FIRST CAPITAL INC
Form 10-Q
November 14, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2016

OR

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

For the transition period from______________________ to___________________

Commission File No. 0-25023

First Capital, Inc.

(Exact name of registrant as specified in its charter)

Indiana	**35-2056949**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

220 Federal Drive NW, Corydon, Indiana 47112

(Address of principal executive offices) (Zip Code)

Registrant's telephone number including area code **1-812-738-2198**

Not applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the 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 X No ____

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes __X__ No ______

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a small reporting company. See definition of “accelerated filer,” “large accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

(Check one): Large Accelerated Filer ___ Accelerated Filer ___

Non-accelerated Filer ___ Smaller Reporting Company _X__

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 3,337,552 shares of common stock were outstanding as of October 28, 2016.

FIRST CAPITAL, INC.

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PART I - FINANCIAL INFORMATION

FIRST CAPITAL, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Unaudited)

	September 30, 2016	December 31, 2015
	(In thousands)	
ASSETS		
Cash and due from banks	$16,255	$14,756
Interest bearing deposits with banks	1,382	3,635
Federal funds sold	52,744	90,783
Total cash and cash equivalents	70,381	109,174
Interest-bearing time deposits	15,540	16,655
Securities available for sale, at fair value	247,250	186,751
Securities-held to maturity	3	4
Loans, net	366,367	359,166
Loans held for sale	2,553	3,081
Federal Home Loan Bank and other stock, at cost	1,650	1,650
Foreclosed real estate	4,254	4,890
Premises and equipment	14,554	13,936
Accrued interest receivable	2,361	2,244
Cash value of life insurance	7,041	6,899
Goodwill	6,472	6,472
Core deposit intangible	1,296	1,406
Other assets	2,355	3,499
Total Assets	$742,077	$715,827
LIABILITIES		
Deposits:		
Noninterest-bearing	$124,205	$125,059
Interest-bearing	534,542	512,118
Total deposits	658,747	637,177
Accrued interest payable	137	167
Accrued expenses and other liabilities	4,487	3,975
Total liabilities	663,371	641,319
EQUITY		
Preferred stock of $.01 par value per share Authorized 1,000,000 shares; none issued	0	0
Common stock of $.01 par value per share Authorized 5,000,000 shares; issued 3,762,933 shares; outstanding 3,337,552 shares (3,338,603 in 2015)	38	38

Additional paid-in capital	39,515	39,515
Retained earnings-substantially restricted	46,012	42,991
Unearned stock compensation	(322)	(382)
Accumulated other comprehensive income	1,652	497
Less treasury stock, at cost -425,381 shares (424,330 in 2015)	(8,297)	(8,263)
Total First Capital, Inc. stockholders' equity	78,598	74,396
Noncontrolling interest in subsidiary	108	112
Total equity	78,706	74,508
Total Liabilities and Equity	$742,077	$715,827

See accompanying notes to consolidated financial statements.

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PART I - FINANCIAL INFORMATION

FIRST CAPITAL, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
INTEREST INCOME	(In thousands, except per share data)			
Loans, including fees	$4,940	$3,983	$15,106	$11,876
Securities:				
Taxable	861	267	2,424	797
Tax-exempt	279	243	862	733
Federal Home Loan Bank dividends	16	20	49	72
Federal funds sold and interest bearing deposits with banks	119	40	409	126
Total interest income	6,215	4,553	18,850	13,604
INTEREST EXPENSE				
Deposits	414	220	1,370	702
Total interest expense	414	220	1,370	702
Net interest income	5,801	4,333	17,480	12,902
Provision for loan losses	200	0	425	50
Net interest income after provision for loan losses	5,601	4,333	17,055	12,852
NONINTEREST INCOME				
Service charges on deposit accounts	1,046	897	2,968	2,527
Commission income	112	121	306	305
Gain on sale of securities	0	0	176	0
Gain on sale of loans	371	131	889	617
Mortgage brokerage fees	0	15	0	61
Increase in cash surrender value of life insurance	40	34	143	101
Other income	181	28	251	193
Total noninterest income	1,750	1,226	4,733	3,804
NONINTEREST EXPENSE				
Compensation and benefits	2,681	1,885	8,018	5,866
Occupancy and equipment	447	317	1,222	940
Data processing	650	441	1,784	1,271
Professional fees	189	258	626	839
Advertising	74	92	249	240
Other operating expenses	883	658	2,859	1,935
Total noninterest expense	4,924	3,651	14,758	11,091
Income before income taxes	2,427	1,908	7,030	5,565
Income tax expense	666	507	1,897	1,463
Net Income	1,761	1,401	5,133	4,102
Less: net income attributable to noncontrolling interest in subsidiary	3	3	10	10

Net Income Attributable to First Capital, Inc.	$1,758	$1,398	$5,123	$4,092
Earnings per common share attributable to First Capital, Inc.				
Basic	$0.53	$0.51	$1.53	$1.49
Diluted	$0.53	$0.51	$1.53	$1.49
Dividends per share	$0.21	$0.21	$0.63	$0.63

See accompanying notes to consolidated financial statements.

PART I - FINANCIAL INFORMATION

FIRST CAPITAL, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended September 30, 2016	Three Months Ended September 30, 2015	Nine Months Ended September 30, 2016	Nine Months Ended September 30, 2015
	(In thousands)			
Net Income	$1,761	$1,401	$5,133	$4,102
OTHER COMPREHENSIVE INCOME (LOSS)				
Unrealized gains (losses) on securities available for sale:				
Unrealized holding gains (losses) arising during the period	(637)	588	2,082	(49)
Income tax (expense) benefit	248	(229)	(811)	19
Net of tax amount	(389)	359	1,271	(30)
Less:reclassification adjustment for realized gains included in net income	0	0	(176)	0
Income tax expense	0	0	60	0
Net of tax amount	0	0	(116)	0
Other Comprehensive Income (Loss), net of tax	(389)	359	1,155	(30)
Comprehensive Income	1,372	1,760	6,288	4,072
Less:comprehensive income attributable to the noncontrolling interest in subsidiary	3	3	10	10
Comprehensive Income Attributable to First Capital, Inc.	$1,369	$1,757	$6,278	$4,062

See accompanying notes to consolidated financial statements.

PART I - FINANCIAL INFORMATION

FIRST CAPITAL, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(Unaudited)

(In thousands, except share and per share data)	Common Stock	Additional Paid-in Capital	Retained Earnings	Unearned Stock Compensation	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Noncontrolling Interest	Total
Balances at January 1, 2015	$32	$24,313	$40,229	$0	$800	$(8,253)	$112	$57,233
Net income	0	0	4,092	0	0	0	10	4,102
Other comprehensive loss	0	0	0	0	(30)	0	0	(30)
Cash dividends	0	0	(1,734)	0	0	0	(14)	(1,748)
Restricted stock grants, net of forfeitures	0	453	0	(453)	0	0	0	0
Stock compensation expense	0	0	0	53	0	0	0	53
Purchase of treasury shares	0	0	0	0	0	(10)	0	(10)
Balances at September 30, 2015	$32	$24,766	$42,587	$(400)	$770	$(8,263)	$108	$59,600
Balances at January 1, 2016	$38	$39,515	$42,991	$(382)	$497	$(8,263)	$112	$74,508
Net income	0	0	5,123	0	0	0	10	5,133
Other comprehensive income	0	0	0	0	1,155	0	0	1,155
Cash dividends	0	0	(2,102)	0	0	0	(14)	(2,116)
Stock compensation expense	0	0	0	60	0	0	0	60
Purchase of treasury shares	0	0	0	0	0	(34)	0	(34)
Balances at September 30, 2016	$38	$39,515	$46,012	$(322)	$1,652	$(8,297)	$108	$78,706

See accompanying notes to consolidated financial statements.

PART I - FINANCIAL INFORMATION

FIRST CAPITAL, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended **September 30,**	
	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES	(In thousands)	
Net income	$5,133	$4,102
Adjustments to reconcile net income to net cash and cash equivalents provided by operating activities:		
Amortization of premiums and accretion of discounts on securities, net	839	516
Depreciation and amortization expense	876	533
Deferred income taxes	400	492
Stock compensation expense	60	53
Increase in cash value of life insurance	(142)	(101)
Gain on life insurance	0	(110)
Gain on sale of securities	(176)	0
Provision for loan losses	425	50
Proceeds from sales of loans	38,608	22,193
Loans originated for sale	(37,191)	(20,292)
Gain on sale of loans	(889)	(617)
Decrease (increase) in accrued interest receivable	(117)	57
Decrease in accrued interest payable	(30)	(37)
Net change in other assets/liabilities	551	(122)
Net Cash Provided By Operating Activities	8,347	6,717
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment in interest-bearing time deposits	(1,975)	(3,610)
Proceeds from maturities and sales of interest-bearing time deposits	3,090	245
Purchase of securities available for sale	(159,338)	(20,375)
Proceeds from maturities of securities available for sale	82,271	15,863
Proceeds from sales of securities available for sale	4,583	0
Principal collected on mortgage-backed obligations	13,183	8,973
Net increase in loans receivable	(7,857)	(5,124)
Proceeds from redemption of Federal Home Loan Bank stock	0	691
Proceeds from sale of foreclosed real estate	867	157
Purchase of premises and equipment	(1,384)	(561)
Net Cash Used In Investing Activities	(66,560)	(3,741)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase (decrease) in deposits	21,570	(10,050)
Purchase of treasury stock	(34)	(10)

Dividends paid	(2,116)	(1,748)
Net Cash Provided By (Used In) Financing Activities	19,420	(11,808)
Net Increase Decrease in Cash and Cash Equivalents	(38,793)	(8,832)
Cash and cash equivalents at beginning of period	109,174	33,243
Cash and Cash Equivalents at End of Period	$70,381	$24,411

See accompanying notes to consolidated financial statements.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Presentation of Interim Information

First Capital, Inc. (“Company”) is the savings and loan holding company for First Harrison Bank (“Bank”). The information presented in this report relates primarily to the Bank's operations. First Harrison Investments, Inc. and First Harrison Holdings, Inc. are wholly-owned Nevada corporate subsidiaries of the Bank that jointly own First Harrison, LLC, a Nevada limited liability corporation that holds and manages an investment portfolio. First Harrison REIT, Inc. (“REIT”) was incorporated as a wholly-owned subsidiary of First Harrison Holdings, Inc. to hold a portion of the Bank’s real estate mortgage loan portfolio. On January 21, 2009, the REIT issued 105 shares of 12.5% redeemable cumulative preferred stock with an aggregate liquidation value of $105,000 in a private placement offering in order to satisfy certain ownership requirements to qualify as a real estate investment trust. At September 30, 2016, this noncontrolling interest represented 0.1% ownership of the REIT. FHB Risk Mitigation Services, Inc. (“Captive”) is a wholly-owned insurance subsidiary of the Company that provides property and casualty insurance coverage to the Company, the Bank and the Bank’s subsidiaries, and reinsurance to ten other third party insurance captives for which insurance may not be currently available or economically feasible in the insurance marketplace. Heritage Hill, LLC is a wholly-owned subsidiary of the Bank that holds and manages certain foreclosed real estate properties.

In the opinion of management, the unaudited consolidated financial statements include all adjustments considered necessary to present fairly the financial position as of September 30, 2016, and the results of operations for the three months and nine months ended September 30, 2016 and 2015 and the cash flows for the nine months ended September 30, 2016 and 2015. All of these adjustments are of a normal, recurring nature. Such adjustments are the only adjustments included in the unaudited consolidated financial statements. Interim results are not necessarily indicative of results for a full year or any other period.

The accompanying unaudited consolidated financial statements and notes have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial statements and are presented as permitted by the instructions to Form 10-Q. Accordingly, they do not contain certain information included in the Company’s annual audited consolidated financial statements and related footnotes for the year ended December 31, 2015 included in the Company’s Annual Report on Form 10-K.

The unaudited consolidated financial statements include the accounts of the Company and its subsidiaries. All material intercompany balances and transactions have been eliminated in consolidation.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. Acquisition of Peoples Bancorp, Inc. of Bullitt County

On December 4, 2015, the Company completed its acquisition of Peoples Bancorp, Inc. of Bullitt County (“Peoples”) and its wholly owned subsidiary The Peoples Bank of Bullitt County (“Peoples Bank”), headquartered in Shepherdsville, Kentucky, pursuant to an Agreement and Plan of Merger dated June 4, 2015 (the “Merger Agreement”). Under the Merger Agreement, Peoples merged with and into the Company, with the Company as the surviving corporation, and Peoples Bank merged with and into the Bank, with the Bank as the surviving financial institution. The acquisition expanded the Company’s presence into Bullitt County, Kentucky and its overall presence in the greater Louisville, Kentucky metropolitan market. The Company expects to benefit from growth in this new market area as well as from expansion of the banking services provided to the existing customers of Peoples Bank. Cost savings are also expected for the combined bank through economies of scale and the consolidation of business operations.

The Company paid cash consideration of $14.7 million in the transaction and issued 580,017 shares of Company common stock, with a total fair value of $14.8 million. As part of the merger, the Company acquired foreclosed real estate with an estimated fair value of $3.75 million (the “Contingent Assets”). Under the terms of the Merger Agreement, if the Company sells the Contingent Assets within 24 months after the effective date of the merger or has entered into a written contract for the sale of the Contingent Assets which are then sold within 60 days after the expiration of that 24-month period, the Company will distribute additional cash consideration of 50% of the sale proceeds in excess of $3.75 million on a pro rata basis to the former shareholders of Peoples. Currently, there is no written contract for the sale of the Contingent Assets and no contingent consideration is anticipated.

The transaction was accounted for using the acquisition method of accounting. Accordingly, the results of operations of Peoples have been included in the Company’s results of operations since the date of acquisition. Under the acquisition method of accounting, the purchase price was assigned to the assets acquired and liabilities assumed based on their estimated fair values, net of applicable income tax effects. The excess of cost over the fair value of the acquired net assets of $1.1 million was recorded as goodwill. The goodwill arising from the acquisition consisted largely of the synergies and economies of scale expected from combining the operations of the Company and Peoples. No amount of the goodwill arising in the acquisition is deductible for income tax purposes.

Acquisition-related costs of approximately $86,000 and $353,000 are included in noninterest expense in the accompanying consolidated statements of income for the three and nine months, respectively, ended September 30, 2015. There were no acquisition-related costs for the three or nine months ended September 30, 2016.

Additional information regarding the Peoples acquisition can be found in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. Investment Securities

Debt and equity securities have been classified in the consolidated balance sheets according to management's intent. Investment securities at September 30, 2016 and December 31, 2015 are summarized as follows:

(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2016				
Securities available for sale:				
Agency mortgage-backed securities	$98,359	$ 728	$ 35	$99,052
Agency CMO	17,195	89	59	17,225
Other debt securities:				
Agency notes and bonds	72,399	117	55	72,461
Municipal obligations	56,576	1,943	110	58,409
Subtotal - debt securities	244,529	2,877	259	247,147
Mutual funds	103	0	0	103
Total securities available for sale	$244,632	$ 2,877	$ 259	$247,250
Securities held to maturity:				
Agency mortgage-backed securities	$3	$ 0	$ 0	$3
Total securities held to maturity	$3	$ 0	$ 0	$3
December 31, 2015				
Securities available for sale:				
Agency mortgage-backed securities	$42,158	$ 123	$ 271	$42,010
Agency CMO	9,391	41	101	9,331
Other debt securities:				
Agency notes and bonds	84,797	11	355	84,453
Municipal obligations	49,527	1,372	60	50,839
Subtotal - debt securities	185,873	1,547	787	186,633
Mutual funds	118	0	0	118

Total securities available for sale	$185,991	$ 1,547	$ 787	$186,751
Securities held to maturity:				
Agency mortgage-backed securities	$4	$ 0	$ 0	$4
Total securities held to maturity	$4	$ 0	$ 0	$4

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(3 – continued)

Agency notes and bonds, agency mortgage-backed securities and agency collateralized mortgage obligations (CMO) include securities issued by the Government National Mortgage Association (GNMA), a U.S. government agency, and the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal Home Loan Bank (FHLB), which are government-sponsored enterprises.

The amortized cost and fair value of debt securities as of September 30, 2016, by contractual maturity, are shown below. Expected maturities of mortgage-backed securities may differ from contractual maturities because the mortgages underlying the obligations may be prepaid without penalty.

	Securities Available for Sale		Securities Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
(In thousands)				
Due in one year or less	$2,543	$2,550	$ 0	$ 0
Due after one year through five years	76,637	76,854	0	0
Due after five years through ten years	17,579	17,855		
Due after ten years	32,216	33,611	0	0
	128,975	130,870	0	0
Mortgage-backed securities and CMO	115,554	116,277	3	3
	$244,529	$247,147	$ 3	$ 3

Information pertaining to investment securities available for sale with gross unrealized losses at September 30, 2016, aggregated by investment category and the length of time that individual investment securities have been in a continuous position, follows:

Number of Investment	Fair Value	Gross Unrealized

	Positions		Losses
(Dollars in thousands)			
Continuous loss position less than twelve months:			
Agency notes and bonds	8	$29,198	$ 55
Agency CMO	5	5,080	43
Agency mortgage-backed securities	10	21,381	34
Municipal obligations	19	10,602	110
Total less than twelve months	42	66,261	242
Continuous loss position more than twelve months:			
Agency CMO	5	2,744	16
Agency mortgage-backed securities	1	571	1
Total more than twelve months	6	3,315	17
Total securities available for sale	48	$69,576	$ 259

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(3 – continued)

Management evaluates securities for other-than-temporary impairment at least quarterly, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recover in fair value.

At September 30, 2016, the U.S. government agency debt securities, including agency notes and bonds, mortgage-backed securities and CMO, and municipal obligations in a loss position had depreciated approximately 0.4% from the amortized cost basis. All of the U.S. government agency securities and municipal obligations are issued by U.S. government agencies, government-sponsored enterprises and municipal governments, or are secured by first mortgage loans and municipal project revenues. These unrealized losses related principally to current interest rates for similar types of securities. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government, its agencies or other governments, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer's financial condition. As the Company has the ability to hold the debt securities until maturity, or the foreseeable future if classified as available for sale, no declines are deemed to be other-than-temporary.

While management does not anticipate any credit-related impairment losses at September 30, 2016, additional deterioration in market and economic conditions may have an adverse impact on credit quality in the future.

During the nine months ended September 30, 2016, the Company realized gross gains on sales of available for sale municipal securities of $176,000. During the three months ended September 30, 2016 and the three and nine months ended September 30, 2015, the Company did not have any security sales.

In June 2014, the Company acquired an additional 31,750 shares of common stock in another financial institution, in addition to the 100,000 shares acquired in December 2013, representing approximately 9% of the outstanding common stock of the entity, for a total investment of $711,000. The investment was accounted for using the cost method of accounting and was included in other assets in the consolidated balance sheet. The Company's investment was sold for $856,000 in July 2016, resulting in a gain of $145,000 which was recognized in the quarter ending September 30, 2016 and is included in other noninterest income in the accompanying statement of income.

4. Loans and Allowance for Loan Losses

The Company’s loan and allowance for loan loss policies are as follows:

Loans are stated at unpaid principal balances, less net deferred loan fees and the allowance for loan losses. The Company grants real estate mortgage, commercial business and consumer loans. A substantial portion of the loan portfolio is represented by mortgage loans to customers in the Louisville, Kentucky metropolitan statistical area (MSA). The ability of the Company’s customers to honor their loan agreements is largely dependent upon the real estate and general economic conditions in this area.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

Loan origination and commitment fees, as well as certain direct costs of underwriting and closing loans, are deferred and amortized as a yield adjustment to interest income over the lives of the related loans using the interest method. Amortization of net deferred loan fees is discontinued when a loan is placed on nonaccrual status.

The recognition of income on a loan is discontinued and previously accrued interest is reversed, when interest or principal payments become ninety (90) days past due unless, in the opinion of management, the outstanding interest remains collectible. Past due status is determined based on contractual terms. Generally, by applying the cash receipts method, interest income is subsequently recognized only as received until the loan is returned to accrual status. The cash receipts method is used when the likelihood of further loss on the loan is remote. Otherwise, the Company applies the cost recovery method and applies all payments as a reduction of the unpaid principal balance until the loan qualifies for return to accrual status. Interest income on impaired loans is recognized using the cost recovery method, unless the likelihood of further loss on the loan is remote.

A loan is restored to accrual status when all principal and interest payments are brought current and the borrower has demonstrated the ability to make future payments of principal and interest as scheduled, which generally requires that the borrower demonstrate a period of performance of at least six consecutive months.

For portfolio segments other than consumer loans, the Company’s practice is to charge-off any loan or portion of a loan when the loan is determined by management to be uncollectible due to the borrower’s failure to meet repayment terms, the borrower’s deteriorating or deteriorated financial condition, the depreciation of the underlying collateral, the loan’s classification as a loss by regulatory examiners, or for other reasons. A partial charge-off is recorded on a loan when the uncollectibility of a portion of the loan has been confirmed, such as when a loan is discharged in bankruptcy, the collateral is liquidated, a loan is restructured at a reduced principal balance, or other identifiable events that lead management to determine the full principal balance of the loan will not be repaid. A specific reserve is recognized as a component of the allowance for estimated losses on loans individually evaluated for impairment. Partial charge-offs on nonperforming and impaired loans are included in the Company’s historical loss experience used to estimate the general component of the allowance for loan losses as discussed below. Specific reserves are not considered charge-offs in management’s analysis of the allowance for loan losses because they are estimates and the outcome of the loan relationship is undetermined. At September 30, 2016, the Company had 10 loans on which partial charge-offs of $468,000 had been recorded.

Consumer loans not secured by real estate are typically charged off at 90 days past due, or earlier if deemed uncollectible, unless the loans are in the process of collection. Overdrafts are charged off after 45 days past due. Charge-offs are typically recorded on loans secured by real estate when the property is foreclosed upon.

The allowance for loan losses reflects management's judgment of probable loan losses inherent in the loan portfolio at the balance sheet date. Additions to the allowance for loan losses are made by the provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

The Company uses a disciplined process and methodology to evaluate the allowance for loan losses on at least a quarterly basis that is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific and general components. The specific component relates to loans that are individually evaluated for impairment or loans otherwise classified as doubtful, substandard, or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan.

The general component covers non-classified loans and classified loans that are found, upon individual evaluation, to not be impaired. Such loans are pooled by segment and losses are modeled using annualized historical loss experience adjusted for qualitative factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Company over the most recent twelve calendar quarters unless the historical loss experience is not considered indicative of the level of risk in the remaining balance of a particular portfolio segment, in which case an adjustment is determined by management. The Company's historical loss experience is then adjusted by an overall loss factor weighting adjustment based on a qualitative analysis prepared by management and reviewed on a quarterly basis. The overall loss factor considers changes in underwriting standards, economic conditions, changes and trends in past due and classified loans and other internal and external factors.

Management also applies additional loss factor multiples to loans classified as watch, special mention and substandard that are not individually evaluated for impairment. The loss factor multiples for classified loans are based on management's assessment of historical trends regarding losses experienced on classified loans in prior periods. See below for additional discussion of the overall loss factor and loss factor multiples for classified loans as of September 30, 2016 and December 31, 2015.

Management exercises significant judgment in evaluating the relevant historical loss experience and the qualitative factors. Management also monitors the differences between estimated and actual incurred loan losses for loans considered impaired in order to evaluate the effectiveness of the estimation process and make any changes in the methodology as necessary.

Management utilizes the following portfolio segments in its analysis of the allowance for loan losses: residential real estate, land, construction, commercial real estate, commercial business, home equity and second mortgage, and other consumer loans. Additional discussion of the portfolio segments and the risks associated with each segment can be found in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

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(4 – continued)

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Values for collateral dependent loans are generally based on appraisals obtained from independent licensed real estate appraisers, with adjustments applied for estimated costs to sell the property, costs to complete unfinished or repair damaged property and other factors. New appraisals are generally obtained for all significant properties when a loan is identified as impaired, and a property is considered significant if the value of the property is estimated to exceed $200,000. Subsequent appraisals are obtained as needed or if management believes there has been a significant change in the market value of the property. In instances where it is not deemed necessary to obtain a new appraisal, management bases its impairment and allowance for loan loss analysis on the original appraisal with adjustments for current conditions based on management's assessment of market factors and management's inspection of the property.

At September 30, 2016, the recorded investments in loans secured by residential real estate properties for which formal foreclosure proceedings are in process was $799,000.

Loans at September 30, 2016 and December 31, 2015 consisted of the following:

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(4 – continued)

(In thousands)	September 30, 2016	December 31, 2015
Real estate mortgage loans:		
Residential	$133,929	$147,933
Land	13,195	12,962
Residential construction	26,972	16,391
Commercial real estate	93,798	84,493
Commercial real estate contruction	8,848	1,090
Commercial business loans	22,888	23,095
Consumer loans:		
Home equity and second mortgage loans	42,093	38,476
Automobile loans	33,025	28,828
Loans secured by savings accounts	1,819	2,096
Unsecured loans	3,782	4,350
Other consumer loans	9,070	7,210
Gross loans	389,419	366,924
Less undisbursed portion of loans in process	(20,495)	(4,926)
Principal loan balance	368,924	361,998
Deferred loan origination fees, net	763	583
Allowance for loan losses	(3,320)	(3,415)
Loans, net	$366,367	$359,166

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

The following table provides the components of the Company's recorded investment in loans at September 30, 2016:

	Residential Real Estate	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
	(In thousands)							
Recorded Investment in Loans:								
Principal loan balance	$133,929	$13,195	$15,325	$93,798	$22,888	$42,093	$47,696	$368,924
Accrued interest receivable	440	56	37	263	59	135	189	1,179
Net deferred loan origination fees and costs	73	13	0	(44)	1	720	0	763
Recorded investment in loans	$134,442	$13,264	$15,362	$94,017	$22,948	$42,948	$47,885	$370,866
Recorded Investment in Loans as Evaluated for Impairment:								
Individually evaluated for impairment	$2,034	$0	$0	$2,983	$61	$62	$30	$5,170
Collectively evaluated for impairment	132,031	13,264	15,362	90,785	22,887	42,886	47,855	365,070
Acquired with deteriorated credit quality	377	0	0	249	0	0	0	626
Ending balance	$134,442	$13,264	$15,362	$94,017	$22,948	$42,948	$47,885	$370,866

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

The following table provides the components of the Company’s recorded investment in loans at December 31, 2015:

	Residential Real Estate	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
	(In thousands)							
Recorded Investment in Loans:								
Principal loan balance	$147,933	$12,962	$12,555	$84,493	$23,095	$38,476	$42,484	$361,998
Accrued interest receivable	584	70	61	281	64	130	171	1,361
Net deferred loan origination fees and costs	58	6	0	(46)	(6)	571	0	583
Recorded investment in loans	$148,575	$13,038	$12,616	$84,728	$23,153	$39,177	$42,655	$363,942
Recorded Investment in Loans as Evaluated for Impairment:								
Individually evaluated for impairment	$1,996	$24	$0	$3,623	$167	$136	$0	$5,946
Collectively evaluated for impairment	145,695	13,014	12,616	80,639	22,986	39,041	42,655	356,646
Acquired with deteriorated credit quality	884	0	0	466	0	0	0	1,350
Ending balance	$148,575	$13,038	$12,616	$84,728	$23,153	$39,177	$42,655	$363,942

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

An analysis of the allowance for loan losses as of September 30, 2016 is as follows:

	Residential Real Estate	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
	(In thousands)							
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	$15	$0	$ 0	$ 0	$ 0	$ 13	$ 6	$34
Collectively evaluated for impairment	367	49	63	1,576	141	813	277	3,286
Acquired with deteriorated credit quality	0	0	0	0	0	0	0	0
Ending balance	$382	$49	$ 63	$ 1,576	$ 141	$ 826	$ 283	$3,320

An analysis of the allowance for loan losses as of December 31, 2015 is as follows:

	Residential Real Estate	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
	(In thousands)							
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	$6	$0	$ 0	$ 49	$ 100	$ 11	$ 0	$166
Collectively evaluated for impairment	521	157	47	1,492	161	615	256	3,249
Acquired with deteriorated credit quality	0	0	0	0	0	0	0	0
Ending balance	$527	$157	$ 47	$ 1,541	$ 261	$ 626	$ 256	$3,415

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

An analysis of the changes in the allowance for loan losses for the three months and nine months ended September 30, 2016 is as follows:

	Residential Real Estate	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
	(In thousands)							
Allowance for loan losses:								
Changes in Allowance for Loan Losses for the three-months ended September 30, 2016								
Beginning balance	$408	$47	$ 42	$ 1,473	$ 162	$791	$ 266	$3,189
Provisions for loan losses	(29)	2	21	100	(21)	31	96	200
Charge-offs	(14)	0	0	0	0	0	(106)	(120)
Recoveries	17	0	0	3	0	4	27	51
Ending balance	$382	$49	$ 63	$ 1,576	$ 141	$826	$ 283	$3,320
Changes in Allowance for Loan Losses for the nine-months ended September 30, 2016								
Beginning balance	$527	$157	$ 47	$ 1,541	$ 261	$626	$ 256	$3,415
Provisions for loan losses	(70)	(99)	16	96	(9)	223	268	425
Charge-offs	(108)	(9)	0	(82)	(114)	(36)	(325)	(674)
Recoveries	33	0	0	21	3	13	84	154
Ending balance	$382	$49	$ 63	$ 1,576	$ 141	$826	$ 283	$3,320

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

An analysis of the changes in the allowance for loan losses for the three months and nine months ended September 30, 2015 is as follows:

	Residential Real Estate	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
	(In thousands)							
Allowance for loan losses:								
Changes in Allowance for Loan Losses for the three-months ended September 30, 2015								
Beginning balance	$634	$173	$ 51	$ 1,669	$ 161	$648	$ 264	$3,600
Provisions for loan losses	(15)	(12)	(2)	(60)	19	26	44	0
Charge-offs	(41)	0	0	0	0	(36)	(79)	(156)
Recoveries	6	0	0	4	5	6	29	50
Ending balance	$584	$161	$ 49	$ 1,613	$ 185	$644	$ 258	$3,494
Changes in Allowance for Loan Losses for the nine-months ended September 30, 2015								
Beginning balance	$609	$201	$ 60	$ 1,501	$ 1,480	$720	$ 275	$4,846
Provisions for loan losses	27	(40)	(11)	96	(97)	(20)	95	50
Charge-offs	(61)	0	0	0				