -            | -          |
| Total interest-bearing liabilities         | 934,538         | 5,272        | 0.56 %     | 826,317         | 2,273        | 0.28 %     | 741,277         | 2,403        | 0.32 %     |
| Noninterest-bearing deposits               | 326,677         |              |            | 296,283         |              |            | 241,357         |              |            |
| Other liabilities                          | 5,917           |              |            | 5,410           |              |            | 6,082           |              |            |

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|  |             |        |             |        |                 |
|--|-------------|--------|-------------|--------|-----------------|
| Stockholders' equity                       | 168,782     |        | 159,741     |        | 152,426         |
| Total liabilities and stockholders' equity | \$1,435,914 |        | \$1,287,751 |        | \$1,141,142     |
| Net interest spread                        | \$50,749    | 3.57 % | \$45,770    | 3.67 % | \$38,447 3.46 % |
| Net interest margin                        |             | 3.74 % |             | 3.76 % | 3.56 %          |

(1) All amounts are reported on a tax-equivalent basis computed using the statutory federal income tax rate of 21% for 2018 and 35% for 2017 and 2016, exclusive of the alternative minimum tax rate and nondeductible interest expense. The tax-equivalent adjustment amounts used in the above table to compute yields aggregated \$114 thousand in 2018, \$242 thousand in 2017 and \$198 thousand in 2016.

(2) Average loan balances include nonaccrual loans.

(3) Interest income on loans includes amortized loan fees, net of costs, and all are included in the yield calculations.

On a tax-equivalent basis, total interest income was \$56.0 million for 2018 compared to \$48.0 million for 2017. The increase in interest income for 2018 compared to 2017 was primarily due to the increase in the average balance of loans coupled with a higher yield on taxable investment securities. Interest income on taxable investment securities increased \$442 thousand or 11.5% in 2018 compared to 2017. For 2018 compared to 2017, average loans increased \$169.7 million and the yield earned on loans remained flat at 4.46%. The increased volume of loans coupled with a disciplined effort to maintain and attempt to improve rates on new loan originations resulted in an increase in tax-equivalent interest income of \$7.6 million. Also impacting interest income is the accretion of acquisition accounting adjustments from the branch acquisition in 2017 for loans of \$319 thousand and \$506 thousand for 2018 and 2017, respectively, which is accounted for using a level yield method. Excluding average nonaccrual loans, the yield on loans would have been 4.49% for 2018 and 2017 and 4.59% for 2016, respectively.

On a tax-equivalent basis, total interest income was \$48.0 million for 2017 compared to \$40.9 million for 2016. The increase in interest income for 2017 compared to 2016 was primarily due to the increase in the average balance of loans coupled with a higher yield on taxable investment securities. Interest income on taxable investment securities increased \$652 thousand or 20.4% in 2017 compared to 2016. In addition, interest-bearing deposits increased due to three fed fund rate hikes of 25bps during 2017. For 2017 compared to 2016, average loans increased \$158.0 million and the yield earned on loans decreased 6 basis points. The increased volume of loans and the higher yield on loans purchased in the branch acquisition during the second quarter of 2017, outweighed the decline in the yield on originated loans resulting in an increase in tax-equivalent interest income of \$6.5 million. Also impacting interest income is the accretion of acquisition accounting adjustments from the branch acquisition for loans of \$420 thousand which is accounted for using a level yield method. In addition, the accretion on certificates of deposits acquired from the branch purchase, decreased interest expense by \$86 thousand.

As a percentage of total average earning assets, loans, investment securities, and interest-bearing deposits were 84.9%, 14.0%, and 1.1%, respectively, for 2018 which reflected an increase in higher-yielding earning assets when compared to 2017. The comparable percentages for 2017 were 80.9%, 16.6%, and 2.5%, respectively, and for 2016 were 76.4%, 18.2%, and 5.4%, respectively. When comparing 2018 to 2017, the overall increase in average balances of earning assets produced \$8.0 million more in interest income the result of a stable yield on loans, coupled with higher yields on taxable investment securities and interest-bearing deposits, as seen in the Rate/Volume Variance Analysis below. When comparing 2017 to 2016, the overall increase in average balances of earning assets produced \$7.2 million more in interest income and the decrease in yields on loans were offset by higher yields on taxable investment securities and interest-bearing deposits which produced \$129 thousand more in interest income, as seen in the Rate/Volume Variance Analysis below.

Interest expense was \$5.3 million for 2018 compared to \$2.3 million for 2017. The increase in interest expense for 2018 was primarily due to increases in short and long-term borrowings, rates paid on interest-bearing deposits and the addition of brokered deposits. The average balances on short-term and long-term deposits increased \$72.8 million and \$3.6 million when compared to 2017, with a rate of 2.12% and 2.89%, respectively. Additionally, brokered deposits were added during 2018 resulting in an average balance of \$14.8 million with a rate of 2.12%. Both demand deposits and money market/savings deposits experienced growth with increases in the average balances of \$5.5 million and \$38.4 million, respectively, while the rates paid on these deposits increased 12 and 15 bps, respectively. Also impacting interest expense is the accretion of acquisition accounting adjustments from the branch acquisition in 2017 for CD's of \$275 thousand. The additional funding sources, along with the increase in rates paid on interest-bearing deposits, were necessary to fund loan growth and remain competitive in the market for core deposits.

Interest expense was \$2.3 million for 2017 compared to \$2.4 million for 2016. The decline in interest expense for 2017 was primarily due to lower expense on certificates of deposit and other time deposits. Interest expense on certificates of deposit and other time deposits declined \$398 thousand in 2017 when compared to 2016, the result of a decrease of \$4.5 million in average balances and a decline of 13 basis points on rates paid on these deposits. The decrease in average certificates of deposits and other time deposits reflected the lower rates due to the Bank not increasing these rates in conjunction with a rising interest rate environment. The decrease in average certificates of deposit and other time deposits was mostly transitioned to non-interest bearing and money market and savings

deposits which reflected average increases of \$54.9 million and \$74.6 million, respectively. Also impacting interest expense is the accretion of acquisition accounting adjustments from the branch acquisition in 2017 for CD's of \$86 thousand.

During 2018, higher rates on interest-bearing liabilities produced \$1.2 million more in interest expense and increased volume produced \$1.8 million more in interest expense, as shown in the table below. In 2017, lower rates on interest-bearing liabilities produced \$218 thousand less in interest expense and increased volume produced \$88 thousand more in interest expense.

The following Rate/Volume Variance Analysis identifies the portion of the changes in tax-equivalent net interest income attributable to changes in volume of average balances or to changes in the yield on earning assets and rates paid on interest-bearing liabilities. The rate and volume variance for each category has been allocated on a consistent basis between rate and volume variances, based on a percentage of rate, or volume, variance to the sum of the absolute two variances.

| (Dollars in thousands)                                  | 2018 over (under) 2017 |                |                  | 2017 over (under) 2016 |                |                  |
|---|------------------------|----------------|------------------|------------------------|----------------|------------------|
|   | Total Variance         | Caused By Rate | Caused By Volume | Total Variance         | Caused By Rate | Caused By Volume |
| <b>Interest income from earning assets:</b>             |                        |                |                  |                        |                |                  |
| Loans   | \$7,589                | \$-            | \$7,589          | \$6,508                | \$(504)        | \$7,012          |
| Taxable investment securities                           | 442                    | 679            | (237 )           | 652                    | 560            | 92               |
| Tax-exempt investment securities                        | (5 )                   | -              | (5 )             | (6 )                   | -              | (6 )             |
| Federal funds sold                                      | -                      | -              | -                | (6 )                   | (3 )           | (3 )             |
| Interest-bearing deposits                               | (48 )                  | 181            | (229 )           | 45                     | 76             | (31 )            |
| Total interest income                                   | 7,978                  | 860            | 7,118            | 7,193                  | 129            | 7,064            |
| <b>Interest expense on deposits and borrowed funds:</b> |                        |                |                  |                        |                |                  |
| Interest-bearing demand deposits                        | 285                    | 275            | 10               | 181                    | 163            | 18               |
| Money market and savings deposits                       | 607                    | 566            | 41               | 70                     | (28 )          | 98               |
| Brokered deposits                                       | 315                    | -              | 315              | -                      | -              | -                |
| Time deposits   | 82                     | 173            | (91 )            | (398 )                 | (372)          | (26 )            |
| Short-term borrowings                                   | 1,605                  | 186            | 1,419            | 17                     | 19             | (2 )             |
| Long-term debt  | 105                    | -              | 105              | -                      | -              | -                |
| Total interest expense                                  | 2,999                  | 1,200          | 1,799            | (130 )                 | (218)          | 88               |
| Net interest income                                     | \$4,979                | \$(340 )       | \$5,319          | \$7,323                | \$347          | \$6,976          |

### Noninterest Income

Noninterest income, excluding discontinued operations, increased \$813 thousand, or 9.9%, in 2018 when compared to 2017. The increase in noninterest income in 2018 when compared to 2017 was primarily due to increases in service charges on deposit accounts of \$251 thousand, other fees on bank services of \$542 thousand included in other noninterest income and trust and investment fee income of \$25 thousand.

The following table summarizes our noninterest income from continuing operations for the years ended December 31.

| (Dollars in thousands) | Years Ended |      | Change from Prior Year |         |
|------------------------|-------------|------|------------------------|---------|
|                        | 2018        | 2017 | 2018/ 17<br>Amount     | Percent |



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|   |         |         |       |      |   |
|---|---------|---------|-------|------|---|
| Service charges on deposit accounts               | \$3,879 | \$3,628 | \$251 | 6.9  | % |
| Trust and investment fee income                   | 1,557   | 1,532   | 25    | 1.6  |   |
| Gains on sales and calls of investment securities | -       | 5       | (5    | )    | - |
| Other noninterest income                          | 3,577   | 3,035   | 542   | 17.9 |   |
| Total   | \$9,013 | \$8,200 | \$813 | 9.9  |   |

Noninterest income from discontinued operations, excluding the gain on sale, decreased \$47 thousand, or less than 1% when compared to 2017. The decrease in noninterest income was primarily in an insurance investment which reported a gain of \$191 thousand in 2018 compared to a gain of \$428 thousand in 2017, partially offset by an increase in insurance agency commissions of \$169 thousand. The sale of the insurance subsidiary resulted in a net gain of \$12.7 million for 2018.

## Noninterest Expense

Noninterest expense, excluding discontinued operations, increased \$3.2 million, or 9.5%, in 2018 when compared to 2017. The increase in noninterest expense in 2018 when compared to 2017 was primarily due to the cost of operating four additional branches and a loan production office for an entire year which caused increases in almost all noninterest expense line items, offset by lower fees for data processing due to renegotiating the core processor contract in 2018, a decline in net other real estate owned expenses and lower legal/professional fees compared to the elevated fees in 2017 related to the branch acquisition. The most significant increases absent the operational costs from the additional branches were in salaries and wages due to accrued bonuses, incentive equity programs and a full year of pay increases from 2017 and higher employer benefits due to more full-time employees and increased health care premiums.

The Company had 343 full-time equivalent employees at December 31, 2018, 327 full-time equivalent employees at December 31, 2017 and 287 full-time equivalent employees at December 31, 2016.

The following table summarizes our noninterest expense from continuing operations for the years ended December 31.

|                                       | Years Ended |          | Change from Prior Year |         |   |
|---------------------------------------|-------------|----------|------------------------|---------|---|
|                                       | 2018        | 2017     | 2018/ 17               |         |   |
| (Dollars in thousands)                |             |          | Amount                 | Percent |   |
| Salaries and wages                    | \$16,535    | \$15,080 | \$1,455                | 9.6     | % |
| Employee benefits                     | 4,001       | 3,551    | 450                    | 12.7    |   |
| Occupancy expense                     | 2,622       | 2,335    | 287                    | 12.3    |   |
| Furniture and equipment expense       | 950         | 906      | 44                     | 4.9     |   |
| Data processing                       | 3,331       | 3,561    | (230)                  | (6.5)   | ) |
| Directors' fees                       | 556         | 380      | 176                    | 46.3    |   |
| Amortization of intangible assets     | 866         | 231      | 635                    | 274.9   |   |
| FDIC insurance premium expense        | 771         | 599      | 172                    | 28.7    |   |
| Other real estate owned expenses, net | 353         | 272      | 81                     | 29.8    |   |
| Legal and professional fees           | 1,981       | 2,254    | (273)                  | (12.1)  | ) |
| Other noninterest expenses            | 4,865       | 4,471    | 394                    | 8.8     |   |
| Total                                 | \$36,831    | \$33,640 | \$3,191                | 9.5     |   |

## Income Taxes

The Company reported an income tax expense for continuing operations of \$5.4 million for 2018, compared to an income tax expense of \$8.7 million for 2017. The effective tax rate for continuing operations was 25.4% for 2018 and 48.6% for 2017. The Company's effective tax rate decreased for 2018 from 2017 due to the enactment of the Tax Act

which reduced the U.S. statutory corporate tax rate from 35% to 21%. Please refer to Note 16 of the Notes to Consolidated Financial Statements included in Part II of this Annual Report on Form 10-K for further information.

## **REVIEW OF FINANCIAL CONDITION**

Asset and liability composition, capital resources, asset quality, market risk, interest sensitivity and liquidity are all factors that affect our financial condition. The following sections discuss each of these factors.

### **Assets**

#### **Interest-Bearing Deposits with Other Banks and Federal Funds Sold**

The Company invests excess cash balances (i.e., the excess cash remaining after funding loans and investing in securities with deposits and borrowings) in interest-bearing accounts and federal funds sold offered by our correspondent banks. These liquid investments are maintained at a level that management believes is necessary to meet current liquidity needs. Total interest-bearing deposits with other banks increased \$40.6 million from \$10.3 million at December 31, 2017 to \$50.9 million at December 31, 2018. This significant increase was primarily the result of receiving \$25.2 million from the sale of Avon on December 31, 2018 along with some large payoffs and paydowns of loans at the end of 2018. Average interest-bearing deposits with other banks decreased \$16.1 million in 2018 when compared to 2017. The decrease in 2018 was due to higher period-end and average balances on loans which absorbed the excess liquidity in both average interest-bearing deposits with other banks and average balances on deposits.

#### **Investment Securities**

The investment portfolio is structured to provide us with liquidity and also plays an important role in the overall management of interest rate risk. Investment securities available for sale are stated at estimated fair value based on quoted prices and may be sold as part of the asset/liability management strategy or which may be sold in response to changing interest rates. Net unrealized holding gains and losses on available for sale debt securities are reported net of related income taxes as accumulated other comprehensive income, a separate component of stockholders' equity. Investment securities in the held to maturity category are stated at cost adjusted for amortization of premiums and accretion of discounts. We have the intent and current ability to hold such securities until maturity. At December 31, 2018, 96% of the portfolio was classified as available for sale and 4% as held to maturity, similar to the 97% and 3%, respectively, at December 31, 2017. The percentage of securities designated as available for sale reflects the amount that management believes is needed to support our anticipated growth and liquidity needs. With the exception of municipal securities and equity securities, our general practice is to classify all newly-purchased debt securities as available for sale. On December 15, 2016, the Company bought \$3.0 million in subordinated notes from a local regional bank which it intends to hold to maturity of December 30, 2026. We do not typically invest in derivative securities and held no such investments at December 31, 2018 or December 31, 2017. Total investment securities decreased \$38.7 million from \$206.9 million at December 31, 2017 to \$168.2 million at December 31, 2018. Average investment securities decreased \$12.0 million in 2018, which was used to partially fund loan growth during 2018.



Investment securities available for sale were \$154.4 million at the end of 2018 and \$197.0 million at the end of 2017. There were no purchases of available for sale securities in 2018, while investment activity for 2017 included purchases of \$53.5 million in mortgage-backed securities and \$31.0 million in U.S. Government agencies. At year-end 2018, 21.0% of the available for sale securities in the portfolio were U.S. Government agencies and 79.0% of the securities were mortgage-backed securities, compared to 22.3% and 74.3%, respectively, at year-end 2017. As seen in the table below, 19% of the available-for-sale portfolio will mature in over one through five years and 38% will mature in over ten years based on contractual maturities. The comparable amounts for 2017 were 38% and 57%, respectively. Our investments in mortgage-backed securities are issued or guaranteed by U.S. Government agencies or government-sponsored agencies.

Investment securities held to maturity totaled \$6.0 million at December 31, 2018. The comparable amount was \$6.2 million at December 31, 2017.

The following table sets forth the maturities and weighted average yields of the bond investment portfolio as of December 31, 2018.

| (Dollars in thousands)                         | 1 Year or Less  |               | 1-5 Years       |               | 5-10 Years      |               | Over 10 Years   |               |
|--|-----------------|---------------|-----------------|---------------|-----------------|---------------|-----------------|---------------|
|  | Carrying Amount | Average Yield | Carrying Amount | Average Yield | Carrying Amount | Average Yield | Carrying Amount | Average Yield |
| Available for sale:                            |                 |               |                 |               |                 |               |                 |               |
| U.S. Treasury and Government agencies          | \$5,919         | 1.31 %        | \$26,443        | 1.70 %        | \$-             | -             | \$-             | -             |
| Mortgage-backed                                | -               | -             | 2,278           | 1.49          | 61,292          | 2.19          | 58,500          | 2.36          |
| Total available for sale                       | \$5,919         | 1.31          | \$28,721        | 1.68          | \$61,292        | 2.19          | \$58,500        | 2.36          |
| Held to maturity:                              |                 |               |                 |               |                 |               |                 |               |
| U.S. Government agencies                       | \$-             | - %           | \$-             | -             | \$-             | -             | \$1,642         | 2.06 %        |
| States and political subdivisions <sup>1</sup> | 500             | 4.34          | 400             | 5.00          | 501             | 5.38          | -               | -             |
| Other Debt Securities                          | -               | -             | -               | -             | 3,000           | 6.50          | -               | -             |
| Total held to maturity                         | \$500           | 4.34          | \$400           | 5.00          | \$3,501         | 6.34          | \$1,642         | 2.06          |

<sup>1</sup> Yields have been adjusted to reflect a tax equivalent basis using the statutory federal tax rate of 21%.

## Loans

The loan portfolio is the primary source of our income. Loans totaled \$1.2 billion at December 31, 2018, an increase of \$101.8 million, or 9.3%, from 2017. Most of our loans are secured by real estate and are classified as construction, residential or commercial real estate loans. The increase in loans was comprised of increases in commercial real estate

loans of \$58.5 million, or 12.6%, residential real estate loans of \$30.4 million, or 7.6%, commercial loans, which include financial and agricultural loans, of \$10.2 million, or 10.5%, construction loans of \$1.8 million, or 1.5% and consumer loans of \$867 thousand, or 13.5% at December 31, 2018 compared to December 31, 2017. At December 31, 2018, the loan portfolio was comprised of 10.7% construction, 35.9% residential real estate and 43.8% commercial real estate. That compares to 11.5%, 36.5% and 42.5%, respectively, at December 31, 2017. Commercial and consumer loans were 9.0% and 0.6%, respectively, of the portfolio at December 31, 2018 and 8.9% and 0.6%, respectively, at December 31, 2017. At December 31, 2018, 73.3% of the loan portfolio had fixed interest rates and 26.7% had adjustable interest rates, compared to 74.2% and 25.8%, respectively, at December 31, 2017. See the discussion below under the caption “Asset Quality - Provision for Credit Losses and Risk Management” and Note 5, “Loans and Allowance for Credit Losses”, in the Notes to Consolidated Financial Statements for additional information. At December 31, 2018 and 2017, the Company did not have any loans held for sale. We do not engage in foreign or subprime lending activities.

The table below sets forth trends in the composition of the loan portfolio over the past five years (including net deferred loan fees/costs).

| (Dollars in thousands)  | December 31, |         |             |         |           |         |           |         |           |         |  |  |
|-------------------------|--------------|---------|-------------|---------|-----------|---------|-----------|---------|-----------|---------|--|--|
|                         | 2018         |         | 2017        |         | 2016      |         | 2015      |         | 2014      |         |  |  |
| Construction            | \$127,572    | 10.7 %  | \$125,746   | 11.5 %  | \$84,002  | 9.6 %   | \$85,632  | 10.8 %  | \$69,157  | 9.7 %   |  |  |
| Residential real estate | 429,560      | 35.9    | 399,190     | 36.5    | 325,768   | 37.4    | 307,063   | 38.6    | 273,336   | 38.5    |  |  |
| Commercial real estate  | 523,427      | 43.8    | 464,887     | 42.5    | 382,681   | 43.9    | 330,253   | 41.5    | 305,788   | 43.0    |  |  |
| Commercial              | 107,522      | 9.0     | 97,284      | 8.9     | 72,435    | 8.3     | 64,911    | 8.2     | 52,671    | 7.4     |  |  |
| Consumer                | 7,274        | 0.6     | 6,407       | 0.6     | 6,639     | 0.8     | 7,255     | 0.9     | 9,794     | 1.4     |  |  |
| Total                   | \$1,195,355  | 100.0 % | \$1,093,514 | 100.0 % | \$871,525 | 100.0 % | \$795,114 | 100.0 % | \$710,746 | 100.0 % |  |  |

The table below sets forth the maturities and interest rate sensitivity of the loan portfolio at December 31, 2018.

| (Dollars in thousands)         | Maturing within one year | Maturing after one but within five years | Maturing after five years | Total       |
|--------------------------------|--------------------------|--|---------------------------|-------------|
| Construction                   | \$ 71,103                | \$ 48,277                                | \$ 8,192                  | \$127,572   |
| Residential real estate        | 44,502                   | 70,762                                   | 314,296                   | 429,560     |
| Commercial real estate         | 58,553                   | 240,133                                  | 224,741                   | 523,427     |
| Commercial                     | 16,801                   | 34,936                                   | 55,785                    | 107,522     |
| Consumer                       | 2,237                    | 3,062                                    | 1,975                     | 7,274       |
| Total                          | \$ 193,196               | \$ 397,170                               | \$ 604,989                | \$1,195,355 |
| Rate terms:                    |                          |  |                           |             |
| Fixed-interest rate loans      | \$ 22,850                | \$ 17,200                                | \$ 279,230                | \$319,280   |
| Adjustable-interest rate loans | 170,346                  | 379,970                                  | 325,759                   | 876,075     |
| Total                          | \$ 193,196               | \$ 397,170                               | \$ 604,989                | \$1,195,355 |

## **Liabilities**

### **Deposits**

The Bank uses deposits primarily to fund loans and to purchase investment securities. Total deposits increased from \$1.20 billion at December 31, 2017 to \$1.21 billion at December 31, 2018. The increase is the result of having \$22.1 million in brokered deposits and an increase in noninterest bearing deposits of \$2.1 million, which was partially offset by the \$14.7 million decline in interest-bearing deposits. Average interest-bearing deposits increased \$31.8 million, or

3.9%, in 2018, compared to an increase of \$86.3 million, or 11.7% in 2017. Average certificates of deposit and other time deposits decreased \$26.9 million, or 9.9% in 2018, compared to a decrease of \$4.5 million, or 1.6% in 2017. Average noninterest-bearing deposits increased \$30.4 million, or 10.3%, in 2018, compared to an increase of \$54.9 million, or 22.8% in 2017. Deposits provided funding for approximately 86.9% and 91.9% of average earning assets for 2018 and 2017, respectively.

Average deposits increased for 2017 primarily in noninterest-bearing deposits of \$54.9 million as well as an increase in interest-bearing transaction accounts of \$90.7 million, partially offset by a decline in certificates of deposit and other time deposits of \$4.5 million. The increase was primarily the result of the deposits acquired in the branch purchase which had a balance of \$187.0 million at December 31, 2017.



The following table sets forth the average balances of deposits and the percentage of each category to total average deposits for the years ended December 31.

| (Dollars in thousands)                          | Average Balances |         |             |         |           |         |
|---|------------------|---------|-------------|---------|-----------|---------|
|   | 2018             |         | 2017        |         | 2016      |         |
| Noninterest-bearing demand                      | \$326,677        | 27.7 %  | \$296,283   | 26.5 %  | \$241,357 | 24.7 %  |
| Interest-bearing deposits                       |                  |         |             |         |           |         |
| Demand  | 215,600          | 18.3    | 210,139     | 18.8    | 194,062   | 19.9    |
| Money market and savings                        | 378,344          | 32.0    | 339,971     | 30.4    | 265,323   | 27.2    |
| Brokered deposits                               | 14,844           | 1.3     | -           | -       | -         | -       |
| Certificates of deposit, \$100,000 to \$249,999 | 74,652           | 6.3     | 91,373      | 8.2     | 98,397    | 10.1    |
| Certificates of deposit, \$250,000 or more      | 23,679           | 2.0     | 27,350      | 2.4     | 29,071    | 3.0     |
| Other time deposits                             | 146,492          | 12.4    | 152,959     | 13.7    | 148,671   | 15.2    |
| Total   | \$1,180,288      | 100.0 % | \$1,118,075 | 100.0 % | \$976,881 | 100.0 % |

The following table sets forth the maturity ranges of certificates of deposit with balances of \$250,000 or more as of December 31, 2018.

| (Dollars in thousands)      |          |
|-----------------------------|----------|
| Three months or less        | \$2,216  |
| Over three through 6 months | 2,970    |
| Over 6 through 12 months    | 6,038    |
| Over 12 months              | 15,528   |
| Total                       | \$26,752 |

### Short-Term Borrowings

Short-term borrowings generally consist of securities sold under agreements to repurchase and short-term borrowings from the FHLB. Securities sold under agreements to repurchase are issued in conjunction with cash management services for commercial depositors. We also borrow from the FHLB on a short-term basis and occasionally borrow from correspondent banks under federal fund lines of credit arrangements to meet short-term liquidity needs. At December 31, 2018 and December 31, 2017 short-term borrowings included advances and repurchase agreements.

The average balance of short-term borrowings increased \$72.8 million, or 1,608.5%, in 2018, while the average balance decreased \$1.2 million, or 21.3%, in 2017. Short-term borrowings were used to supplement deposits as a funding source in 2018, whereas borrowings in 2017 were due to significant loan closings and related funding late in December of 2017.

The following table sets forth our position with respect to short-term borrowings.

| (Dollars in thousands)               | 2018     |               | 2017    |               | 2016    |               |
|--------------------------------------|----------|---------------|---------|---------------|---------|---------------|
|                                      | Balance  | Interest Rate | Balance | Interest Rate | Balance | Interest Rate |
| Average outstanding for the year     | \$77,311 | 2.12 %        | \$4,525 | 0.68 %        | \$5,753 | 0.24 %        |
| Outstanding at year end              | 60,812   | 2.62          | 21,734  | 1.36          | 3,203   | 0.25          |
| Maximum outstanding at any month end | 113,418  | -             | 21,734  | -             | 9,877   | -             |

### Long-Term Debt

The Company uses long-term borrowings to meet longer term liquidity needs, specifically to fund loan growth when liquidity from deposit growth is not sufficient. The Company had \$15.0 million outstanding at the end of 2018 and \$0 at the end of 2017. The \$15.0 million in fixed rate long-term borrowings from Federal Home Loan Bank carries an interest rate of 2.82% and will mature in April 2020.

### Capital Resources Management

Total stockholders' equity for the Company was \$183.2 million at December 31, 2018, compared to \$163.7 million at December 31, 2017. The increase in stockholders' equity in 2018 was primarily due to net income during the year and the sale of Avon, which was partially offset by dividends paid to common stockholders. The ratio of period-end equity to total assets was 12.35% for 2018, as compared to 11.75% for 2017. This ratio increased primarily due to the significant increase in stockholders' equity due to the sale of Avon.

We record unrealized holding gains (losses), net of tax, on investment securities available for sale as accumulated other comprehensive income (loss), a separate component of stockholders' equity. At December 31, 2018, the portion of the investment portfolio designated as "available for sale" had net unrealized holding (losses), net of tax, of (\$3.0) million compared to net unrealized holding (losses), net of tax, of \$(1.3) million at December 31, 2017.

In August of 2018 the Economic Growth, Regulatory Relief, and Consumer Protection Act ("EGRRCPA") directed the FRB to revise the Small Bank Holding Company Policy Statement to raise the total consolidated asset limit in the Policy Statement from \$1 billion to \$3 billion. The Company meets the conditions of the revised policy statement and is, therefore, exempt from the consolidated capital requirements at December 31, 2018.

The following table compares the Bank's capital ratios to the minimum regulatory requirements as of December 31, 2018, 2017 and 2016.

| (Dollars in thousands)        | 2018      | 2017      | 2016      | Minimum<br>Regulatory<br>Requirements<br>for 2018 |    |
|-------------------------------|-----------|-----------|-----------|---|----|
| Common equity Tier 1 capital  | \$140,265 | \$126,751 | \$122,543 |   |    |
| Tier 1 capital                | 140,265   | 126,751   | 122,543   |   |    |
| Tier 2 capital                | 10,644    | 10,082    | 9,027     |   |    |
| Total risk-based capital      | 150,909   | 136,833   | 131,570   |   |    |
| Net risk-weighted assets      | 1,185,050 | 1,107,074 | 885,206   |   |    |
| Adjusted average total assets | 1,432,686 | 1,342,484 | 1,126,136 |   |    |
| Risk-based capital ratios:    |           |           |           |   |    |
| Common equity Tier 1          | 11.84     | % 11.45   | % 13.84   | % 6.38  | *% |
| Tier 1                        | 11.84     | 11.45     | 13.84     | 7.88  | *  |
| Total capital                 | 12.73     | 12.36     | 14.86     | 9.88  | *  |
| Tier 1 leverage ratio         | 9.79      | 9.44      | 10.88     | 4.00  |    |

\* includes phased in capital conservation buffer for 2018 of 1.875%

See Note 18 to the Consolidated Financial Statements for further information about the regulatory capital positions of the Company (December 31, 2017) and the Bank (December 31, 2018 and 2017).

In July 2013, U.S. federal banking agencies published the Basel III Capital Rules establishing a new comprehensive capital framework for U.S. banking organizations. The Basel III Capital Rules were effective on January 1, 2015 and were fully phased in on January 1, 2019. On January 1, 2019, the Basel III Capital Rules required the Company to

maintain (i) a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% “capital conservation buffer,” (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer, (iii) a minimum ratio of Total capital to risk-weighted assets of at least 8.0%, plus the capital conservation buffer and (iv) a minimum leverage ratio of 4%, calculated as the ratio of Tier 1 capital to average assets. The Basel III Capital Rules eliminate the inclusion of certain instruments, such as trust preferred securities, from Tier 1 capital. Instruments issued prior to May 19, 2010 will be grandfathered for companies with consolidated assets of \$15 billion or less.

The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the conservation buffer will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall. The implementation of the capital conservation buffer began on January 1, 2016 at 0.625% and will be phased in over a four-year period, increased by that amount on each January 1, until reaching 2.5% on January 1, 2019.

The Basel III Capital Rules also revise the “prompt corrective action” regulations by (i) introducing a CET1 ratio requirement at each level (other than critically undercapitalized), with the required CET1 ratio being 6.5% for well-capitalized status and (ii) increasing the minimum Tier 1 capital ratio requirement for each category (other than critically undercapitalized), with the minimum Tier 1 capital ratio for well-capitalized status being 8% (as compared to the prior 6%). The Basel III Capital Rules do not change the total risk-based capital requirement for any prompt corrective action category.

The Bank currently meets all capital adequacy requirements under the Basel III Capital Rules. For additional information regarding the Basel III Capital Rules, see “Business - Supervision and Regulation - Capital Requirements.”

### **Asset Quality - Provision for Credit Losses and Risk Management**

Originating loans involves a degree of risk that credit losses will occur in varying amounts according to, among other factors, the types of loans being made, the credit-worthiness of the borrowers over the terms of the loans, the quality of the collateral for the loans, if any, as well as general economic conditions. Through the Company's and the Bank's Asset/Liability Management Committees, the Company's Audit Committee and the Company's Board actively reviews critical risk positions, including credit, market, liquidity and operational risk. The Company's goal in managing risk is to reduce earnings volatility, control exposure to unnecessary risk, and ensure appropriate returns for risk assumed. Senior members of management actively manage risk at the product level, supplemented with corporate level oversight through the Asset/Liability Management Committee and internal audit function. The risk management structure is designed to identify risk through a systematic process, enabling timely and appropriate action to avoid and mitigate risk.

Credit risk is mitigated through loan portfolio diversification, limiting exposure to any single industry or customer, collateral protection, and prudent lending policies and underwriting criteria. The following discussion provides information and statistics on the overall quality of the Company's loan portfolio. Note 1 to the Consolidated Financial Statements describes the accounting policies related to nonperforming loans (nonaccrual and delinquent 90 days or more), TDRs and loan charge-offs and describes the methodologies used to develop the allowance for credit losses, including the specific, formula and unallocated components (also discussed below). Management believes the policies governing nonperforming loans, TDRs and charge-offs are consistent with regulatory standards. The amount of the allowance for credit losses and the resulting provision are reviewed monthly by senior members of management and approved quarterly by the Board of Directors.

The allowance is increased by provisions for credit losses charged to expense and recoveries of loans previously charged off. It is decreased by loans charged off in the current period. Loans, or portions thereof, are charged off when considered uncollectible by management. Provisions for credit losses are made to bring the allowance for credit losses within the range of balances that are considered appropriate.

The adequacy of the allowance for credit losses is determined based on management's estimate of the inherent risks associated with lending activities, estimated fair value of collateral, past experience and present indicators such as loan delinquency trends, nonaccrual loans and current market conditions. Management believes the current allowance is adequate to provide for probable losses inherent in our loan portfolio; however, future changes in the composition of the loan portfolio and financial condition of borrowers may result in additions to the allowance. Examination of the portfolio and allowance by various regulatory agencies and consultants engaged by the Company may result in the need for additional provisions based on information available at the time of the examination. The Bank maintains a separate allowance for credit losses, which is only available to absorb losses from their respective loan portfolios. The allowance set by the Bank is subject to regulatory examination and determination as to its adequacy.

The allowance for credit losses is comprised of three parts: (i) the specific allowance; (ii) the historical formula allowance; and (iii) the qualitative formula allowance. The specific allowance is established against impaired loans until charge offs are made. Loans are considered impaired (i.e., nonaccrual loans and accruing TDRs) when it is probable that the Company will not collect all principal and interest payments according to the loan's contractual terms. The qualitative formula allowance is determined based on management's assessment of industry trends and economic factors in the markets in which we operate. The determination of the formula allowance involves a higher risk of uncertainty and considers current risk factors that may not have yet manifested themselves in our historical loss factors.

The specific allowance is used to individually allocate an allowance to loans identified as impaired. An impaired loan may involve deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. If it is determined that there is a loss associated with an impaired loan, a specific allowance is established until a charge off is made. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

The historical formula allowance is used to estimate the loss on internally risk-rated loans, exclusive of those identified as impaired. Loans are grouped by type (construction, residential real estate, commercial real estate, commercial or consumer). Each loan type is assigned allowance factors based on management's estimate of the risk, complexity and size of individual loans within a particular category using average historical charge-offs by segment over the last 16 quarters, except for 1-4 family residential and consumer loans which use the last 8 quarters. Loans that are identified as pass-watch, special mention, substandard and doubtful are considered to have elevated credit risk.

The qualitative formula allowance is used to estimate the loss on loans stemming from more global factors such as delinquencies, loss history, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of management, national and local economic trends, concentrations of credit, the quality of the loan review system and the effect of external factors such as competition and regulatory requirements. These loans are assigned higher allowance factors than favorably rated loans due to management's concerns regarding collectability or management's knowledge of particular elements regarding the borrower.

On May 19, 2017, the Bank purchased three branches which resulted in \$122.9 million in loans being added to the Bank's portfolio. Management evaluated expected cash flows, prepayment speeds and estimated loss factors to measure fair values for the loans acquired. The Bank only acquired loans which were deemed to be performing loans with no signs of credit deterioration. The Bank re-evaluates these acquired loans quarterly noting they remained in performing condition, therefore no allowance has been recorded as of December 31, 2018.

As seen in the table below, the provision for credit losses was \$1.7 million for 2018, \$2.3 million for 2017 and \$1.8 million for 2016. The decrease in the level of provision for credit losses in 2018 was primarily due to lower net charge-offs and improved credit quality when compared to 2017. Net loan charge-offs totaled \$1.1 million in 2018, \$1.2 million in 2017 and \$1.4 million in 2016. Real estate loans were 58%, 44% and 75% of total net loans charged off during 2018, 2017 and 2016, respectively. During 2017, management made a change in methodology necessary due to the increase in loans migrating to the pass-watch risk rating category and due to the amount of unseasoned growth in the originated portfolio experienced in 2016 and 2017. The change in methodology resulted in \$1.4 million in additional provision for credit losses for 2017.

The allowance for credit losses was \$10.3 million, or 0.99% of average outstanding loans at December 31, 2018, compared to an allowance of \$9.8 million, or 0.99% of average outstanding loans at December 31, 2017. The higher allowance at the end of 2018 when compared to the end of 2017 was the result of significant growth in the loan portfolio. At December 31, 2016, the allowance for credit losses was \$8.7 million, or 1.06% of average outstanding loans. The ratio of net charge-offs to average loans was 0.10% in 2018, 0.13% in 2017 and 0.17% in 2016.

The overall credit quality declined in 2018 compared to 2017 primarily due to a delinquent agricultural loan which was placed on nonaccrual late in the fourth quarter of 2018 for approximately \$7.5 million. This relationship required a partial charge-off and no additional loss is anticipated due to collateral values exceeding the outstanding loan and therefore no specific reserve required resulting in no impact on the allowance for credit losses. Despite this problem credit, accruing TDRs declined \$4.7 million when comparing 2018 to 2017 which reflects continued workout efforts on outstanding problem loans many of which were TDRs and nonperforming assets. When comparing 2018 to 2017 loan risk categories, special mention loans decreased \$3.3 million and substandard loans increased \$7.3 million. The decrease in special mention loans were due to continued workout efforts made by the Bank throughout 2018. The increase in substandard loans was primarily impacted by the delinquent agricultural loan previously mentioned. Management will continue to monitor and charge off nonperforming assets as rapidly as possible, and focus on the generation of healthy loan growth and new business development opportunities.

The following table sets forth a summary of our loan loss experience for the years ended December 31.

| (Dollars in thousands)     | 2018    | 2017    | 2016    | 2015     | 2014     |
|----------------------------|---------|---------|---------|----------|----------|
| Balance, beginning of year | \$9,781 | \$8,726 | \$8,316 | \$7,695  | \$10,725 |
| Loans charged off          |         |         |         |          |          |
| Construction               | (397 )  | (54 )   | (615 )  | (1,058 ) | (725 )   |
| Residential real estate    | (406 )  | (445 )  | (580 )  | (283 )   | (2,407 ) |
| Commercial real estate     | (240 )  | (100 )  | (503 )  | (920 )   | (1,648 ) |
| Commercial                 | (441 )  | (946 )  | (497 )  | (396 )   | (2,389 ) |
| Consumer                   | (27 )   | (32 )   | (45 )   | (67 )    | (163 )   |

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|  |             |           |           |           |           |
|--|-------------|-----------|-----------|-----------|-----------|
| Total  | (1,511 )    | (1,577 )  | (2,240 )  | (2,724 )  | (7,332 )  |
| Recoveries   |             |           |           |           |           |
| Construction   | 43          | 30        | 35        | 125       | 149       |
| Residential real estate  | 112         | 40        | 298       | 398       | 376       |
| Commercial real estate   | 29          | 31        | 25        | 379       | 58        |
| Commercial   | 203         | 215       | 428       | 319       | 341       |
| Consumer   | 12          | 25        | 16        | 49        | 28        |
| Total  | 399         | 341       | 802       | 1,270     | 952       |
| Net loans charged off  | (1,112 )    | (1,236 )  | (1,438 )  | (1,454 )  | (6,380 )  |
| Provision for credit losses  | 1,674       | 2,291     | 1,848     | 2,075     | 3,350     |
| Balance, end of year   | \$10,343    | \$9,781   | \$8,726   | \$8,316   | \$7,695   |
| Average loans outstanding  | \$1,153,169 | \$983,484 | \$825,475 | \$748,101 | \$707,381 |
| Percentage of net charge-offs to average loans outstanding during the year | 0.10        | % 0.13    | % 0.17    | % 0.19    | % 0.90    |
| Percentage of allowance for credit losses at year end to average loans     | 0.90        | % 0.99    | % 1.06    | % 1.11    | % 1.09    |
| Percentage of allowance for credit losses at year end to loans             | 0.87        | % 0.89    | % 1.00    | % 1.05    | % 1.08    |



The following table sets forth the allocation of the allowance for credit losses and the percentage of loans in each category to total loans for the years ended December 31.

|                         | 2018     |            | 2017    |            | 2016    |            | 2015    |            | 2014    |            |
|-------------------------|----------|------------|---------|------------|---------|------------|---------|------------|---------|------------|
|                         | Amount   | % of Loans | Amount  | % of Loans | Amount  | % of Loans | Amount  | % of Loans | Amount  | % of Loans |
| (Dollars in thousands)  |          |            |         |            |         |            |         |            |         |            |
| Construction            | \$2,662  | 10.7 %     | \$2,460 | 11.5 %     | \$2,787 | 9.6 %      | \$1,646 | 10.8 %     | \$1,303 | 9.7 %      |
| Residential real estate | 2,353    | 35.9       | 2,284   | 36.5       | 1,953   | 37.4       | 2,181   | 38.6       | 2,834   | 38.5       |
| Commercial real estate  | 3,077    | 43.8       | 2,594   | 42.5       | 2,610   | 43.9       | 2,999   | 41.5       | 2,379   | 43.0       |
| Commercial              | 1,949    | 9.0        | 2,241   | 8.9        | 1,223   | 8.3        | 558     | 8.2        | 448     | 7.4        |
| Consumer                | 302      | 0.6        | 202     | 0.6        | 153     | 0.8        | 156     | 0.9        | 229     | 1.4        |
| Unallocated             | -        | -          | -       | -          | -       | -          | 776     | -          | 502     | -          |
| Total                   | \$10,343 | 100.0 %    | \$9,781 | 100.0 %    | \$8,726 | 100.0 %    | \$8,316 | 100.0 %    | \$7,695 | 100.0 %    |

At December 31, 2018, nonperforming assets were \$18.0 million, an increase of \$10.6 million, or 143.3%, when compared to December 31, 2017. Accruing TDRs were \$8.7 million at December 31, 2018, a decrease of \$4.7 million, or 35.0%, when compared to December 31, 2017. At December 31, 2018, the ratio of nonaccrual loans to total assets was 1.12%, an increase from 0.36% at December 31, 2017. The ratio of accruing TDRs to total assets at December 31, 2018 was 0.58%, improving from 0.96% at December 31, 2017. When comparing December 31, 2018 to December 31, 2017, the negative trend in nonperforming assets, as well as the corresponding asset quality ratios, was due to the significant nonaccrual loan mentioned above. When comparing December 31, 2017 to December 31, 2016, the positive trend in nonperforming assets, as well as the corresponding asset quality ratios, was due to continued work-out efforts and loan charge-offs. The slight increase in accruing TDRs from December 31, 2016 to December 31, 2017, was due to legacy nonaccrual TDRs transferring to accruing TDRs which also represented improving credit quality.

The Company continues to focus on the resolution of its nonperforming and problem loans. The efforts to accomplish this goal include frequently contacting borrowers until the delinquency is cured or until an acceptable payment plan has been agreed upon; obtaining updated appraisals; provisioning for credit losses; charging off loans; transferring loans to other real estate owned; aggressively marketing other real estate owned; and selling loans. The reduction of nonperforming and problem loans is and will continue to be a high priority for the Company.

The following table summarizes our nonperforming assets and accruing TDRs as of December 31.

| (Dollars in thousands)                                   | 2018     | 2017     | 2016     | 2015     | 2014     |
|--|----------|----------|----------|----------|----------|
| Nonperforming assets                                     |          |          |          |          |          |
| Nonaccrual loans   |          |          |          |          |          |
| Construction   | \$2,842  | \$3,003  | \$3,818  | \$7,529  | \$6,046  |
| Residential real estate                                  | 4,099    | 1,482    | 3,903    | 2,259    | 4,035    |
| Commercial real estate                                   | 9,374    | 149      | 1,152    | 2,022    | 3,121    |
| Commercial   | 340      | 337      | -        | 161      | 141      |
| Consumer   | -        | -        | 99       | 122      | 123      |
| Total nonaccrual loans                                   | 16,655   | 4,971    | 8,972    | 12,093   | 13,466   |
| Loans 90 days or more past due and still accruing        |          |          |          |          |          |
| Construction   | -        | -        | -        | -        | -        |
| Residential real estate                                  | 139      | 421      | -        | -        | 83       |
| Commercial real estate                                   | -        | 218      | -        | -        | -        |
| Commercial   | -        | -        | 10       | -        | -        |
| Consumer   | -        | -        | 10       | 7        | 4        |
| Total loans 90 days or more past due and still accruing  | 139      | 639      | 20       | 7        | 87       |
| Other real estate owned                                  | 1,222    | 1,794    | 2,477    | 4,252    | 3,691    |
| Total nonperforming assets                               | \$18,016 | \$7,404  | \$11,469 | \$16,352 | \$17,244 |
| Accruing TDRs  |          |          |          |          |          |
| Construction   | \$51     | \$3,972  | \$4,189  | \$4,069  | \$4,022  |
| Residential real estate                                  | 4,454    | 4,536    | 3,875    | 5,686    | 6,368    |
| Commercial real estate                                   | 4,158    | 4,818    | 4,936    | 5,740    | 6,237    |
| Commercial   | -        | -        | -        | -        | 47       |
| Consumer   | -        | -        | -        | -        | -        |
| Total accruing TDRs                                      | \$8,663  | \$13,326 | \$13,000 | \$15,495 | \$16,674 |
| As a percent of total loans:                             |          |          |          |          |          |
| Nonaccrual loans   | 1.39 %   | 0.45 %   | 1.03 %   | 1.52 %   | 1.89 %   |
| Accruing TDRs  | 0.72 %   | 1.22 %   | 1.49 %   | 1.95 %   | 2.35 %   |
| Nonaccrual loans and accruing TDRs                       | 2.12 %   | 1.67 %   | 2.52 %   | 3.47 %   | 4.24 %   |
| As a percent of total loans and other real estate owned: |          |          |          |          |          |
| Nonperforming assets                                     | 1.51 %   | 0.68 %   | 1.31 %   | 2.05 %   | 2.41 %   |
| Nonperforming assets and accruing TDRs                   | 2.23 %   | 1.89 %   | 2.80 %   | 3.98 %   | 4.75 %   |
| As a percent of total assets:                            |          |          |          |          |          |
| Nonaccrual loans   | 1.12 %   | 0.36 %   | 0.77 %   | 1.07 %   | 1.22 %   |
| Nonperforming assets                                     | 1.21 %   | 0.53 %   | 0.99 %   | 1.44 %   | 1.57 %   |
| Accruing TDRs  | 0.58 %   | 0.96 %   | 1.12 %   | 1.37 %   | 1.52 %   |
| Nonperforming assets and accruing TDRs                   | 1.80 %   | 1.49 %   | 2.11 %   | 2.81 %   | 3.08 %   |



## Market Risk Management and Interest Sensitivity

The Company's net income is largely dependent on its net interest income. Net interest income is susceptible to interest rate risk to the extent that interest-bearing liabilities mature or re-price on a different basis than interest-earning assets. When interest-bearing liabilities mature or re-price more quickly than interest-earning assets in a given period, a significant increase in market rates of interest could adversely affect net interest income. Similarly, when interest-earning assets mature or re-price more quickly than interest-bearing liabilities, falling interest rates could result in a decrease in net interest income. Net interest income is also affected by changes in the portion of interest-earning assets that are funded by interest-bearing liabilities rather than by other sources of funds, such as noninterest-bearing deposits and stockholders' equity.

The Company's interest rate risk management goals are (1) to increase net interest income at a growth rate consistent with the growth rate of total assets, and (2) to minimize fluctuations in net interest margin as a percentage of interest-earning assets. Management attempts to achieve these goals by balancing, within policy limits, the volume of floating-rate liabilities with a similar volume of floating-rate assets; by keeping the average maturity of fixed-rate asset and liability contracts reasonably matched; by maintaining a pool of administered core deposits; and by adjusting pricing rates to market conditions on a continuing basis.

The Company's Board of Directors has established a comprehensive asset liability management policy, which is administered by management's Asset Liability Management Committee ("ALCO"). The policy establishes limits on risk, which are quantitative measures of the percentage change in net interest income (a measure of net interest income at risk) and the fair value of equity capital (a measure of economic value of equity or "EVE" at risk) resulting from a hypothetical change in the yield curve of U.S. Treasury interest rates for maturities from one day to thirty years. The Company evaluates the potential adverse impacts that changing interest rates may have on its short-term earnings, long-term value, and liquidity by outsourcing simulation analysis through the use of computer modeling. The simulation model captures optionality factors such as call features and interest rate caps and floors imbedded in investment and loan portfolio contracts. As with any method of gauging interest rate risk, there are certain shortcomings inherent in the interest rate modeling methodology used by the Company. When interest rates change, actual movements in different categories of interest-earning assets and interest-bearing liabilities, loan prepayments, and withdrawals of time and other deposits, may deviate significantly from assumptions used in the model. As an example, certain money market deposit accounts are assumed to reprice at 50% of the interest rate change in each of the up rate shock scenarios even though this is not a contractual requirement. As a practical matter, management would likely lag the impact of any upward movement in market rates on these accounts as a mechanism to manage the Company's net interest margin. Finally, the methodology does not measure or reflect the impact that higher rates may have on adjustable-rate loan customers' ability to service their debts, or the impact of rate changes on demand for loan, lease, and deposit products.

The Company presents a current base case and several alternative simulations at least once a quarter and reports the analysis to the Board of Directors. In addition, more frequent forecasts could be produced when interest rates are particularly uncertain or when other business conditions so dictate.

The statement of condition is subject to quarterly testing for six alternative interest rate shock possibilities to indicate the inherent interest rate risk. Average interest rates are shocked by +/- 100, 200, 300 and 400 basis points (“bp”), although the Company may elect not to use particular scenarios that it determines are impractical in a current rate environment. It is management’s goal to structure the balance sheet so that net interest earnings at risk over a twelve-month period and the economic value of equity at risk do not exceed policy guidelines at the various interest rate shock levels.

Measures of net interest income at risk produced by simulation analysis are indicators of an institution’s short-term performance in alternative rate environments. These measures are typically based upon a relatively brief period, usually one year. They do not necessarily indicate the long-term prospects or economic value of the institution.

The measures of equity value at risk indicate the ongoing economic value of the Company by considering the effects of changes in interest rates on all of the Company’s cash flows, and by discounting the cash flows to estimate the present value of assets and liabilities. The difference between these discounted values of the assets and liabilities is the economic value of equity (“EVE”), which, in theory, approximates the fair value of the Company’s net assets.

The following tables present the projected change in the Bank’s net portfolio at December 31, 2018 and 2017 that would occur upon an immediate change in interest rates based on independent analysis, but without giving effect to any steps that management might take to counteract that change:

Estimated Changes in Net Interest Income

| Change in Interest Rates: | +400 bp | +300 bp | +200 bp | +100 bp | -100 bp   | -200 bp  |
|---------------------------|---------|---------|---------|---------|-----------|----------|
| Policy Limit              | 40.00 % | 30.00 % | 20.00 % | 10.00 % | (10.00 )% | (20.00)% |
| December 31, 2018         | 2.2 %   | 1.6 %   | 1.2 %   | 0.8 %   | (5.6 )%   | (12.7 )% |
| December 31, 2017         | 3.2 %   | 2.5 %   | 1.8 %   | 0.9 %   | (6.9 )%   | (12.8 )% |

## Estimated Changes in Economic Value of Equity (EVE)

| Change in Interest Rates: | +400 bp | +300 bp | +200 bp | +100 bp | -100 bp   | -200 bp  |
|---------------------------|---------|---------|---------|---------|-----------|----------|
| Policy Limit              | 25.00 % | 20.00 % | 15.00 % | 10.00 % | (20.00 )% | (35.00)% |
| December 31, 2018         | (7.0 )% | (5.0 )% | (2.8 )% | (0.6 )% | (4.7 )%   | (12.6 )% |
| December 31, 2017         | (1.7 )% | (0.7 )% | 0.4 %   | 0.6 %   | (6.1 )%   | (17.1 )% |

As with any method of measuring interest rate risk, certain shortcomings are inherent in the method of analysis presented in the foregoing tables. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as adjustable rate mortgage loans, have features which restrict changes in interest rates on a short-term basis and over the life of the asset. Further, if interest rates change, expected rates of prepayments on loans and early withdrawals from certificates of deposit could deviate significantly from those assumed in calculating the tables.

**Off-Balance Sheet Arrangements**

In the normal course of business, to meet the financing needs of its customers, the Bank is party to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. The Bank's exposure to credit loss in the event of nonperformance by the other party to these financial instruments is represented by the contractual amount of the instruments. The Bank uses the same credit policies in making commitments and conditional obligations as they use for on-balance sheet instruments. The Bank generally requires collateral or other security to support the financial instruments with credit risk. The amount of collateral or other security is determined based on management's credit evaluation of the counterparty. The Bank evaluates each customer's creditworthiness on a case-by-case basis.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Letters of credit and other commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the letters of credit and commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. Further information about these arrangements is provided in Note 22 to the Consolidated Financial Statements.

Management does not believe that any of the foregoing arrangements have or are reasonably likely to have a current or future effect on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

## **Liquidity Management**

Liquidity describes our ability to meet financial obligations that arise during the normal course of business. Liquidity is primarily needed to meet the borrowing and deposit withdrawal requirements of customers and to fund current and planned expenditures. Liquidity is derived through increased customer deposits, maturities in the investment portfolio, loan repayments and income from earning assets. To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets. We have arrangements with correspondent banks whereby we have \$15 million available in federal funds lines of credit and a reverse repurchase agreement available to meet any short-term needs which may not otherwise be funded by the Bank's portfolio of readily marketable investments that can be converted to cash. The Bank is also a member of the FHLB, which provides another source of liquidity, and had credit availability of approximately \$154.7 million from the FHLB as of December 31, 2018.

At December 31, 2018, our loan to deposit ratio was approximately 98.6%, higher than the 90.9% at year-end 2017. Investment securities available for sale totaling \$154.4 million at the end of 2018 were available for the management of liquidity and interest rate risk. The comparable amount was \$197.0 million at December 31, 2017. Cash and cash equivalents were \$67.2 million at December 31, 2018, an increase of \$35.4 million, or 111.3%, compared to the \$31.8 million at year-end 2017, which reflects the cash received from the sale of Avon and loan paydowns in the fourth quarter of 2018. Management is not aware of any demands, commitments, events or uncertainties that will materially affect our ability to maintain liquidity at satisfactory levels.

### **Item 7A. Quantitative and Qualitative Disclosures About Market Risk.**

The information required by this item may be found in Item 7 of Part II of this annual report under the caption "Market Risk Management and Interest Sensitivity", which is incorporated herein by reference.

**Item 8. Financial Statements and Supplementary Data.**

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| <u>Reports of Independent Registered Public Accounting Firm</u>         | <u>45</u> |
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## MANAGEMENT’S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of Shore Bancshares, Inc. (the “Company”) is responsible for the preparation, integrity and fair presentation of the consolidated financial statements included in this annual report. The Company’s consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and, as such, include some amounts that are based on the best estimates and judgments of management.

The Company’s management is responsible for establishing and maintaining adequate internal control over financial reporting. This internal control system is designed to provide reasonable assurance to management and the Board of Directors regarding the reliability of the Company’s financial reporting and the preparation and presentation of financial statements for external reporting purposes in conformity with accounting principles generally accepted in the United States of America, as well as to safeguard assets from unauthorized use or disposition. The system of internal control over financial reporting is evaluated for effectiveness by management and tested for reliability through a program of internal audit with actions taken to correct potential deficiencies as they are identified. Because of inherent limitations in any internal control system, no matter how well designed, misstatement due to error or fraud may occur and not be detected, including the possibility of the circumvention or overriding of controls. Accordingly, even an effective internal control system can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, internal control effectiveness may vary over time.

Management assessed the effectiveness of the Company’s internal control over financial reporting as of December 31, 2018 based upon criteria set forth in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 COSO Framework).

Based on this assessment and on the foregoing criteria, management has concluded that, as of December 31, 2018, the Company’s internal control over financial reporting is effective. Yount, Hyde & Barbour, the Company’s independent registered public accounting firm that audited the financial statements included in this annual report, has issued a report on the Company’s internal control over financial reporting, which appears on the following page.

March 15, 2019

/s/ Lloyd L. Beatty, Jr.  
Lloyd L. Beatty, Jr.  
President and Chief Executive Officer  
(Principal Executive Officer)

/s/ Edward C. Allen  
Edward C. Allen  
Senior Vice President and Chief Financial Officer  
(Principal Financial Officer)



Report of Independent Registered Public Accounting Firm

To the Stockholders and the Board of Directors

Shore Bancshares, Inc.

Easton, Maryland

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Shore Bancshares, Inc. (the Company) as of December 31, 2018 and 2017, 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 consolidated financial statements (collectively, the financial statements). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company's internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013, and our report dated March 15, 2019 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Yount, Hyde & Barbour, P.C.

We have served as the Company's auditor since 2017.

Winchester, Virginia

March 15, 2019

## **Report of Independent Registered Public Accounting Firm**

To the Stockholders and the Board of Directors

Shore Bancshares, Inc.

Easton, Maryland

### **Opinion on the Internal Control Over Financial Reporting**

We have audited Shore Bancshares, Inc.'s (the Company) internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013. In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheets as of December 31, 2018 and 2017, 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 consolidated financial statements of the Company, and our report dated March 15, 2019 expressed an unqualified opinion.

### **Basis for Opinion**

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting in the accompanying *Management's Report on Internal Control Over Financial Reporting*. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

### **Definition and Limitations of Internal Control Over Financial Reporting**

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ Yount, Hyde & Barbour, P.C.

Winchester, Virginia

March 15, 2019

## SHORE BANCSHARES, INC.

## CONSOLIDATED BALANCE SHEETS

December 31,

| (In thousands, except share and per share data)                                       | 2018               | 2017               |
|---|--------------------|--------------------|
| <b>ASSETS</b>   |                    |                    |
| Cash and due from banks   | \$16,294           | \$21,534           |
| Interest-bearing deposits with other banks  | 50,931             | 10,286             |
| Cash and cash equivalents   | 67,225             | 31,820             |
| Investment securities:  |                    |                    |
| Available-for-sale, at fair value   | 154,432            | 196,955            |
| Held to maturity, at amortized cost - fair value of \$6,000 (2018) and \$6,391 (2017) | 6,043              | 6,247              |
| Equity securities, at fair value  | 1,269              | -                  |
| Restricted securities   | 6,476              | 3,735              |
| Loans   | 1,195,355          | 1,093,514          |
| Less: allowance for credit losses   | (10,343 )          | (9,781 )           |
| Loans, net  | 1,185,012          | 1,083,733          |
| Premises and equipment, net   | 22,711             | 22,630             |
| Goodwill  | 17,518             | 17,518             |
| Other intangible assets, net  | 2,857              | 3,723              |
| Other real estate owned, net  | 1,222              | 1,794              |
| Other assets  | 17,678             | 14,464             |
| Assets of discontinued operations   | 633                | 11,241             |
| <b>TOTAL ASSETS</b>   | <b>\$1,483,076</b> | <b>\$1,393,860</b> |
| <b>LIABILITIES</b>  |                    |                    |
| Deposits:   |                    |                    |
| Noninterest-bearing   | \$330,466          | \$328,322          |
| Interest-bearing  | 881,875            | 874,459            |
| Total deposits  | 1,212,341          | 1,202,781          |
| Short-term borrowings   | 60,812             | 21,734             |
| Long-term borrowings  | 15,000             | -                  |
| Other liabilities   | 8,415              | 4,544              |
| Liabilities of discontinued operations  | 3,323              | 1,065              |
| <b>TOTAL LIABILITIES</b>  | <b>1,299,891</b>   | <b>1,230,124</b>   |
| Commitments and contingencies   |                    |                    |
| <b>STOCKHOLDERS' EQUITY</b>   |                    |                    |
|   | 127                | 127                |

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Common stock, par value \$.01 per share; shares authorized - 35,000,000; shares issued and outstanding - 12,749,497 (2018) and 12,688,224 (including 15,913 unvested restricted stock) (2017)

|  |             |             |
|--|-------------|-------------|
| Additional paid in capital                 | 65,434      | 65,256      |
| Retained earnings                          | 120,574     | 99,662      |
| Accumulated other comprehensive loss       | (2,950 )    | (1,309 )    |
| TOTAL STOCKHOLDERS' EQUITY                 | 183,185     | 163,736     |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$1,483,076 | \$1,393,860 |

The notes to the consolidated financial statements are an integral part of these statements.



## SHORE BANCSHARES, INC.

## CONSOLIDATED STATEMENTS OF INCOME

For the Years Ended December 31,

| (In thousands, except per share data)                        | 2018     | 2017     |
|--|----------|----------|
| <b>INTEREST INCOME</b>                                       |          |          |
| Interest and fees on loans                                   | \$51,332 | \$43,617 |
| Interest and dividends on investment securities:             |          |          |
| Taxable  | 4,289    | 4,009    |
| Tax-exempt   | -        | 3        |
| Interest on deposits with other banks                        | 286      | 334      |
| Total interest income  | 55,907   | 47,963   |
| <b>INTEREST EXPENSE</b>                                      |          |          |
| Interest on deposits   | 3,531    | 2,242    |
| Interest on short-term borrowings                            | 1,636    | 31       |
| Interest on long-term borrowings                             | 105      | -        |
| Total interest expense                                       | 5,272    | 2,273    |
| <b>NET INTEREST INCOME</b>                                   | 50,635   | 45,690   |
| Provision for credit losses                                  | 1,674    | 2,291    |
| <b>NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES</b> | 48,961   | 43,399   |
| <b>NONINTEREST INCOME</b>                                    |          |          |
| Service charges on deposit accounts                          | 3,879    | 3,628    |
| Trust and investment fee income                              | 1,557    | 1,532    |
| Gains on sales and calls of investment securities            | -        | 5        |
| Other noninterest income                                     | 3,577    | 3,035    |
| Total noninterest income                                     | 9,013    | 8,200    |
| <b>NONINTEREST EXPENSE</b>                                   |          |          |
| Salaries and wages   | 16,535   | 15,080   |
| Employee benefits  | 4,001    | 3,551    |
| Occupancy expense  | 2,622    | 2,335    |
| Furniture and equipment expense                              | 950      | 906      |
| Data processing  | 3,331    | 3,561    |
| Directors' fees  | 556      | 380      |
| Amortization of other intangible assets                      | 866      | 231      |
| FDIC insurance premium expense                               | 771      | 599      |
| Other real estate owned expenses, net                        | 353      | 272      |
| Legal and professional fees                                  | 1,981    | 2,254    |

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|   |                 |                 |
|---|-----------------|-----------------|
| Other noninterest expenses                              | 4,865           | 4,471           |
| Total noninterest expense                               | 36,831          | 33,640          |
| Income from continuing operations before income taxes   | 21,143          | 17,959          |
| Income tax expense                                      | 5,380           | 8,734           |
| <b>Income from continuing operations</b>                | 15,763          | 9,225           |
| Income from discontinued operations before income taxes | 1,421           | 1,826           |
| Gain on sale of insurance agency                        | 12,736          | -               |
| Income tax expense (benefit)                            | 4,923           | (211 )          |
| <b>Income from discontinued operations</b>              | 9,234           | 2,037           |
| <b>NET INCOME</b>                                       | <b>\$24,997</b> | <b>\$11,262</b> |
| Basic earnings per common share                         |                 |                 |
| Income from continuing operations                       | \$1.24          | \$0.73          |
| Income from discontinued operations                     | 0.72            | 0.16            |
| Net income  | \$1.96          | \$0.89          |
| Diluted earnings per common share                       |                 |                 |
| Income from continuing operations                       | \$1.24          | \$0.73          |
| Income from discontinued operations                     | 0.72            | 0.16            |
| Net income  | \$1.96          | \$0.89          |
| Dividends paid per common share                         | \$0.32          | \$0.22          |

The notes to the consolidated financial statements are an integral part of these statements.

SHORE BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Years Ended December 31,

| (Dollars in thousands)  | 2018     | 2017     |
|---|----------|----------|
| Net income  | \$24,997 | \$11,262 |
| Other comprehensive (loss):   |          |          |
| Investment securities:  |          |          |
| Unrealized holding (losses) on available-for-sale-securities  | (2,308 ) | (150 )   |
| Tax effect  | 639      | 45       |
| Reclassification of (gains) recognized in net income  | -        | (5 )     |
| Tax effect  | -        | 2        |
| Amortization of unrealized loss on securities transferred from available-for-sale to held-to-maturity | 30       | 30       |
| Tax effect  | (8 )     | (12 )    |
| Total other comprehensive (loss)  | (1,647 ) | (90 )    |
| Comprehensive income  | \$23,350 | \$11,172 |

The notes to the consolidated financial statements are an integral part of these statements.

## SHORE BANCSHARES, INC.

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

For the Years Ended December 31, 2018 and 2017

| (In thousands)  | Common<br>Stock | Additional<br>Paid in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income(Loss) | Total<br>Stockholders'<br>Equity |
|---|-----------------|----------------------------------|----------------------|---|----------------------------------|
| Balances, January 1, 2017   | \$ 127          | \$ 64,201                        | \$ 90,964            | \$ (993 )   | \$ 154,299                       |
| Net income  | -               | -                                | 11,262               | -   | 11,262                           |
| Other comprehensive (loss)  | -               | -                                | -                    | (90 )   | (90 )                            |
| Reclass of stranded tax effects from change in tax<br>tax rate                    | -               | -                                | 226                  | (226 )  | -                                |
| Stock-based compensation  | -               | 1,055                            | -                    | -   | 1,055                            |
| Cash dividends declared   | -               | -                                | (2,790 )             | -   | (2,790 )                         |
| Balances, December 31, 2017   | 127             | 65,256                           | 99,662               | (1,309 )  | 163,736                          |
| Cumulative effect adjustment (ASU 2016-01)  | -               | -                                | (6 )                 | 6   | -                                |
| Net income  | -               | -                                | 24,997               | -   | 24,997                           |
| Other comprehensive (loss)  | -               | -                                | -                    | (1,647 )  | (1,647 )                         |
| Stock-based compensation  | -               | 447                              | -                    | -   | 447                              |
| Exercise of options and vesting of restricted stock, net<br>of shares surrendered | -               | (269 )                           | -                    | -   | (269 )                           |
| Cash dividends declared   | -               | -                                | (4,079 )             | -   | (4,079 )                         |
| Balances, December 31, 2018   | \$ 127          | \$ 65,434                        | \$ 120,574           | \$ (2,950 )   | \$ 183,185                       |

The notes to the consolidated financial statements are an integral part of these statements.



## SHORE BANCSHARES, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31,

| (Dollars in thousands)  | 2018      | 2017      |
|---|-----------|-----------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |           |           |
| Net Income  | \$24,997  | \$11,262  |
| Adjustments to reconcile net income to net cash provided by operating activities:           |           |           |
| Net accretion of acquisition accounting estimates   | (679 )    | (506 )    |
| Provision for credit losses   | 1,674     | 2,291     |
| Depreciation and amortization   | 2,297     | 1,649     |
| Net amortization of securities  | 649       | 820       |
| Stock-based compensation expense  | 447       | 1,055     |
| Deferred income tax (benefit) expense   | (1,610 )  | 4,476     |
| (Gains) on sales and calls of securities  | -         | (5 )      |
| Losses on disposals of premises and equipment   | -         | 22        |
| Losses on sales and valuation adjustments on other real estate owned                        | 290       | 207       |
| Net (gain) on disposal of discontinued operations   | (12,736 ) | -         |
| Fair value adjustment on equity securities  | 5         | -         |
| Net changes in:   |           |           |
| Accrued interest receivable   | 164       | (827 )    |
| Other assets  | (3,331 )  | (1,245 )  |
| Accrued interest payables   | 539       | (9 )      |
| Other liabilities   | 5,590     | 331       |
| Net cash provided by operating activities   | 18,296    | 19,521    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |           |           |
| Proceeds from maturities and principal payments of investment securities available for sale | 38,914    | 46,484    |
| Proceeds from sales and calls of investment securities available for sale                   | -         | 4,000     |
| Purchases of investment securities available for sale                                       | -         | (84,499 ) |
| Proceeds from maturities and principal payments of investment securities held to maturity   | 228       | 479       |
| Purchases of equity securities  | (616 )    | -         |
| Net change in loans   | (102,644) | (100,038) |
| Purchases of premises and equipment   | (1,133 )  | (1,259 )  |
| Proceeds from sales of other real estate owned  | 378       | 571       |
| Cash received in branch acquisition (net of cash paid)                                      | -         | 64,045    |
| Net purchases of restricted securities  | (2,741 )  | (2,085 )  |
| Net proceeds from disposal of discontinued operations                                       | 25,159    | -         |
| Net cash used in investing activities   | (42,455 ) | (72,302 ) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>  |           |           |
| Net changes in:   |           |           |
| Noninterest-bearing deposits  | 2,144     | 32,185    |

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|   |            |           |
|---|------------|-----------|
| Interest-bearing deposits   | 7,690      | (39,263 ) |
| Short-term borrowings   | 39,078     | 18,531    |
| Long-term borrowings  | 15,000     | -         |
| Common stock dividends paid   | (4,079 )   | (2,790 )  |
| Repurchase of shares for tax withholding on exercised options and vested restricted stock             | (269 )     | -         |
| Net cash provided by financing activities   | 59,564     | 8,663     |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS  | 35,405     | (44,118 ) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR  | 31,820     | 75,938    |
| CASH AND CASH EQUIVALENTS AT END OF YEAR  | \$67,225   | \$31,820  |
| Supplemental cash flows information:  |            |           |
| Interest paid   | \$5,008    | \$2,368   |
| Income taxes paid   | \$5,365    | \$3,900   |
| Transfers from loans to other real estate owned   | \$96       | \$95      |
| Unrealized (loss) on securities available for sale  | \$(2,308 ) | \$(155 )  |
| Amortization of unrealized loss on securities transferred from available for sale to held to maturity | \$30       | \$30      |
| Branch purchase:  |            |           |
| Tangible assets acquired (net of cash received)   | \$-        | \$129,188 |
| Identifiable intangible assets acquired   | \$-        | \$3,954   |
| Liabilities assumed   | \$-        | \$212,463 |

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

**SHORE BANCSHARES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

For the Years Ended December 31, 2018 and 2017

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

The consolidated financial statements include the accounts of Shore Bancshares, Inc. and its subsidiaries (collectively referred to in these Notes as the “Company”), with all significant intercompany transactions eliminated. The investments in subsidiaries are recorded on the Company’s books (Parent only) on the basis of its equity in the net assets of the subsidiaries. The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America (“GAAP”). For purposes of comparability, certain reclassifications have been made to amounts previously reported to conform with the current period presentation.

**Nature of Operations**

The Company engages in the banking business through Shore United Bank, a Maryland commercial bank with trust powers. The Company’s primary source of revenue is interest earned on commercial, real estate and consumer loans made to customers located in Maryland, Delaware and the Eastern Shore of Virginia. The Company engages in the trust services business through the trust department at Shore United Bank under the trade name Wye Financial & Trust.

**Use of Estimates**

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements, and affect the reported amounts of revenues earned and expenses incurred during the reporting period. Actual results could differ from those estimates. Estimates that could change significantly relate to the determination of the allowance for loan losses, the determination of fair values related to impaired loans and other real estate owned, fair values initially assigned in an acquisition and subsequent evaluations of the related goodwill and intangible assets for impairment, and the valuation of deferred tax assets.

**Investment Securities Available for Sale**

Investment securities available for sale are stated at estimated fair value based on quoted prices. They represent those debt securities which management may sell as part of its asset/liability management strategy or which may be sold in



response to changing interest rates, changes in prepayment risk or other similar factors. Realized gains and losses are recorded in noninterest income and are determined on a trade date basis using the specific identification method. Premiums and discounts are amortized or accreted into interest income using the interest method over the expected lives of the individual securities. Interest on investment securities is recognized in interest income on an accrual basis. Net unrealized holding gains and losses on these securities are reported as accumulated other comprehensive income, a separate component of stockholders' equity, net of related income taxes. Declines in the fair value of individual available-for-sale securities below their cost that are other than temporary result in write-downs of the individual securities to their fair value and are reflected in earnings as realized losses. Factors affecting the determination of whether an other-than-temporary impairment has occurred include a downgrade of the security by a rating agency, a significant deterioration in the financial condition of the issuer, or a determination that management has the intent to sell the security or will be required to sell the security before recovery of its amortized cost.

### **Investment Securities Held to Maturity**

Investment securities held to maturity are stated at cost adjusted for amortization of premiums and accretion of discounts. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. The Company intends and has the ability to hold such securities until maturity. Declines in the fair value of individual held-to-maturity securities below their cost that are other than temporary result in write-downs of the individual securities to their fair value. Factors affecting the determination of whether an other-than-temporary impairment has occurred include a downgrade of the security by a rating agency, a significant deterioration in the financial condition of the issuer, or a determination that management has the intent to sell the security or will be required to sell the security before recovery of its amortized cost.

### **Equity Securities**

Equity securities with readily determinable fair values are carried at fair value, with changes in fair value reported in net income. Any equity securities without readily determinable fair values are carried at cost, minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for identical or similar investments. Restricted equity securities are carried at cost and are periodically evaluated for impairment based on the ultimate recovery of par value. The entirety of any impairment on equity securities is recognized in earnings.

## Loans

Loans are stated at their principal amount outstanding net of any deferred fees, premiums, discounts and costs and net of any partial charge-offs. Interest income on loans is accrued at the contractual rate based on the principal amount outstanding. Fees charged and costs capitalized for originating loans are being amortized substantially on the interest method over the term of the loan. A loan is placed on nonaccrual (i.e., interest income is no longer accrued) when it is specifically determined to be impaired or when principal or interest is delinquent for 90 days or more, unless the loan is well secured and in the process of collection. Any unpaid interest previously accrued on those loans is reversed from income. Interest payments received on nonaccrual loans are applied as a reduction of the loan principal balance unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

A loan is considered impaired if it is probable that the Company will not collect all principal and interest payments according to the loan's contractual terms. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. The impairment of a loan is measured at the present value of expected future cash flows using the loan's effective interest rate, or at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Generally, the Company measures impairment on such loans by reference to the fair value of the collateral. Once the amount of impairment has been determined, the uncollectible portion is charged off. Income on impaired loans is recognized on a cash basis, and payments are first applied against the principal balance outstanding (i.e., placing impaired loans on nonaccrual status). Generally, interest income is not recognized on impaired loans unless the likelihood of further loss is remote. The allowance for credit losses may include specific reserves related to impaired loans. Specific reserves remain until charge offs are made. Impaired loans do not include groups of smaller balance homogeneous loans such as residential mortgage and consumer installment loans that are evaluated collectively for impairment. Reserves for probable credit losses related to these loans are based on historical loss ratios and an analysis of qualitative factors and are included in the formula portion of the allowance for credit losses. See additional discussion below under the section, "Allowance for Credit Losses".

A loan is considered a troubled debt restructuring ("TDR") if a borrower is experiencing financial difficulties and a creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses. Loans are identified to be restructured when signs of impairment arise such as borrower interest rate reduction request, slowness to pay, or when an inability to repay becomes evident. The terms being offered are evaluated to determine if they are more liberal than those that would be indicated by policy or industry standards for similar, untroubled credits. In those situations where the terms or the interest rates are considered to be more favorable than industry standards or the current underwriting guidelines of the Company's banking subsidiary, the loan is classified as a TDR. All loans designated as TDRs are considered impaired loans and may be on either accrual or nonaccrual status. In instances where the loan has been placed on nonaccrual status, six consecutive months of timely payments are required prior to returning the loan to accrual status.

All loans classified as TDRs which are restructured and accrue interest under revised terms require a full and comprehensive review of the borrower's financial condition, capacity for repayment, realistic assessment of collateral values, and the assessment of risk entered into any workout agreement. Current financial information on the borrower, guarantor, and underlying collateral is analyzed to determine if it supports the ultimate collection of principal and interest. For commercial loans, the cash flows are analyzed, both for the underlying project and globally. For consumer loans, updated salary, credit history and cash flow information is obtained. Current market conditions are also considered. Following a full analysis, the determination of the appropriate loan structure is made. The Company does not participate in any specific government or Company sponsored loan modification programs. All TDR loan agreements are contracts negotiated with each of the borrowers.

### **Allowance for Credit Losses**

The allowance for credit losses is maintained at a level believed adequate by management to absorb losses inherent in the loan portfolio as of the balance sheet date and is based on the size and current risk characteristics of the loan portfolio, an assessment of individual problem loans and actual loss experience, current economic events in specific industries and geographical areas, including unemployment levels, and other pertinent factors, including regulatory guidance and general economic conditions and other observable data. Determination of the allowance is inherently subjective as it requires significant estimates, including the amounts and timing of expected future cash flows or collateral value of impaired loans, estimated losses on pools of homogeneous loans that are based on historical loss experience, and consideration of current economic trends, all of which may be susceptible to significant change. Loans, or portions thereof, that are considered uncollectible are charged off against the allowance, while recoveries of amounts previously charged off are credited to the allowance. The criteria for charge offs are addressed in the Bank's Collection and Workout Policy. Per the policy, the recognition of the loss of loans or portions of loans will occur when there is a reasonable probability of loss. When the amount of loss can be readily calculated, the loss will be recognized. In cases where a probable charge-off amount cannot be calculated, specific reserves will be maintained. A provision for credit losses is charged to income based on management's periodic evaluation of the factors previously mentioned, as well as other pertinent factors. Evaluations are conducted at least quarterly and more often if deemed necessary.

The allowance for credit losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on two basic principles of accounting: (i) Topic 450, “*Contingencies*”, of the Financial Accounting Standards Board’s Accounting Standards Codification (“ASC”), which requires that losses be accrued when they are probable of occurring and estimable; and (ii) ASC Topic 310, “*Receivables*”, which requires that losses be accrued based on the differences between the loan balance and the value of collateral, present value of future cash flows or values that are observable in the secondary market. Management uses many factors to estimate the inherent loss that may be present in our loan portfolio, including economic conditions and trends, the value and adequacy of collateral, the volume and mix of the loan portfolio, and our internal loan processes. Actual losses could differ significantly from management’s estimates. In addition, GAAP itself may change from one previously acceptable method to another. Although the economics of transactions would be the same, the timing of events that would impact the transactions could change.

Three basic components comprise our allowance for credit losses: (i) the specific allowance; (ii) the historical formula allowance; and (iii) the qualitative formula allowance. Each component is determined based on estimates that can and do change when the actual events occur. The specific allowance is established against impaired loans (i.e., nonaccrual loans and troubled debt restructurings (“TDRs”)) based on our assessment of the losses that may be associated with the individual loans. The specific allowance remains until charge-offs are made. An impaired loan may show deficiencies in the borrower’s overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral.

The historical formula allowance is used to estimate the loss on internally risk-rated loans, exclusive of those identified as impaired. Loans are grouped by type (construction, residential real estate, commercial real estate, commercial or consumer). Each loan type is assigned allowance factors based on management’s estimate of the risk, complexity and size of individual loans within a particular category using average historical charge-offs by segment over the last 16 quarters. Loans identified as pass-watch, special mention, substandard, and doubtful are considered to have elevated credit risk. These loans are assigned higher allowance factors than favorably rated loans due to management’s concerns regarding collectability or management’s knowledge of particular elements regarding the borrower. The qualitative formula allowance captures losses that have impacted the portfolio but have yet to be recognized in either the specific or historical formula allowance. A pass-watch loan has adequate risk and may include loans which may have been upgraded from another higher risk category. A special mention loan has potential weaknesses that could result in a future loss to the Company if the weaknesses are realized. A substandard loan has certain deficiencies that could result in a future loss to the Company if these deficiencies are not corrected. A doubtful loan has enough risk that there is a high probability that the Company will sustain a loss.

Management has significant discretion in making the adjustments inherent in the determination of the provision and allowance for credit losses, including in connection with the valuation of collateral, the estimation of a borrower’s prospects of repayment, and the establishment of the allowance factors in the formula allowance and unallocated allowance components of the allowance. The establishment of allowance factors is a continuing exercise, based on management’s ongoing assessment of the totality of all factors, including, but not limited to, delinquencies, loss history, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of management, national and local economic trends, concentrations of credit, the quality of the loan review system and the effect of external factors such as competition and regulatory requirements, and their impact on the portfolio.

Allowance factors may change from period to period, resulting in an increase or decrease in the amount of the provision or allowance, based on the same volume and classification of loans. Changes in allowance factors will have a direct impact on the amount of the provision, and a corresponding effect on net income. Errors in management's perception and assessment of these factors and their impact on the portfolio could result in the allowance not being adequate to cover losses in the portfolio, and may result in additional provisions or charge-offs.

### **Premises and Equipment**

Land is carried at cost and premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are calculated using the straight-line method over the estimated useful lives of the assets. Useful lives range from three to 10 years for furniture, fixtures and equipment; three to five years for computer hardware and data handling equipment; and 10 to 40 years for buildings and building improvements. Land improvements are amortized over a period of 15 years and leasehold improvements are amortized over the term of the respective lease. Sale-leaseback transactions are considered normal leasebacks and any realized gains are deferred and amortized to other income on a straight-line basis over the initial lease term. Maintenance and repairs are charged to expense as incurred, while improvements which extend the useful life of an asset are capitalized and depreciated over the estimated remaining life of the asset.

Long-lived assets are evaluated periodically for impairment when events or changes in circumstances indicate the carrying amount may not be recoverable. Impairment exists when the expected undiscounted future cash flows of a long-lived asset are less than its carrying value. In that event, the Company recognizes a loss for the difference between the carrying amount and the estimated fair value of the asset.

### **Goodwill and Other Intangible Assets**

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Other intangible assets represent purchased assets that also lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset or liability. Goodwill and other intangible assets are initially required to be recorded at fair value. Determining fair value is subjective, requiring the use of estimates, assumptions and management judgment.

Goodwill and other intangible assets with indefinite lives are tested at least annually for impairment, usually during the fourth quarter, or on an interim basis if circumstances dictate. Intangible assets that have finite lives are amortized over their estimated useful lives and also are subject to impairment testing.

Impairment testing requires that the fair value of each of the Company's reporting units be compared to the carrying amount of its net assets, including goodwill. If the fair value of a reporting unit is less than book value, an expense may be required to write down the related goodwill or purchased intangibles to record an impairment loss. As of December 31, 2018, the Company had one reporting unit and operating segment (i.e., the Bank).

During the fourth quarter of 2018 and 2017, goodwill and other intangible assets were subjected to the annual assessment for impairment. As a result of the assessment, it was determined that it was not more likely than not that the fair values of the Company's reporting units were less than their carrying amounts so no impairment was recorded.

### **Other Real Estate Owned**

Other real estate owned represents assets acquired in satisfaction of loans either by foreclosure or deeds taken in lieu of foreclosure. Properties acquired are recorded at fair value less estimated selling costs at the time of acquisition, establishing a new cost basis. Thereafter, costs incurred to operate or carry the properties as well as reductions in value as determined by periodic appraisals are charged to operating expense. Gains and losses resulting from the final disposition of the properties are included in noninterest income.

### **Borrowings**

Short-term and long-term borrowings are comprised primarily of FHLB borrowings. A portion of the Company's short-term borrowings are repurchase agreements. The repurchase agreements are securities sold to the Company's customers, at the customers' request, under a continuing "roll-over" contract that matures in one business day. The underlying securities sold are U.S. Government agency securities, which are segregated from the Company's other investment securities by its safekeeping agents.

### **Income Taxes**

The Company and its subsidiaries file a consolidated federal income tax return. The Company accounts for income taxes using the liability method in accordance with required accounting guidance. Under this method, deferred tax assets and liabilities are determined by applying the applicable federal and state income tax rates to cumulative temporary differences. These temporary differences represent differences between financial statement carrying amounts and the corresponding tax bases of certain assets and liabilities. Deferred taxes result from such temporary differences.

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date. A valuation allowance, if needed, reduces deferred tax assets to the expected amount most likely to be realized. Realization of deferred tax assets is dependent on the generation of a sufficient level of future taxable income, recoverable taxes paid in prior years and tax planning strategies. The Company evaluates all positive and negative evidence before determining if a valuation allowance is deemed necessary regarding the realization of deferred tax assets.

The Company recognizes accrued interest and penalties as a component of tax expense. Significant judgement is required in evaluating the Company's uncertain tax positions and determining its provision for income taxes.

The U.S. Tax Cuts and Jobs Act ("Tax Act") was enacted on December 22, 2017 and introduced significant changes to U.S. income tax law. Effective in 2018, the Tax Act reduces the U.S. statutory tax rate from 35% to 21% and creates new taxes on certain foreign-sourced earnings and certain related-party payments, which are referred to as the global intangible low-tax income tax and base erosion tax, respectively. In addition, in 2017 the Company was subject to a one-time transition tax on accumulated foreign subsidiary earnings not previously subject to U.S. income tax. Accounting for the income tax effects of the Tax Act required significant judgements and estimates in the interpretation and calculations of the provisions of the Tax Act.

The provision for income taxes includes the impact of reserve provisions and changes in the reserves that are considered appropriate as well as the related net interest and penalties. In addition, the Company is subject to the continuous examination of its income tax returns by the IRS and other tax authorities which may assert assessments against the Company. The Company regularly assesses the likelihood of adverse outcomes resulting from these examinations and assessments to determine the adequacy of its provision for income taxes. The Company remains subject to examination for tax years ending on or after December 31, 2015.

### **Basic and Diluted Earnings Per Common Share**

Basic earnings per share is calculated by dividing net income available to common stockholders by the weighted-average number of common shares outstanding and does not include the effect of any potentially dilutive common stock equivalents. Included in this calculation due to dividend participation rights are restricted stock awards which have been granted. Diluted earnings per share is calculated by dividing net income by the weighted-average number of shares outstanding, adjusted for the effect of any potentially dilutive common stock equivalents.

### **Transfers of Financial Assets**

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (i) the assets have been isolated from the Company, (ii) 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 (iii) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

### **Cash and Cash Equivalents**

Cash and due from banks, interest-bearing deposits with other banks and federal funds sold are considered “cash and cash equivalents” for financial reporting purposes. Certain interest-bearing deposits with banks may exceed balances that are recoverable under Federal Deposit Insurance Corporation (“FDIC”) insurance. Balances in excess of FDIC insurance at December 31, 2018 were approximately \$2.0 million.

### **Share-Based Compensation**

The Company may grant share-based compensation to employees and non-employee directors in the form of restricted stock, restricted stock units and stock options. The fair value of restricted stock is determined based on the closing price of the Parent’s common stock on the date of grant. The Company recognizes compensation expense related to restricted stock on a straight-line basis over the vesting period for service-based awards, plus additional recognition of costs associated with accelerated vesting based on the projected attainment of Company performance measures. Restricted stock units (“RSUs”) are payable solely in cash which are accounted for as other liabilities in the consolidated statements of condition. The fair value of RSUs is initially valued based on the closing price of the Parent’s common stock on the date of grant and is amortized in the statement of income over the vesting period. The RSUs are subsequently remeasured in the same manner described above at the end of each reporting period until settlement. The fair value of stock options is estimated at the date of grant using the Black-Scholes option pricing model and related assumptions. The Company uses historical data to predict option exercise and employee termination behavior. Expected volatilities are based on the historical volatility of the Parent’s common stock. The expected term of options granted is derived from actual historical exercise activity and represents the period of time that options granted are expected to be outstanding. The risk-free rate is derived from the U.S. Treasury yield curve in effect at the time of grant based on the expected life of the option. The dividend yield is equal to the dividend yield of the Parent’s common stock at the time of grant. The timing of the expense related to stock options reflects estimated forfeitures, adjusted for actual forfeiture experience. Expense related to stock options is recorded in the statements of income as a component of salaries and benefits for employees and as a component of other noninterest expense for non-employee directors, with a corresponding increase to capital surplus in shareholders’ equity. As the expense related to stock options is recognized, a deferred tax asset is established that represents an estimate of future income tax deductions from the release of restrictions or the exercise of stock options. See Note 13 for a further discussion.

### **Fair Value**



The Company measures certain financial assets and liabilities at fair value, with the measurements made on a recurring or nonrecurring basis. Significant financial instruments measured at fair value on a recurring basis are investment securities available for sale. Impaired loans and other real estate owned are significant financial instruments measured at fair value on a nonrecurring basis. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. In determining fair value, the Company is required to maximize the use of observable inputs and minimize the use of unobservable inputs, reducing subjectivity. See Note 20 for a further discussion of fair value.

### **Advertising Costs**

Advertising costs are generally expensed as incurred. The Company incurred advertising costs for continuing operations of approximately \$509 thousand for the years ended December 31, 2018 and 2017, respectively.

### **Comprehensive Income**

Changes in unrealized gains and losses on available-for-sale securities is the only component of accumulated other comprehensive income for the Company. There were no reclassifications from accumulated other comprehensive income (loss) in 2018. In 2017, the amount reclassified out of other accumulated comprehensive income (loss) was a gain on call of available-for-sale securities of \$5 thousand. The related tax effect for the reclassification was \$2 thousand.

In February 2018, the FASB issued ASU 2018-02, *“Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income (‘AOCI’)*. The Company early adopted this new standard in 2017. ASU 2018-01 requires reclassification from AOCI to retained earnings for stranded tax effects resulting from the impact of newly enacted federal corporate income tax rate on items included in AOCI. The amount of this reclassification in 2017 was \$226 thousand.

### **Discontinued Operations**

During the year ended December 31, 2018, the Company completed the sale of its Insurance Agency, Avon Dixon (“Avon”), which represented the Company’s Insurance segment. In accordance with ASC 205-20, the Company determined that the sale of Avon and the discontinued operation of the Company’s Premium Finance Company, Mubell Finance, LLC (“Mubell”), assets and liabilities that will be sold or settled separately within one year met the criteria to be classified as a discontinued operation and the related operating results and financial condition have been presented as discontinued operations on the consolidated financial statements. See Note 2 for additional information. Unless otherwise indicated, information included in these notes to the consolidated financial statements is presented on a consolidated operations basis, which includes results from both continuing and discontinued operations, for all periods presented.

## Segment Reporting

In connection with the sale of Avon and the discontinued operation of Mubell, which represented the Company's Insurance segment, the Company reassessed its reportable operating segments. Based on this internal evaluation, the Company determined that its previously disclosed reportable segment, Insurance products and services, is no longer applicable. Accordingly, to better reflect how the Company is now managed and how information is reviewed by the chief operating decision maker, the Company's chief executive officer, the Company determined that all services offered by the Company relate to Commercial Banking. As a result, the Company's only reportable segment is Commercial Banking.

## Recent Accounting Standards

ASU No. 2016-02 - In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The FASB made subsequent amendments to Topic 842 in July 2018 through ASU 2018-10 ("Codification Improvements to Topic 842, Leases.") and ASU 2018-11 ("Leases (Topic 842): Targeted Improvements.") Among these amendments is the provision in ASU 2018-11 that provides entities with an additional (and optional) transition method to adopt the new leases standard. Under this new transition method, an entity initially applies the new leases standard at the adoption date and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. Consequently, an entity's reporting for the comparative periods presented in the financial statements in which it adopts the new leases standard will continue to be in accordance with current GAAP (Topic 840, Leases). The Company is currently assessing the impact that ASU No. 2016-02 will have on its consolidated financial statements. The Company has put together an inventory of all leases and accumulated the lease data necessary to apply the amended guidance. The effect of adopting this standard on January 1, 2019 was an approximate \$3.8 million increase in assets and liabilities on our balance sheet.

ASU No. 2016-13 - In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full

amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments in this ASU are effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. The Company believes this ASU will have a significant impact on our consolidated financial statements and the method in which we calculate our credit losses, primarily on loans and held to maturity securities. At this time, the Company has established a project management team which meets periodically to discuss and assign roles and responsibilities, key tasks to complete, and a general time line to be followed for implementation. The team has been working with an advisory consultant and has purchased a vendor model for implementation. Historical data has been collected and uploaded to the new model and the team is in the process of finalizing the methodologies that will be utilized. The team expects to be running a parallel simulation to its current incurred loss impairment model in the first quarter of 2019. The Company is continuing to evaluate the extent of the potential impact of this standard and continues to keep current on evolving interpretations and industry practices via webcasts, publications, conferences, and peer bank meetings.

ASU No. 2017-04 – In January 2017, the FASB issued ASU No. 2017-04, “Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment”. The amendments in this ASU simplify how an entity is required to test goodwill for impairment by eliminating Step 2 from the goodwill impairment test. Step 2 measures a goodwill impairment loss by comparing the implied fair value of a reporting unit’s goodwill with the carrying amount of that goodwill. Instead, under the amendments in this ASU, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. Public business entities that are U.S. Securities and Exchange Commission (SEC) filers should adopt the amendments in this ASU for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The guidance is not expected to have a significant impact on the Company’s financial positions, results of operations or disclosures.

ASU No. 2017-08 – In March 2017, the FASB issued ASU 2017-08, “Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities.” The amendments in this ASU shorten the amortization period for certain callable debt securities purchased at a premium. Upon adoption of the standard, premiums on these qualifying callable debt securities will be amortized to the earliest call date. Discounts on purchased debt securities will continue to be accreted to maturity. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Upon transition, entities should apply the guidance on a modified retrospective basis, with a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption and provide the disclosures required for a change in accounting principle. The adoption of ASU No. 2017-08 is not expected to have a material impact on the Company’s consolidated financial statements.

ASU No. 2018-02 – In February 2018, the FASB issued ASU 2018-02, “Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income.” The amendments provide financial statement preparers with an option to reclassify stranded tax effects within accumulated other comprehensive income to retained earnings in each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act (or portion thereof) is recorded. The amendments are effective for all organizations for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. Organizations should apply the proposed amendments either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act is recognized. The Company elected to reclassify the stranded income tax effects from the Tax Cuts and Jobs Act in the financial statements for the period ending December 31, 2017. The amount of this reclassification in 2017 was \$226 thousand.

ASU No. 2018-07 - In June 2018, the FASB issued ASU 2018-07, “Compensation- Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting.” The amendments expand the scope of Topic 718 to include share-based payments issued to non-employees for goods or services, which were previously excluded. The amendments will align the accounting for share-based payments to nonemployees and employees more similarly. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. The adoption of ASU No. 2018-07 is not expected to have a material impact on the Company’s consolidated financial statements.

ASU No. 2018-13 – In August 2018, the FASB issued ASU 2018-13, “Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement.” The amendments modify the disclosure requirements in Topic 820 to add disclosures regarding changes in unrealized gains and losses, the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements and the narrative description of measurement uncertainty. Certain disclosure requirements in Topic 820 are also removed or modified. The amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. Certain of the amendments are to be applied prospectively while others are to be applied retrospectively. Early adoption is permitted. As ASU No. 2018-13 only revises disclosure requirements, it will not have a material impact on the Company’s Consolidated Financial Statements.

## **NOTE 2. SALE OF SUBSIDIARY**

### **Avon-Dixon Agency Sale**

On December 31, 2018, the Company completed the sale of specific assets and activities related to its Insurance Agency, Avon Dixon, LLC (“Avon”) to Alera Group Agency, LLC (“Alera”). Also, on this date the Company discontinued its operations of its Premium Finance Company, Mubell Finance, LLC (“Mubell”). Together, these

companies are referred to as the “Insurance Subsidiaries”. The Insurance subsidiaries represented the Company's insurance products and services segment, the activities of which related to originating, servicing and underwriting retail insurance policies. Assets sold to Alera included various intangible assets and a 40% interest in a segregated portfolio of Eastern Re. Ltd., a specialty reinsurance company. The Mubell Company, along with certain other assets and liabilities that will be sold or settled separately within one year, is classified as discontinued operations in the accompanying Consolidated Balance Sheets and Consolidated Statements of Income.

The specific assets acquired by Alera include, among other things, the insurance origination offices, insurance expirations, workforce and system procedures, trade names and goodwill. Alera has assumed certain obligations and liabilities of the Company under the acquired leases, and with respect to the employment of transferred employees. The Company received \$25.2 million cash payment, upon the closing of the transaction.

The following table summarizes the calculation of the net gain on disposal of discontinued operations:

| (\$ in thousands)                               | Year Ended December 31, 2018 |
|---|------------------------------|
| Proceeds from the transaction                   | \$ 29,276                    |
| Compensation expense related to the transaction | 2,588                        |
| Broker fees                                     | 935                          |
| Other transaction costs                         | 594                          |
| Net cash proceeds                               | 25,159                       |
| Net assets sold                                 | (12,423 )                    |
| Net gain on disposal                            | \$ 12,736                    |

The following tables present the financial information of discontinued operations as of the dates and for the periods indicated:

### Balance Sheets of Discontinued Operations

| (\$ in thousands)                 | December 31, |          |
|-----------------------------------|--------------|----------|
|                                   | 2018         | 2017     |
| <b>ASSETS</b>                     |              |          |
| Premises and equipment, net       | \$-          | \$424    |
| Goodwill                          | 8            | 10,100   |
| Other assets                      | 625          | 717      |
| Assets of discontinued operations | \$633        | \$11,241 |

### LIABILITIES

|  |         |         |
|--|---------|---------|
| Accrued expenses and other liabilities | \$3,323 | \$1,065 |
| Liabilities of discontinued operations | \$3,323 | \$1,065 |

### Statements of Income of Discontinued Operations

| (\$ in thousands)                                       | For the Years<br>Ended<br>December 31, |         |
|---|--|---------|
|   | 2018                                   | 2017    |
| Noninterest income                                      |  |         |
| Net gain on disposal                                    | \$12,736                               | \$-     |
| Insurance agency commissions                            | 9,006                                  | 8,837   |
| All other income  | 335                                    | 551     |
| Total noninterest income                                | 22,077                                 | 9,388   |
| Noninterest expense                                     |  |         |
| Salaries and wages                                      | 5,156                                  | 4,931   |
| Employee benefits                                       | 1,173                                  | 1,094   |
| Occupancy expense                                       | 428                                    | 361     |
| Amortization of intangible assets                       | 47                                     | 84      |
| Legal and professional fees                             | 77                                     | 54      |
| Other noninterest expenses                              | 1,039                                  | 1,038   |
| Total noninterest expense                               | 7,920                                  | 7,562   |
| Income from discontinued operations before income taxes | 14,157                                 | 1,826   |
| Income tax expense (benefit)                            | 4,923                                  | (211 )  |
| Income from discontinued operations                     | \$9,234                                | \$2,037 |



**Statements of Cash Flows of Discontinued Operations**

| (\$ in thousands)   | For the Years Ended<br>December 31, |          |
|---|-------------------------------------|----------|
|   | 2018                                | 2017     |
| Cash flows from operating activities:   |                                     |          |
| Net income  | \$ 9,234                            | \$ 2,037 |
| Adjustments to reconcile net income to cash provided by operating activities: |                                     |          |
| Depreciation and amortization   | 107                                 | 142      |
| Stock-based compensation expense  | -                                   | 12       |
| Net decrease (increase) in other assets                                       | (1,919 )                            | (1,844 ) |
| Net increase in other liabilities   | 2,258                               | 404      |
| Losses on disposal of premises and equipment                                  | -                                   | 2        |
| Net (gain) on sale of insurance agency  | (12,736 )                           | -        |
| Net cash (used in) operating activities                                       | (3,056 )                            | 753      |
| Cash flows from investing activities:   |                                     |          |
| Purchases of premises and equipment   | 3                                   | (345 )   |
| Proceeds from sale of insurance agency  | 25,159                              | -        |
| Net cash provided by (used in) investing activities                           | 25,162                              | (345 )   |
| Net cash provided by discontinued operations                                  | \$ 22,106                           | \$ 408   |

**NOTE 3. BUSINESS COMBINATION**



***Northwest Bank Branch Acquisition***

On May 19, 2017, the Bank purchased three branches from Northwest Bank (“NWBI”) located in Arbutus, Elkridge, and Owings Mills, Maryland. Pursuant to the transaction, the Bank acquired \$122.9 million in loans and \$212.5 million in deposits, as well as the branch premises and equipment. In connection with its purchase of the branches from NWBI, the Bank received a cash payment from NWBI of \$64.0 million, which was net of a premium paid on deposits of \$17.2 million. In addition to the premium paid on deposits, other costs associated with the acquisition totaled \$977 thousand. This acquisition provides the Bank with the opportunity to enhance its footprint in Maryland by extending its branch network across the Eastern Shore to the greater Baltimore area communities of Elkridge, Owings Mills and Arbutus.

The Company has accounted for the branch purchases under the acquisition method of accounting in accordance with FASB ASC topic 805, “Business Combinations,” whereby the acquired assets and liabilities were recorded by the Bank at their estimated fair values as of their acquisition date.

The acquired assets and assumed liabilities of the NWBI branches were measured at estimated fair value. Management made significant estimates and exercised significant judgement in accounting for the acquisition of the NWBI branches. Management evaluated expected cash flows, prepayment speeds and estimated loss factors to measure fair values for loans. Deposits were valued based upon interest rates, original and remaining terms and maturities, as well as current rates for similar funds in the same markets. Premises were based on recent appraised values, whereas equipment was acquired based on the remaining book value from NWBI, which approximated fair value. Management engaged independent outside experts to provide the fair value estimates. Subsequent to the purchase, Management made a measurement period adjustment for deferred taxes related to intangible assets of \$291 thousand.

The following table provides the purchase price as of the acquisition date of May 19, 2017, the identifiable assets acquired and liabilities assumed at their estimated fair values, and the resulting goodwill of \$15.0 million recorded from the acquisition:

|  |            |
|--|------------|
| Purchase Price Consideration:                    |            |
| Cash consideration                               | \$ 17,186  |
| Total purchase price for NWBI branch acquisition | \$ 17,186  |
| Assets acquired at fair value:                   |            |
| Cash and cash equivalents                        | \$ 81,231  |
| Loans  | 122,862    |
| Premises and equipment, net                      | 6,326      |
| Core deposit intangible                          | 3,954      |
| Deferred tax assets                              | 291        |
| Total fair value of assets acquired              | \$ 214,664 |
| Liabilities assumed at fair value:               |            |
| Deposits   | \$ 212,456 |
| Other liabilities                                | 7          |
| Total fair value of liabilities assumed          | \$ 212,463 |
| Net assets acquired at fair value:               | \$ 2,201   |
| Amount of goodwill resulting from acquisition    | \$ 14,985  |

The total amount of goodwill arising from this transaction of \$15.0 million is expected to be deductible for tax purposes, pursuant to section 197 of the Internal Revenue Code.

### ***Acquired loans***

The following table outlines the contractually required payments receivable, cash flows we expect to receive, and the accretable yield and carrying value for all NWBI loans as of the acquisition date.

| Contractually<br>Required<br>Payments<br>Receivable | Cash Flows<br>Expected To Be<br>Collected | Accretable FMV<br>Adjustments | Carrying Value<br>of Loans<br>Receivable |
|---|---|-------------------------------|--|
|---|---|-------------------------------|--|

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|                           |            |         |       |            |
|---------------------------|------------|---------|-------|------------|
| Performing loans acquired | \$ 125,131 | 125,131 | 2,269 | \$ 122,862 |
|---------------------------|------------|---------|-------|------------|

The Company recorded all loans acquired at the estimated fair value on the purchase date with no carryover of the related allowance for loan losses. The Company only acquired loans which were deemed to be performing loans with no signs of credit deterioration.

The Company determined the net discounted value of cash flows on approximately 864 performing loans totaling \$125.1 million. The valuation took into consideration the loans' underlying characteristics, including account types, remaining terms, annual interest rates, interest types, past delinquencies, timing of principal and interest payments, current market rates, loan-to-value ratios, loss exposures, and remaining balances. These performing loans were segregated into pools based on loan and payment type. The effect of this fair valuation process was a net accretable discount adjustment of \$2.3 million at acquisition.

**NOTE 4. INVESTMENT SECURITIES**

The following table provides information on the amortized cost and estimated fair values of investment securities.

| (Dollars in thousands)         | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|--------------------------------|----------------|------------------------|-------------------------|----------------------|
| Available-for-sale securities: |                |                        |                         |                      |
| December 31, 2018              |                |                        |                         |                      |
| U.S. Government agencies       | \$ 34,285      | \$ 2                   | \$ 651                  | \$ 33,636            |
| Mortgage-backed                | 124,162        | 115                    | 3,481                   | 120,796              |
| Total                          | 158,447        | 117                    | 4,132                   | 154,432              |
| December 31, 2017              |                |                        |                         |                      |
| U.S. Government agencies       | \$ 45,806      | \$ 23                  | \$ 497                  | \$ 45,332            |
| Mortgage-backed                | 152,198        | 157                    | 1,390                   | 150,965              |
| Equity                         | 666            | -                      | 8                       | 658                  |
| Total                          | \$ 198,670     | \$ 180                 | \$ 1,895                | \$ 196,955           |

The Company adopted ASU 2016-01 effective January 1, 2018 and equity securities with an aggregate fair value of \$1.3 million at December 31, 2018 are presented separately on the balance sheet. A cumulative effect adjustment of \$(6) thousand was recorded to retained earnings from accumulated other comprehensive loss upon adoption. The fair value adjustment recorded through earnings totaled \$(5) thousand for the year ended December 31, 2018.

## Held-to-maturity securities:

December 31, 2018

|                                   |         |      |      |         |
|-----------------------------------|---------|------|------|---------|
| U.S. Government agencies          | \$1,642 | \$-  | \$25 | \$1,617 |
| States and political subdivisions | 1,401   | 14   | -    | 1,415   |
| Other Debt Securities (1)         | 3,000   | -    | 32   | 2,968   |
| Total                             | \$6,043 | \$14 | \$57 | \$6,000 |

December 31, 2017

|                                   |         |       |     |         |
|-----------------------------------|---------|-------|-----|---------|
| U.S. Government agencies          | \$1,844 | \$21  | \$- | \$1,865 |
| States and political subdivisions | 1,403   | 47    | -   | 1,450   |
| Other Debt Securities (1)         | 3,000   | 76    | -   | 3,076   |
| Total                             | \$6,247 | \$144 | \$- | \$6,391 |

(1) On December 15, 2016, the Company bought \$3.0 million in ten-year subordinated notes from a local regional bank with a fixed rate of 6.5% for the first five years and a floating rate for the remaining five years. After the first

five years the note is callable by the issuer. The Company intends to hold to maturity of December 30, 2026 if the notes are not called.

The following table provides information about gross unrealized losses and fair value by length of time that the individual securities have been in a continuous unrealized loss position at December 31, 2018.

| (Dollars in thousands)         | Less than<br>12 Months |                      | More than<br>12 Months |                      | Total         |                      |
|--------------------------------|------------------------|----------------------|------------------------|----------------------|---------------|----------------------|
|                                | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| December 31, 2018              |                        |                      |                        |                      |               |                      |
| Available-for-sale securities: |                        |                      |                        |                      |               |                      |
| U.S. Government agencies       | \$ 1,079               | \$ 10                | \$ 32,362              | \$ 641               | \$ 33,441     | \$ 651               |
| Mortgage-backed                | 13,981                 | 261                  | 99,904                 | 3,220                | 113,885       | 3,481                |
| Total                          | \$ 15,060              | \$ 271               | \$ 132,266             | \$ 3,861             | \$ 147,326    | \$ 4,132             |
| Held-to-maturity securities:   |                        |                      |                        |                      |               |                      |
| U.S. Government agencies       | -                      | -                    | 1,617                  | 25                   | 1,617         | 25                   |
| Other debt securities          | 2,968                  | 32                   | -                      | -                    | 2,968         | 32                   |
| Total                          | \$ 2,968               | \$ 32                | \$ 1,617               | \$ 25                | \$ 4,585      | \$ 57                |

| (Dollars in thousands)         | Less than<br>12 Months |                      | More than<br>12 Months |                      | Total         |                      |
|--------------------------------|------------------------|----------------------|------------------------|----------------------|---------------|----------------------|
|                                | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| December 31, 2017              |                        |                      |                        |                      |               |                      |
| Available-for-sale securities: |                        |                      |                        |                      |               |                      |
| U.S. Government agencies       | \$ 37,550              | \$ 453               | \$ 5,956               | \$ 44                | \$ 43,506     | \$ 497               |
| Mortgage-backed                | 96,622                 | 700                  | 28,215                 | 690                  | 124,837       | 1,390                |
| Equity securities              | -                      | -                    | 666                    | 8                    | 666           | 8                    |
| Total                          | \$ 134,172             | \$ 1,153             | \$ 34,837              | \$ 742               | \$ 169,009    | \$ 1,895             |

All of the securities with unrealized losses in the portfolio have modest duration risk, low credit risk, and minimal losses when compared to total amortized cost. The unrealized losses on debt securities that exist are the result of market changes in interest rates since original purchase and are not related to credit concerns. Because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost bases, which may be at maturity for debt securities, the Company considers the unrealized losses to be temporary. There were eighty-two available-for-sale securities in an unrealized loss position at December 31, 2018, of which 74 were mortgage-backed and 8 were U.S. Government agencies. Two held-to-maturity securities were in an unrealized loss position at December 31, 2018, one mortgage-backed and one other debt security.

The following table provides information on the amortized cost and estimated fair values of investment securities by maturity date at December 31, 2018.

| (Dollars in thousands)                 | Available for sale<br>Amortized |            | Held to maturity<br>Amortized |            |
|--|---------------------------------|------------|-------------------------------|------------|
|  | Cost                            | Fair Value | Cost                          | Fair Value |
| Due in one year or less                | \$5,992                         | \$5,919    | \$500                         | \$505      |
| Due after one year through five years  | 29,332                          | 28,721     | 400                           | 406        |
| Due after five years through ten years | 62,893                          | 61,292     | 3,501                         | 3,472      |
| Due after ten years                    | 60,230                          | 58,500     | 1,642                         | 1,617      |
| Total                                  | \$158,447                       | \$154,432  | \$6,043                       | \$6,000    |

The maturity dates for debt securities are determined using contractual maturity dates.

The following table sets forth the amortized cost and estimated fair values of securities which have been pledged as collateral for obligations to federal, state and local government agencies, and other purposes as required or permitted by law, or sold under agreements to repurchase. All pledged securities are in the available-for-sale investment portfolio.

| (Dollars in thousands)                | December 31,<br>2018 |               | December 31, 2017 |               |
|---------------------------------------|----------------------|---------------|-------------------|---------------|
|                                       | Amortized            |               | Amortized         |               |
|                                       | Cost                 | Fair<br>Value | Cost              | Fair<br>Value |
| Pledged available-for-sale securities | \$99,729             | \$97,170      | \$131,035         | \$129,880     |

There were no obligations of states or political subdivisions with carrying values, as to any issuer, exceeding 10% of stockholders' equity at December 31, 2018 or 2017.

Proceeds from sales of investment securities were \$0 for the years ended December 31, 2018 and 2017, respectively. Gross gains from sales and calls of investment securities were \$0 and \$5 thousand for the years ended December 31, 2018 and 2017, respectively. There were no gross losses in 2018 and 2017.

#### NOTE 5. LOANS AND ALLOWANCE FOR CREDIT LOSSES

The Company makes residential mortgage, commercial and consumer loans to customers primarily in Baltimore City, Baltimore County, Howard County, Kent County, Queen Anne's County, Caroline County, Talbot County and Dorchester County in Maryland, Kent County, Delaware and in Accomack County, Virginia. The following table provides information about the principal classes of the loan portfolio at December 31, 2018 and 2017.

| (Dollars in thousands)      | 2018        | 2017        |
|-----------------------------|-------------|-------------|
| Construction                | \$127,572   | \$125,746   |
| Residential real estate     | 429,560     | 399,190     |
| Commercial real estate      | 523,427     | 464,887     |
| Commercial                  | 107,522     | 97,284      |
| Consumer                    | 7,274       | 6,407       |
| Total loans                 | 1,195,355   | 1,093,514   |
| Allowance for credit losses | (10,343 )   | (9,781 )    |
| Total loans, net            | \$1,185,012 | \$1,083,733 |



In the normal course of banking business, loans are made to officers and directors and their affiliated interests. These loans are made on substantially the same terms and conditions as those prevailing at the time for comparable transactions with persons who are not related to the Company and are not considered to involve more than the normal risk of collectability. As of December 31, 2018 and 2017, such loans outstanding, both direct and indirect (including guarantees), to directors, their associates and policy-making officers, totaled approximately \$13.2 million and \$13.8 million, respectively. During 2018 and 2017, loan additions were approximately \$1.9 million and \$2.3 million, respectively, and loan repayments were approximately \$2.6 million and \$1.8 million, respectively. Net loan origination costs, included in balances above, totaled \$789 thousand and \$609 thousand as of December 31, 2018 and 2017, respectively. At December 31, 2018 and December 31, 2017 included in total loans were \$92.8 million and \$108.1 million in loans, respectively, acquired as part of the NWBI branch acquisition. These balances are presented net of the related discount which totaled \$1.4 million at December 31, 2018 and \$1.8 million at December 31, 2017.

In the normal course of banking business, risks related to specific loan categories are as follows:

**Construction loans** – Construction loans are offered primarily to builders and individuals to finance the construction of single family dwellings. In addition, the Bank periodically finances the construction of commercial projects. Credit risk factors include the borrower's ability to successfully complete the construction on time and within budget, changing market conditions which could affect the value and marketability of projects, changes in the borrower's ability or willingness to repay the loan and potentially rising interest rates which can impact both the borrower's ability to repay and the collateral value.

**Residential real estate** – Residential real estate loans are typically made to consumers and are secured by residential real estate. Credit risk arises from the borrower's continuing financial stability, which can be adversely impacted by job loss, divorce, illness, or personal bankruptcy, among other factors. Also impacting credit risk would be a shortfall in the value of the residential real estate in relation to the outstanding loan balance in the event of a default or subsequent liquidation of the real estate collateral.

**Commercial real estate** – Commercial real estate loans consist of both loans secured by owner occupied properties and non-owner occupied properties where an established banking relationship exists and involves investment properties for warehouse, retail, and office space with a history of occupancy and cash flow. These loans are subject to adverse changes in the local economy and commercial real estate markets.

Credit risk associated with owner occupied properties arises from the borrower's financial stability and the ability of the borrower and the business to repay the loan. Non-owner occupied properties carry the risk of a tenant's deteriorating credit strength, lease expirations in soft markets and sustained vacancies which can adversely impact cash flow.

Commercial – Commercial loans are secured or unsecured loans for business purposes. Loans are typically secured by accounts receivable, inventory, equipment and/or other assets of the business. Credit risk arises from the successful operation of the business which may be affected by competition, rising interest rates, regulatory changes and adverse conditions in the local and regional economy.

Consumer – Consumer loans include home equity loans and lines, installment loans and personal lines of credit. Credit risk is similar to residential real estate loans above as it is subject to the borrower's continuing financial stability and the value of the collateral securing the loan.

The following tables include impairment information relating to loans and the allowance for credit losses as of December 31, 2018 and 2017.

| (Dollars in thousands)                      | Construction | Residential<br>real estate | Commercial<br>real estate | Commercial | Consumer | Total        |
|---|--------------|----------------------------|---------------------------|------------|----------|--------------|
| December 31, 2018                           |              |                            |                           |            |          |              |
| Loans individually evaluated for impairment | \$ 2,893     | \$ 8,553                   | \$ 13,532                 | \$ 340     | \$ -     | \$ 25,318    |
| Loans collectively evaluated for impairment | 124,679      | 421,007                    | 509,895                   | 107,182    | 7,274    | 1,170,037    |
| Total loans                                 | \$ 127,572   | \$ 429,560                 | \$ 523,427                | \$ 107,522 | \$ 7,274 | \$ 1,195,355 |
| Allowance for credit losses allocated to:   |              |                            |                           |            |          |              |
| Loans individually evaluated for impairment | \$ 320       | \$ 301                     | \$ 104                    | \$ 36      | \$ -     | \$ 761       |
| Loans collectively evaluated for impairment | 2,342        | 2,052                      | 2,973                     | 1,913      | 302      | 9,582        |
| Total loans                                 | \$ 2,662     | \$ 2,353                   | \$ 3,077                  | \$ 1,949   | \$ 302   | \$ 10,343    |
| (Dollars in thousands)                      |              |                            |                           |            |          |              |
| December 31, 2017                           |              |                            |                           |            |          |              |
|   | \$ 6,975     | \$ 6,018                   | \$ 4,967                  | \$ 337     | \$ -     | \$ 18,297    |

|   |            |            |            |           |          |              |
|---|------------|------------|------------|-----------|----------|--------------|
| Loans individually evaluated for impairment |            |            |            |           |          |              |
| Loans collectively evaluated for impairment | 118,771    | 393,172    | 459,920    | 96,947    | 6,407    | 1,075,217    |
| Total loans                                 | \$ 125,746 | \$ 399,190 | \$ 464,887 | \$ 97,284 | \$ 6,407 | \$ 1,093,514 |

Allowance for credit losses allocated to:

|   |          |          |          |          |        |          |
|---|----------|----------|----------|----------|--------|----------|
| Loans individually evaluated for impairment | \$ 500   | \$ 239   | \$ 33    | \$ 33    | \$ -   | \$ 805   |
| Loans collectively evaluated for impairment | 1,960    | 2,045    | 2,561    | 2,208    | 202    | 8,976    |
| Total loans                                 | \$ 2,460 | \$ 2,284 | \$ 2,594 | \$ 2,241 | \$ 202 | \$ 9,781 |

The allowance for loan losses was 0.87% of total loans at December 31, 2018, compared to 0.89% at December 31, 2017.

The following tables provide information on impaired loans and any related allowance by loan class as of December 31, 2018 and 2017. The difference between the unpaid principal balance and the recorded investment is the amount of partial charge-offs that have been taken and interest paid on nonaccrual loans that has been applied to principal.

| (Dollars in thousands)     | Unpaid principal balance | Recorded investment with no allowance | Recorded investment with an allowance | Related allowance | Average recorded investment | Interest income recognized |
|----------------------------|--------------------------|---------------------------------------|---------------------------------------|-------------------|-----------------------------|----------------------------|
| December 31, 2018          |                          |                                       |                                       |                   |                             |                            |
| Impaired nonaccrual loans: |                          |                                       |                                       |                   |                             |                            |
| Construction               | \$3,219                  | \$ 127                                | \$ 2,715                              | \$ 320            | \$ 2,988                    | \$ -                       |
| Residential real estate    | 4,281                    | 2,605                                 | 1,494                                 | 118               | 1,884                       | -                          |
| Commercial real estate     | 10,029                   | 9,307                                 | 67                                    | 67                | 2,149                       | -                          |
| Commercial                 | 445                      | -                                     | 340                                   | 36                | 336                         | -                          |
| Consumer                   | -                        | -                                     | -                                     | -                 | -                           | -                          |
| Total                      | \$17,974                 | \$ 12,039                             | \$ 4,616                              | \$ 541            | \$ 7,357                    | \$ -                       |
| Impaired accruing TDRs:    |                          |                                       |                                       |                   |                             |                            |
| Construction               | \$51                     | \$ 51                                 | \$ -                                  | \$ -              | \$ 866                      | \$ 35                      |
| Residential real estate    | 4,454                    | 1,440                                 | 3,014                                 | 183               | 4,606                       | 125                        |
| Commercial real estate     | 4,158                    | 1,286                                 | 2,872                                 | 37                | 4,416                       | 149                        |
| Commercial                 | -                        | -                                     | -                                     | -                 | -                           | -                          |
| Consumer                   | -                        | -                                     | -                                     | -                 | -                           | -                          |
| Total                      | \$8,663                  | \$ 2,777                              | \$ 5,886                              | \$ 220            | \$ 9,888                    | \$ 309                     |
| Total impaired loans:      |                          |                                       |                                       |                   |                             |                            |
| Construction               | \$3,270                  | \$ 178                                | \$ 2,715                              | \$ 320            | \$ 3,854                    | \$ 35                      |
| Residential real estate    | 8,735                    | 4,045                                 | 4,508                                 | 301               | 6,490                       | 125                        |
| Commercial real estate     | 14,187                   | 10,593                                | 2,939                                 | 104               | 6,565                       | 149                        |
| Commercial                 | 445                      | -                                     | 340                                   | 36                | 336                         | -                          |
| Consumer                   | -                        | -                                     | -                                     | -                 | -                           | -                          |
| Total                      | \$26,637                 | \$ 14,816                             | \$ 10,502                             | \$ 761            | \$ 17,245                   | \$ 309                     |

| (Dollars in thousands)     | Unpaid principal balance | Recorded investment with no allowance | Recorded investment with an allowance | Related allowance | Average recorded investment | Interest income recognized |
|----------------------------|--------------------------|---------------------------------------|---------------------------------------|-------------------|-----------------------------|----------------------------|
| December 31, 2017          |                          |                                       |                                       |                   |                             |                            |
| Impaired nonaccrual loans: |                          |                                       |                                       |                   |                             |                            |
| Construction               | \$ 3,100                 | \$ 182                                | \$ 2,821                              | \$ 459            | \$ 3,181                    | \$ -                       |
| Residential real estate    | 1,620                    | 1,482                                 | -                                     | -                 | 3,191                       | -                          |
| Commercial real estate     | 795                      | 149                                   | -                                     | -                 | 542                         | -                          |
| Commercial                 | 425                      | -                                     | 337                                   | 33                | 200                         | -                          |
| Consumer                   | -                        | -                                     | -                                     | -                 | 41                          | -                          |
| Total                      | \$ 5,940                 | \$ 1,813                              | \$ 3,158                              | \$ 492            | \$ 7,155                    | \$ -                       |
| Impaired accruing TDRs:    |                          |                                       |                                       |                   |                             |                            |
| Construction               | \$ 3,972                 | \$ 3,038                              | \$ 934                                | \$ 41             | \$ 4,067                    | \$ 101                     |
| Residential real estate    | 4,536                    | 2,042                                 | 2,494                                 | 239               | 3,831                       | 161                        |
| Commercial real estate     | 4,818                    | 4,084                                 | 734                                   | 33                | 4,860                       | 185                        |
| Commercial                 | -                        | -                                     | -                                     | -                 | -                           | -                          |
| Consumer                   | -                        | -                                     | -                                     | -                 | -                           | -                          |
| Total                      | \$ 13,326                | \$ 9,164                              | \$ 4,162                              | \$ 313            | \$ 12,758                   | \$ 447                     |
| Total impaired loans:      |                          |                                       |                                       |                   |                             |                            |
| Construction               | \$ 7,072                 | \$ 3,220                              | \$ 3,755                              | \$ 500            | \$ 7,248                    | \$ 101                     |
| Residential real estate    | 6,156                    | 3,524                                 | 2,494                                 | 239               | 7,022                       | 161                        |
| Commercial real estate     | 5,613                    | 4,233                                 | 734                                   | 33                | 5,402                       | 185                        |
| Commercial                 | 425                      | -                                     | 337                                   | 33                | 200                         | -                          |
| Consumer                   | -                        | -                                     | -                                     | -                 | 41                          | -                          |
| Total                      | \$ 19,266                | \$ 10,977                             | \$ 7,320                              | \$ 805            | \$ 19,913                   | \$ 447                     |

The following tables provide a roll-forward for troubled debt restructurings as of December 31, 2018 and December 31, 2017.

|                                      | 1/1/2018    |          |                          |             |                                      | 12/31/2018   |             |                   |  |
|--------------------------------------|-------------|----------|--------------------------|-------------|--------------------------------------|--------------|-------------|-------------------|--|
| (Dollars in thousands)               | TDR Balance | New TDRs | Disbursements (Payments) | Charge offs | Reclassifications/ Transfer In/(Out) | Payoffs      | TDR Balance | Related Allowance |  |
| For the year ended December 31, 2018 |             |          |                          |             |                                      |              |             |                   |  |
| Accruing TDRs                        |             |          |                          |             |                                      |              |             |                   |  |
| Construction                         | \$ 3,972    | \$ -     | \$ (229)                 | ) \$ (397)  | ) \$ (695)                           | ) \$ (2,600) | \$ 51       | \$ -              |  |
| Residential real estate              | 4,536       | -        | (85)                     | ) -         | 541                                  | (538)        | 4,454       | 183               |  |
| Commercial real estate               | 4,818       | -        | (441)                    | ) -         | -                                    | (219)        | 4,158       | 37                |  |
| Commercial                           | -           | -        | -                        | -           | -                                    | -            | -           | -                 |  |
| Consumer                             | -           | -        | -                        | -           | -                                    | -            | -           | -                 |  |
| Total                                | \$ 13,326   | \$ -     | \$ (755)                 | ) \$ (397)  | ) \$ (154)                           | ) \$ (3,357) | \$ 8,663    | \$ 220            |  |
| Nonaccrual TDRs                      |             |          |                          |             |                                      |              |             |                   |  |
| Construction                         | \$ 2,878    | \$ -     | \$ (163)                 | ) \$ -      | ) \$ 83                              | ) \$ -       | \$ 2,798    | \$ 320            |  |
| Residential real estate              | -           | -        | -                        | ) (80)      | ) 80                                 | -            | -           | -                 |  |
| Commercial real estate               | 83          | -        | -                        | -           | (83)                                 | -            | -           | -                 |  |
| Commercial                           | 337         | -        | (17)                     | ) -         | -                                    | -            | 320         | 16                |  |
| Consumer                             | -           | -        | -                        | -           | -                                    | -            | -           | -                 |  |
| Total                                | \$ 3,298    | \$ -     | \$ (180)                 | ) \$ (80)   | ) \$ 80                              | ) \$ -       | \$ 3,118    | \$ 336            |  |
| Total                                | \$ 16,624   | \$ -     | \$ (935)                 | ) \$ (477)  | ) \$ (74)                            | ) \$ (3,357) | \$ 11,781   | \$ 556            |  |

|                                      | 1/1/2017    |          |                          |             |                                      | 12/31/17   |             |                   |  |
|--------------------------------------|-------------|----------|--------------------------|-------------|--------------------------------------|------------|-------------|-------------------|--|
| (Dollars in thousands)               | TDR Balance | New TDRs | Disbursements (Payments) | Charge offs | Reclassifications/ Transfer In/(Out) | Payoffs    | TDR Balance | Related Allowance |  |
| For the year ended December 31, 2017 |             |          |                          |             |                                      |            |             |                   |  |
| Accruing TDRs                        |             |          |                          |             |                                      |            |             |                   |  |
| Construction                         | \$ 4,189    | \$ -     | \$ (25)                  | ) \$ -      | ) \$ (58)                            | ) \$ (134) | \$ 3,972    | \$ 41             |  |
| Residential real estate              | 3,875       | -        | (333)                    | ) (89)      | ) 1,535                              | (452)      | 4,536       | 239               |  |
| Commercial real estate               | 4,936       | -        | (118)                    | ) -         | -                                    | -          | 4,818       | 33                |  |
| Commercial                           | -           | -        | -                        | -           | -                                    | -          | -           | -                 |  |
| Consumer                             | -           | -        | -                        | -           | -                                    | -          | -           | -                 |  |
| Total                                | \$ 13,000   | \$ -     | \$ (476)                 | ) \$ (89)   | ) \$ 1,477                           | ) \$ (586) | \$ 13,326   | \$ 313            |  |

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|                         |              |           |               |              |               |               |                |            |
|-------------------------|--------------|-----------|---------------|--------------|---------------|---------------|----------------|------------|
| Nonaccrual TDRs         |              |           |               |              |               |               |                |            |
| Construction            | \$3,818      | \$-       | \$ (890       | ) \$ -       | \$ (50        | ) \$ -        | \$2,878        | \$ 459     |
| Residential real estate | 1,603        | -         | (68           | ) -          | (1,535        | ) -           | -              | -          |
| Commercial real estate  | 83           | -         | -             | -            | -             | -             | 83             | -          |
| Commercial Consumer     | -            | 345       | (8            | ) -          | -             | -             | 337            | 33         |
|                         | -            | -         | -             | -            | -             | -             | -              | -          |
| Total                   | \$5,504      | \$345     | \$ (966       | ) \$ -       | \$ (1,585     | ) \$ -        | \$3,298        | \$ 492     |
| <br>Total               | <br>\$18,504 | <br>\$345 | <br>\$ (1,442 | <br>) \$ (89 | <br>) \$ (108 | <br>) \$ (586 | <br>) \$16,624 | <br>\$ 805 |

The following tables provide information on loans that were modified and considered TDRs during 2018 and 2017.

| (Dollars in thousands)                  | Number<br>of<br>contracts | Premodification<br>outstanding<br>recorded<br>investment | Postmodification<br>outstanding<br>recorded<br>investment | Related<br>allowance |
|---|---------------------------|--|---|----------------------|
| TDRs:                                   |                           |  |   |                      |
| For the year ended<br>December 31, 2018 |                           |  |   |                      |
| Construction                            | -                         | \$ -   | \$ -  | \$ -                 |
| Residential real estate                 | -                         | -  | -   | -                    |
| Commercial real estate                  | -                         | -  | -   | -                    |
| Commercial                              | -                         | -  | -   | -                    |
| Consumer                                | -                         | -  | -   | -                    |
| Total                                   | -                         | \$ -   | \$ -  | \$ -                 |
| For the year ended<br>December 31, 2017 |                           |  |   |                      |
| Construction                            | -                         | \$ -   | \$ -  | \$ -                 |
| Residential real estate                 | -                         | -  | -   | -                    |
| Commercial real estate                  | 1                         | 760  | 755   | -                    |
| Commercial                              | 1                         | 462  | 345   | -                    |
| Consumer                                | -                         | -  | -   | -                    |
| Total                                   | 2                         | \$ 1,222   | \$ 1,100  | \$ -                 |

During the year ended December 31, 2018, there were no new TDR's or previously recorded TDR's which were modified.

The following tables provide information on TDRs that defaulted during 2018 and 2017 within 12 months of their restructuring. Generally, a loan is considered in default when principal or interest is past due 90 days or more, the loan is placed on nonaccrual, charged-off, or there is a transfer to OREO or repossessed assets.

| (Dollars in thousands)                  | Number<br>of<br>contracts | Recorded<br>investment | Related<br>allowance |
|---|---------------------------|------------------------|----------------------|
| TDRs that subsequently defaulted:       |                           |                        |                      |
| For the year ended<br>December 31, 2018 |                           |                        |                      |
| Construction                            | -                         | \$ -                   | \$ -                 |



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|                         |   |      |      |
|-------------------------|---|------|------|
| Residential real estate | - | -    | -    |
| Commercial real estate  | - | -    | -    |
| Commercial              | - | -    | -    |
| Consumer                | - | -    | -    |
| Total                   | - | \$ - | \$ - |

|                         |   |      |      |
|-------------------------|---|------|------|
| For the year ended      |   |      |      |
| December 31, 2017       |   |      |      |
| Construction            | - | \$ - | \$ - |
| Residential real estate | - | -    | -    |
| Commercial real estate  | - | -    | -    |
| Commercial              | - | -    | -    |
| Consumer                | - | -    | -    |
| Total                   | - | \$ - | \$ - |

Management uses risk ratings as part of its monitoring of the credit quality in the Company's loan portfolio. The Company added pass/watch credits to an existing pool that included loans that are risk rated as special mention and substandard to be collectively evaluated for impairment for both quantitative and qualitative factors at December 31, 2017. The Company believes that attributing additional reserves to this pool of loans better reflects the perceived risk for the total loan portfolio, due to the significant organic loan growth over the past 24 months, the increase in pass/performing rated credits, and increasing balances/concentrations in certain segments of the loan portfolio. Loans that are identified as special mention, substandard or doubtful are adversely rated. These loans and the pass/watch loans are assigned higher qualitative factors than favorably rated loans in the calculation of the formula portion of the allowance for credit losses. At December 31, 2018, there were no nonaccrual loans classified as special mention or doubtful and \$16.7 million of nonaccrual loans were identified as substandard. Similarly, at December 31, 2017, there were no nonaccrual loans classified as special mention or doubtful and \$5.0 million of nonaccrual loans were identified as substandard.

The following tables provide information on loan risk ratings as of December 31, 2018 and 2017.

| (Dollars in thousands)  | Pass/Performing | Pass/Watch | Special<br>Mention | Substandard | Doubtful | Total        |
|-------------------------|-----------------|------------|--------------------|-------------|----------|--------------|
| December 31, 2018       |                 |            |                    |             |          |              |
| Construction            | \$ 93,977       | \$ 30,735  | \$ -               | \$ 2,860    | \$ -     | \$ 127,572   |
| Residential real estate | 386,553         | 33,739     | 3,769              | 5,499       | -        | 429,560      |
| Commercial real estate  | 389,219         | 113,873    | 4,515              | 15,820      | -        | 523,427      |
| Commercial              | 90,777          | 15,727     | 642                | 376         | -        | 107,522      |
| Consumer                | 6,805           | 466        | -                  | 3           | -        | 7,274        |
| Total                   | \$ 967,331      | \$ 194,540 | \$ 8,926           | \$ 24,558   | \$ -     | \$ 1,195,355 |

| (Dollars in thousands)  | Pass/Performing | Pass/Watch | Special<br>Mention | Substandard | Doubtful | Total        |
|-------------------------|-----------------|------------|--------------------|-------------|----------|--------------|
| December 31, 2017       |                 |            |                    |             |          |              |
| Construction            | \$ 88,836       | \$ 30,674  | \$ -               | \$ 6,236    | \$ -     | \$ 125,746   |
| Residential real estate | 355,575         | 34,973     | 4,456              | 4,186       | -        | 399,190      |
| Commercial real estate  | 342,051         | 109,041    | 7,420              | 6,375       | -        | 464,887      |
| Commercial              | 72,440          | 24,102     | 308                | 434         | -        | 97,284       |
| Consumer                | 5,260           | 1,147      | -                  | -           | -        | 6,407        |
| Total                   | \$ 864,162      | \$ 199,937 | \$ 12,184          | \$ 17,231   | \$ -     | \$ 1,093,514 |

The following tables provide information on the aging of the loan portfolio as of December 31, 2018 and 2017.

Accruing

Total

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| (Dollars in thousands)  | Current     | 30-59    | 60-89    | Greater | past due | Nonaccrual | Total       |
|-------------------------|-------------|----------|----------|---------|----------|------------|-------------|
|                         |             | days     | days     | than    |          |            |             |
| December 31, 2018       |             | past due | past due | 90 days |          |            |             |
| Construction            | \$124,535   | \$ 195   | \$ -     | \$ -    | \$195    | \$ 2,842   | \$127,572   |
| Residential real estate | 423,732     | 1,384    | 206      | 139     | 1,729    | 4,099      | 429,560     |
| Commercial real estate  | 512,252     | 253      | 1,548    | -       | 1,801    | 9,374      | 523,427     |
| Commercial              | 107,089     | 83       | 10       | -       | 93       | 340        | 107,522     |
| Consumer                | 7,238       | 30       | 6        | -       | 36       | -          | 7,274       |
| Total                   | \$1,174,846 | \$ 1,945 | \$ 1,770 | \$ 139  | \$3,854  | \$ 16,655  | \$1,195,355 |
| Percent of total loans  | 98.3 %      | 0.2 %    | 0.1 %    | - %     | 0.3 %    | 1.4 %      | 100.0 %     |

| (Dollars in thousands)  | Current     | 30-59    | 60-89    | Greater | Total    | Nonaccrual | Total       |
|-------------------------|-------------|----------|----------|---------|----------|------------|-------------|
|                         |             | days     | days     | than    |          |            |             |
| December 31, 2017       |             | past due | past due | 90 days | past due |            |             |
| Construction            | \$122,475   | \$ 268   | \$ -     | \$ -    | \$268    | \$ 3,003   | \$125,746   |
| Residential real estate | 394,653     | 1,589    | 1,045    | 421     | 3,055    | 1,482      | 399,190     |
| Commercial real estate  | 460,998     | 1,061    | 2,461    | 218     | 3,740    | 149        | 464,887     |
| Commercial              | 96,774      | 173      | -        | -       | 173      | 337        | 97,284      |
| Consumer                | 6,395       | 6        | 6        | -       | 12       | -          | 6,407       |
| Total                   | \$1,081,295 | \$ 3,097 | \$ 3,512 | \$ 639  | \$7,248  | \$ 4,971   | \$1,093,514 |
| Percent of total loans  | 98.8 %      | 0.3 %    | 0.3 %    | 0.1 %   | 0.7 %    | 0.5 %      | 100.0 %     |

The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for 2018 and 2017.

Allocation of a portion of the allowance to one loan class does not preclude its availability to absorb losses in other loan classes.

| (Dollars in thousands)       | Construction | Residential<br>real estate | Commercial<br>real estate | Commercial | Consumer | Total    |
|------------------------------|--------------|----------------------------|---------------------------|------------|----------|----------|
| 2018                         |              |                            |                           |            |          |          |
| Allowance for credit losses: |              |                            |                           |            |          |          |
| Beginning Balance            | \$ 2,460     | \$ 2,284                   | \$ 2,594                  | \$ 2,241   | \$ 202   | \$9,781  |
| Charge-offs                  | (397 )       | (406 )                     | (240 )                    | (441 )     | (27 )    | (1,511 ) |
| Recoveries                   | 43           | 112                        | 29                        | 203        | 12       | 399      |
| Net charge-offs              | (354 )       | (294 )                     | (211 )                    | (238 )     | (15 )    | (1,112 ) |
| Provision                    | 556          | 363                        | 694                       | (54 )      | 115      | 1,674    |
| Ending Balance               | \$ 2,662     | \$ 2,353                   | \$ 3,077                  | \$ 1,949   | \$ 302   | \$10,343 |

| (Dollars in thousands)       | Construction | Residential<br>real estate | Commercial<br>real estate | Commercial | Consumer | Total    |
|------------------------------|--------------|----------------------------|---------------------------|------------|----------|----------|
| 2017                         |              |                            |                           |            |          |          |
| Allowance for credit losses: |              |                            |                           |            |          |          |
| Beginning Balance            | \$ 2,787     | \$ 1,953                   | \$ 2,610                  | \$ 1,145   | \$ 231   | \$8,726  |
| Charge-offs                  | (54 )        | (445 )                     | (100 )                    | (946 )     | (32 )    | (1,577 ) |
| Recoveries                   | 30           | 40                         | 31                        | 215        | 25       | 341      |
| Net charge-offs              | (24 )        | (405 )                     | (69 )                     | (731 )     | (7 )     | (1,236 ) |
| Provision                    | (303 )       | 736                        | 53                        | 1,827      | (22 )    | 2,291    |
| Ending Balance               | \$ 2,460     | \$ 2,284                   | \$ 2,594                  | \$ 2,241   | \$ 202   | \$9,781  |

#### Foreclosure Proceedings

Consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure totaled \$ 949 thousand and \$ 530 thousand as of December 31, 2018 and 2017. There were no residential real estate properties included in the balance of other real estate owned at December 31, 2018 and December 31, 2017.

All accruing TDRs were in compliance with their modified terms. One loan was transferred to nonaccrual during 2018. Both performing and non-performing TDRs had no further commitments associated with them as of December 31, 2018 and December 31, 2017.

**NOTE 6. PREMISES AND EQUIPMENT**

The following table provides information on premises and equipment for our continuing operations at December 31, 2018 and 2017.

| (Dollars in thousands)          | 2018     | 2017     |
|---------------------------------|----------|----------|
| Land                            | \$7,884  | \$7,884  |
| Buildings and land improvements | 20,597   | 20,265   |
| Furniture and equipment         | 6,387    | 5,665    |
|                                 | 34,868   | 33,814   |
| Accumulated depreciation        | (12,157) | (11,184) |
| Total                           | \$22,711 | \$22,630 |

Depreciation expense of continuing operations totaled \$1.0 million for 2018 and \$1.0 million for 2017.

The Company leases facilities under operating leases. Rental expense of continuing operations for the years ended December 31, 2018 2017 was \$475 thousand, and \$460 thousand, respectively. Future minimum annual rental payments excluding discontinued operations are approximately as follows:

| (Dollars in thousands)       |         |
|------------------------------|---------|
| 2019                         | \$463   |
| 2020                         | 217     |
| 2021                         | 170     |
| 2022                         | 176     |
| 2023                         | 178     |
| Thereafter                   | 235     |
| Total minimum lease payments | \$1,439 |

#### NOTE 7. GOODWILL AND OTHER INTANGIBLE ASSETS

The following table provides information on the significant components of goodwill and other acquired intangible assets at December 31, 2018 and 2017. On December 31, 2018 the Company sold its insurance subsidiary, Avon Dixon, LLC and discontinued operations of its premium finance company, Mubell, LLC, which have been removed from the table. In addition, on May 19, 2017, the Bank acquired three branches located in Arbutus, Owings Mills and Elkridge, Maryland from NWBI. The purchase of these branches resulted in core deposit intangibles of \$4.0 million and goodwill of \$15.0 million.

December 31, 2018

| (Dollars in thousands)        | Gross Carrying Amount | Accumulated Impairment Charges | Accumulated Amortization | Net Carrying Amount | Weighted Average Remaining Life (in years) |
|-------------------------------|-----------------------|--------------------------------|--------------------------|---------------------|--|
| Goodwill                      | \$ 19,728             | \$ (1,543 )                    | \$ (667 )                | \$ 17,518           | -  |
| Other intangible assets       |                       |                                |                          |                     |  |
| Amortizable                   |                       |                                |                          |                     |  |
| Core deposit intangible       | \$ 3,954              | \$ -                           | \$ (1,097 )              | \$ 2,857            | 7.2  |
| Total other intangible assets | \$ 3,954              | \$ -                           | \$ (1,097 )              | \$ 2,857            |  |

December 31, 2017

|  | Gross Carrying | Accumulated Impairment | Accumulated | Net Carrying | Weighted Average Remaining Life |
|--|----------------|------------------------|-------------|--------------|---------------------------------|
|  |                |                        |             |              |                                 |

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|                               | Amount    | Charges   | Amortization | Amount      | (in years) |
|-------------------------------|-----------|-----------|--------------|-------------|------------|
| Goodwill                      | \$ 19,728 | \$ (1,543 | ) \$ (667    | ) \$ 17,518 | -          |
| Other intangible assets       |           |           |              |             |            |
| Amortizable                   |           |           |              |             |            |
| Core deposit intangible       | 3,954     | -         | (231         | ) 3,723     | 9.4        |
| Total other intangible assets | \$ 3,954  | \$ -      | \$ (231      | ) \$ 3,723  |            |

The aggregate amortization expense was \$866 thousand and \$231 thousand for the years ended December 31, 2018 and 2017, respectively.

The following table provides information on current period and estimated future amortization expense for amortizable other intangible assets.

| (Dollars in thousands)                |            | Amortization<br>Expense |
|---------------------------------------|------------|-------------------------|
| Estimate for years ended December 31, | 2019       | \$ 605                  |
|                                       | 2020       | 533                     |
|                                       | 2021       | 461                     |
|                                       | 2022       | 389                     |
|                                       | 2023       | 317                     |
|                                       | Thereafter | 552                     |

#### NOTE 8. OTHER ASSETS

The Company had the following other assets at December 31, 2018 and 2017, excluding discontinued operations.

| (Dollars in thousands)                 | 2018     | 2017     |
|--|----------|----------|
| Accrued interest receivable            | \$3,345  | \$3,509  |
| Deferred income taxes                  | 4,182    | 4,098    |
| Prepaid expenses                       | 1,067    | 1,286    |
| Cash surrender value on life insurance | 3,726    | 3,637    |
| Other assets                           | 5,358    | 1,934    |
| Total                                  | \$17,678 | \$14,464 |

#### NOTE 9. OTHER LIABILITIES

The Company had the following other liabilities at December 31, 2018 and 2017, excluding discontinued operations.

| (Dollars in thousands)          | 2018    | 2017    |
|---------------------------------|---------|---------|
| Accrued interest payable        | \$604   | \$65    |
| Other accounts payable          | 3,213   | 3,217   |
| Deferred compensation liability | 1,040   | 1,219   |
| Income taxes payable            | 3,454   | -       |
| Other liabilities               | 104     | 43      |
| Total                           | \$8,415 | \$4,544 |



**NOTE 10. DEPOSITS**

The approximate amount of certificates of deposit of \$250,000 or more was \$26.7 million and \$25.3 million at December 31, 2018 and 2017, respectively.

The following table provides information on the approximate maturities of total time deposits at December 31, 2018 and 2017.

| (Dollars in thousands)     | 2018      | 2017      |
|----------------------------|-----------|-----------|
| Due in one year or less    | \$128,268 | \$142,880 |
| Due in one to three years  | 90,942    | 70,285    |
| Due in three to five years | 41,521    | 49,650    |
| Total                      | \$260,731 | \$262,815 |

As of December 31, 2018 and 2017, deposits, both direct and indirect, to directors, their associates and policy-making officers, totaled approximately \$3.9 million and \$3.6 million, respectively.

At December 31, 2018 we had \$22.1 million in brokered deposits and \$8.4 million at December 31, 2017.

**NOTE 11. BORROWINGS**

The Company may periodically borrow from a correspondent federal funds line of credit arrangement, under a secured reverse repurchase agreement, or from the Federal Home Loan Bank to meet short-term liquidity needs.

The following table summarizes certain information on short-term borrowings for the years ended December 31, 2018 and 2017.

| (Dollars in thousands)        | 2018    |       | 2017    |       |
|-------------------------------|---------|-------|---------|-------|
|                               | Amount  | Rate  | Amount  | Rate  |
| Average for the Year          |         |       |         |       |
| Repurchase agreements         | \$3,341 | 1.09% | \$3,324 | 0.49% |
| FHLB Advances                 | 73,970  | 2.16  | 1,183   | 1.20  |
| Overnight Fed Funds purchased | -       | -     | 18      | 1.84  |
| At Year End                   |         |       |         |       |
| Repurchase agreements         | \$823   | 1.87% | \$6,072 | 0.78% |
| FHLB Advances                 | 59,989  | 2.63  | 15,662  | 1.63  |
| Overnight Fed Funds purchased | -       | -     | -       | -     |

Securities sold under agreements to repurchase are securities sold to customers, at the customers' request, under a "roll-over" contract that matures in one business day. The underlying securities sold are U.S. Government agency securities, which are segregated in the Company's custodial accounts from other investment securities.

The Bank had \$15.0 million in federal funds lines of credit and a reverse repurchase agreement available on a short-term basis from correspondent banks at December 31, 2018 and 2017. In addition, the Bank had secured credit availability of approximately \$154.7 million and \$205.6 million from the Federal Home Loan Bank at December 31, 2018 and 2017, respectively. These lines of credit are paid for monthly on a fee basis of 0.08%. The Bank has pledged as collateral, under a blanket lien, all qualifying residential loans under borrowing agreements with the Federal Home Loan Bank. The Bank had short-term borrowings of \$60.0 million from the Federal Home Loan Bank at December 31, 2018 and \$15.7 million at December 31, 2017. At December 31, 2018, the Bank had \$15.0 million of fixed rate long-term borrowings from the Federal Home Loan Bank, which carry an interest rate of 2.82% and mature in April 2020.

**NOTE 12. BENEFIT PLANS**

### **401(k) and Profit Sharing Plan**

The Company has a 401(k) and profit sharing plan covering substantially all full-time employees. The plan calls for matching contributions by the Company, and the Company makes discretionary contributions based on profits. Company contributions to this plan excluding discontinued operations and included in noninterest expense totaled \$532 thousand and \$461 thousand for 2018 and 2017, respectively.

### **NOTE 13. STOCK-BASED COMPENSATION**

At the 2016 annual meeting, stockholders approved the Shore Bancshares, Inc. 2016 Stock and Incentive Plan (“2016 Equity Plan”), replacing the Shore Bancshares, Inc. 2006 Stock and Incentive Plan (“2006 Equity Plan”), which expired on that date. The Company may issue shares of common stock or grant other equity-based awards pursuant to the 2016 Equity Plan. Stock-based awards granted to date generally are time-based, vest in equal installments on each anniversary of the grant date and range over a one- to three-year period of time, and, in the case of stock options, expire 10 years from the grant date. As part of the 2016 Equity Plan, a performance equity incentive award program, known as the “Long-term incentive plan” allows participating officers of the Company to earn incentive awards of performance share/restricted stock units if certain pre-determined targets are achieved at the end of a three-year performance cycle. Stock-based compensation expense based on the grant date fair value is recognized ratably over the requisite service period for all awards and reflects forfeitures as they occur. The 2016 Equity Plan originally reserved 750,000 shares of common stock for grant, and 652,167 shares remained available for grant at December 31, 2018.

The following tables provide information on stock-based compensation expense for 2018 and 2017.

| (Dollars in thousands)                                  | December 31, |         |
|---|--------------|---------|
|   | 2018         | 2017    |
| Stock-based compensation expense                        | \$447        | \$1,055 |
| Excess tax benefits related to stock-based compensation | 34           | 28      |

| (Dollars in thousands)  | December 31, |              |     |       |
|---|--------------|--------------|-----|-------|
|   | 2018         | 2017         |     |       |
| Unrecognized stock-based compensation expense                             | \$223        | \$801        |     |       |
| Weighted average period unrecognized expense is expected to be recognized | 0.9          | <b>years</b> | 1.0 | years |

The following table summarizes restricted stock award activity for the Company under the 2016 Equity Plan for the two years ended December 31, 2018.

|                                  | Year Ended December 31, 2018 |  | Year Ended December 31, 2017 |  |
|----------------------------------|------------------------------|--|------------------------------|--|
|                                  | Number of Shares             | Weighted Average Grant Date Fair Value | Number of Shares             | Weighted Average Grant Date Fair Value |
| Nonvested at beginning of period | 15,913                       | \$ 15.39                               | 17,066                       | \$ 11.46                               |
| Granted                          | 15,826                       | 18.63                                  | 22,927                       | 16.71                                  |
| Vested                           | (31,739 )                    | 17.05                                  | (24,080 )                    | 13.86                                  |
| Cancelled                        | -                            | -                                      | -                            | -                                      |
| Nonvested at end of period       | -                            | \$ -                                   | 15,913                       | \$ 15.39                               |

The total fair value of restricted stock awards that vested was \$585 thousand in 2018 and \$334 thousand in 2017.

Restricted stock units (RSUs) are similar to restricted stock, except the recipient does not receive the stock immediately, but instead receives it upon the terms and conditions of the Company's long-term incentive plans which are subject to performance milestones achieved at the end of a three-year period. Each RSU cliff vests at the end of the three-year period and entitles the recipient to receive one share of common stock on a specified issuance date. The recipient does not have any stockholder rights, including voting rights, with respect to the shares underlying awarded RSUs until the recipient becomes the holder of those shares.

During 2018, the Company entered into a long-term incentive program agreement with officers of the Company and its subsidiaries to award RSUs based on a performance metric to be achieved as of December 31, 2020. Assuming the

performance metric is achieved, these awards will cliff vest on this date, in which the final number of common shares to be issued will be determined. The range of RSUs which could potentially be awarded at the end of the performance cycle is between 11,194 shares and 44,792 shares, assuming a certain performance metric is met. In addition, two members of the long-term incentive plan from 2018 forfeited their RSUs due to leaving the Company before the end of the vesting period. The table below presents management's evaluation of the probable number of common stock awards to be issued at the end of the performance cycle.

During 2017, the Company entered into a long-term incentive program agreement with officers of the Company and its subsidiaries to award RSUs based on a performance metric to be achieved as of December 31, 2019. Assuming the performance metric is achieved, these awards will cliff vest on this date, in which the final number of common shares to be issued will be determined. The range of RSUs which could potentially be awarded at the end of the performance cycle is between 10,712 shares and 42,865 shares, assuming a certain performance metric is met. In addition, two members of the long-term incentive plan from 2017 forfeited their RSUs due to leaving the Company before the end of the vesting period. The table below presents management's evaluation of the probable number of common stock awards to be issued at the end of the performance cycle.

The following table summarizes restricted stock units activity based on management's evaluation of the probable number of common stock awards to be issued at the end of the performance cycle for the Company under the 2016 Equity Plan for the two years ended December 31, 2018.

|                                    | Year Ended December 31, 2018 |  | Year Ended December 31, 2017 |  |
|------------------------------------|------------------------------|--|------------------------------|--|
|                                    | Number of Shares             | Weighted Average Grant Date Fair Value | Number of Shares             | Weighted Average Grant Date Fair Value |
| Outstanding at beginning of period | 90,266                       | \$ 12.08                               | 46,342                       | \$ 10.64                               |
| Granted                            | 11,194                       | 17.36                                  | 43,924                       | 13.59                                  |
| Vested                             | (40,423 )                    | 9.49                                   | -                            | -                                      |
| Forfeited                          | (22,475 )                    | 16.55                                  | -                            | -                                      |
| Outstanding at end of period       | 38,562                       | \$ 14.69                               | 90,266                       | \$ 12.08                               |

The fair value of restricted stock units that vested during 2018 and 2017 was \$383 thousand and \$0, respectively.

The following table summarizes stock option activity for the Company under the 2016 Equity Plan for the two years ended December 31, 2018.

|                                    | Year Ended December 31, 2018 |                                  | Year Ended December 31, 2017 |                                  |
|------------------------------------|------------------------------|----------------------------------|------------------------------|----------------------------------|
|                                    | Number of Shares             | Weighted Average Exercise Prices | Number of Shares             | Weighted Average Exercise Prices |
| Outstanding at beginning of period | 62,429                       | \$ 8.47                          | 62,086                       | \$ 8.29                          |
| Granted                            | -                            | -                                | 1,202                        | 16.65                            |
| Exercised                          | (35,180 )                    | 7.54                             | (859 )                       | 6.64                             |
| Expired/Cancelled                  | -                            | -                                | -                            | -                                |
| Outstanding at end of period       | 27,249                       | \$ 9.68                          | 62,429                       | \$ 8.47                          |
| Exercisable at end of period       | 27,249                       | \$ 9.68                          | 61,828                       | \$ 8.40                          |

There were no stock options granted during 2018. The weighted average fair value of stock options granted during 2017 was \$10.99. The Company estimates the fair value of options using the Black-Scholes valuation model with weighted average assumptions for dividend yield, expected volatility, risk-free interest rate and expected lives (in years). The expected dividend yield is calculated by dividing the total expected annual dividend payout by the average stock price. The expected volatility is based on historical volatility of the underlying securities. The risk-free interest rate is based on the Federal Reserve Bank's constant maturities daily interest rate in effect at grant date. The expected contract life of the options represents the period of time that the Company expects the awards to be outstanding based on historical experience with similar awards. The following weighted average assumptions were used as inputs to the

Black-Scholes valuation model for options granted in 2017.

|                                   | 2017  |       |
|-----------------------------------|-------|-------|
| Dividend yield                    | 0.84  | %     |
| Expected volatility               | 64.80 | %     |
| Risk-free interest rate           | 2.42  | %     |
| Expected contract life (in years) | 10    | years |

At December 31, 2018, the aggregate intrinsic value of the options outstanding under the 2016 Equity Plan was \$132 thousand based on the \$14.54 market value per share of Shore Bancshares, Inc.'s common stock at December 31, 2018. Similarly, the aggregate intrinsic value of the options exercisable was \$513 thousand at December 31, 2017. The intrinsic value of options exercised during 2018 was \$376 thousand based on the \$18.22 market value per share of the Company's common stock at January 31, 2018. The intrinsic value of options exercised in 2017 was \$8 thousand based on the \$15.89 market value per share of the Company's common stock at January 30, 2017. At December 31, 2018, the weighted average remaining contract life of options outstanding and exercisable was 6.4 years.

**NOTE 14. DEFERRED COMPENSATION**

The Shore Bancshares, Inc. Executive Deferred Compensation Plan (the “Plan”) is for members of management and highly compensated employees of Shore Bancshares, Inc. and its subsidiaries. The Plan permits a participant to elect, each year, to defer receipt of up to 100% of his or her salary and bonus to be earned in the following year. The Plan also permits the participant to defer the receipt of performance-based compensation not later than six months before the end of the period for which it is to be earned. The deferred amounts are credited to an account maintained on behalf of the participant and are invested at the discretion of each participant in certain deemed investment options selected by the Compensation Committee of the Board of Shore Bancshares, Inc. Shore Bancshares, Inc. may also make matching, mandatory and discretionary contributions for certain participants. A participant is fully vested at all times in the amounts that he or she elects to defer.

Any contributions by Shore Bancshares, Inc. will vest over a five-year period. There were no elective deferrals made by plan participants during 2018 or 2017.

The following table provides information on Shore Bancshares, Inc.’s contributions to the Plan for 2018 and 2017 and the related deferred compensation liability at December 31, 2018 and 2017.

| (Dollars in thousands)             | 2018 | 2017 |
|------------------------------------|------|------|
| Deferred compensation contribution | \$ - | \$ - |

| (Dollars in thousands)          | 2018  | 2017  |
|---------------------------------|-------|-------|
| Deferred compensation liability | \$268 | \$393 |

Shore United Bank assumed agreements held by the former CNB Bank under which its former directors had elected to defer part of their fees and compensation while serving on the former Board of CNB. The amounts deferred are invested in insurance policies, on the lives of the respective individuals. Amounts available under the policies are to be paid to the individuals as retirement benefits over future years. The following table includes information on the cash surrender value and the accrued benefit obligation included in other assets and other liabilities at December 31, 2018 and 2017.

| (Dollars in thousands)     | 2018    | 2017    |
|----------------------------|---------|---------|
| Cash surrender value       | \$3,726 | \$3,637 |
| Accrued benefit obligation | 773     | 826     |



**NOTE 15. OTHER EXPENSES**

The following table summarizes the Company's other noninterest expenses for the years ended December 31, excluding discontinued operations:

| (Dollars in thousands)           | 2018    | 2017    |
|----------------------------------|---------|---------|
| Advertising and marketing        | \$ 509  | \$ 509  |
| Other customer expense           | 352     | 360     |
| Other expense                    | 1,888   | 1,643   |
| Other loan expense               | 336     | 271     |
| Software expense                 | 934     | 862     |
| Travel and entertainment expense | 328     | 297     |
| Trust professional fees          | 518     | 529     |
| Total noninterest expense        | \$4,865 | \$4,471 |

**NOTE 16. INCOME TAXES**

The following table provides information on components of income tax expense for continuing operations for each of the two years ended December 31.

| (Dollars in thousands)                 | 2018    | 2017    |
|--|---------|---------|
| Current tax expense:                   |         |         |
| Federal                                | \$4,110 | \$4,258 |
| State                                  | 1,167   | -       |
|  | 5,277   | 4,258   |
| Deferred income tax (benefit) expense: |         |         |
| Federal                                | (120 )  | 2,903   |
| State                                  | 223     | 1,573   |
|  | 103     | 4,476   |
| Total income tax expense               | \$5,380 | \$8,734 |

The U.S. Tax Cuts and Jobs Act (“Tax Act”) was enacted on December 22, 2017 and introduced significant changes to U.S. income tax law. Beginning in 2018, the Tax Act reduced the U.S. statutory tax rate from 35% to 21% and created new taxes on certain foreign-sourced earnings and certain related-party payments, which are referred to as the global intangible low-taxes income tax and the base erosion tax, respectively. In addition, in 2017 the Company was subject to a one-time transition tax on accumulated foreign subsidiary earnings not previously subject to U.S. income tax.

The following table provides a reconciliation of tax computed at the statutory federal tax rate to the actual tax expense for continuing operations for each of the two years ended December 31.

|  | 2018   | 2017   |
|--|--------|--------|
| Tax at federal statutory rate              | 21.0%  | 35.0%  |
| Tax effect of:                             |        |        |
| Tax-exempt income                          | (0.5 ) | (1.0 ) |
| Other non-deductible expenses              | 0.2    | 0.1    |
| State income taxes, net of federal benefit | 5.2    | 5.1    |
| Tax impact from enacted change in tax rate | -      | 7.6    |
| Other                                      | (0.5 ) | 1.8    |
| Actual income tax expense rate             | 25.4%  | 48.6%  |

The following table provides information on significant components of the Company's deferred tax assets and liabilities as of December 31. The Company recorded a provisional adjustment to our U.S. deferred income taxes as of December 31, 2017 to reflect the reduction in the U.S. statutory tax rate from 35% to 21% resulting from the Tax Act.

| (Dollars in thousands)   | 2018    | 2017    |
|--|---------|---------|
| Deferred tax assets:   |         |         |
| Allowance for credit losses  | \$2,797 | \$2,625 |
| Reserve for off-balance sheet commitments  | 81      | 81      |
| Net operating loss carry forward   | -       | 741     |
| Write-downs of other real estate owned   | 273     | 212     |
| Nonaccrual loan interest   | 260     | 95      |
| Unrealized losses on available-for-sale securities                                 | 1,105   | 460     |
| Unrealized losses on available-for-sale securities transferred to held to maturity | 12      | 20      |
| Other  | 524     | 635     |
| Total deferred tax assets  | 5,052   | 4,869   |
| Deferred tax liabilities:  |         |         |
| Depreciation   | 238     | 408     |
| Acquisition on loans FMV adjustment  | 60      | 84      |
| Purchase accounting adjustments  | 247     | 1,994   |
| Deferred capital gain on branch sale   | 200     | 207     |
| Other  | 125     | 241     |
| Total deferred tax liabilities   | 870     | 2,934   |
| Net deferred tax assets  | \$4,182 | \$1,935 |

#### NOTE 17. EARNINGS PER COMMON SHARE

Basic earnings per common share is calculated by dividing net income available to (allocable to) common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per common share is calculated by dividing net income available to (allocable to) common stockholders by the weighted average number of common shares outstanding during the period, adjusted for the dilutive effect of common stock equivalents (stock-based awards). The following table provides information relating to the calculation of earnings per common share.

| (In thousands, except per share data)       | 2018     | 2017    |
|---|----------|---------|
| Net income from continuing operations       | \$15,763 | \$9,225 |
| Net income from discontinued operations     | 9,234    | 2,037   |
| Net income                                  | 24,997   | 11,262  |
| Weighted average shares outstanding - basic | 12,739   | 12,682  |

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|  |        |        |
|--|--------|--------|
| Dilutive effect of common stock equivalents-options                | 12     | 22     |
| Dilutive effect of common stock equivalents-restricted stock units | 2      | 14     |
| Weighted average shares outstanding - diluted                      | 12,753 | 12,718 |
| Basic earnings per common share                                    |        |        |
| Income form continuing operations                                  | \$1.24 | \$0.73 |
| Income form discontinued operations                                | 0.72   | 0.16   |
| Net income   | \$1.96 | \$0.89 |
| Diluted earnings per common share                                  |        |        |
| Income form continuing operations                                  | \$1.24 | \$0.73 |
| Income form discontinued operations                                | 0.72   | 0.16   |
| Net income   | \$1.96 | \$0.89 |

For all periods presented, the calculations of diluted income per common share excluded no weighted average common stock equivalents because the effect of including them would have anti-dilutive.

**NOTE 18. REGULATORY CAPITAL REQUIREMENTS**

Banks and bank holding companies are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Banks' assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Banks' capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

*Basel III*

The FRB and the FDIC approved the final rules implementing the Basel Committee on Banking Supervision's ("BCBS") capital guidelines for U.S. banks. Under the final rules, minimum requirements increased for both the quantity and quality of capital held by the Company. The rules include a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum ratio of Tier 1 capital to risk-weighted assets to 6.0%, require a minimum ratio of Total Capital to risk-weighted assets of 8.0%, and require a minimum Tier 1 leverage ratio of 4.0%. A new capital conservation buffer, comprised of common equity Tier 1 capital, is also established above the regulatory minimum capital requirements. This capital conservation buffer was phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and increased each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019. Strict eligibility criteria for regulatory capital instruments were also implemented under the final rules. The final rules also revise the definition and calculation of Tier 1 capital, Total Capital, and risk-weighted assets. At December 31, 2018 the capital conservation buffer was 1.875% and the Bank's specific capital buffer was 4.73%.

The phase-in period for the final rules began on January 1, 2015, with full compliance with all of the final rules' requirements phased in over a multi-year schedule, ending on January 1, 2019.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain amounts and ratios (set forth in the table below) of Common Equity Tier 1, Tier 1 and total capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (leverage ratio). As of December 31, 2018, management believes that Shore United Bank met all capital adequacy requirements to which it was subject.

As of December 31, 2018, the most recent notification from the Federal Reserve Bank categorized Shore United Bank, as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes would change the Bank's classification. To be categorized as well capitalized, the Bank must maintain minimum common equity Tier 1, Tier 1 risk-based and total risk-based capital ratios, and Tier 1 leverage ratios, which are described below.

The minimum ratios for capital adequacy purposes are 6.38%, 7.88%, 9.88% and 4.00% for the common equity Tier 1, Tier 1 risk-based capital, total risk-based capital and leverage ratios, respectively which include a capital conservation buffer of 1.875% respectively. To be categorized as well capitalized, a bank must maintain minimum ratios of 6.50%, 8.00%, 10.00% and 5.00% for its common equity Tier 1, Tier 1 risk-based capital, total risk-based capital and leverage ratios, respectively.

The following tables present the capital amounts and ratios as of December 31, 2018 and 2017.

| (Dollars in thousands) | Common Equity/<br>Tier 1<br>Capital | Total Risk-<br>Based<br>Capital | Net Risk-<br>Weighted<br>Assets | Adjusted<br>Average<br>Total<br>Assets | Common<br>Equity<br>Tier 1<br>ratio | Tier 1<br>Risk-Based<br>Capital<br>Ratio | Total<br>Risk-Based<br>Capital<br>Ratio | Tier 1<br>Leverage<br>Ratio |
|------------------------|-------------------------------------|---------------------------------|---------------------------------|--|-------------------------------------|--|---|-----------------------------|
| December 31, 2018      | N/A                                 | N/A                             | N/A                             | N/A                                    | N/A                                 | N/A                                      | N/A                                     | N/A                         |
| Company (1)            | \$ 140,265                          | \$ 150,909                      | \$ 1,185,050                    | \$ 1,432,686                           | 11.84 %                             | 11.84 %                                  | 12.73 %                                 | 9.79 %                      |
| Shore United Bank      |                                     |                                 |                                 |  |                                     |  |   |                             |

| (Dollars in thousands) | Common Equity/<br>Tier 1<br>Capital | Total Risk-<br>Based<br>Capital | Net Risk-<br>Weighted<br>Assets | Adjusted<br>Average<br>Total<br>Assets | Common<br>Equity<br>Tier 1<br>ratio | Tier 1<br>Risk-Based<br>Capital<br>Ratio | Total<br>Risk-Based<br>Capital<br>Ratio | Tier 1<br>Leverage<br>Ratio |
|------------------------|-------------------------------------|---------------------------------|---------------------------------|--|-------------------------------------|--|---|-----------------------------|
| December 31, 2017      | \$ 132,370                          | \$ 142,452                      | \$ 1,112,259                    | \$ 1,345,876                           | 11.90 %                             | 11.90 %                                  | 12.81 %                                 | 9.84 %                      |
| Company                | 126,751                             | 136,833                         | 1,107,074                       | 1,342,484                              | 11.45 %                             | 11.45 %                                  | 12.36 %                                 | 9.44 %                      |
| Shore United Bank      |                                     |                                 |                                 |  |                                     |  |   |                             |

In August of 2018 the Economic Growth, Regulatory Relief, and Consumer Protection Act (“EGRRCPA”) directed the Federal Reserve Board (“FRB”) to revise the Small Bank Holding Company Policy Statement to raise the total consolidated asset limit in the Policy Statement from \$1 billion to \$3 billion. The Company was previously (1) required to comply with the minimum capital requirements on a consolidated basis; however, the Company continues to meet the conditions of the revised policy statement and was, therefore, exempt from the consolidated capital requirements at December 31, 2018.

The Company, also began filing less extensive and less frequent regulatory reports with the FRB, which will reduce administrative costs for the Company.

Bank and holding company regulations, as well as Maryland law, impose certain restrictions on dividend payments by the Bank, as well as restricting extensions of credit and transfers of assets between the Bank and the Company.

At December 31, 2018, the Bank could pay dividends to the parent to the extent of its earnings so long as it maintained required capital ratios. The Bank paid \$4.0 million and \$0 of dividends to Shore Bancshares, Inc. for the years ended December 31, 2018 and 2017, respectively. Shore Bancshares, Inc. had no outstanding receivables from subsidiaries at December 31, 2018 or 2017.

**NOTE 19. ACCUMULATED OTHER COMPREHENSIVE INCOME**

The Company records unrealized holding gains (losses), net of tax, on investment securities available for sale as accumulated other comprehensive income (loss), a separate component of stockholders' equity. The following table provides information on the changes in the components of accumulated other comprehensive income (loss) for 2018 and 2017.

| (Dollars in thousands)   | Unrealized<br>gains (losses) on<br>available-for-sale<br>securities | Unrealized gains<br>(losses) on<br>securities<br>Available-for-sale<br>to<br>Held-to-maturity | Accumulated<br>other<br>comprehensive<br>income (loss) |
|--|---|---|--|
| Balance, December 31, 2017                                       | \$ (1,255   | ) \$ (54  | ) \$ (1,309 )  |
| Cumulative effect adjustment (ASU 2016-01)                       | 6   | -   | 6  |
| Other comprehensive income (loss)                                | (1,669  | )   | 22 (1,647 )  |
| Balance, December 31, 2018                                       | \$ (2,918   | ) \$ (32  | ) \$ (2,950 )  |
| Balance, December 31, 2016                                       | \$ (931   | ) \$ (62  | ) \$ (993 )  |
| Other comprehensive income (loss)                                | (105  | )   | 18 (87 )   |
| Reclassification of (gain) recognized                            | (3  | )   | -  |
| Reclassification of stranded tax effects from change in tax rate | (216  | )   | (10 (226 )   |
| Balance, December 31, 2017                                       | \$ (1,255   | ) \$ (54  | ) \$ (1,309 )  |



The following table presents the amounts reclassified out of accumulated comprehensive income (loss) for the years ended December 31, 2018 and 2017.

Details about Accumulated Other

| Comprehensive Income Components<br><br>(dollars in thousands) | Amount<br>Reclassified from<br>Accumulated<br>Other<br>Comprehensive<br>Income<br>Year Ended<br>December 31, |         | Affected Line Item in the Statement<br>Where     |
|---|--|---------|--|
|   | 2018   | 2017    | Net Income is Presented                          |
| Realized (gains) on available for sale investment securities  | \$ -   | \$ (5 ) | Gain on sales and calls of investment securities |
| Related income tax  | \$ -   | \$ 2    | Income tax expense                               |
| Total Reclassification for the Period                         | \$ -   | \$ (3 ) |  |

**NOTE 20. FAIR VALUE MEASUREMENTS**

Accounting guidance under GAAP defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. This accounting guidance also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available for sale and equity securities with readily determinable fair values are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, such as impaired loans, loans held for sale and other real estate owned (foreclosed assets). These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Under fair value accounting guidance, assets and liabilities are grouped at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine their fair values. These hierarchy levels are:

Level 1 inputs – Unadjusted quoted prices in active markets for identical assets or liabilities that the entity has the ability to access at the measurement date.

Level 2 inputs – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs – Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

### **Assets Measured at Fair Value on a Recurring Basis**

#### Investment Securities Available for Sale

Fair value measurement for investment securities available for sale is based on quoted prices from an independent pricing service. The fair value measurements consider observable data that may include present value of future cash flows, prepayment assumptions, credit loss assumptions and other factors. The Company classifies its investments in U.S. Treasury securities, if any, as Level 1 in the fair value hierarchy, and it classifies its investments in U.S. Government agencies securities and mortgage-backed securities issued or guaranteed by U.S. Government sponsored entities as Level 2.

#### Equity Securities

Fair value measurement for equity securities is based on quoted market prices retrieved by the Company via on-line resources. Although these securities have readily available fair market values, the Company deems that they be classified as level 2 investments in the fair value hierarchy due to not being considered traded in a highly active market.

The tables below present the recorded amount of assets measured at fair value on a recurring basis at December 31, 2018 and 2017. No assets were transferred from one hierarchy level to another during 2018 or 2017.

| (Dollars in thousands)         | Fair Value | Quoted Prices (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|--------------------------------|------------|-------------------------|---|---|
| December 31, 2018              |            |                         |   |   |
| Securities available for sale: |            |                         |   |   |
| U.S. Government agencies       | \$33,636   | \$ -                    | \$ 33,636                                     | \$ -                                      |
| Mortgage-backed                | 120,796    | -                       | 120,796                                       | -   |
|                                | 154,432    | -                       | 154,432                                       | -   |
| Equity                         | 1,269      | -                       | 1,269   | -   |
| Total                          | \$155,701  | \$ -                    | \$ 155,701                                    | \$ -                                      |

| (Dollars in thousands)         | Fair Value | Quoted Prices (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|--------------------------------|------------|-------------------------|---|---|
| December 31, 2017              |            |                         |   |   |
| Securities available for sale: |            |                         |   |   |
| U.S. Government agencies       | \$45,332   | \$ -                    | \$ 45,332                                     | \$ -                                      |
| Mortgage-backed                | 150,965    | -                       | 150,965                                       | -   |
| Equity                         | 658        | -                       | 658   | -   |
| Total                          | \$196,955  | \$ -                    | \$ 196,955                                    | \$ -                                      |

#### Assets Measured at Fair Value on a Nonrecurring Basis

##### Impaired Loans

Loans are considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loan impairment is measured using the present value of expected cash flows, the loan's observable market price or the fair value of the collateral (less selling costs) if the loans are collateral dependent and these are considered Level 3 in the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory and/or accounts receivable. The value of business equipment, inventory and accounts receivable, discounted on management's review

and analysis. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and the client's business.

Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the factors identified above. Valuation techniques are consistent with those techniques applied in prior periods.

Other Real Estate Owned (Foreclosed Assets)

Foreclosed assets are adjusted for fair value upon transfer of loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value and fair value. The estimated fair value for foreclosed assets included in Level 3 are determined by independent market based appraisals and other available market information, less costs to sell, that may be reduced further based on market expectations or an executed sales agreement. If the fair value of the collateral deteriorates subsequent to the initial recognition, the Company records the foreclosed asset as a non-recurring Level 3 adjustment. Valuation techniques are consistent with those techniques applied in prior periods.

The following tables set forth the Company's financial assets subject to fair value adjustments (impairment) on a nonrecurring basis at December 31, 2018 and 2017, that are valued at the lower of cost or market. Assets are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

| (Dollars in thousands)<br>December 31, 2018 | Quantitative Information about Level 3 Fair Value Measurements |                               |  |                       |
|---|--|-------------------------------|--|-----------------------|
|   | Fair Value   | Valuation Technique           | Unobservable Input                               | Range                 |
| Nonrecurring measurements:                  |  |                               |  |                       |
| Impaired loans                              | \$3,839  | Appraisal of collateral       | 1 Appraisal adjustments<br>2 Liquidation expense | 0% - 17%<br>0% - 10%  |
| Impaired loans                              | \$5,902  | Discounted cash flow analysis | 1 Discount rate                                  | 4% - 7.25%            |
| Other real estate owned                     | \$1,222  | Appraisal of collateral       | 1 Appraisal adjustments<br>2 Liquidation expense | 15% - 40%<br>5% - 10% |

  

| (Dollars in thousands)<br>December 31, 2017 | Quantitative Information about Level 3 Fair Value Measurements |                               |  |                       |
|---|--|-------------------------------|--|-----------------------|
|   | Fair Value   | Valuation Technique           | Unobservable Input                               | Range                 |
| Nonrecurring measurements:                  |  |                               |  |                       |
| Impaired loans                              | \$510  | Appraisal of collateral       | 1 Liquidation expense                            | 2 10 %                |
| Impaired loans                              | \$6,005  | Discounted cash flow analysis | 1 Discount rate                                  | 4% - 8.5%             |
| Other real estate owned                     | \$1,794  | Appraisal of collateral       | 1 Appraisal adjustments<br>2 Liquidation expense | 20% - 30%<br>5% - 10% |

Fair value is generally determined through independent appraisals of the underlying collateral (impaired loans and (1)OREO) or discounted cash flow analyses (impaired loans), which generally include various level III inputs which are not identifiable.

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

**Fair Value of Financial Assets and Financial Liabilities**

The carrying amounts and estimated fair values of the Company's financial instruments are presented in the following tables. Fair values for December 31, 2018 were estimated using an exit price notion in accordance with the prospective adoption of ASU 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities." Fair values for December 31, 2017 were estimated using the guidance in effect for that period, which permitted the use of an entry price notion in the compilation of this disclosure.

| (Dollars in thousands)                     | December 31, 2018  |                            | December 31, 2017  |                            |
|--|--------------------|----------------------------|--------------------|----------------------------|
|  | Carrying<br>Amount | Estimated<br>Fair<br>Value | Carrying<br>Amount | Estimated<br>Fair<br>Value |
| <b>Financial assets</b>                    |                    |                            |                    |                            |
| <b>Level 1 inputs</b>                      |                    |                            |                    |                            |
| Cash and cash equivalents                  | \$67,225           | \$67,225                   | \$31,820           | \$31,820                   |
| <b>Level 2 inputs</b>                      |                    |                            |                    |                            |
| Investment securities held to maturity     | \$6,043            | \$6,000                    | \$6,247            | \$6,391                    |
| Restricted securities                      | 6,476              | 6,476                      | 3,735              | 3,735                      |
| Cash surrender value on life insurance     | 3,726              | 3,726                      | 3,637              | 3,637                      |
| <b>Level 3 inputs</b>                      |                    |                            |                    |                            |
| Loans, net                                 | 1,185,012          | 1,150,418                  | 1,083,733          | 1,072,951                  |
| <b>Financial liabilities</b>               |                    |                            |                    |                            |
| <b>Level 2 inputs</b>                      |                    |                            |                    |                            |
| <b>Deposits:</b>                           |                    |                            |                    |                            |
| Noninterest-bearing demand                 | \$330,466          | \$330,466                  | \$328,322          | \$328,322                  |
| Checking plus interest                     | 239,809            | 239,809                    | 231,898            | 231,898                    |
| Money market                               | 232,613            | 232,613                    | 223,123            | 223,123                    |
| Savings                                    | 148,723            | 148,723                    | 156,623            | 156,623                    |
| Club                                       | 387                | 387                        | 398                | 398                        |
| Brokered Deposits                          | 22,084             | 22,075                     | -                  | -                          |
| Certificates of deposit, \$100,000 or more | 97,905             | 96,435                     | 107,343            | 105,691                    |
| Other time                                 | 140,354            | 136,292                    | 155,074            | 151,339                    |
| Short-term borrowings                      | 60,812             | 60,812                     | 21,734             | 21,734                     |
| Long-term borrowings                       | 15,000             | 15,012                     | -                  | -                          |

**NOTE 21. FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK**

In the normal course of business, to meet the financing needs of its customers, the Bank is party to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. The Banks' exposure to credit loss in the event of nonperformance by the other party to these financial instruments is represented by the contractual amount of the instruments. The Bank uses the same credit policies in making commitments and conditional obligations as they do for on-balance sheet instruments. The Bank generally requires collateral or other security to support the financial instruments with credit risk. The amount of collateral or other security is determined based on management's credit evaluation of the counterparty. The Bank evaluates each customer's creditworthiness on a case-by-case basis.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Letters of credit and other commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the letters of credit and commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements.

The following table provides information on commitments outstanding as of December 31, 2018 and 2017.

| (Dollars in thousands)       | December 31, 2018 | December 31, 2017 |
|------------------------------|-------------------|-------------------|
| Commitments to extend credit | \$ 210,463        | \$ 206,065        |
| Letters of credit            | 6,917             | 7,142             |
| Total                        | \$ 217,380        | \$ 213,207        |

The Bank has established an allowance for off balance sheet credit exposures. The allowance is established as losses are estimated to have occurred through a loss for off balance sheet credit exposures charged to earnings. Losses are charged against the allowance when management believes the required funding of these exposures is uncollectible. While this evaluation is completed on a regular basis, it is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

**NOTE 22. RELATED PARTY TRANSACTIONS**

Shore Bancshares Inc. and its Bank subsidiary will periodically rent ballroom space from the Tidewater Inn located in Easton Maryland, to hold company meetings and events. A director of the board of Shore Bancshares Inc. holds a 61% interest in a limited liability company which owns the Tidewater Inn. During 2018 and 2017, approximately \$20 thousand and \$25 thousand in expenses were paid for rental and catering services.

### **NOTE 23. CONTINGENCIES**

In the normal course of business, Shore Bancshares, Inc. and its Bank subsidiary may become involved in litigation arising from banking, financial, and other activities. Management, after consultation with legal counsel, does not anticipate that the future liability, if any, arising out of current proceedings will have a material effect on the Company's financial condition, operating results, or liquidity.



**NOTE 24. PARENT COMPANY FINANCIAL INFORMATION**

The following tables provide condensed financial information for Shore Bancshares, Inc. (Parent Company Only).

## Condensed Balance Sheets

December 31,

| (Dollars in thousands)                                  | 2018             | 2017             |
|---|------------------|------------------|
| <b>Assets</b>   |                  |                  |
| Cash  | \$26,583         | \$683            |
| Investment securities available for sale, at fair value | 918              | 1,127            |
| Investment in subsidiaries                              | 157,855          | 157,880          |
| Premises and equipment, net                             | 3,772            | 3,435            |
| Other assets  | 1,593            | 2,209            |
| <b>Total assets</b>                                     | <b>\$190,721</b> | <b>\$165,334</b> |
| <b>Liabilities</b>                                      |                  |                  |
| Accrued interest payable                                | \$1              | \$-              |
| Other liabilities                                       | 6,494            | 932              |
| Short-term borrowings                                   | 1,041            | 666              |
| <b>Total liabilities</b>                                | <b>7,536</b>     | <b>1,598</b>     |
| <b>Stockholders' equity</b>                             |                  |                  |
| Common stock  | 127              | 127              |
| Additional paid in capital                              | 65,434           | 65,256           |
| Retained earnings                                       | 120,574          | 99,662           |
| Accumulated other comprehensive loss                    | (2,950 )         | (1,309 )         |
| <b>Total stockholders' equity</b>                       | <b>183,185</b>   | <b>163,736</b>   |
| <b>Total liabilities and stockholders' equity</b>       | <b>\$190,721</b> | <b>\$165,334</b> |

## Condensed Statements of Income

For the Years Ended December 31,

| (Dollars in thousands) | 2018 | 2017 |
|------------------------|------|------|
| Income                 |      |      |

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|   |          |          |
|---|----------|----------|
| Dividends from subsidiaries   | \$4,000  | \$1,000  |
| Management and other fees from subsidiaries   | 8,160    | 7,811    |
| Gain on sale of subsidiary  | 12,736   | -        |
| Other operating income  | 30       | 94       |
| Total income  | 24,926   | 8,905    |
| Expenses  |          |          |
| Interest expense  | 54       | 36       |
| Salaries and employee benefits  | 4,580    | 4,799    |
| Occupancy and equipment expense   | 630      | 592      |
| Other operating expenses  | 3,421    | 2,878    |
| Total expenses  | 8,685    | 8,305    |
| Income before income tax expense (benefit) and equity in undistributed net income of subsidiaries | 16,241   | 600      |
| Income tax expense (benefit)  | 4,298    | (138 )   |
| Income before equity in undistributed net income of subsidiaries                                  | 11,943   | 738      |
| Equity in undistributed net income of subsidiaries  | 13,054   | 10,524   |
| Net income  | \$24,997 | \$11,262 |

## Condensed Statements of Cash Flows

For the Years Ended December 31,

| (Dollars in thousands)  | 2018     | 2017     |
|---|----------|----------|
| Cash flows from operating activities:   |          |          |
| Net income  | \$24,997 | \$11,262 |
| Adjustments to reconcile net income to cash provided by operating activities:               |          |          |
| Equity in undistributed net income of subsidiaries  | (13,054) | (10,524) |
| Depreciation and amortization   | 469      | 452      |
| Stock-based compensation expense  | 447      | 1,055    |
| Gain on sale of subsidiary  | (12,736) | -        |
| Net decrease in other assets  | 1,001    | 843      |
| Net increase (decrease) in other liabilities  | 3,267    | (806 )   |
| Net cash provided by operating activities   | 4,391    | 2,282    |
| Cash flows from investing activities:   |          |          |
| Proceeds from maturities and principal payments of investment securities available for sale | 187      | 534      |
| Purchases of premises and equipment   | (590 )   | (148 )   |
| Payments for advances to subsidiary   | -        | (267 )   |
| Cash of subsidiary retained upon disposal   | 726      | -        |
| Proceeds from sale of subsidiary  | 25,159   | -        |
| Net cash provided by investing activities   | 25,482   | 119      |
| Cash flows from financing activities:   |          |          |
| Increase in short-term borrowings   | 375      | 666      |
| Repayment of long-term debt   | -        | (843 )   |
| Common stock dividends paid   | (4,079 ) | (2,790 ) |
| Repurchase of shares for tax withholding on exercised options and vested restricted stock   | (269 )   | -        |
| Net cash used in financing activities   | (3,973 ) | (2,967 ) |
| Net increase (decrease) in cash and cash equivalents  | 25,900   | (566 )   |
| Cash and cash equivalents at beginning of year  | 683      | 1,249    |
| Cash and cash equivalents at end of year  | \$26,583 | \$683    |
| Supplemental cash flow information:   |          |          |
| Transfer of available for sale securities to banking subsidiary                             | \$-      | \$10,233 |

**NOTE 25. REVENUE RECOGNITION**

On January 1, 2018, the Company adopted ASU No. 2014-09 “*Revenue from Contracts with Customers*” (Topic 606) and all subsequent ASUs that modified Topic 606. The implementation of the new standard did not have a material impact on the measurement or recognition of revenue; as such, a cumulative effect adjustment to opening retained earnings was not deemed necessary. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts were not adjusted and continue to be reported in accordance with our historic accounting under Topic 605.

Topic 606 does not apply to revenue associated with financial instruments, including revenue from loans and securities. Topic 606 is applicable to noninterest revenue streams such as trust and asset management income, deposit related fees, interchange fees and merchant income. However, the recognition of these revenue streams did not change significantly upon adoption of Topic 606. Substantially all of the Company’s revenue is generated from contracts with customers. Noninterest revenue streams in-scope of Topic 606 are discussed below.

### **Service Charges on Deposit Accounts**

Service charges on deposit accounts consist of account analysis fees (i.e., net fees earned on analyzed business and public checking accounts), monthly service fees, check orders, and other deposit account related fees. The Company's performance obligation for account analysis fees and monthly service fees is generally satisfied, and the related revenue recognized, over the period in which the service is provided.

Check orders and other deposit account related fees are largely transactional based, and therefore, the Company's performance obligation is satisfied, and related revenue recognized, at a point in time. Payment for service charges on deposit accounts is primarily received immediately or at the end of the month through a direct charge to customers' accounts.

### **Trust and Investment Fee Income**

Trust and investment fee income are primarily comprised of fees earned from the management and administration of trusts and other customer assets. The Company's performance obligation is generally satisfied over time and the resulting fees are recognized monthly, based upon the month-end market value of the assets under management and the applicable fee rate. Payment is generally received a few days after month end through a direct charge to customers' accounts. The Company does not earn performance-based incentives.

Optional services such as real estate sales and tax return preparation services are also available to existing trust and asset management customers. The Company's performance obligation for these transactional-based services is generally satisfied, and related revenue recognized, at a point in time (i.e., as incurred). Payment is received shortly after services are rendered.

### **Other Noninterest Income**

Other noninterest income consists of: fees, exchange, other service charges, safety deposit box rental fees, and other miscellaneous revenue streams. Fees and other service charges are primarily comprised of debit and credit card income, ATM fees, merchant services income, and other service charges. Debit and credit card income is primarily comprised of interchange fees earned whenever the Company's debit and credit cards are processed through card payment networks such as Visa. ATM fees are primarily generated when a Company cardholder uses a non-Company ATM or a non-Company cardholder uses a Company ATM. Merchant services income mainly represents fees charged

to merchants to process their debit and credit card transactions, in addition to account management fees. Other service charges include revenue from processing wire transfers, bill pay service, cashier's checks, and other services. The Company's performance obligation for fees, exchange, and other service charges are largely satisfied, and related revenue recognized, when the services are rendered or upon completion. Payment is typically received immediately or in the following month. Safe deposit box rental fees are charged to the customer on an annual basis and recognized upon receipt of payment. The Company determined that rentals and renewals of safe deposit boxes will be recognized on a monthly basis consistent with the duration of the performance obligation.

The following presents noninterest income, segregated by revenue streams in-scope and out-of-scope of Topic 606, for December 31, 2018 and 2017.

| (Dollars in thousands)                         | December 31, |         |
|--|--------------|---------|
|  | 2018         | 2017    |
| Noninterest Income                             |              |         |
| In-scope of Topic 606:                         |              |         |
| Service charges on deposit accounts            | \$3,879      | \$3,628 |
| Trust and investment fee income                | 1,557        | 1,532   |
| Other noninterest income                       | 3,504        | 2,964   |
| Noninterest Income (in-scope of Topic 606)     | 8,940        | 8,124   |
| Noninterest Income (out-of-scope of Topic 606) | 73           | 76      |
| Total Noninterest Income (1)                   | \$9,013      | \$8,200 |

(1) Noninterest income associated with discontinued operations is reported in Note 2.

### Contract Balances

A contract asset balance occurs when an entity performs a service for a customer before the customer pays consideration (resulting in a contract receivable) or before payment is due (resulting in a contract asset). A contract liability balance is an entity's obligation to transfer a service to a customer for which the entity has already received payment (or payment is due) from the customer. The Company's noninterest revenue streams are largely based on transactional activity, or standard month-end revenue accruals such as asset management fees based on month-end market values. Consideration is often received immediately or shortly after the Company satisfies its performance obligation and revenue is recognized. The Company does not typically enter into long-term revenue contracts with customers, and therefore, does not experience significant contract balances. As of December 31, 2018 and December 31, 2017, the Company did not have any significant contract balances.

### Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.



**Item 9A. Controls and Procedures.**

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports filed under the Exchange Act with the SEC, such as this annual report, is recorded, processed, summarized and reported within the time periods specified in those rules and forms, and that such information is accumulated and communicated to the Company's management, including the principal executive officer (the "PEO") and the principal accounting officer ("PAO"), as appropriate, to allow for timely decisions regarding required disclosure. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

An evaluation of the effectiveness of these disclosure controls as of December 31, 2018 was carried out under the supervision and with the participation of the Company's management, including the PEO and the PAO. Based on that evaluation, the Company's management, including the PEO and the PAO, has concluded that the Company's disclosure controls and procedures are, in fact, effective at the reasonable assurance level.

During the fourth quarter of 2018, there was no change in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

As required by Section 404 of the Sarbanes-Oxley Act of 2002, management has performed an evaluation and testing of the Company's internal control over financial reporting as of December 31, 2018. Management's report on the Company's internal control over financial reporting and the related attestation report of the Company's independent registered public accounting firm are included in Item 8 of Part II of this annual report, and each such report is incorporated into this Item 9A by reference thereto.

**Item 9B. Other Information.**

None.





## **PART III**

### **Item 10. Directors, Executive Officers and Corporate Governance.**

The Company has adopted a Code of Ethics that applies to all of its directors, officers, and employees, including its principal executive officer, principal financial officer, principal accounting officer, or controller, or persons performing similar functions. A written copy of the Company's Code of Ethics will be provided to stockholders, free of charge, upon request to: W. David Morse, Secretary, Shore Bancshares, Inc., 18 E. Dover Street, Easton, Maryland 21601 or (410) 763-7800.

All other information required by this item is incorporated herein by reference to the following sections of the Company's definitive proxy statement to be filed in connection with the 2019 Annual Meeting of Stockholders:

- Election of Directors (Proposal 1);
- Continuing Directors;
- Executive Officers;
- Qualifications of Director Nominees and Continuing Directors;
- Section 16(a) Beneficial Ownership Reporting Compliance; and
- Corporate Governance Matters (under the heading, "Board Committees").

### **Item 11. Executive Compensation.**

The information required by this item is incorporated herein by reference to the following sections of the Company's definitive proxy statement to be filed in connection with the 2019 Annual Meeting of Stockholders:

- Executive Compensation
- Director Compensation

### **Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.**

The Company maintains the Shore Bancshares, Inc. 2016 Stock and Incentive Compensation Plan (the "2016 Plan") under which it may issue shares of common stock or grant other equity-based awards (stock options, stock appreciation rights, stock awards, stock units, and performance units) to directors, executive officers, and key

employees at the discretion of the Compensation Committee of the Board of Shore Bancshares, Inc. The plan was approved by the Company's Board of Directors and its stockholders.

**Item 13. Certain Relationships and Related Transactions, and Director Independence.**

The information required by this item is incorporated herein by reference to the sections of the Company's definitive proxy statement to be filed in connection with the 2019 Annual Meeting of Stockholders entitled "Certain Relationships and Related Transactions" and "Corporate Governance Matters" (under the heading, "Director Independence").

**Item 14. Principal Accounting Fees and Services.**

The information required by this item is incorporated herein by reference to the section of the Company's definitive proxy statement to be filed in connection with the 2019 Annual Meeting of Stockholders entitled "Audit Fees and Services".

## **PART IV**

### **Item 15. Exhibits, Financial Statement Schedules.**

(a)(1), (2) and (c) Financial statements and schedules:

Reports of Independent Registered Public Accounting Firms

Consolidated Balance Sheets at December 31, 2018 and 2017

Consolidated Statements of Income — Years Ended December 31, 2018 and 2017

Consolidated Statements of Comprehensive Income — Years Ended December 31, 2018 and 2017

Consolidated Statements of Changes in Stockholders' Equity — Years Ended December 31, 2018 and 2017

Consolidated Statements of Cash Flows — Years Ended December 31, 2018 and 2017

Notes to Consolidated Financial Statements for the years ended December 31, 2018 and 2017

(a)(3) and (b) Exhibits required to be filed by Item 601 of Regulation S-K:

The exhibits filed or furnished with this annual report are shown on the Exhibit Index that follows the signatures to this annual report, which index is incorporated herein by reference.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Shore Bancshares, Inc.

Date: March 15, 2019 By: /s/ Lloyd L. Beatty, Jr.  
Lloyd L. Beatty, Jr.  
*President and Chief Executive Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

/s/ Blenda W. Armistead  
Blenda W. Armistead, Director  
March 15, 2019

/s/ Frank E. Mason, III  
Frank E. Mason, III, Director  
March 15, 2019

/s/ Christopher F. Spurry  
Christopher F. Spurry, Director  
March 15, 2019

/s/ James A. Judge  
James A. Judge, Director  
March 15, 2019

/s/ Clyde V. Kelly, III  
Clyde V. Kelly, III, Director  
March 15, 2019

/s/ Jeffery E. Thompson  
Jeffery E. Thompson, Director  
March 15, 2019

/s/ David A. Fike  
David A. Fike, Director  
March 15, 2019

/s/ John H. Wilson  
John H. Wilson, Director  
March 15, 2019

/s/ David J. Bates  
David J. Bates, Director  
March 15, 2019

/s/ Lloyd L. Beatty, Jr.  
Lloyd L. Beatty, Jr.  
Director, President, and Chief Executive Officer  
(Principal Executive Officer)  
March 15, 2019

/s/ David W. Moore  
David W. Moore, Director  
March 15, 2019

/s/ R. Michael Clemmer, Jr.  
R. Michael Clemmer, Jr., Director

/s/ Edward C. Allen

March 15, 2019

Edward C. Allen

Senior Vice President and Chief Financial Officer

(Principal Accounting Officer)

March 15, 2019

**EXHIBIT LIST**

| Exhibit No. | Description  |
|-------------|--|
| 3.1(i)      | <u>Amended and Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 of the Company's Form 8-K filed on December 14, 2000)</u>  |
| 3.1(ii)     | <u>Articles Supplementary relating to the Fixed Rate Cumulative Perpetual Preferred Stock, Series A (incorporated by reference Exhibit 4.1 of the Company's Form 8-K filed on January 13, 2009)</u>  |
| 3.1(iii)    | <u>Articles Supplementary relating to the reclassification of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, as common stock (incorporated by reference Exhibit 3.1(i) of the Company's Form 8-K filed on June 17, 2009)</u>                     |
| 3.2(i)      | <u>Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(i) of the Company's Form 10-K for the year ended December 31, 2010)</u>  |
| 3.2(ii)     | <u>First Amendment to Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(ii) of the Company's Form 10-K for the year ended December 31, 2010)</u>  |
| 3.2(iii)    | <u>Second Amendment to Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(iii) of the Company's Form 10-K for the year ended December 31, 2010)</u>  |
| 3.2(iv)     | <u>Third Amendment to Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(iv) of the Company's Form 10-K for the year ended December 31, 2010)</u>  |
| 10.1        | <u>Amended and Restated Employment Agreement, dated June 16, 2011, between the Company and W. Moorhead Vermilye (incorporated by reference to Exhibit 10.1 to the Company's Form 10-Q/A for the quarter ended June 30, 2011 filed on November 14, 2011).</u> |
| 10.2        | <u>Employment Agreement, dated June 16, 2011, between the Company and Lloyd L. Beatty, Jr. (incorporated by reference to Exhibit 10.2 of the Company's Form 10-Q/A for the quarter ended June 30, 2011 filed on November 14, 2011)</u>                       |
| 10.3        | <u>Amended Summary of Compensation Arrangement for William W. Duncan, Jr. (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on February 14, 2007, as amended by Form 8-K/A filed on May 3, 2007)</u>                                |
| 10.4        | <u>Summary of Compensation Arrangement between Centreville National Bank and F. Winfield Trice, Jr. (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on August 13, 2007)</u>   |
| 10.5        | <u>Employment Agreement between The Avon-Dixon Agency, LLC and Mark M. Freestate (incorporated by reference to Exhibit 10.6 of the Company's Annual Report on Form 10-K for the year ended December 31, 2006)</u>  |

- 10.6 Shore Bancshares, Inc. Management Incentive Plan (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on April 21, 2010)
- 10.7 Shore Bancshares, Inc. Amended and Restated Executive Deferred Compensation Plan (incorporated by reference to Exhibit 10.2 of the Company's Form 8-K filed on February 14, 2007)
- 10.8 Deferral Election, Investment Designation, and Beneficiary Designation Forms under the Shore Bancshares, Inc. Amended and Restated Executive Deferred Compensation Plan (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed on October 2, 2006)
- 10.9 Form of Centreville National Bank of Maryland Director Indexed Fee Continuation Plan Agreement with Messrs. Freestate and Pierson (incorporated by reference to Exhibit 10.2 to the Company's Form 8-K filed on December 12, 2006)
- 10.10 Form of Amended and Restated Director Indexed Fee Continuation Plan Agreement between Centreville National Bank and Messrs. Freestate and Pierson (incorporated by reference to Exhibit 10.2 of the Company's Current Report on Form 8-K filed on January 7, 2009)



- 10.11 Form of Centreville National Bank Life Insurance Endorsement Split Dollar Plan Agreement with Messrs. Freestate and Pierson (incorporated by reference to Exhibit 10.3 to the Company's Form 8-K filed on December 12, 2006)
- 10.12 Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan (incorporated by reference to Exhibit 10.7 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2005)
- 10.13 First Amendment to The Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan for the benefit of W. Moorhead Vermilye (incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed on January 7, 2009)
- 10.14 Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan Trust Agreement (incorporated by reference to Exhibit 10.7 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2005)
- 10.15 1998 Stock Option Plan (incorporated by reference to Exhibit 10 of the Company's Registration Statement on Form S-8 filed with the SEC on September 25, 1998 (Registration No. 333-64319))
- 10.16 Talbot Bancshares, Inc. Employee Stock Option Plan (incorporated by reference to Exhibit 10 of the Company's Registration Statement on Form S-8 filed May 4, 2001 (Registration No. 333-60214))
- 10.17 Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (incorporated by reference to Appendix A of the Company's 2006 definitive proxy statement filed on March 24, 2006)
- 10.18 Form of Restricted Stock Award Agreement under the 2006 Stock and Incentive Compensation Plan (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on April 11, 2007)
- 10.19 Form of Performance Share/Restricted Stock Unit Award Agreement (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on July 8, 2015).
- 10.20 Amended and Restated Employment Agreement, dated September 21, 2015, between the Company and Lloyd L. Beatty, Jr. (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on September 25, 2015).
- 10.21 Amended and Restated Employment Agreement, dated February 16, 2017, between the Company and Lloyd L. Beatty, Jr. (incorporated by reference to Exhibit 10.21 to the Company's Form 10-K filed on March 16, 2017)
- 10.22 Amended and Restated Employment Agreement, dated October 31, 2017, between Shore Bancshares, Inc. and Lloyd L. Beatty, Jr. (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on November 1, 2017)
- 10.23 Employment Agreement, dated October 31, 2017, between Shore Bancshares, Inc. and Donna J. Stevens (incorporated by reference to Exhibit 10.2 to the Company's Form 8-K filed on November 1, 2017)
- 10.24 Employment Agreement, dated October 31, 2017, between Shore United Bank and Patrick M. Bilbrough (incorporated by reference to Exhibit 10.3 to the Company's Form 8-K filed on November 1, 2017)

- 10.25 Change in Control Agreement, dated October 31, 2017, between Shore United Bank and Edward C. Allen (incorporated by reference to Exhibit 10.4 to the Company's Form 8-K filed on November 1, 2017)
- 10.26 Change in Control Agreement, dated October 31, 2017, between The Avon-Dixon Agency, LLC and Richard C. Trippe (incorporated by reference to Exhibit 10.5 to the Company's Form 8-K filed on November 1, 2017)
- 10.27 Change in Control Agreement, dated November 1, 2018, by and between Lloyd L. Beatty, Jr. and Shore Bancshares, Inc. (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on November 2, 2018)
- 10.28 Change in Control Agreement, dated November 1, 2018, by and between Donna Stevens and Shore Bancshares, Inc. (incorporated by reference to Exhibit 10.2 to the Company's Form 8-K filed on November 2, 2018)
- 21 Subsidiaries of the Company (included in the "BUSINESS—General" section of Item 1 of Part I of this Annual Report on Form 10-K)
- 23.1 Consent of Yount, Hyde & Barbour, P.C. (filed herewith)
- 31.1 Certifications of the PEO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith)
- 31.2 Certifications of the PAO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith)
- 32 Certification pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith)
- 101.INS XBRL Instance Document (filed herewith)
- 101.SCH XBRL Taxonomy Extension Schema (filed herewith)
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase (filed herewith)
- 101.DEF XBRL Taxonomy Extension Definition Linkbase (filed herewith)
- 101.LAB XBRL Taxonomy Extension Label Linkbase (filed herewith)
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase (filed herewith)