

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended **September 30, 2018**

OR

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

For the transition period from _____ to _____.

Commission File Number: **001-37886**

CAPSTAR FINANCIAL HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

Tennessee

(State or other jurisdiction of
incorporation or organization)

1201 Demonbreun Street, Suite 700

Nashville, Tennessee

(Address of principal executive office)

81-1527911

(IRS Employer
Identification No.)

37203

(zip code)

(615) 732-6400

(Registrant's telephone number, including area code)

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 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 (§5232.405 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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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

Non-Accelerated Filer

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

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

Shares outstanding as of November 5, 2018

Common Stock, par value \$1.00 per share

17,261,763

Non-voting Common Stock, par value \$1.00 per share

132,561

CAPSTAR FINANCIAL HOLDINGS, INC.
QUARTERLY REPORT ON FORM 10-Q
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The terms “we,” “our,” “us,” “the Company,” “CSTR” and “CapStar” that appear in this Quarterly Report on Form 10-Q (this “Report”) refer to CapStar Financial Holdings, Inc. and its wholly owned subsidiary, CapStar Bank. The terms “CapStar Bank,” “the Bank” and “our Bank” that appear in this Report refer to CapStar Bank.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Report contains “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). These forward-looking statements reflect our current views with respect to, among other things, future events including, without limitation, the terms, timing and closing of the proposed mergers with Athens Bancshares Corporation and Athens Federal Community Bank (collectively, “Athens”) and our financial performance. These statements are often, but not always, made through the use of words or phrases such as “may,” “should,” “could,” “predict,” “potential,” “believe,” “will likely result,” “expect,” “continue,” “will,” “anticipate,” “seek,” “aspire,” “roadmap,” “achieve,” “estimate,” “intend,” “plan,” “project,” “projection,” “forecast,” “goal,” “target,” “would,” and “outlook,” or the negative version of those words or other comparable words of a future or forward-looking nature. These forward-looking statements are not historical facts, and are based on current expectations, estimates and projections about our industry, management’s beliefs and certain assumptions made by management, many of which, by their nature, are inherently uncertain and beyond our control. The inclusion of these forward-looking statements should not be regarded as a representation by us or any other person that such expectations, estimates and projections will be achieved. Accordingly, we caution you that any such forward-looking statements are not guarantees of future performance and are subject to risks, assumptions and uncertainties that are difficult to predict. Although we believe that the expectations reflected in these forward-looking statements are reasonable as of the date of this Report, actual results may prove to be materially different from the results expressed or implied by the forward-looking statements. There are or will be important factors that could cause our actual results to differ materially from those indicated in these forward-looking statements, including, but not limited to, the following:

The acceptance by customers of Athens of the Company’s products and services; the ability of the Company to meet expectations regarding the benefits, costs, synergies, and financial and operational impact of the mergers with Athens Bancshares Corporation and Athens Federal Community Bank (collectively, “Athens”); the possibility that any of the anticipated benefits, costs, synergies and financial and operational improvements of the Athens merger will not be realized or will not be realized as expected; the possibility that the Athens merger integration may be more expensive or take more time to complete than anticipated; the opportunities to enhance market share in certain markets and market acceptance of the Company generally in new markets; economic conditions (including interest rate environment, government economic and monetary policies, the strength of global financial markets and inflation and deflation) that impact the financial services industry as a whole and/or our business; the concentration of our business in the Nashville metropolitan statistical area (“MSA”) and the effect of changes in the economic, political and environmental conditions on this market; increased competition in the financial services industry, locally, regionally or nationally, which may adversely affect pricing and the other terms offered to our clients; our dependence on our management team and board of directors and changes in our management and board composition; our reputation in the community; our ability to execute our strategy and to achieve our ROAA and efficiency ratio goals, hire seasoned bankers, loan and deposit growth through organic growth and strategic acquisitions; credit risks related to the size of our borrowers and our ability to adequately identify, assess and limit our credit risk; our concentration of large loans to a small number of borrowers; the significant portion of our loan portfolio that originated during the past two years and therefore may less reliably predict future collectability than older loans; the adequacy of reserves (including our allowance for loan losses) and the appropriateness of our methodology for calculating such reserves; non-performing loans and leases; non-performing assets; charge-offs, non-accruals, troubled-debt restructurings, impairments and other credit-related issues; adverse trends in the healthcare service industry, which is an integral component of our market’s economy; our management of risks inherent in our commercial real estate loan portfolio, and the risk of a prolonged downturn in the real estate market, which could impair the value of our collateral and our ability to sell collateral upon any foreclosure; governmental legislation and regulation, including changes in the nature and timing of the adoption and effectiveness of new requirements under the Dodd-Frank Act of 2010, as amended, the Tax Cuts and Jobs Act of 2017, Basel guidelines, capital requirements, accounting regulation or standards and other applicable laws and regulations; the loss of large depositor relationships, which could force us to fund our business through more expensive and less stable sources; operational and liquidity risks associated with our business, including liquidity risks inherent in correspondent banking; volatility in interest rates and our overall management of interest rate risk, including managing the sensitivity of our interest-earning assets and interest-bearing liabilities to interest rates, and the impact to our earnings from a change in interest rates; the potential for our Bank’s regulatory lending limits and other factors related to our size to restrict our growth and prevent us from effectively implementing our business strategy; strategic acquisitions we may undertake to achieve our goals; the sufficiency of our capital, including sources of capital and the extent to which we may be required to raise additional capital to meet our goals; fluctuations to the fair value of our investment securities that are beyond our control; deterioration in the fiscal position of the U.S. government and downgrades in Treasury and federal agency securities; potential exposure to fraud, negligence, computer theft and cyber-crime; the adequacy of our risk management framework; our dependence on our information technology and telecommunications systems and

the potential for any systems failures or interruptions; our dependence upon outside third parties for the processing and handling of our records and data; our ability to adapt to technological change; the financial soundness of other financial institutions; our exposure to environmental liability risk associated with our lending activities; our engagement in derivative transactions; our involvement from time to time in legal proceedings and examinations and remedial actions by regulators; the susceptibility of our market to natural disasters and acts of God; and the effectiveness of our internal controls over financial reporting and our ability to remediate any future material weakness in our internal controls over financial reporting.

The foregoing factors should not be construed as exhaustive and should be read in conjunction with those factors that are detailed from time to time in the Company's periodic and current reports filed with the Securities and Exchange Commission (the "SEC"), including those factors included in the Company's most recent Annual Report on Form 10-K under the heading "Item 1A. Risk Factors" and in the Company's Quarterly Reports on Form 10-Q and Current Reports on Form 8-K. If one or more events related to these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may differ materially from our forward-looking statements. Accordingly, you should not place undue reliance on any such forward-looking statements. Any forward-looking statement speaks only as of the date of this Report, and we do not undertake any obligation to publicly update or review any forward-looking statement, whether as a result of new information, future developments or otherwise, except as required by law. New risks and uncertainties may emerge from time to time, and it is not possible for us to predict their occurrence or how they will affect us.

PART I. FINANCIAL INFORMATION
Item 1. Consolidated Financial Statements

CAPSTAR FINANCIAL HOLDINGS, INC. & SUBSIDIARY
Consolidated Balance Sheets
(Dollars in thousands, except share data)

	September 30, 2018 (unaudited)	December 31, 2017
Assets		
Cash and due from banks	\$ 8,563	\$ 9,506
Interest-bearing deposits in financial institutions	41,279	68,572
Federal funds sold	2,747	4,719
Total cash and cash equivalents	<u>52,589</u>	<u>82,797</u>
Securities available-for-sale, at fair value	187,469	192,621
Securities held-to-maturity, fair value of \$3,766, and \$3,848 at September 30, 2018 and December 31, 2017, respectively	3,740	3,759
Loans held for sale	50,499	74,093
Loans	1,073,870	947,537
Less allowance for loan losses	(15,218)	(13,721)
Loans, net	<u>1,058,652</u>	<u>933,816</u>
Premises and equipment, net	9,584	5,884
Restricted equity securities	8,817	8,806
Accrued interest receivable	4,430	4,084
Goodwill	6,219	6,219
Core deposit intangible	—	23
Other assets	34,908	32,327
Total assets	<u>\$ 1,416,907</u>	<u>\$ 1,344,429</u>
Liabilities and Shareholders' Equity		
Deposits:		
Non-interest-bearing	\$ 239,792	\$ 301,742
Interest-bearing	307,299	274,681
Savings and money market accounts	376,985	367,246
Time	202,327	176,197
Total deposits	<u>1,126,403</u>	<u>1,119,866</u>
Federal Home Loan Bank advances	125,000	70,000
Other liabilities	7,994	7,617
Total liabilities	<u>1,259,397</u>	<u>1,197,483</u>
Shareholders' equity:		
Series A convertible preferred stock, \$1 par value; 5,000,000 shares authorized; 878,049 shares issued and outstanding at September 30, 2018 and December 31, 2017	878	878
Common stock, voting, \$1 par value; 20,000,000 shares authorized; 11,992,561 and 11,449,465 shares issued and outstanding at September 30, 2018 and December 31, 2017, respectively	11,993	11,450
Common stock, nonvoting, \$1 par value; 5,000,000 shares authorized; 132,561 shares issued and outstanding at September 30, 2018 and December 31, 2017	133	133
Additional paid-in capital	121,646	118,120
Retained earnings	28,741	18,892
Accumulated other comprehensive loss, net of income tax	(5,881)	(2,527)
Total shareholders' equity	<u>157,510</u>	<u>146,946</u>
Total liabilities and shareholders' equity	<u>\$ 1,416,907</u>	<u>\$ 1,344,429</u>

See accompanying notes to consolidated financial statements (unaudited).

CAPSTAR FINANCIAL HOLDINGS, INC. & SUBSIDIARY
Consolidated Statements of Income (Unaudited)
(Dollars in thousands, except share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Interest income:				
Loans, including fees	\$ 14,167	\$ 12,095	\$ 40,197	\$ 33,935
Securities:				
Taxable	951	838	2,775	2,827
Tax-exempt	248	304	784	944
Federal funds sold	17	7	56	26
Restricted equity securities	132	108	389	271
Interest-bearing deposits in financial institutions	267	169	679	387
Total interest income	15,782	13,521	44,880	38,390
Interest expense:				
Interest-bearing deposits	1,146	635	2,793	1,839
Savings and money market accounts	1,409	772	3,827	2,360
Time deposits	985	706	2,468	1,750
Federal funds purchased	1	2	3	13
Federal Home Loan Bank advances	698	563	1,813	1,083
Total interest expense	4,239	2,678	10,904	7,045
Net interest income	11,543	10,843	33,976	31,345
Provision for loan losses	481	(195)	1,328	12,900
Net interest income after provision for loan losses	11,062	11,038	32,648	18,445
Noninterest income:				
Treasury management and other deposit service charges	528	427	1,357	1,097
Net gain (loss) on sale of securities	(1)	9	2	42
Tri-Net fees	373	367	1,227	748
Mortgage banking income	1,634	2,030	4,329	4,617
Other noninterest income	684	539	2,157	1,667
Total noninterest income	3,218	3,372	9,072	8,171
Noninterest expense:				
Salaries and employee benefits	6,514	5,119	19,111	14,989
Data processing and software	803	709	2,411	2,040
Professional fees	255	336	1,074	1,050
Occupancy	544	531	1,600	1,518
Equipment	520	564	1,661	1,604
Regulatory fees	228	270	664	877
Merger related expenses	540	—	875	—
Other operating	666	946	2,259	2,988
Total noninterest expense	10,070	8,475	29,655	25,066
Income before income taxes	4,210	5,935	12,065	1,550
Income tax expense	554	1,516	1,702	141
Net income	\$ 3,656	\$ 4,419	\$ 10,363	\$ 1,409
Per share information:				
Basic net income per share of common stock	\$ 0.30	\$ 0.39	\$ 0.87	\$ 0.13
Diluted net income per share of common stock	\$ 0.28	\$ 0.35	\$ 0.79	\$ 0.11
Weighted average shares outstanding:				
Basic	12,040,229	11,279,364	11,851,476	11,239,093
Diluted	13,113,775	12,750,423	13,052,758	12,758,091

See accompanying notes to consolidated financial statements (unaudited).

CAPSTAR FINANCIAL HOLDINGS, INC. & SUBSIDIARY
Consolidated Statements of Comprehensive Income (Unaudited)
(Dollars in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net income	\$ 3,656	\$ 4,419	\$ 10,363	\$ 1,409
Other comprehensive income (loss):				
Unrealized gains (losses) on securities available-for-sale:				
Unrealized holding gains (losses) arising during the period	(1,193)	526	(6,120)	2,433
Reclassification adjustment for (gains) losses included in net income	1	(9)	(2)	(42)
Tax effect	312	(198)	1,600	(915)
Net of tax	(880)	319	(4,522)	1,476
Unrealized losses on securities transferred to held-to-maturity:				
Reclassification adjustment for losses included in net income	—	79	14	162
Tax effect	—	(30)	(4)	(62)
Net of tax	—	49	10	100
Unrealized gains (losses) on cash flow hedges:				
Unrealized holding gains (losses) arising during the period	129	89	697	(123)
Reclassification adjustment for (gains) losses included in net income	224	159	698	472
Tax effect	(50)	(33)	(237)	47
Net of tax	303	215	1,158	396
Other comprehensive income (loss)	(577)	583	(3,354)	1,972
Comprehensive income	\$ 3,079	\$ 5,002	\$ 7,009	\$ 3,381

See accompanying notes to consolidated financial statements (unaudited).

CAPSTAR FINANCIAL HOLDINGS, INC. & SUBSIDIARY
Consolidated Statements of Changes in Shareholders' Equity (Unaudited)
(Dollars in thousands, except share data)

	Preferred stock	Common Stock, voting		Common Stock, nonvoting		Additional paid-in capital	Retained earnings	Accumulated other comprehensive loss	Total shareholders' equity
		Shares	Amount	Shares	Amount				
Balance December 31, 2016	\$ 878	11,204,515	\$ 11,205	—	\$ —	\$ 116,143	\$ 17,132	\$ (6,151)	\$ 139,207
Issuance of restricted common stock, net of forfeitures and withholdings to satisfy employee tax obligations	—	21,480	21	—	—	(285)	—	—	(264)
Stock-based compensation expense	—	—	—	—	—	771	—	—	771
Excess tax benefit from stock compensation	—	71,517	72	—	—	572	—	—	644
Exercise of common stock warrants	—	48,986	49	—	—	416	—	—	465
Net income	—	—	—	—	—	—	1,409	—	1,409
Other comprehensive income	—	—	—	—	—	—	—	1,972	1,972
Balance September 30, 2017	<u>\$ 878</u>	<u>11,346,498</u>	<u>\$ 11,347</u>	<u>—</u>	<u>\$ —</u>	<u>\$ 117,617</u>	<u>\$ 18,541</u>	<u>\$ (4,179)</u>	<u>\$ 144,204</u>
Balance December 31, 2017	\$ 878	11,449,465	\$ 11,450	132,561	\$ 133	\$ 118,120	\$ 18,892	\$ (2,527)	\$ 146,946
Issuance of restricted common stock, net of forfeitures and withholdings to satisfy employee tax obligations	—	23,195	23	—	—	(443)	—	—	(420)
Stock-based compensation expense	—	—	—	—	—	940	—	—	940
Exercise of employee common stock options	—	333,726	334	—	—	1,609	—	—	1,943
Exercise of common stock warrants	—	186,175	186	—	—	1,420	—	—	1,606
Common and preferred stock dividends declared	—	—	—	—	—	—	(514)	—	(514)
Net income	—	—	—	—	—	—	10,363	—	10,363
Other comprehensive income (loss)	—	—	—	—	—	—	—	(3,354)	(3,354)
Balance September 30, 2018	<u>\$ 878</u>	<u>11,992,561</u>	<u>\$ 11,993</u>	<u>132,561</u>	<u>\$ 133</u>	<u>\$ 121,646</u>	<u>\$ 28,741</u>	<u>\$ (5,881)</u>	<u>\$ 157,510</u>

See accompanying notes to consolidated financial statements (unaudited).

CAPSTAR FINANCIAL HOLDINGS, INC. & SUBSIDIARY
Consolidated Statements of Cash Flows (Unaudited)
(Dollars in thousands)

	Nine Months Ended September 30,	
	2018	2017
Cash flows from operating activities:		
Net income	\$ 10,363	\$ 1,409
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,328	12,900
Accretion of discounts on acquired loans and deferred fees	(948)	(537)
Depreciation and amortization	303	345
Net amortization of premiums on investment securities	803	984
Net gain on sale of securities	(2)	(42)
Mortgage banking income	(4,329)	(4,617)
Tri-Net fees	(1,227)	(748)
Net gain on sale of loans	(6)	(67)
Net loss on disposal of premises and equipment	—	137
Stock-based compensation	940	771
Deferred income tax expense (benefit)	406	(445)
Origination of loans held for sale	(395,851)	(409,179)
Proceeds from loans held for sale	425,007	403,497
Net increase in accrued interest receivable and other assets	(1,974)	(1,320)
Net increase (decrease) in accrued interest payable and other liabilities	1,766	(2,630)
Net cash provided by operating activities	<u>36,579</u>	<u>458</u>
Cash flows from investing activities:		
Activities in securities available-for-sale:		
Purchases	(22,127)	(11,754)
Sales	5,778	34,299
Maturities, prepayments and calls	14,611	14,718
Activities in securities held-to-maturity:		
Maturities, prepayments and calls	—	1,332
Purchase of restricted equity securities	(11)	(2,767)
Net increase in loans	(125,216)	(49,154)
Purchase of premises and equipment	(3,980)	(1,074)
Proceeds from the sale of premises and equipment	—	3
Net cash used in investing activities	<u>(130,945)</u>	<u>(14,397)</u>
Cash flows from financing activities:		
Net increase (decrease) in deposits	6,537	(37,228)
Proceeds from Federal Home Loan Bank advances	110,000	135,000
Payments on Federal Home Loan Bank advances	(55,000)	(95,000)
Exercise of common stock options and warrants, net of repurchase of restricted shares	3,129	845
Common and preferred stock dividends paid	(508)	—
Net cash provided by financing activities	<u>64,158</u>	<u>3,617</u>
Net decrease in cash and cash equivalents	<u>(30,208)</u>	<u>(10,322)</u>
Cash and cash equivalents at beginning of period	82,797	80,111
Cash and cash equivalents at end of period	<u>\$ 52,589</u>	<u>\$ 69,789</u>
Supplemental disclosures of cash paid:		
Interest paid	\$ 10,624	\$ 6,951
Income taxes	942	2,142
Supplemental disclosures of noncash transactions:		
Loans charged off to the allowance for loan losses	\$ 251	\$ 12,369

See accompanying notes to consolidated financial statements (unaudited).

CAPSTAR FINANCIAL HOLDINGS, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated financial statements as of and for the period ended September 30, 2018 include CapStar Financial Holdings, Inc. and its wholly owned subsidiary, CapStar Bank (the “Bank”, together referred to as the “Company”). Significant intercompany transactions and accounts are eliminated in consolidation.

The accompanying unaudited consolidated financial statements have been prepared in accordance with instructions to Form 10-Q and do not include all information and footnotes required by U.S. generally accepted accounting principles (“U.S. GAAP”) for complete financial statements. All adjustments consisting of normally recurring accruals that, in the opinion of management, are necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. These unaudited consolidated financial statements should be read in conjunction with the Company’s consolidated financial statements and related notes appearing in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, determination of impairment of intangible assets, including goodwill, the valuation of our investment portfolio, deferred tax assets and estimated liabilities. There have been no significant changes to the Company’s critical accounting policies as disclosed in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

Subsequent Events

Accounting Standards Codification (“ASC”) 855, Subsequent Events, establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. The Company evaluated all events or transactions that occurred after September 30, 2018 through the date of the issued financial statements.

NOTE 2 – SECURITIES

The amortized cost and fair value of securities available-for-sale and held-to-maturity at September 30, 2018 and December 31, 2017 are summarized as follows (dollars in thousands):

	September 30, 2018				December 31, 2017			
	Amortized Cost	Gross unrealized gains	Gross unrealized (losses)	Estimated fair value	Amortized Cost	Gross unrealized gains	Gross unrealized (losses)	Estimated fair value
Securities available-for-sale:								
U. S. government agency securities	\$ 11,054	\$ —	\$ (589)	\$ 10,465	\$ 11,433	\$ 12	\$ (168)	\$ 11,277
State and municipal securities	45,738	228	(1,721)	44,245	51,790	1,430	(222)	52,998
Mortgage-backed securities	109,983	—	(4,781)	105,202	108,236	40	(1,714)	106,562
Asset-backed securities	15,687	26	—	15,713	16,575	—	(198)	16,377
Other debt securities	11,868	26	(50)	11,844	5,326	81	—	5,407
Total	\$ 194,330	\$ 280	\$ (7,141)	\$ 187,469	\$ 193,360	\$ 1,563	\$ (2,302)	\$ 192,621
Securities held-to-maturity:								
State and municipal securities	\$ 3,740	\$ 31	\$ (5)	\$ 3,766	\$ 3,759	\$ 89	\$ —	\$ 3,848
Total	\$ 3,740	\$ 31	\$ (5)	\$ 3,766	\$ 3,759	\$ 89	\$ —	\$ 3,848

Security fair values are established by an independent pricing service as of the dates indicated. The difference between amortized cost and fair value reflects current interest rates and represents the potential gain (loss) had the portfolio been liquidated on those dates. Security gains (losses) are realized only in the event of dispositions prior to maturity or other-than-temporary impairment. Securities with unrealized losses as of September 30, 2018 and December 31, 2017, and the length of time they were in continuous loss positions as of such dates are as follows (dollars in thousands):

	Less than 12 months		12 months or more		Total	
	Estimated fair value	Gross unrealized losses	Estimated fair value	Gross unrealized losses	Estimated fair value	Gross unrealized losses
September 30, 2018						
U. S. government agency securities	\$ 1,827	\$ (76)	\$ 8,638	\$ (513)	\$ 10,465	\$ (589)
State and municipal securities	28,333	(1,134)	7,531	(592)	35,864	(1,726)
Mortgage-backed securities	32,051	(871)	73,151	(3,910)	105,202	(4,781)
Asset-backed securities	—	—	—	—	—	—
Other debt securities	5,518	(50)	—	—	5,518	(50)
Total temporarily impaired securities	<u>\$ 67,729</u>	<u>\$ (2,131)</u>	<u>\$ 89,320</u>	<u>\$ (5,015)</u>	<u>\$ 157,049</u>	<u>\$ (7,146)</u>
December 31, 2017						
U. S. government agency securities	\$ 7,375	\$ (90)	\$ 1,912	\$ (78)	\$ 9,287	\$ (168)
State and municipal securities	7,490	(106)	5,798	(116)	13,288	(222)
Mortgage-backed securities	29,832	(322)	67,813	(1,392)	97,645	(1,714)
Asset-backed securities	—	—	16,377	(198)	16,377	(198)
Other debt securities	—	—	—	—	—	—
Total temporarily impaired securities	<u>\$ 44,697</u>	<u>\$ (518)</u>	<u>\$ 91,900</u>	<u>\$ (1,784)</u>	<u>\$ 136,597</u>	<u>\$ (2,302)</u>

As noted in the table above, as of September 30, 2018, the Company had unrealized losses of \$7.1 million in its investment securities portfolio. The unrealized losses associated with these investment securities are driven by changes in interest rates and are recorded as a component of equity. These investment securities will continue to be monitored as a part of our ongoing impairment analysis. Management evaluates the financial performance of the issuers on a quarterly basis to determine if it is probable that the issuers can make all contractual principal and interest payments. If a shortfall in future cash flows is identified, a credit loss will be deemed to have occurred and will be recognized as a charge to earnings and a new cost basis for the security will be established.

Because the Company currently does not intend to sell any investment securities that have an unrealized loss at September 30, 2018, and it is not more-likely-than-not that we will be required to sell these investment securities before recovery of their amortized cost bases, which may be at maturity, we do not consider these securities to be other-than-temporarily impaired at September 30, 2018.

Securities with a market value of \$148.7 million at September 30, 2018 were pledged to collateralize public deposits, derivative positions and Federal Home Loan Bank advances.

Results from sales of debt and equity securities were as follows (dollars in thousands):

	Nine Months Ended September 30, 2018	Nine Months Ended September 30, 2017
Proceeds	\$ 5,778	\$ 34,299
Gross gains	107	99
Gross losses	(105)	(57)

The amortized cost and fair value of securities at September 30, 2018, by contractual maturity, are shown below (dollars in thousands). Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately.

	Available-for-sale		Held-to-maturity	
	Amortized cost	Estimated fair value	Amortized cost	Estimated fair value
Due in less than one year	\$ 1,763	\$ 1,756	\$ 394	\$ 396
Due one to five years	21,080	21,095	3,346	3,370
Due five to ten years	28,383	27,302	—	—
Due beyond ten years	17,434	16,401	—	—
Mortgage-backed securities	109,983	105,202	—	—
Asset-backed securities	15,687	15,713	—	—
Total	\$ 194,330	\$ 187,469	\$ 3,740	\$ 3,766

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES

A summary of the loan portfolio as of September 30, 2018 and December 31, 2017 follows (dollars in thousands):

	September 30, 2018	December 31, 2017
Commercial real estate	\$ 404,753	\$ 350,622
Consumer real estate	112,957	102,581
Construction and land development	129,799	82,586
Commercial and industrial	398,626	373,248
Consumer	8,274	6,862
Other	19,793	31,983
Total	1,074,202	947,882
Less net unearned income	(332)	(345)
Total loans	1,073,870	947,537
Allowance for loan losses	(15,218)	(13,721)
Total loans, net	\$ 1,058,652	\$ 933,816

The adequacy of the allowance for loan losses (ALL) is assessed at the end of each quarter. The ALL includes a specific component related to loans that are individually evaluated for impairment and a general component related to loans that are segregated into homogenous pools and collectively evaluated for impairment. The ALL factors applied to these pools are an estimate of probable incurred losses based on management's evaluation of historical net losses from loans with similar characteristics, which are adjusted by management to reflect current events, trends, and conditions. The adjustments include consideration of the following: changes in lending policies and procedures, economic conditions, nature and volume of the portfolio, experience of lending management, volume and severity of past due loans, quality of the loan review system, value of underlying collateral for collateral dependent loans, concentrations, and other external factors.

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes all commercial loans, and consumer relationships with an outstanding balance greater than \$500,000, individually and assigns each loan a risk rating. This analysis is performed on a continual basis by the relationship managers and credit department personnel. On at least an annual basis an independent party performs a formal credit risk review of a sample of the loan portfolio. Among other things, this review assesses the appropriateness of the loan's risk rating. The Company uses the following definitions for risk ratings:

Special Mention – A special mention asset possesses deficiencies or potential weaknesses deserving of management's attention. If uncorrected, such weaknesses or deficiencies may expose the Company to an increased risk of loss in the future.

Substandard – A substandard asset is inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard assets, does not have to exist in individual assets classified substandard.

Doubtful – A doubtful asset has all weaknesses inherent in one classified substandard, with the added characteristic that weaknesses make collection or liquidation in full, on the basis of existing facts, conditions, and values, highly questionable and improbable. The probability of loss is extremely high, but certain important and reasonable specific pending factors which may work to the advantage and strengthening of the asset exist, therefore, its classification as an estimated loss is deferred until a more exact status may be determined. Pending factors include proposed merger, acquisition or liquidation procedures, capital injection, perfecting liens on additional collateral, and refinancing plans.

Loans not falling into the criteria above are considered to be pass-rated loans. The Company utilizes six loan grades within the pass risk rating.

The following tables present the loan balances by category as well as risk rating (dollars in thousands):

	Non-impaired Loans				Total Impaired Loans	Total
	Pass/Watch	Special Mention	Substandard	Total Non-impaired		
September 30, 2018						
Commercial real estate	\$ 402,254	\$ —	\$ 1,353	\$ 403,607	\$ 1,146	\$ 404,753
Consumer real estate	112,640	—	225	112,865	92	112,957
Construction and land development	129,799	—	—	129,799	—	129,799
Commercial and industrial	379,446	6,992	6,769	393,207	5,419	398,626
Consumer	8,174	—	—	8,174	100	8,274
Other	19,793	—	—	19,793	—	19,793
Total	<u>\$ 1,052,106</u>	<u>\$ 6,992</u>	<u>\$ 8,347</u>	<u>\$ 1,067,445</u>	<u>\$ 6,757</u>	<u>\$ 1,074,202</u>
December 31, 2017						
Commercial real estate	\$ 349,415	\$ —	\$ —	\$ 349,415	\$ 1,207	\$ 350,622
Consumer real estate	102,571	—	10	102,581	—	102,581
Construction and land development	82,586	—	—	82,586	—	82,586
Commercial and industrial	349,494	11,193	11,073	371,760	1,488	373,248
Consumer	6,849	—	13	6,862	—	6,862
Other	31,983	—	—	31,983	—	31,983
Total	<u>\$ 922,898</u>	<u>\$ 11,193</u>	<u>\$ 11,096</u>	<u>\$ 945,187</u>	<u>\$ 2,695</u>	<u>\$ 947,882</u>

None of the Company's loans had a risk rating of "Doubtful" as of September 30, 2018 or December 31, 2017.

The following tables detail the changes in the ALL for the three and nine months ended September 30, 2018 and 2017 (dollars in thousands):

	<u>Commercial real estate</u>	<u>Consumer real estate</u>	<u>Construction and land development</u>	<u>Commercial and industrial</u>	<u>Consumer</u>	<u>Other</u>	<u>Total</u>
Three Months Ended September 30, 2018							
Balance, beginning of period	\$ 3,551	\$ 1,057	\$ 1,764	\$ 7,779	\$ 120	\$ 434	\$ 14,705
Charged-off loans	—	—	—	—	—	—	—
Recoveries	6	1	—	22	3	—	32
Provision for loan losses	(412)	(75)	449	767	(30)	(218)	481
Balance, end of period	<u>\$ 3,145</u>	<u>\$ 983</u>	<u>\$ 2,213</u>	<u>\$ 8,568</u>	<u>\$ 93</u>	<u>\$ 216</u>	<u>\$ 15,218</u>
Three Months Ended September 30, 2017							
Balance, beginning of period	\$ 3,533	\$ 1,081	\$ 911	\$ 6,395	\$ 57	\$ 477	\$ 12,454
Charged-off loans	—	—	—	—	—	—	—
Recoveries	3	—	—	1,860	—	—	1,863
Provision for loan losses	(242)	(97)	576	(306)	22	(148)	(195)
Balance, end of period	<u>\$ 3,294</u>	<u>\$ 984</u>	<u>\$ 1,487</u>	<u>\$ 7,949</u>	<u>\$ 79</u>	<u>\$ 329</u>	<u>\$ 14,122</u>
	<u>Commercial real estate</u>	<u>Consumer real estate</u>	<u>Construction and land development</u>	<u>Commercial and industrial</u>	<u>Consumer</u>	<u>Other</u>	<u>Total</u>
Nine Months Ended September 30, 2018							
Balance, beginning of period	\$ 3,324	\$ 1,063	\$ 1,628	\$ 7,209	\$ 91	\$ 406	\$ 13,721
Charged-off loans	—	—	—	(226)	(25)	—	(251)
Recoveries	16	4	—	348	52	—	420
Provision for loan losses	(195)	(84)	585	1,237	(25)	(190)	1,328
Balance, end of period	<u>\$ 3,145</u>	<u>\$ 983</u>	<u>\$ 2,213</u>	<u>\$ 8,568</u>	<u>\$ 93</u>	<u>\$ 216</u>	<u>\$ 15,218</u>
Nine Months Ended September 30, 2017							
Balance, beginning of period	\$ 2,655	\$ 1,013	\$ 1,574	\$ 5,618	\$ 76	\$ 698	\$ 11,634
Charged-off loans	—	—	—	(12,369)	—	—	(12,369)
Recoveries	4	—	—	1,862	91	—	1,957
Provision for loan losses	635	(29)	(87)	12,838	(88)	(369)	12,900
Balance, end of period	<u>\$ 3,294</u>	<u>\$ 984</u>	<u>\$ 1,487</u>	<u>\$ 7,949</u>	<u>\$ 79</u>	<u>\$ 329</u>	<u>\$ 14,122</u>

A breakdown of the ALL and the loan portfolio by loan category at September 30, 2018 and December 31, 2017 follows (dollars in thousands):

	Commercial real estate	Consumer real estate	Construction and land development	Commercial and industrial	Consumer	Other	Total
September 30, 2018							
Allowance for Loan Losses:							
Collectively evaluated for impairment	\$ 3,145	\$ 983	\$ 2,213	\$ 5,868	\$ 93	\$ 216	\$ 12,518
Individually evaluated for impairment	—	—	—	2,700	—	—	2,700
Balances, end of period	<u>\$ 3,145</u>	<u>\$ 983</u>	<u>\$ 2,213</u>	<u>\$ 8,568</u>	<u>\$ 93</u>	<u>\$ 216</u>	<u>\$ 15,218</u>
Loans:							
Collectively evaluated for impairment	\$ 403,607	\$ 112,865	\$ 129,799	\$ 393,207	\$ 8,174	\$ 19,793	\$ 1,067,445
Individually evaluated for impairment	1,146	92	—	5,419	100	—	6,757
Balances, end of period	<u>\$ 404,753</u>	<u>\$ 112,957</u>	<u>\$ 129,799</u>	<u>\$ 398,626</u>	<u>\$ 8,274</u>	<u>\$ 19,793</u>	<u>\$ 1,074,202</u>
December 31, 2017							
Allowance for Loan Losses:							
Collectively evaluated for impairment	\$ 3,324	\$ 1,063	\$ 1,628	\$ 7,109	\$ 91	\$ 406	\$ 13,621
Individually evaluated for impairment	—	—	—	100	—	—	100
Balances, end of period	<u>\$ 3,324</u>	<u>\$ 1,063</u>	<u>\$ 1,628</u>	<u>\$ 7,209</u>	<u>\$ 91</u>	<u>\$ 406</u>	<u>\$ 13,721</u>
Loans:							
Collectively evaluated for impairment	\$ 349,415	\$ 102,581	\$ 82,586	\$ 371,760	\$ 6,862	\$ 31,983	\$ 945,187
Individually evaluated for impairment	1,207	—	—	1,488	—	—	2,695
Balances, end of period	<u>\$ 350,622</u>	<u>\$ 102,581</u>	<u>\$ 82,586</u>	<u>\$ 373,248</u>	<u>\$ 6,862</u>	<u>\$ 31,983</u>	<u>\$ 947,882</u>

The following table presents the allocation of the ALL for each respective loan category with the corresponding percentage of the ALL in each category to total loans, net of deferred fees as of September 30, 2018 and December 31, 2017 (dollars in thousands):

	September 30, 2018		December 31, 2017	
	Amount	Percent of total loans, net of deferred fees	Amount	Percent of total loans, net of deferred fees
Commercial real estate	\$ 3,145	0.29%	\$ 3,324	0.35%
Consumer real estate	983	0.09	1,063	0.11
Construction and land development	2,213	0.21	1,628	0.17
Commercial and industrial	8,568	0.80	7,209	0.77
Consumer	93	0.01	91	0.01
Other	216	0.02	406	0.04
Total allowance for loan losses	<u>\$ 15,218</u>	<u>1.42%</u>	<u>\$ 13,721</u>	<u>1.45%</u>

The following table presents the Company's impaired loans that were evaluated for specific loss allowance as of September 30, 2018 and December 31, 2017 (dollars in thousands):

	September 30, 2018			December 31, 2017		
	Recorded investment	Unpaid principal balance	Related allowance	Recorded investment	Unpaid principal balance	Related allowance
With no related allowance recorded:						
Commercial real estate	\$ 1,146	\$ 1,617	\$ —	\$ 1,207	\$ 1,645	\$ —
Consumer real estate	92	92	—	—	—	—
Construction and land development	—	—	—	—	—	—
Commercial and industrial	—	—	—	—	—	—
Consumer	100	100	—	—	—	—
Other	—	—	—	—	—	—
Subtotal	<u>1,338</u>	<u>1,809</u>	<u>—</u>	<u>1,207</u>	<u>1,645</u>	<u>—</u>
With an allowance recorded:						
Commercial real estate	—	—	—	—	—	—
Consumer real estate	—	—	—	—	—	—
Construction and land development	—	—	—	—	—	—
Commercial and industrial	5,419	5,419	2,700	1,488	2,770	100
Consumer	—	—	—	—	—	—
Other	—	—	—	—	—	—
Subtotal	<u>5,419</u>	<u>5,419</u>	<u>2,700</u>	<u>1,488</u>	<u>2,770</u>	<u>100</u>
Total	<u>\$ 6,757</u>	<u>\$ 7,228</u>	<u>\$ 2,700</u>	<u>\$ 2,695</u>	<u>\$ 4,415</u>	<u>\$ 100</u>

The following table presents information related to the average recorded investment and interest income recognized on impaired loans for the three and nine months ended September 30, 2018 and 2017 (dollars in thousands):

	Three Months Ended September 30, 2018		Three Months Ended September 30, 2017		Nine Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
	Average recorded investment	Interest income recognized	Average recorded investment	Interest income recognized	Average recorded investment	Interest income recognized	Average recorded investment	Interest income recognized
With no related allowance recorded:								
Commercial real estate	\$ 1,159	\$ 15	\$ 1,245	\$ —	\$ 1,189	\$ 25	\$ 1,272	\$ —
Consumer real estate	92	—	—	—	92	3	—	—
Construction and land development	—	—	—	—	—	—	—	—
Commercial and industrial	—	—	—	—	—	—	—	—
Consumer	100	—	—	—	100	3	—	—
Other	—	—	—	—	—	—	—	—
Subtotal	<u>1,351</u>	<u>15</u>	<u>1,245</u>	<u>—</u>	<u>1,381</u>	<u>31</u>	<u>1,272</u>	<u>—</u>
With an allowance recorded:								
Commercial real estate	—	—	—	—	—	—	—	—
Consumer real estate	—	—	—	—	—	—	—	—
Construction and land development	—	—	—	—	—	—	—	—
Commercial and industrial	5,419	—	1,941	—	5,369	118	2,141	—
Consumer	—	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—	—
Subtotal	<u>5,419</u>	<u>—</u>	<u>1,941</u>	<u>—</u>	<u>5,369</u>	<u>118</u>	<u>2,141</u>	<u>—</u>
Total	<u>\$ 6,770</u>	<u>\$ 15</u>	<u>\$ 3,186</u>	<u>\$ —</u>	<u>\$ 6,750</u>	<u>\$ 149</u>	<u>\$ 3,413</u>	<u>\$ —</u>

Interest income recognized on a cash basis for impaired loans amounted to \$15,000 and \$25,000 for the three and nine months ended September 30, 2018. No interest income was recognized on a cash basis for impaired loans during the three or nine months ended September 30, 2017.

The following table presents the aging of the recorded investment in past-due loans as of September 30, 2018 and December 31, 2017 by class of loans (dollars in thousands):

	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Loans Not Past Due	Total
September 30, 2018						
Commercial real estate	\$ 2,474	\$ —	\$ —	\$ 2,474	\$ 402,279	\$ 404,753
Consumer real estate	220	—	215	435	112,522	112,957
Construction and land development	133	—	—	133	129,666	129,799
Commercial and industrial	—	563	4,856	5,419	393,207	398,626
Consumer	—	—	—	—	8,274	8,274
Other	307	—	—	307	19,486	19,793
Total	<u>\$ 3,134</u>	<u>\$ 563</u>	<u>\$ 5,071</u>	<u>\$ 8,768</u>	<u>\$ 1,065,434</u>	<u>\$ 1,074,202</u>
December 31, 2017						
Commercial real estate	\$ —	\$ —	\$ —	\$ —	\$ 350,622	\$ 350,622
Consumer real estate	—	—	218	218	102,363	102,581
Construction and land development	—	—	—	—	82,586	82,586
Commercial and industrial	1,967	209	—	2,176	371,072	373,248
Consumer	—	—	13	13	6,849	6,862
Other	—	—	—	—	31,983	31,983
Total	<u>\$ 1,967</u>	<u>\$ 209</u>	<u>\$ 231</u>	<u>\$ 2,407</u>	<u>\$ 945,475</u>	<u>\$ 947,882</u>

The following table presents the recorded investment in non-accrual loans, past due loans over 89 days outstanding and accruing and troubled debt restructurings (“TDR”) by class of loans as of September 30, 2018 and December 31, 2017 (dollars in thousands):

	Non-Accrual	Past Due Over 89 Days and Accruing	Troubled Debt Restructurings
September 30, 2018			
Commercial real estate	\$ —	\$ —	\$ 1,146
Consumer real estate	92	215	—
Construction and land development	—	—	—
Commercial and industrial	5,419	—	—
Consumer	100	—	—
Other	—	—	—
Total	<u>\$ 5,611</u>	<u>\$ 215</u>	<u>\$ 1,146</u>
December 31, 2017			
Commercial real estate	\$ 1,207	\$ —	\$ 1,207
Consumer real estate	—	218	—
Construction and land development	—	—	—
Commercial and industrial	1,488	—	—
Consumer	—	13	—
Other	—	—	—
Total	<u>\$ 2,695</u>	<u>\$ 231</u>	<u>\$ 1,207</u>

As of September 30, 2018 and December 31, 2017, all loans classified as nonperforming were deemed to be impaired.

As of both September 30, 2018 and December 31, 2017, the Company had a recorded investment in TDR of \$1.1 million. The Company had no specific allowance for those loans at September 30, 2018 or December 31, 2017 and there were no commitments to lend additional amounts. Loans accounted for as TDR include modifications from original terms such as those due to bankruptcy proceedings, certain modifications of amortization periods or extended suspension of principal payments due to customer financial difficulties. In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Bank’s loan policy. Loans accounted for as TDR are individually evaluated for impairment.

There were no TDR identified during the three or nine months ended September 30, 2018 or 2017. There were no TDR for which there was a payment default within twelve months following the modification during the three or nine months ended September 30, 2018 or 2017.

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

NOTE 4 – FEDERAL HOME LOAN BANK ADVANCES

The Company had outstanding borrowings totaling of \$125.0 million and \$70.0 million at September 30, 2018 and December 31, 2017, respectively, via various advances. These advances are non-callable; interest payments are due monthly, with principal due at maturity.

The following is a summary of the contractual maturities and average effective rates of outstanding advances (dollars in thousands):

Year	September 30, 2018		December 31, 2017	
	Amount	Interest Rates	Amount	Interest Rates
2018	\$ 115,000	2.18%	\$ 70,000	1.66%
2019	10,000	2.45	—	—
2020	—	—	—	—
2021	—	—	—	—
2022	—	—	—	—
Thereafter	—	—	—	—
Total	<u>\$ 125,000</u>	<u>2.21%</u>	<u>\$ 70,000</u>	<u>1.66%</u>

Advances from the FHLB are collateralized by investment securities with a market value of \$3.9 million, FHLB stock and certain commercial and residential real estate mortgage loans totaling \$420.6 million under a blanket mortgage collateral agreement. At September 30, 2018, the amount of available credit from the FHLB totaled \$59.4 million.

NOTE 5 – ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following were changes in accumulated other comprehensive income (loss) by component, net of tax, for the nine months ended September 30, 2018 and 2017 (dollars in thousands):

	Gains and Losses on Cash Flow Hedges	Unrealized Gains and Losses on Available for Sale Securities	Unrealized Losses on Securities Transferred to Held to Maturity	Total
Nine Months Ended September 30, 2018				
Beginning Balance	\$ (3,679)	\$ 1,162	\$ (10)	\$ (2,527)
Other comprehensive income (loss) before reclassification, net of tax	1,800	(4,521)	—	(2,721)
Amounts reclassified from accumulated other comprehensive income (loss), net of tax	(642)	(1)	10	(633)
Net current period other comprehensive income (loss)	<u>1,158</u>	<u>(4,522)</u>	<u>10</u>	<u>(3,354)</u>
Ending Balance	<u>\$ (2,521)</u>	<u>\$ (3,360)</u>	<u>\$ —</u>	<u>\$ (5,881)</u>
Nine Months Ended September 30, 2017				
Beginning Balance	\$ (4,241)	\$ (698)	\$ (1,212)	\$ (6,151)
Other comprehensive income (loss) before reclassification, net of tax	985	1,502	—	2,487
Amounts reclassified from accumulated other comprehensive income (loss), net of tax	(589)	(26)	100	(515)
Net current period other comprehensive income (loss)	<u>396</u>	<u>1,476</u>	<u>100</u>	<u>1,972</u>
Ending Balance	<u>\$ (3,845)</u>	<u>\$ 778</u>	<u>\$ (1,112)</u>	<u>\$ (4,179)</u>

The following were significant amounts reclassified out of each component of accumulated other comprehensive income (loss) for the three and nine months ended September 30, 2018 and 2017 (dollars in thousands):

Details about Accumulated Other Comprehensive Income Components	Three Months Ended September 30,		Nine Months Ended September 30,		Affected Line Item in the Statement Where Net Income is Presented
	2018	2017	2018	2017	
	Unrealized losses on cash flow hedges	\$ (111)	\$ (109)	\$ (330)	
	(108)	(168)	(368)	(267)	Interest expense - Federal Home Loan
	16	—	56	—	Bank advances
	<u>\$ (203)</u>	<u>\$ (277)</u>	<u>\$ (642)</u>	<u>\$ (589)</u>	Income tax benefit
					Net of tax
Unrealized (gains) losses on available-for-sale securities	\$ 1	\$ (9)	\$ (2)	\$ (42)	Net (gain) loss on sale of securities
	—	3	1	16	Income tax expense
	<u>\$ 1</u>	<u>\$ (6)</u>	<u>\$ (1)</u>	<u>\$ (26)</u>	Net of tax
Unrealized losses on securities transferred to held-to-maturity	\$ —	\$ 79	\$ 14	\$ 162	Interest income - securities
	—	(30)	(4)	(62)	Income tax benefit
	<u>\$ —</u>	<u>\$ 49</u>	<u>\$ 10</u>	<u>\$ 100</u>	Net of tax

NOTE 6 – INCOME TAXES

The Company's effective tax rate for the three and nine months ended September 30, 2018 was 13.2% and 14.1% compared to 25.5% and 9.1% for the three and nine months ended September 30, 2017. In March 2016, the FASB issued guidance to simplify several aspects of the accounting for share-based payment award transactions, including income tax consequences. In addition to other changes, the guidance changes the accounting for excess tax benefits and tax deficiencies from generally being recognized in additional paid-in capital to recognition as income tax expense or benefit in the period they occur. The Company adopted the new guidance in the first quarter of 2017. As a result, the Company's income tax expense was reduced by \$422,000 and \$1,062,000 for the three and nine months ended September 30, 2018, respectively, and by \$144,000 and \$310,000 for the three and nine months ended September 30, 2017, respectively.

On December 22, 2017, Public Law 115-97, informally referred to as the Tax Cuts and Jobs Act (the "Tax Reform Act") was enacted into law. The Tax Reform Act provides for significant changes to the U.S. tax code that impact businesses. Effective January 1, 2018, the Tax Reform Act reduced the U.S. federal tax rate for corporations from 35% to 21% for U.S. taxable income.

The effective tax rate compared favorably to the statutory federal rate of 21% and Tennessee excise tax rate of 6.5% primarily due to investments in qualified municipal securities, company owned life insurance, state tax credits, net of the effect of certain non-deductible expenses and the recognition of excess tax benefits related to stock compensation.

NOTE 7 – COMMITMENTS AND CONTINGENCIES

In the normal course of business, the Company has outstanding commitments and contingent liabilities, such as commitments to extend credit and standby letters of credit, which are not included in the accompanying financial statements. The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual or notional amount of those instruments. The Company uses the same credit policies in making such commitments as it does for instruments that are included in the balance sheet.

The following table sets forth outstanding financial instruments whose contract amounts represent credit risk as of September 30, 2018 and December 31, 2017 (dollars in thousands):

Financial instruments whose contract amounts represent credit risk:	Contract or notional amount	
	September 30, 2018	December 31, 2017
Unused commitments to extend credit	\$ 622,212	\$ 584,494
Standby letters of credit	11,526	11,552
Total	<u>\$ 633,738</u>	<u>\$ 596,046</u>

The Company is party to litigation and claims arising in the normal course of business. Management believes that the liabilities, if any, arising from such litigation and claims as of September 30, 2018, will not have a material impact on the financial statements of the Company.

NOTE 8 – DERIVATIVES

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

Interest Rate Swaps Designated as Cash Flow Hedges

Forward starting interest rate swaps with notional amounts totaling \$20 million as of September 30, 2018 and December 31, 2017 were designated as cash flow hedges of certain liabilities and were determined to be fully effective during all periods presented. As such, no amount of ineffectiveness has been included in net income. Therefore, the aggregate fair value of the swaps is recorded in other assets (liabilities) with changes in fair value recorded in other comprehensive income (loss). The amount included in accumulated other comprehensive income (loss) would be reclassified to current earnings should the hedges no longer be considered effective. The Company expects the hedges to remain fully effective during the remaining terms of the swaps.

Summary information about the interest-rate swaps designated as cash flow hedges was as follows (dollars in thousands):

	<u>September 30, 2018</u>	<u>December 31, 2017</u>
Notional amounts	\$ 20,000	\$ 20,000
Weighted average pay rates	3.54%	3.54%
Weighted average receive rates	3 month LIBOR	3 month LIBOR
Weighted average maturity	4.7 years	5.5 years
Fair value	\$ (462)	\$ (1,375)
Amount of unrealized loss recognized in accumulated other comprehensive income, net of tax	\$ (341)	\$ (1,016)

Pursuant to its interest rate swap agreements, the Company pledged collateral to the counterparties in the form of investment securities with a market value of \$2.1 million at September 30, 2018. There was no collateral posted from the counterparties to the Company as of September 30, 2018. It is possible that the Company may need to post additional collateral in the future or that the counterparties may be required to post collateral to the Company in the future.

Other Interest Rate Swaps

The Company also enters into swaps to facilitate customer transactions and meet their financing needs. Upon entering into these transactions the Company enters into offsetting positions with large U.S. financial institutions in order to minimize risk to the Company. A summary of the Company's customer related interest rate swaps was as follows (dollars in thousands):

	<u>September 30, 2018</u>		<u>December 31, 2017</u>	
	<u>Notional amount</u>	<u>Estimated fair value</u>	<u>Notional amount</u>	<u>Estimated fair value</u>
Interest rate swap agreements:				
Pay fixed/receive variable swaps	\$ 37,199	\$ 492	\$ 41,863	\$ 55
Pay variable/receive fixed swaps	37,199	(492)	41,863	(55)
Total	<u>\$ 74,398</u>	<u>\$ —</u>	<u>\$ 83,726</u>	<u>\$ —</u>

NOTE 9 - STOCK OPTIONS AND RESTRICTED SHARES

During 2008, the board of directors of the Bank approved the CapStar Bank 2008 Stock Incentive Plan. Following the formation of CapStar Financial Holdings, Inc. in 2016, and in connection with the Share Exchange, the outstanding awards of restricted stock and stock options under the CapStar Bank 2008 Stock Incentive Plan were exchanged for similar awards of restricted stock and stock options issued by CapStar Financial Holdings, Inc. under the CapStar Financial Holdings, Inc. Stock Incentive Plan (the "Plan"), which the board of directors adopted in 2016. The Stock Incentive Plan provides for the grant of stock-based incentives, including

stock options, restricted stock units, performance awards and restricted stock, to employees, directors and service providers that are subject to forfeiture until vesting conditions have been satisfied by the award recipient under the terms of the award. The Plan is intended to help align the interests of employees and our shareholders and reward our employees for improved Company performance. The Plan reserved 1,569,475 shares of stock for issuance of stock incentives. In April 2018 the board of directors reserved an additional 400,000 shares of stock for issuance of stock incentives. Stock incentives include both restricted share and stock option grants. Total shares issuable under the plan were 506,435 at September 30, 2018.

The Company has recognized stock-based compensation expense, within salaries and employee benefits for employees, and within other non-interest expense for directors, in the consolidated statements of income as follows (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Stock-based compensation expense before income taxes	\$ 310	\$ 288	\$ 940	\$ 771
Less: deferred tax benefit	(81)	(110)	(246)	(295)
Reduction of net income	\$ 229	\$ 178	\$ 694	\$ 476

Restricted Shares

Compensation expense is recognized over the vesting period of the awards based on the fair value of the stock at the issue date. The fair value of each restricted stock grant is based on valuations performed by independent consultants. The recipients have the right to vote and receive dividends but cannot sell, transfer, assign, pledge, hypothecate, or otherwise encumber the restricted stock until the shares have vested. Restricted shares fully vest on the third anniversary of the grant date. A summary of the changes in the Company's nonvested restricted shares for the nine months ended September 30, 2018 follows:

Nonvested Shares	Restricted Shares	Weighted Average Grant Date Fair Value
Nonvested at beginning of period	187,253	\$ 14.21
Granted	53,869	19.11
Vested	(99,603)	12.61
Forfeited	(8,065)	15.95
Nonvested at end of period	133,454	\$ 17.28

As of September 30, 2018, there was \$1.6 million of unrecognized compensation cost related to nonvested shares granted under the Plan. The cost is expected to be recognized over a weighted-average period of 2.0 years. The total fair value of shares vested during the nine months ended September 30, 2018 and 2017 was \$1.9 million and \$1.1 million.

Stock Options

Option awards are generally granted with an exercise price equal to the fair value of the Company's common stock at the date of grant. Option awards generally have a four year vesting period and a ten year contractual term.

The fair value of each option grant is estimated on the date of grant using the Black Scholes option pricing model. There were no options granted in 2018 or 2017.

A summary of the activity in stock options for the nine months ended September 30, 2018 follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)
Outstanding at beginning of period	804,800	\$ 10.59	
Granted	—	—	
Exercised	(508,834)	10.11	
Forfeited or expired	—	—	
Outstanding at end of period	<u>295,966</u>	<u>\$ 11.43</u>	<u>4.0</u>
Fully vested and expected to vest	<u>294,134</u>	<u>\$ 11.42</u>	<u>3.7</u>
Exercisable at end of period	<u>268,466</u>	<u>\$ 11.34</u>	<u>3.7</u>

Information related to stock options during each year follows:

	2018	2017
Intrinsic value of options exercised	\$ 4,282,055	\$ 684,275
Cash received from option exercises	5,144,090	821,500
Tax benefit realized from option exercises	1,119,329	263,446
Weighted average fair value of options granted	—	—

As of September 30, 2018, there was \$0.1 million of unrecognized compensation cost related to nonvested stock options granted under the Plan. The cost is expected to be recognized over a weighted-average period of 1.0 year.

NOTE 10 – REGULATORY CAPITAL REQUIREMENTS

The Company and the Bank are subject to regulatory capital requirements administered by the Federal Reserve and the Bank is also subject to the regulatory capital requirements of the Tennessee Department of Financial Institutions. Failure to meet capital requirements can initiate certain mandatory – and possibly additional discretionary – actions by regulators that could, in that event, have a material adverse effect on the institutions' financial statements. The relevant regulations require the Company and the Bank to meet specific capital adequacy guidelines that involve quantitative measures of their assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting principles. The capital classifications of the Company and the Bank are also subject to qualitative judgments by their regulators about components, risk weightings, and other factors. Those qualitative judgments could also affect the capital status of the Company and the Bank and the amount of dividends the Company and the Bank may distribute. The final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Bank on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital. Management believes as of September 30, 2018, the Company and the Bank met all regulatory capital adequacy requirements to which they are subject.

The Company's and the Bank's capital amounts and ratios as of September 30, 2018 and December 31, 2017 are presented in the following table (dollars in thousands).

	Actual		Minimum capital requirement (1)		Minimum to be well-capitalized (2)	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
At September 30, 2018:						
Total capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	\$ 171,866	12.62%	\$ 108,958	8.00%	N/A	N/A
CapStar Bank	154,906	11.38	108,897	8.00	\$ 136,122	10.00
Tier I capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	156,469	11.49	81,718	6.00	N/A	N/A
CapStar Bank	139,509	10.25	81,673	6.00	108,897	8.00
Common equity Tier 1 capital to risk weighted assets:						
CapStar Financial Holdings, Inc.	147,469	10.83	61,289	4.50	N/A	N/A
CapStar Bank	123,009	9.04	61,255	4.50	88,479	6.50
Tier I capital to average assets:						
CapStar Financial Holdings, Inc.	156,469	11.02	56,770	4.00	N/A	N/A
CapStar Bank	139,509	9.83	56,760	4.00	70,950	5.00
At December 31, 2017:						
Total capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	\$ 156,434	12.52%	\$ 99,932	8.00%	N/A	N/A
CapStar Bank	142,396	11.40	99,928	8.00	\$ 124,909	10.00
Tier I capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	142,534	11.41	74,949	6.00	N/A	N/A
CapStar Bank	128,496	10.29	74,946	6.00	99,928	8.00
Common equity Tier 1 capital to risk weighted assets:						
CapStar Financial Holdings, Inc.	133,703	10.70	56,212	4.50	N/A	N/A
CapStar Bank	112,165	8.98	56,209	4.50	81,191	6.50
Tier I capital to average assets:						
CapStar Financial Holdings, Inc.	142,534	10.77	53,218	4.00	N/A	N/A
CapStar Bank	128,496	9.71	53,215	4.00	66,519	5.00

- (1) For the calendar year 2018, the Company must maintain a capital conservation buffer of Tier 1 common equity capital in excess of minimum risk-based capital ratios by at least 1.875% to avoid limits on capital distributions and certain discretionary bonus payments to executive officers and similar employees.
- (2) For the Company to be well-capitalized, the Bank must be well-capitalized and the Company must not be subject to any written agreement, order, capital directive, or prompt corrective action directive issued by the Federal Reserve to meet and maintain a specific capital level for any capital measure.

NOTE 11 – EARNINGS PER SHARE

The following is a summary of the basic and diluted earnings per share calculation for the three and nine months ended September 30, 2018 and 2017 (dollars in thousands, except share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Basic net income per share calculation:				
Numerator – Net income	\$ 3,656	\$ 4,419	\$ 10,363	\$ 1,409
Denominator – Average common shares outstanding	12,040,229	11,279,364	11,851,476	11,239,093
Basic net income per share	<u>\$ 0.30</u>	<u>\$ 0.39</u>	<u>\$ 0.87</u>	<u>\$ 0.13</u>
Diluted net income per share calculation:				
Numerator – Net income	\$ 3,656	\$ 4,419	\$ 10,363	\$ 1,409
Denominator – Average common shares outstanding	12,040,229	11,279,364	11,851,476	11,239,093
Dilutive shares contingently issuable	1,073,546	1,471,059	1,201,282	1,518,998
Average diluted common shares outstanding	<u>13,113,775</u>	<u>12,750,423</u>	<u>13,052,758</u>	<u>12,758,091</u>
Diluted net income per share	<u>\$ 0.28</u>	<u>\$ 0.35</u>	<u>\$ 0.79</u>	<u>\$ 0.11</u>

NOTE 12 – FAIR VALUE

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

- Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
- Level 2: Significant observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data.
- Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Bank used the following methods and significant assumptions to estimate fair value:

Investment Securities: The fair values for investment securities are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2), using matrix pricing. Matrix pricing is a mathematical technique commonly used to price debt securities that are not actively traded and, values debt securities by relying on quoted prices for the specific securities and the securities' relationship to other benchmark quoted securities (Level 2 inputs). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3). See below for additional discussion of Level 3 valuation methodologies and significant inputs. The fair values of all securities are determined from third party pricing services without adjustment.

Derivatives-Interest Rate Swaps: The fair values of derivatives are based on valuation models using observable market data as of the measurement date (Level 2). The Bank's derivatives are traded in an over-the-counter market where quoted market prices are not always available. Therefore, the fair values of derivatives are determined using quantitative models that utilize multiple market inputs. The inputs will vary based on the type of derivative, but could include interest rates, prices and indices to generate continuous yield or pricing curves, prepayment rates, and volatility factors to value the position. The majority of market inputs are actively quoted and can be validated through external sources, including brokers, market transactions and third-party pricing services. The fair values of all interest rate swaps are determined from third party pricing services without adjustment.

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

Other Real Estate Owned: Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals which are updated no less frequently than annually. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach with data from comparable properties. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Appraisals may be adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and/or management's expertise and knowledge of the collateral. Such adjustments result in a Level 3 classification of the inputs for determining fair value. Real estate owned properties are evaluated on a quarterly basis for additional impairment and adjusted accordingly. The Company had no other real estate owned at September 30, 2018 or December 31, 2017.

Loans Held For Sale: Loans held for sale are carried at the lower of cost or fair value, which is evaluated on a pool-level basis. The fair value of loans held for sale is determined using quoted prices for similar assets, adjusted for specific attributes of that loan or other observable market data, such as outstanding commitments from third party investors (Level 2). There were no loans held for sale carried at fair value at September 30, 2018 or December 31, 2017.

Assets and liabilities measured at fair value on a recurring basis are summarized below (dollars in thousands):

	Fair value measurements at September 30, 2018			
	Carrying Value	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Securities available-for-sale:				
U.S. government-sponsored agencies	\$ 10,465	\$ —	\$ 10,465	\$ —
Obligations of states and political subdivisions	44,245	—	44,245	—
Mortgage-backed securities-residential	105,202	—	105,202	—
Asset-backed securities	15,713	—	15,713	—
Other debt securities	11,844	—	11,844	—
Total securities available-for-sale	<u>\$ 187,469</u>	<u>\$ —</u>	<u>\$ 187,469</u>	<u>\$ —</u>
Derivatives:				
Interest rate swaps - customer related	\$ 624	\$ —	\$ 624	\$ —
Liabilities:				
Derivatives:				
Interest rate swaps - customer related	\$ (624)	\$ —	\$ (624)	\$ —
Interest rate swaps - cash flow hedges	(462)	—	(462)	—
Total derivatives	<u>\$ (1,086)</u>	<u>\$ —</u>	<u>\$ (1,086)</u>	<u>\$ —</u>

	Fair value measurements at December 31, 2017			
	Carrying Value	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Securities available-for-sale:				
U.S. government-sponsored agencies	\$ 11,277	\$ —	\$ 11,277	\$ —
Obligations of states and political subdivisions	52,998	—	52,998	—
Mortgage-backed securities-residential	106,562	—	106,562	—
Asset-backed securities	16,377	—	16,377	—
Other debt securities	5,407	—	5,407	—
Total securities available-for-sale	<u>\$ 192,621</u>	<u>\$ —</u>	<u>\$ 192,621</u>	<u>\$ —</u>
Derivatives:				
Interest rate swaps - customer related	<u>\$ 184</u>	<u>\$ —</u>	<u>\$ 184</u>	<u>\$ —</u>
Liabilities:				
Derivatives:				
Interest rate swaps - customer related	\$ (184)	\$ —	\$ (184)	\$ —
Interest rate swaps - cash flow hedges	(1,375)	—	(1,375)	—
Total derivatives	<u>\$ (1,559)</u>	<u>\$ —</u>	<u>\$ (1,559)</u>	<u>\$ —</u>

Assets measured at fair value on a nonrecurring basis are summarized below (dollars in thousands):

	Fair value measurements at September 30, 2018			
	Carrying Value	Quoted prices in active markets for identical assets (level 1)	Significant other observable inputs (level 2)	Significant unobservable inputs (level 3)
Assets:				
Impaired loans:				
Commercial and industrial	\$ 2,719	—	—	2,719

	Fair value measurements at December 31, 2017			
	Carrying Value	Quoted prices in active markets for identical assets (level 1)	Significant other observable inputs (level 2)	Significant unobservable inputs (level 3)
Assets:				
Impaired loans:				
Commercial and industrial	\$ 1,388	—	—	1,388

The following table presents quantitative information about Level 3 fair value measurements for assets measured at fair value on a non-recurring basis at September 30, 2018 and December 31, 2017 (dollars in thousands):

September 30, 2018	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted-Average)
Impaired loans:				
Commercial and industrial	\$ 2,719	Discounted cash flow	Probability of default Loss severity	5%-60% 5%-50%

December 31, 2017	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted-Average)
Impaired loans:				
Commercial and industrial	\$ 1,388	Sales comparison approach	Appraisal discounts	15%

Fair Value of Financial Instruments

The carrying value and estimated fair values of the Bank's financial instruments at September 30, 2018 and December 31, 2017 were as follows (dollars in thousands):

	September 30, 2018		December 31, 2017		Fair value level of input
	Carrying amount	Fair value	Carrying amount	Fair value	
Financial assets:					
Cash and due from banks, interest-bearing deposits in financial institutions	\$ 49,842	\$ 49,842	\$ 78,078	\$ 78,078	Level 1
Federal funds sold	2,747	2,747	4,719	4,719	Level 1
Securities available-for-sale	187,469	187,469	192,621	192,621	Level 2
Securities held-to-maturity	3,740	3,766	3,759	3,848	Level 2
Loans held for sale	50,499	51,326	74,093	75,549	Level 2
Restricted equity securities	8,817	N/A	8,806	N/A	N/A
Loans, net	1,073,870	1,065,226	947,537	944,037	Level 3
Accrued interest receivable	4,430	4,430	4,084	4,084	Level 2
Other assets	23,519	23,519	22,663	22,663	Level 2
Financial liabilities:					
Deposits	1,126,403	1,074,725	1,119,866	1,065,669	Level 3
Federal Home Loan Bank advances	125,000	124,983	70,000	69,980	Level 2
Other liabilities	2,447	2,447	3,672	3,672	Level 3

The methods and assumptions, not previously presented, used to estimate fair values are described as follows:

(a) *Cash and Due from Banks, Interest-Bearing Deposits in Financial Institutions*

For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

(b) *Federal Funds Sold*

Federal funds sold clear on a daily basis. For this reason, the carrying amount is a reasonable estimate of fair value.

(c) *Restricted Equity Securities*

It is not practical to determine the fair value of restricted securities due to restrictions placed on their transferability.

(d) *Loans, net*

During the first quarter of 2018, the Company adopted ASU 2016-01, "Recognition and Measurement of Financial Assets and Liabilities." The amendments included within this standard, which are applied prospectively, require the Company to disclose fair value of financial instruments measured at amortized cost on the balance sheet to measure that fair value using an exit price notion. Prior to adopting the amendments included in the standard, the Company was allowed to measure fair value under an entry price notion. The entry price notion previously applied by the Company used a discounted cash flows technique to calculate the present value of expected future cash flows for a financial instrument. The exit price notion uses the same approach, but also incorporates other factors, such as enhanced credit risk, illiquidity risk and market factors that sometimes exist in exit prices in dislocated markets.

As of September 30, 2018, the technique used by the Company to estimate the exit price of the loan portfolio consists of similar procedures to those used as of December 31, 2017, but with added emphasis on both illiquidity risk and credit risk not captured by the previously applied entry price notion. The fair value of the Company's loan portfolio has always included a credit risk assumption in the determination of the fair value of its loans. This credit risk assumption is intended to approximate the fair value that a market participant would realize in a hypothetical orderly transaction. The Company's loan portfolio is initially fair valued using a segmented approach. The Company divides its loan portfolio into the following categories: variable rate loans, impaired loans and all other loans. The results are then adjusted to account for credit risk as described above. However, under the new guidance, the Company believes a further credit risk discount must be applied through the use of a discounted cash flow model to compensate for illiquidity risk, based on certain assumptions included within the discounted cash flow model, primarily the use of discount rates that better capture inherent credit risk over the lifetime of a loan. This consideration of enhanced credit risk provides an estimated exit price for the Company's loan portfolio.

For variable-rate loans that reprice frequently and have no significant change in credit risk, fair values approximate carrying values. Fair values for impaired loans are estimated using discounted cash flow models or based on the fair value of the underlying collateral.

As of December 31, 2017, the fair value of the Company's loan portfolio includes a credit risk assumption in the determination of the fair value of its loans. This credit risk assumption is intended to approximate the fair value that a market participant would realize in a hypothetical orderly transaction. The Company's loan portfolio is initially fair valued using a segmented approach. The Company divides its loan portfolio into the following categories: variable rate loans, impaired loans and all other loans. The results are then adjusted to account for credit risk. For variable-rate loans that reprice frequently and have no significant change in credit risk, fair values approximate carrying values. Fair values for impaired loans are estimated using discounted cash flow models or based on the fair value of the underlying collateral. For other loans, fair values are estimated using discounted cash flow models, using current market interest rates offered for loans with similar terms to borrowers of similar credit quality. The values derived from the discounted cash flow approach for each of the above portfolios are then further discounted to incorporate credit risk. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price as of December 31, 2017.

(e) *Accrued Interest Receivable*

The carrying amounts of accrued interest approximate fair value.

(f) *Other Assets*

Included in other assets are bank owned life insurance, certain interest rate swap agreements and the cash flow hedge relationships. The fair values of interest rate swap agreements and the cash flow hedge relationships are based on independent pricing services that utilize pricing models with observable market inputs. For bank owned life insurance, the carrying amount is based on the cash surrender value and is a reasonable estimate of fair value.

(g) *Deposits*

The fair value of demand deposits, savings accounts and certain money market deposits is the amount payable on demand at the reporting date. The fair value of certificates of deposit is estimated by discounted cash flow models, using current market interest rates offered on certificates with similar remaining maturities.

(h) *Federal Home Loan Bank Advances*

The fair value of fixed rate Federal Home Loan Bank Advances is estimated using discounted cash flow models, using current market interest rates offered on certificates, advances and other borrowings with similar remaining maturities.

(i) *Other Liabilities*

Included in other liabilities are accrued interest payable, certain interest rate swap agreements, the cash flow hedge relationships and contingent consideration. The fair values of interest rate swap agreements and the cash flow hedge relationships are based on independent pricing services that utilize pricing models with observable market inputs. The fair value of contingent consideration is estimated by a discounted cash flow model that utilizes various unobservable inputs. The carrying amounts of accrued interest approximate fair value.

(j) *Off-Balance Sheet Instruments*

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

(k) *Limitations*

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instruments. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Bank's entire holdings of a particular instrument. Because no market exists for a significant portion of the Bank's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on estimating on and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. For example, fixed assets are not considered financial instruments and their value has not been incorporated into the fair value estimates. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

NOTE 13 – SUBSEQUENT EVENT

On October 1, 2018, pursuant to the Agreement and Plan of Merger, dated as of June 11, 2018 (the "Merger Agreement"), by and between CapStar Financial Holdings, Inc., a Tennessee corporation ("CapStar"), and Athens Bancshares Corporation, a Tennessee corporation ("Athens"), Athens was merged with and into CapStar, with CapStar continuing as the surviving entity (the "Merger"). Immediately following the Merger, Athens Federal Community Bank, National Association, a wholly owned subsidiary of Athens, merged with and into CapStar Bank, a wholly owned subsidiary of CapStar (the "Bank Merger"), with CapStar Bank continuing as the surviving entity in the Bank Merger.

On the terms and subject to the conditions set forth in the Merger Agreement, at the effective time of the Merger (the "Effective Time"), each share of common stock, par value \$0.01, of Athens ("Athens Common Stock") issued and outstanding immediately prior to the completion of the merger (other than dissenting shares and shares of Athens common stock owned directly or indirectly by Athens, CapStar and their wholly owned subsidiaries (in each case, other than shares of Athens common stock held in a fiduciary capacity or in connection with debts previously contracted) was converted into the right to receive 2.864 shares (the "Exchange Ratio") of voting common stock, par value \$1.00 per share, of CapStar ("CapStar Common Stock"), with cash paid in lieu of fractional shares. This resulted in the issuance of 5,181,916 shares of CapStar common stock on October 1, 2018.

At the Effective Time, each outstanding and unexercised Athens stock option granted under the Athens Bancshares Corporation 2010 Equity Incentive Plan (the "Athens Equity Plan") that was held by an employee or service provider of Athens who had terminated service prior to the Effective Time was cancelled and converted into the right to receive the cash value of the merger consideration (determined in accordance with the terms of the Merger Agreement), less the applicable option exercise price and less applicable withholding taxes. Except as described in the prior sentence, each outstanding and unexercised Athens stock option granted under the Athens Equity Plan was converted into an option to purchase shares of CapStar Common Stock, with the number of shares and exercise price adjusted to reflect the Exchange Ratio in accordance with the terms of the Merger Agreement. The converted options resulted in the right to purchase 548,051 shares of CapStar Common Stock at a weighted average exercise price of \$5.06.

Total acquisition consideration resulting from the Merger amounted to approximately \$92.9 million.

The foregoing description of the Merger Agreement does not purport to be complete and is qualified in its entirety by reference to the full text of the Merger Agreement, a copy of which was attached as Exhibit 2.1 to CapStar's Form 8-K filed with the U.S. Securities and Exchange Commission on June 14, 2018 and the terms of which are incorporated herein by reference.

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

The following is a discussion of our financial condition at September 30, 2018 and December 31, 2017 and our results of operations for the three and nine months ended September 30, 2018 and 2017. The purpose of this discussion is to focus on information about our financial condition and results of operations which is not otherwise apparent from the consolidated financial statements. The following discussion and analysis should be read along with our consolidated financial statements and the related notes included elsewhere in this Report and our Annual Report on Form 10-K for the year ended December 31, 2017. Annualized results for interim periods may not be indicative of results for the full year or future periods. In addition to historical information, this discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions that could cause actual results to differ materially from our current expectations. Factors that could cause such differences are discussed in the section entitled "Cautionary Note Regarding Forward-Looking Statements" in this Report and the section entitled "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2017. We assume no obligation to update any of these forward-looking statements except to the extent required by applicable law.

The following discussion and analysis pertains to our historical results on a consolidated basis. However, because we conduct all of our material business operations through our wholly owned subsidiary, CapStar Bank, the following discussion and analysis relates to activities primarily conducted at the subsidiary level.

All dollar amounts in the tables in this section are in thousands of dollars, except per share data or when otherwise specifically noted.

Overview

Our diluted net income per share of common stock for the three and nine months ended September 30, 2018 was \$0.28 and \$0.79, respectively, compared to \$0.35 and \$0.11, respectively, for the three and nine months ended September 30, 2017. The increase in our net income for the nine months ended September 30, 2018 compared to the same period in 2017 was primarily due to decreased loan charge-offs and the resulting provision for loan losses. During the nine months ended September 30, 2018 and 2017, loan charge-offs amounted to \$0.3 million and \$12.4 million, respectively. At September 30, 2018, loans increased to \$1.07 billion, as compared to \$0.95 billion at December 31, 2017. Total deposits increased to \$1.13 billion at September 30, 2018 from \$1.12 billion at December 31, 2017.

On October 1, 2018, the Company and Athens Bancshares Corporation ("Athens"), the bank holding company for Athens Federal Community Bank, National Association ("Athens Federal"), located in Athens, Tennessee, completed a merger pursuant to which Athens merged with and into CapStar and Athens Federal merged with and into CapStar Bank. We incurred merger related expenses in connection with this transaction amounting to \$0.5 million and \$0.9 million during the three and nine months ended September 30, 2018. No merger related expenses were incurred during the three and nine months ended September 30, 2017.

The Company's primary revenue sources are net interest income and fees from various financial services provided to customers. Net interest income is the difference between interest income earned on loans, investment securities and other interest earning assets less interest expense on deposit accounts and other interest bearing liabilities. Loan volume and interest rates earned on those loans are critical to our overall profitability. Similarly, deposit volume is crucial to funding loans, and rates paid on deposits directly impact our profitability. Business volumes are influenced by competition, new business acquisition efforts and economic factors including market interest rates, business spending and consumer confidence.

Net interest income increased \$0.7 million, or 6.5%, for the three months ended September 30, 2018 compared to the same period in 2017 and increased \$2.6 million, or 8.4%, for the nine months ended September 30, 2018 compared to the same period in 2017. The positive effects of increased yields on earning assets were partially offset by the negative effect of increasing deposit costs. Net interest margin increased to 3.35% for the three months ended September 30, 2018, compared with 3.31% for the same period of 2017 and increased to 3.40% for the nine months ended September 30, 2018, compared with 3.23% for the same period of 2017.

In response to the assessment of risk in the loan portfolio, including net loan growth and charge-offs, we recorded a \$0.5 million and \$1.3 million provision for loan losses, respectively, for the three and nine months ended September 30, 2018 compared to \$(0.2) million and \$12.9 million, respectively, for the three and nine months ended September 30, 2017. The 2017 provision for loan losses was caused primarily by deterioration in the credit quality of commercial and industrial loans to one borrower. The provision for loan losses represents a charge to earnings necessary to establish an allowance for loan losses that, in management's evaluation, is adequate to provide coverage for the estimated probable inherent losses on outstanding loans. Our allowance for loan losses at September 30, 2018 was 1.42% of total loans, compared with 1.45% of total loans at December 31, 2017.

Total non-interest income for the three months ended September 30, 2018 decreased \$0.2 million, or 4.6%, compared with the same period in 2017, and comprised 17% of total revenues. For the nine months ended September 30, 2018, total non-interest income increased \$0.9 million, or 11.0%, compared with the same period in 2017, and comprised 17% of total revenues. These increases were primarily the result of higher Tri-Net fees related to increased volumes of commercial real estate loan sales.

As we grew our team and expanded in the Nashville MSA, total non-interest expense for the three and nine months ended September 30, 2018 increased \$1.6 million, or 18.8%, and \$4.6 million, or 18.3%, respectively, compared with the same periods in 2017. Our efficiency ratio for the three months ended September 30, 2018 was 68.2% compared to 59.6% for the same period in 2017. For the nine months ended September 30, 2018 our efficiency ratio was 68.9% compared to 63.4% for the same period in 2017. The increases in our efficiency ratio are a reflection of our investment in new employees, increased incentive compensation consistent with the Company's overall performance, and the addition of merger related expenses resulting from our merger with Athens.

Our effective tax rate for the three and nine months ended September 30, 2018 was 13.2% and 14.1%, respectively, compared to 25.5% and 9.1% for the same periods in 2017. The changes in the effective tax rate are largely the result of the ratio of excess tax benefits from stock compensation to income before income taxes.

Tangible common equity ("TCE"), a non-GAAP measure, is a measure of a company's capital which is useful in evaluating the quality and adequacy of capital. The ratio of tangible common equity to total tangible assets was 10.1% as of September 30, 2018, compared with 9.8% at December 31, 2017. See "Management's Discussion and Analysis of Financial Condition and Results of Operations — Non-GAAP Financial Measures" for details on reconciliations to the most directly comparable U.S. GAAP measures.

The following sections provide more details on subjects presented in this overview.

(a) Results of Operations

The following is a summary of our results of operations:

	Three Months Ended September 30,		2018 - 2017 Percent Increase (Decrease)	Nine Months Ended September 30,		2018 - 2017 Percent Increase (Decrease)
	2018	2017		2018	2017	
Interest income	\$ 15,782	\$ 13,521	16.7%	\$ 44,880	\$ 38,390	16.9%
Interest expense	4,239	2,678	58.3%	10,904	7,045	54.8%
Net interest income	11,543	10,843	6.5%	33,976	31,345	8.4%
Provision for loan losses	481	(195)	347.2%	1,328	12,900	(89.7)%
Net interest income after provision for loan losses	11,062	11,038	0.2%	32,648	18,445	77.0%
Noninterest income	3,218	3,372	(4.6)%	9,072	8,171	11.0%
Noninterest expense	10,070	8,475	18.8%	29,655	25,066	18.3%
Net income before income taxes	4,210	5,935	(29.1)%	12,065	1,550	678.3%
Income tax expense	554	1,516	(63.5)%	1,702	141	1107.7%
Net income	\$ 3,656	\$ 4,419	(17.3)%	\$ 10,363	\$ 1,409	635.4%
<i>Basic net income per share of common stock</i>	\$ 0.30	\$ 0.39	(22.5)%	\$ 0.87	\$ 0.13	597.4%
<i>Fully diluted net income per share of common stock</i>	\$ 0.28	\$ 0.35	(19.6)%	\$ 0.79	\$ 0.11	618.8%

Annualized return on average assets and annualized return on average shareholders' equity were 1.02% and 9.28%, respectively, for the third quarter of 2018, compared with 1.28% and 12.38%, respectively, for the same period in 2017.

Annualized return on average assets and annualized return on average shareholders' equity were 1.00% and 9.11%, respectively, for the nine months ended September 30, 2018, compared with 0.14% and 1.33%, respectively, for the same period in 2017.

Net Interest Income

The largest component of our net income is net interest income – the difference between the income earned on interest-earning assets and the interest paid on deposits and borrowed funds used to support our assets. Net interest income divided by total average interest-earning assets represents our net interest margin. The major factors that affect net interest income and net interest margin are changes in volumes, the yield on interest-earning assets and the cost of interest-bearing liabilities. Our margin can also be affected by economic conditions, the competitive environment, loan demand and deposit flow. Our ability to respond to changes in these factors by using effective asset-liability management techniques is critical to maintaining the stability of the net interest margin and our net interest income.

The following tables set forth the amount of our average balances, interest income or interest expense for each category of interest-earning assets and interest-bearing liabilities and the average interest rate for interest-earning assets and interest-bearing liabilities, net interest spread and net interest margin for the three and nine months ended September 30, 2018 and 2017:

	For the Three Months Ended September 30,					
	2018			2017		
	Average Outstanding Balance	Interest Income/Expense	Average Yield/Rate	Average Outstanding Balance	Interest Income/Expense	Average Yield/Rate
Interest-Earning Assets						
Loans (1)	\$ 1,070,060	\$ 13,484	5.00%	\$ 991,238	\$ 11,375	4.55%
Loans held for sale	54,701	683	4.96%	67,886	720	4.21%
Securities:						
Taxable investment securities (2)	154,570	1,083	2.80%	156,973	946	2.41%
Investment securities exempt from federal income tax (3)	41,461	248	3.03%	50,953	304	3.67%
Total securities	196,031	1,331	2.85%	207,926	1,250	2.72%
Cash balances in other banks	50,844	267	2.08%	49,151	169	1.36%
Funds sold	2,475	17	2.73%	1,711	7	1.67%
Total interest-earning assets	1,374,111	15,782	4.58%	1,317,912	13,521	4.12%
Noninterest-earning assets	47,762			50,081		
Total assets	<u>\$ 1,421,873</u>			<u>\$ 1,367,993</u>		
Interest-Bearing Liabilities						
Interest-bearing deposits:						
Interest-bearing transaction accounts	\$ 318,586	1,146	1.43%	\$ 291,250	635	0.87%
Savings and money market deposits	391,107	1,409	1.43%	354,972	772	0.86%
Time deposits	203,841	985	1.92%	211,122	706	1.32%
Total interest-bearing deposits	913,534	3,540	1.54%	857,344	2,113	0.98%
Borrowings and repurchase agreements	109,891	699	2.53%	123,859	565	1.81%
Total interest-bearing liabilities	1,023,425	4,239	1.64%	981,203	2,678	1.08%
Noninterest-bearing deposits	233,739			237,156		
Total funding sources	1,257,164			1,218,359		
Noninterest-bearing liabilities	8,445			8,078		
Shareholders' equity	156,264			141,556		
Total liabilities and shareholders' equity	<u>\$ 1,421,873</u>			<u>\$ 1,367,993</u>		
Net interest spread (4)			2.93%			3.04%
Net interest income/margin (5)		<u>\$ 11,543</u>	3.35%		<u>\$ 10,843</u>	3.31%

- (1) Average loan balances include nonaccrual loans. Interest income on loans includes amortization of deferred loan fees, net of deferred loan costs.
- (2) Taxable investment securities include restricted equity securities.
- (3) Yields on tax exempt securities are shown on a tax equivalent basis.
- (4) Net interest spread is the average yield on total interest-earning assets minus the average rate on total interest-bearing liabilities.
- (5) Net interest margin is annualized net interest income calculated on a tax equivalent basis divided by total average interest-earning assets for the period.

For the Nine Months Ended September 30,

	2018			2017		
	Average Outstanding Balance	Interest Income/Expense	Average Yield/Rate	Average Outstanding Balance	Interest Income/Expense	Average Yield/Rate
Interest-Earning Assets						
Loans (1)	\$ 1,032,114	\$ 38,058	4.93%	\$ 998,247	\$ 32,580	4.36%
Loans held for sale	60,312	2,139	4.74%	43,790	1,355	4.14%
Securities:						
Taxable investment securities (2)	155,331	3,164	2.72%	170,804	3,098	2.42%
Investment securities exempt from federal income tax (3)	43,722	784	3.03%	53,236	944	3.64%
Total securities	199,053	3,948	2.78%	224,040	4,042	2.71%
Cash balances in other banks	49,930	679	1.82%	48,980	387	1.06%
Funds sold	2,967	56	2.50%	2,359	26	1.46%
Total interest-earning assets	1,344,376	44,880	4.48%	1,317,416	38,390	3.95%
Noninterest-earning assets	45,671			49,873		
Total assets	<u>\$ 1,390,047</u>			<u>\$ 1,367,289</u>		
Interest-Bearing Liabilities						
Interest-bearing deposits:						
Interest-bearing transaction accounts	\$ 294,994	2,793	1.27%	\$ 307,992	1,839	0.80%
Savings and money market deposits	399,698	3,827	1.28%	389,425	2,360	0.81%
Time deposits	190,735	2,468	1.73%	193,436	1,750	1.21%
Total interest-bearing deposits	885,427	9,088	1.37%	890,853	5,949	0.89%
Borrowings and repurchase agreements	98,033	1,816	2.48%	100,221	1,096	1.46%
Total interest-bearing liabilities	983,460	10,904	1.48%	991,074	7,045	0.95%
Noninterest-bearing deposits	246,991			225,623		
Total funding sources	1,230,451			1,216,697		
Noninterest-bearing liabilities	7,542			8,627		
Shareholders' equity	152,054			141,965		
Total liabilities and shareholders' equity	<u>\$ 1,390,047</u>			<u>\$ 1,367,289</u>		
Net interest spread (4)			3.00%			3.00%
Net interest income/margin (5)		<u>\$ 33,976</u>	3.40%		<u>\$ 31,345</u>	3.23%

- (1) Average loan balances include nonaccrual loans. Interest income on loans includes amortization of deferred loan fees, net of deferred loan costs.
- (2) Taxable investment securities include restricted equity securities.
- (3) Yields on tax exempt securities are shown on a tax equivalent basis.
- (4) Net interest spread is the average yield on total interest-earning assets minus the average rate on total interest-bearing liabilities.
- (5) Net interest margin is annualized net interest income calculated on a tax equivalent basis divided by total average interest-earning assets for the period.

Our net interest margin was 3.35% and 3.31% for the third quarter of 2018 and 2017, respectively. For the nine months ended September 30, 2018 and 2017, our net interest margin was 3.40% and 3.23%, respectively. The increase in net interest margin for both periods was primarily due to rising yields on earning assets offset by rising deposit costs. From December 31, 2016 to September 30, 2018, the LIBOR – 1 month interest rate increased from 0.72% to 2.27%. Approximately 65% of our loan portfolio is variable in nature.

For the third quarter of 2018 and 2017, average loan yields increased from 4.55% to 5.00% which was primarily driven by increases in short-term interest rate indexes affecting the variable rate portion of our loan portfolio, offset by competitive pricing pressures. For the nine months ended September 30, 2018 and 2017, average loan yields increased from 4.36% to 4.93%.

For the third quarter of 2017 and 2018, average security yields increased from 2.72% to 2.85% and from 2.71% to 2.78% for the nine months ended September 30, 2017 and 2018, respectively, primarily due to increases in the LIBOR rate on the variable rate portion of our securities portfolio.

The resulting yield on average interest-earning assets increased 46 basis points for the third quarter of 2018 compared to the similar period in 2017 and 53 basis points for the nine months ended September 30, 2018 compared to the similar period of 2017.

The average rate paid on interest-bearing liabilities was 1.64% for the third quarter of 2018, as compared to 1.08% for the same period in 2017. For the nine months ended September 30, 2018 and 2017, the average rate paid on interest-bearing liabilities was 1.48% and 0.95%, respectively. These increases were due to the increases in the Fed Funds rate which increased from 0.75% at December 31, 2016 to 2.25% at September 30, 2018. We passed along a portion of these rate increases to our clients.

Asset/Liability Management and Interest Rate Risk

Managing interest rate risk is fundamental for the financial services industry. By considering both on and off-balance sheet financial instruments, management evaluates interest rate sensitivity while attempting to optimize net interest income within the constraints of prudent capital adequacy, liquidity needs, market opportunities and customer requirements.

Interest Rate Simulation Sensitivity Analysis

We use earnings at risk, or EAR, simulations to assess the impact of changing rates on earnings under a variety of scenarios and time horizons. The simulation model is designed to reflect the dynamics of interest earning assets, interest bearing liabilities and off-balance sheet financial instruments. These simulations utilize both instantaneous and parallel changes in the level of interest rates, as well as non-parallel changes such as changing slopes and twists of the yield curve. Static simulation models are based on current exposures and assume a constant balance sheet with no new growth. Dynamic simulation models are also utilized that rely on detailed assumptions regarding changes in existing lines of business, new business, and changes in management and client behavior. By estimating the effects of interest rate increases and decreases, the model can reveal approximate interest rate risk exposure. The simulation model is used by management to gauge approximate results given a specific change in interest rates at a given point in time. The model is therefore a tool to indicate earnings trends in given interest rate scenarios and does not indicate actual expected results.

At September 30, 2018, our EAR static simulation results indicated that our balance sheet is asset sensitive to parallel shifts in interest rates. This indicates that our assets generally reprice faster than our liabilities, which results in a favorable impact to net interest income when market interest rates increase. Many assumptions are used to calculate the impact of interest rate fluctuations on our net interest income, such as asset prepayments, non-maturity deposit price sensitivity and decay rates, and key rate drivers. Because of the inherent use of these estimates and assumptions in the model, our actual results may, and most likely will, differ from our static EAR results. In addition, static EAR results do not include actions that our management may undertake to manage the risks in response to anticipated changes in interest rates or client behavior. For example, as part of our asset/liability management strategy, management has the ability to increase asset duration and/or decrease liability duration in order to reduce asset sensitivity, or to decrease asset duration and/or increase liability duration in order to increase asset sensitivity.

The following table illustrates the results of our EAR analysis to determine the extent to which our net interest income over the next 12 months would change if prevailing interest rates increased or decreased by the specified amounts.

	Net interest income change
Increase 200bp	2.7%
Increase 100bp	1.4
Decrease 100bp	(3.7)
Decrease 200bp	(15.3)

Provision for Loan Losses

Our policy is to maintain an allowance for loan losses at a level sufficient to absorb probable incurred losses inherent in the loan portfolio. The allowance is increased by a provision for loan losses, which is a charge to earnings, is decreased by charge-offs and is increased by loan recoveries. Our allowance for loan losses as a percentage of total loans was 1.42% and 1.45% at September 30, 2018 and December 31, 2017, respectively.

The provision for loan losses amounted to \$0.5 million and \$1.3 million, respectively, for the three and nine months ended September 30, 2018 compared to \$(0.2) million and \$12.9 million, respectively, for the three and nine months ended September 30, 2017. Provision expense is impacted by the absolute level of loans, loan growth, the credit quality of the loan portfolio and the amount of net charge-offs.

Provision expense increased for the three months ended September 30, 2018 compared to the comparable period in 2017 primarily due to increased loan growth. Provision expense decreased for the nine months ended September 30, 2018 compared to the comparable period in 2017 due to decreased charge-offs. Charge-offs for the nine months ended September 30, 2018 were \$0.3 million compared to \$12.4 million for the nine months ended September 30, 2017.

Based upon our evaluation of the loan portfolio, we believe the allowance for loan losses to be appropriate to absorb our estimate of probable losses existing in the loan portfolio at September 30, 2018. While our policies and procedures used to estimate the allowance for loan losses, as well as the resultant provision for loan losses charged to operations, are considered adequate by management, they are necessarily approximate and imprecise. There are factors beyond our control, such as conditions in the local and national economy, local real estate markets, or particular industry or borrower-specific conditions, which may materially negatively impact our asset quality and the adequacy of our allowance for loan losses and, thus, the resulting provision for loan losses. See “Notes to Consolidated Financial Statements (Unaudited) — Note 3 — Loans and Allowance for Loan Losses” for additional information on our allowance for loan losses.

Noninterest Income

In addition to net interest income, we generate other types of recurring noninterest income from our lines of business. Our banking operations generate revenue from service charges and fees on deposit accounts. We have a mortgage banking line of business that generates revenue from originating and selling mortgages, a line of business that originates and sells commercial real estate loans (Tri-Net), and we have a revenue-sharing relationship with a registered broker-dealer, which generates wealth management fees. In addition to these types of recurring noninterest income, we own insurance on several key employees and record income on the increase in the cash surrender value of these policies.

The following table sets forth the principal components of noninterest income for the periods indicated.

	Three Months Ended September 30,		2018-2017 Percent Increase (Decrease)	Nine Months Ended September 30,		2018-2017 Percent Increase (Decrease)
	2018	2017		2018	2017	
Noninterest income:						
Treasury management and other deposit service charges	\$ 528	\$ 427	23.8%	\$ 1,357	\$ 1,097	23.7%
Net gain (loss) on sale of securities	(1)	9	(110.0)%	2	42	(95.0)%
Tri-Net fees	373	367	2.0%	1,227	748	64.0%
Mortgage banking income	1,634	2,030	(19.5)%	4,329	4,617	(6.2)%
Other noninterest income	684	539	26.5%	2,157	1,667	29.3%
Total noninterest income	\$ 3,218	\$ 3,372	(4.6)%	\$ 9,072	\$ 8,171	11.0%

The increase in treasury management and other deposit service charges for the three and nine months ended September 30, 2018 compared to the same periods in 2017 is driven primarily by transaction volume, which can fluctuate from period to period.

Tri-Net fees represent a line of business, implemented in the fourth quarter of 2016, which originates and sells commercial real estate loans to third-party investors. All of these loan sales transfer servicing rights to the buyer. The volume of loan sales has increased since this new line of business was implemented.

Mortgage banking income consists of mortgage fee income from the origination and sale of mortgage loans. These mortgage fees are for loans that we originated and that are subsequently sold to third-party investors. All of these loan sales transfer servicing rights to the buyer. Mortgage origination fees will fluctuate from quarter to quarter as the interest rate environment changes and due to the timing of loan sales.

Other noninterest income consists of various revenue streams. The increase in other noninterest income for the three and nine months ended September 30, 2018 compared to the same periods in 2017 is primarily due to increases in one-time, transaction related loan fees.

Noninterest Expense

Our total noninterest expense increase reflects expenses that we have incurred as we build the foundation to support our recent growth and enable us to execute our growth strategy. The following table presents the primary components of noninterest expense for the periods indicated.

	Three Months Ended September 30,		2018-2017 Percent Increase (Decrease)	Nine Months Ended September 30,		2018-2017 Percent Increase (Decrease)
	2018	2017		2018	2017	
Noninterest expense:						
Salaries and employee benefits	\$ 6,514	\$ 5,119	27.2%	\$ 19,111	\$ 14,989	27.5%
Data processing and software	803	709	13.3%	2,411	2,040	18.2%
Professional fees	255	336	(23.9)%	1,074	1,050	2.3%
Occupancy	544	531	2.5%	1,600	1,518	5.4%
Equipment	520	564	(7.8)%	1,661	1,604	3.6%
Regulatory fees	228	270	(15.3)%	664	877	(24.3)%
Merger related expenses	540	—	100.0%	875	—	100.0%
Other operating	666	946	(22.4)%	2,259	2,988	(22.1)%
Total noninterest expense	<u>\$ 10,070</u>	<u>\$ 8,475</u>	<u>18.8%</u>	<u>\$ 29,655</u>	<u>\$ 25,066</u>	<u>18.3%</u>

Salaries and employee benefits increased 27.2% and 27.5%, respectively, for the three and nine months ended September 30, 2018 compared to the similar periods in 2017. The increase is primarily related to increased incentive expense related to improved financial performance and the addition of personnel associated with continued expansion in the Nashville MSA. The number of full-time employees increased from 170 at January 1, 2017 to 185 at September 30, 2018.

Data processing and software expense increased during the periods presented due to an increase in the volume of transactions and implementation of new software in our mortgage banking line of business.

Merger related expenses during the three and nine months ended September 30, 2018 are the result of our recently completed merger with Athens. Merger related expenses are expected to approximate \$11.5 million in total over the course of the acquisition.

Other operating expense declined for the three and nine months ended September 30, 2018 compared to the similar periods in 2017 primarily because of one-time costs incurred in 2017 related to the move of our corporate headquarters and expenses related to the loans charged off in the second quarter of 2017.

Our efficiency ratio (ratio of noninterest expense to the sum of net interest income and noninterest income) was 68.2% for the three months ended September 30, 2018 compared to 59.6% for the same period 2017. For the nine months ended September 30, 2018 and 2017, our efficiency ratio was 68.9% and 63.4%, respectively. The efficiency ratio for both periods was negatively impacted by growth in our expenses that outpaced increases in our revenues. The increases in our efficiency ratio are a reflection of our investment in new employees, increased incentive compensation consistent with the Company's overall performance, and the addition of merger related expenses resulting from our merger with Athens. The efficiency ratio measures the amount of expense that is incurred to generate a dollar of revenue. For the nine months ended September 30, 2018, our revenue base (net interest income plus noninterest income) grew at a rate of approximately 0.5 times our noninterest expense.

Income Tax Provision

During the three and nine months ended September 30, 2018, we recorded income tax expense of \$0.6 million and \$1.7 million, respectively, compared to \$1.5 million and \$0.1 million, respectively, for the three and nine months ended September 30, 2017. Our income tax expense for the nine months ended September 30, 2018 reflects an effective income tax rate of 14.1% compared to 9.1% for the same period in 2017. Our effective tax rate differs from the statutory tax rate by our investments in municipal securities, company owned life insurance, state tax credits, net of the effect of certain non-deductible expenses and the recognition of excess tax benefits related to stock compensation.

In March 2016, the FASB issued guidance to simplify several aspects of the accounting for share-based payment award transactions, including income tax consequences. In addition to other changes, the guidance changes the accounting for excess tax benefits and tax deficiencies from generally being recognized in additional paid-in capital to recognition as income tax expense or benefit in the period they occur. The Company adopted the new guidance in the first quarter of 2017. As a result, the Company's income tax expense was reduced by \$422,000 and \$1,062,000 for the three and nine months ended September 30, 2018, respectively, and by \$144,000 and \$310,000 for the three and nine months ended September 30, 2017, respectively.

(b) Financial Condition

Balance Sheet

Total assets increased \$72.5 million, or 5.4%, from \$1.34 billion at December 31, 2017 to \$1.42 billion at September 30, 2018. Loans grew \$126.3 million, or 13.3%, in the first nine months of 2018, offset by a decrease in cash of \$30.2 million, or 36.5%, for the same period. Loans held for sale decreased \$23.6 million, or 31.8%, during the first nine months of 2018.

Total liabilities increased \$62.0 million, or 5.2%, from \$1.20 billion at December 31, 2017 to \$1.26 billion at September 30, 2018. Deposits increased \$6.5 million, or 0.6%, over the same period of time. We increased our Federal Home Loan Bank advances \$55.0 million during the first nine months of 2018 to help fund our loan growth.

Loans and Leases

The composition of loans and leases at September 30, 2018 and December 31, 2017 and the percentage of each classification to total loans are summarized as follows:

	September 30, 2018		December 31, 2017	
	Amount	Percent	Amount	Percent
Commercial real estate - owner occupied	\$ 117,904	11.0%	\$ 101,132	10.7%
Commercial real estate - non-owner occupied	286,849	26.7%	249,490	26.3%
Consumer real estate	112,957	10.5%	102,581	10.8%
Construction and land development	129,799	12.1%	82,586	8.7%
Commercial and industrial	398,626	37.1%	373,248	39.4%
Consumer	8,274	0.8%	6,862	0.7%
Other	19,793	1.8%	31,983	3.4%
Total loans	<u>\$ 1,074,202</u>	<u>100.0%</u>	<u>\$ 947,882</u>	<u>100.0%</u>

At September 30, 2018, our loan portfolio composition remained relatively consistent with the composition at December 31, 2017. The commercial real estate owner-occupied category contains loans which are similar in many ways to our commercial and industrial lending in that these loans are generally made to businesses on the basis of the cash flows of the business rather than on the valuation of the real estate.

Non-Performing Loans and Assets

Information summarizing non-performing assets, including non-accrual loans follows:

	September 30, 2018	December 31, 2017
Non-accrual loans	\$ 5,611	\$ 2,695
Troubled debt restructurings	1,146	1,207
Loans past due over 89 days and still accruing	215	231
Non-performing loans	5,611	2,695
Foreclosed real estate	—	—
Non-performing assets	\$ 5,611	\$ 2,695
Non-performing loans as a percentage of total loans	0.52%	0.28%
Non-performing assets as a percentage of total assets	0.40%	0.20%

The following table sets forth the major classifications of non-accrual loans:

	September 30, 2018	December 31, 2017
Commercial real estate	\$ —	\$ 1,207
Consumer real estate	92	—
Construction and land development	—	—
Commercial and industrial	5,419	1,488
Consumer	100	—
Other	—	—
Total loans	\$ 5,611	\$ 2,695

(c) Liquidity

Liquidity risk is the risk that we will be unable to meet our obligations as they become due because of an inability to liquidate assets or obtain adequate funding. To manage liquidity risk, management has established a comprehensive management process for identifying, measuring, monitoring and controlling liquidity risk. Because of its critical importance to the viability of the Bank, liquidity risk management is fully integrated into our risk management processes. Critical elements of our liquidity risk management include: effective corporate governance consisting of oversight by the board of directors and active involvement by management; appropriate strategies, policies, procedures, and limits used to manage and mitigate liquidity risk; comprehensive liquidity risk measurement and monitoring systems (including assessments of the current and prospective cash flows or sources and uses of funds) that are commensurate with the complexity and business activities of the Bank; active management of intraday liquidity and collateral; an appropriately diverse mix of existing and potential future funding sources; adequate levels of highly liquid marketable securities free of legal, regulatory, or operational impediments, that can be used to meet liquidity needs in stressful situations; comprehensive contingency funding plans that sufficiently address potential adverse liquidity events and emergency cash flow requirements; and internal controls and internal audit processes sufficient to determine the adequacy of the institution's liquidity risk management process.

The role of liquidity management is to ensure funds are available to meet depositors' withdrawal and borrowers' credit demands while at the same time maximizing financial results. This is accomplished by balancing changes in demand for funds with changes in the supply of those funds. Liquidity is provided by short-term liquid assets that can be converted to cash, investment securities available-for-sale, various lines of credit available to us, and the ability to attract funds from external sources, principally deposits.

Our most liquid assets are comprised of cash and due from banks, available-for-sale marketable investment securities and federal funds sold. The fair value of the available-for-sale investment portfolio was \$187.5 million at September 30, 2018. We pledge portions of our investment securities portfolio to secure public fund deposits, derivative positions and Federal Home Loan Bank ("FHLB") advances. At September 30, 2018, total investment securities pledged for these purposes comprised 78% of the estimated fair value of the entire investment portfolio, leaving \$42.6 million of unpledged securities.

We have a large base of non-maturity customer deposits, defined as demand, savings, and money market deposit accounts. At September 30, 2018, such deposits totaled \$924.0 million and represented 82% of our total deposits.

Other sources of funds available to meet daily needs include FHLB advances. As a member of the FHLB of Cincinnati, the Company has access to credit products offered by the FHLB. The Company views these borrowings as a low cost alternative to other time deposits. At September 30, 2018, available credit from the FHLB totaled \$59.4 million. Additionally, we had available federal funds purchased lines with correspondent banks totaling \$110.0 million at September 30, 2018.

The principal source of cash for CapStar Financial Holdings, Inc. (the "Parent Company") is dividends paid to it as the sole shareholder of the Bank. At September 30, 2018, the Bank was able to pay up to \$23.5 million in dividends to the Parent Company without regulatory approval subject to the ongoing capital requirements of the Bank.

Accordingly, management believes that our funding sources are at sufficient levels to satisfy our short-term and long-term liquidity needs.

(d) Capital Resources

At September 30, 2018, shareholders' equity totaled \$157.5 million, an increase of \$10.6 million since December 31, 2017. Accordingly, as of September 30, 2018, the Company and the Bank were well-capitalized under the regulatory framework for prompt corrective action. See the Consolidated Statement of Changes in Shareholders' Equity and Note 10 of the consolidated financial statements for further detail of the changes in equity since the end of 2017.

Off-Balance Sheet Arrangements

In the normal course of business, we enter into various transactions that, in accordance with GAAP, are not included in our consolidated balance sheet. We enter into these transactions to meet the financing needs of our clients. These transactions include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amounts recognized in our consolidated balance sheets. Most of these commitments mature within two years and are expected to expire without being drawn upon. Standby letters of credit are included in the determination of the amount of risk-based capital that the Company and the Bank are required to hold.

We enter into contractual loan commitments to extend credit, normally with fixed expiration dates or termination clauses, at specified rates and for specific purposes. Substantially all of our commitments to extend credit are contingent upon clients maintaining specific credit standards until the time of loan funding.

Standby letters of credit are written conditional commitments issued by us to guarantee the performance of a client to a third party. In the event that the client does not perform in accordance with the terms of the agreement with the third party, we would be required to fund the commitment. The maximum potential amount of future payments we could be required to make is represented by the contractual amount of the commitment. If the commitment is funded, we would be entitled to seek recovery from the client. Our policies generally require that standby letter of credit arrangements contain security and debt covenants similar to those contained in loan agreements.

We minimize our exposure to loss under loan commitments and standby letters of credit by subjecting them to the same credit approval and monitoring procedures as we do for on-balance sheet instruments. We assess the credit risk associated with certain commitments to extend credit and establish a liability for probable credit losses. The effect on our revenue, expenses, cash flows and liquidity of the unused portions of these commitments cannot be reasonably predicted because there is no guarantee that the lines of credit will be used.

Our off-balance sheet arrangements are summarized in Note 7 of the consolidated financial statements.

(e) **Non-GAAP Financial Measures**

This Report includes the following financial measures that have been prepared other than in accordance with generally accepted accounting principles in the United States (“non-GAAP financial measures”): tangible common equity, tangible common equity to total tangible assets and tangible common equity per share. The Company believes that these non-GAAP financial measures (i) provide useful information to management and investors that is supplementary to its financial condition, results of operations and cash flows computed in accordance with GAAP, (ii) enable a more complete understanding of factors and trends affecting the Company’s business, and (iii) allow investors to evaluate the Company’s performance in a manner similar to management, the financial services industry, bank stock analysts and bank regulators; however, the Company acknowledges that its non-GAAP financial measures have a number of limitations. As such, you should not view these disclosures as a substitute for results determined in accordance with GAAP, and they are not necessarily comparable to non-GAAP financial measures that other companies use.

The following table presents a reconciliation of tangible common equity, tangible common equity to total tangible assets and tangible common equity per share to the most directly comparable GAAP financial measures.

(dollars in thousands, except per share data)

	<u>September 30, 2018</u>	<u>December 31, 2017</u>
Total equity	\$ 157,510	\$ 146,946
Less core deposit intangible	—	(23)
Less goodwill	(6,219)	(6,219)
Less preferred equity	(9,000)	(9,000)
Tangible common equity	<u>\$ 142,291</u>	<u>\$ 131,704</u>
Total assets	\$ 1,416,907	\$ 1,344,429
Less core deposit intangible	—	(23)
Less goodwill	(6,219)	(6,219)
Total tangible assets	<u>\$ 1,410,688</u>	<u>\$ 1,338,187</u>
Total shareholders' equity to total assets	11.12%	10.93%
Tangible common equity ratio	10.09%	9.84%
Total shares of common stock outstanding	12,125,122	11,582,026
Book value per share of common stock	\$ 12.25	\$ 11.91
Tangible book value per share of common stock	11.74	11.37

(f) Recently Issued Accounting Pronouncements

ASU 2014-09, Revenue from Contracts with Customers

In May 2014, the FASB issued guidance to change the recognition of revenue from contracts with customers. The core principle of the new guidance is that an entity should recognize revenue to reflect the transfer of goods and services to customers in an amount equal to the consideration the entity receives or expects to receive. The guidance was effective for the Company for reporting periods beginning after December 15, 2017 and had no significant impact on financial reporting.

The Company's revenue is comprised of net interest income and noninterest income. The scope of the guidance explicitly excludes net interest income as well as many other revenues for financial assets and liabilities including loans, leases, securities, and derivatives. Accordingly, the majority of the Company's revenues were not affected. The Company has performed an assessment of revenue contracts related to revenue streams that are within the scope of the standard. The accounting policies have not changed since the principles of revenue recognition from the ASU are consistent with existing guidance and current practices applied by our businesses. We have not identified material changes to the timing or amount of revenue recognition nor have we identified a significant need for material changes to disclosures.

ASU 2016-02, Leases

In February 2016, the FASB amended the Leases topic of the Accounting Standards Codification to revise certain aspects of recognition, measurement, presentation, and disclosure of leasing transactions. The amendments will be effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted.

We expect to adopt the guidance using the modified retrospective method and practical expedients for transition. The practical expedients allow us to largely account for our existing leases consistent with current guidance except for the incremental balance sheet recognition for lessees. We have started an initial evaluation of our leasing contracts and activities. We have also started developing our methodology to estimate the right-of use assets and lease liabilities, which will be based on the present value of lease payments (the December 31, 2017 future minimum lease payments were \$14.6 million). We do not expect a material change to the timing of expense recognition, but we are early in the implementation process and will continue to evaluate the impact. We are evaluating our existing disclosures and may need to provide additional information as a result of adoption of the ASU.

ASU 2016-13, Financial Instruments – Credit Losses

In September 2016, the FASB issued guidance to change the accounting for credit losses and modify the impairment model for certain debt securities. The amendments will be effective for the Company for reporting periods beginning after December 15, 2019. Early adoption is permitted for all organizations for periods beginning after December 15, 2018.

The Company will apply the amendments to the ASU through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. While early adoption is permitted beginning in first quarter 2019, we do not expect to elect that option. We are evaluating the impact of the ASU on our consolidated financial statements. In addition to our allowance for loan losses, we will also record an allowance for credit losses on debt securities instead of applying the impairment model currently utilized. The amount of the adjustments will be impacted by each portfolio's composition and credit quality at the adoption date as well as economic conditions and forecasts at that time.

ASU 2017-04, Simplifying the Test of Goodwill Impairment

In January 2017, the FASB amended the Goodwill and Other Topic of the Accounting Standards Codification to simplify the accounting for goodwill impairment for public business entities and other entities that have goodwill reported in their financial statements and have not elected the private company alternative for the subsequent measurement of goodwill. The amendment removes Step 2 of the goodwill impairment test. A goodwill impairment will now be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. The effective date and transition requirements for the technical corrections will be effective for the Company for reporting periods beginning after December 15, 2019.

ASU 2017-09, Scope of Modification Accounting

In May 2017, the FASB amended the requirements in the Compensation—Stock Compensation Topic of the Accounting Standards Codification related to changes to the terms or conditions of a share-based payment award. The amendments provide guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting. The amendments were effective for the Company for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. The Company adopted the amendments during the period ended March 31, 2018. These amendments did not have a material effect on the Company's financial statements.

In August 2017, the FASB amended the requirements of the Derivatives and Hedging Topic of the Accounting Standards Codification to improve the financial reporting of hedging relationships to better portray the economic results of an entity's risk management activities in its financial statements. The amendments will be effective for the Company for interim and annual periods beginning after December 15, 2018. Early adoption is permitted. The Company adopted this standard December 1, 2017. There was no material effect on the financial statements.

ASU 2018-02, Income Statement: Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income

In February 2018, the FASB Issued (2018-02), Income Statement (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income, which allows Companies to reclassify the stranded effects in other comprehensive income to retained earnings as a result of the change in the tax rates under the Tax Reform Act. During the period ended December 31, 2017, the Company opted to early adopt this pronouncement by retrospective application to each period in which the effect of the change in the tax rate under the Tax Reform Act is recognized. The Company made an election to reclassify income tax effects of the Tax Reform Act, amounting to approximately \$259,000, from accumulated other comprehensive income to retained earnings. The impact of the reclassification from other comprehensive income to retained earnings was included in the Statement of Changes in Shareholders' Equity for the year ended December 31, 2017.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

(g) Impact of Inflation

The consolidated financial statements and related consolidated financial data presented herein have been prepared in accordance with U.S. GAAP and practices within the banking industry which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effects of general levels of inflation.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Information required by this item is included in Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations – Interest Rate Simulation Sensitivity Analysis."

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company, with the participation of its management, including its Chief Executive Officer and Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this Report. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this Report, the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed in the Company's filings under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and to ensure that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There have been no changes in the Company's internal control over financial reporting that occurred during the period covered by this Report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

General

From time to time, the Company is party to legal actions that are routine and incidental to its business. Given the nature, scope and complexity of the extensive legal and regulatory landscape applicable to the Company's business, including laws and regulations governing consumer protection, fair lending, fair labor, privacy, information security and anti-money laundering and anti-terrorism laws, the Company, like all banking organizations, is subject to heightened legal and regulatory compliance and litigation risk. However, based upon available information and in consultation with legal counsel, management does not expect the ultimate disposition of any or a combination of these actions to have a material adverse effect on the Company's assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and/or results of operations.

Litigation Against Gaylon M. Lawrence & The Lawrence Group

On October 31, 2017, CapStar filed a complaint, captioned *CapStar Financial Holdings, Inc. v. Gaylon M. Lawrence & The Lawrence Group*, Case No. 3:17-cv-01421, in the U.S. District Court for the Middle District of Tennessee, in connection with Mr. Lawrence and The Lawrence Group's acquisition of CapStar stock. The complaint alleges that defendants violated Section 13(d) of the Securities Exchange Act of 1934 (the "Exchange Act") by filing materially false and misleading Schedules 13D regarding defendants' acquisition of a minority stake (1,156,675 shares) of CapStar stock. It also alleged that defendants violated the Change in Bank Control Act, 12 U.S.C. § 1817(j) (the "CBCA"), by attempting to acquire control of CapStar without first receiving approval from the Federal Reserve, and also that defendants violated Tennessee Code Section 45-2-107 by controlling banks without having registered as a bank holding company.

By order dated December 18, 2017, the court granted CapStar's motion for expedited discovery, which is presently underway. Defendants have filed a motion to dismiss the action as well as a separate motion to stay. The motion to stay was denied by the court on May 21, 2018. On September 24, 2018, the court denied in part and granted in part defendants' motion to dismiss, permitting CapStar's claims that defendants violated Tennessee Code Section 45-2-107 under Section 13(d) of the Exchange Act to proceed.

Mr. Lawrence has also filed an Interagency Notice of Change in Control pursuant to the CBCA with the Federal Reserve on October 30, 2017, seeking permission to acquire up to 15% of the outstanding voting shares of CapStar's common stock. At the Federal Reserve's direction, on March 13, 2018, Mr. Lawrence requested that the Federal Reserve suspend processing of this notice. On November 6, 2018, the Federal Reserve notified the Company that it has determined not to disapprove the notice, subject to compliance by Mr. Lawrence and his affiliates with extensive representations and commitments set forth in correspondence between Mr. Lawrence and the Federal Reserve.

Item 1A. Risk Factors

In evaluating an investment in the Company's securities, investors should consider carefully, among other things, information under the heading "Cautionary Note Regarding Forward-Looking Statements" in this Report as well as those factors that are detailed from time to time in the Company's periodic and current reports filed with the SEC, including those factors included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017 under the heading "Item 1A. Risk Factors" and in the Company's Quarterly Reports on Form 10-Q and Current Reports on Form 8-K. There have been no material changes from the risk factors previously disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

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

Unregistered Sales of Equity Securities

The following table shows information relating to the repurchase of shares of common stock by the Company during the three months ended September 30, 2018.

	Total number of shares purchased (1)	Average price paid per share	Total number of shares purchased as part of publicly announced plan	Maximum number of shares that may yet be purchased under the plan
July 1 - July 31	7,026	\$ 19.21	—	—
August 1 - August 31	78,711	17.86	—	—
September 1 - September 30	49,350	17.48	—	—
Total	135,087	\$ 17.79	—	—

(1) Activity represents shares of stock withheld to pay the exercise price, if applicable, and/or taxes due upon vesting of restricted shares and exercise of stock options and warrants.

Use of Proceeds

On September 27, 2016, the Company sold 1,688,049 shares of its common stock, including 387,750 shares purchased by the underwriters pursuant to the full exercise of their purchase option, in its initial public offering (“IPO”). In addition, certain selling shareholders participated in the IPO and sold an aggregate of 1,284,701 shares of the Company’s common stock.

The shares were sold at a public offering price of \$15.00 per share, resulting in aggregate gross proceeds of approximately \$44.6 million. The aggregate offering price for the shares sold by the Company was approximately \$25.3 million, and after deducting approximately \$1.6 million for the underwriting discount and approximately \$1.7 million of offering expenses paid to third parties, the Company received net proceeds of approximately \$21.6 million. The aggregate offering price for the shares sold by the selling shareholders was approximately \$19.3 million.

All of the shares were sold pursuant to our Registration Statement on Form S-1, as amended (File No. 333-213367), which was declared effective by the SEC on September 21, 2016. The offering did not terminate until all of the shares offered were sold. The Company made no payments to its directors, officers or persons owning ten percent or more of its common stock or to their associates, or to its affiliates in connection with the issuance and sale of the common stock. Keefe, Bruyette & Woods, Inc. and Sandler O’Neill & Partners, L.P. acted as lead book-running managers for the IPO. Our common stock is currently trading on the Nasdaq Global Select Market under the symbol “CSTR.”

There has been no material change in the planned use of proceeds from our IPO as described in our prospectus filed with the SEC on September 23, 2016 pursuant to Rule 424(b)(4) under the Securities Act. Pending application of the IPO proceeds, we have invested the net proceeds in short-term investments.

Item 6. Exhibits

<u>Exhibit Number</u>	<u>Description</u>
2.1	<u>Agreement and Plan of Merger, dated as of June 11, 2018, by and between CapStar Financial Holdings, Inc. and Athens Bancshares Corporation (incorporated by reference herein to Exhibit 2.1 to the Company’s Current Report on Form 8-K filed on June 14, 2018).</u>
31.1	<u>Certification of Chief Executive Officer of CapStar Financial Holdings, Inc. pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, as amended.*</u>
31.2	<u>Certification of Chief Financial Officer of CapStar Financial Holdings, Inc. pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, as amended.*</u>
32.1	<u>Certification of Chief Executive Officer of CapStar Financial Holdings, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as amended.**</u>
32.2	<u>Certification of Chief Financial Officer of CapStar Financial Holdings, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as amended.**</u>
101.INS	XBRL Instance Document.*
101.SCH	XBRL Taxonomy Extension Schema Document.*
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.*
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.*
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.*
101.DEF	XBRL Taxonomy Extension Definition Document.*

* Filed with this Quarterly Report on Form 10-Q.

** Furnished with this Quarterly Report on Form 10-Q.

SIGNATURES

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

CAPSTAR FINANCIAL HOLDINGS, INC.

By: /s/ Robert B. Anderson
Robert B. Anderson
Chief Financial Officer and Chief Administrative Officer

Date: November 7, 2018

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER PURSUANT TO RULE 13A-14(A) OF THE SECURITIES EXCHANGE ACT OF 1934,
AS AMENDED, ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Claire W. Tucker, certify that:

1. I have reviewed this quarterly report on Form 10-Q of CapStar Financial Holdings, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 7, 2018

By: /s/ Claire W. Tucker
Claire W. Tucker
President and Chief Executive Officer

CERTIFICATION OF CHIEF FINANCIAL OFFICER PURSUANT TO RULE 13A-14(A) OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED, ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Robert B. Anderson, certify that:

1. I have reviewed this quarterly report on Form 10-Q of CapStar Financial Holdings, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 7, 2018

By: /s/ Robert B. Anderson
Robert B. Anderson
Chief Financial Officer and
Chief Administrative Officer

CERTIFICATION OF CHIEF EXECUTIVE OFFICER PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of CapStar Financial Holdings, Inc. (the "Company") for the period ended September 30, 2018, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Claire W. Tucker, President and Chief Executive Officer of the Company, certify in my capacity as an officer of the Company, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

1. The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities and Exchange Act of 1934, as amended; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 7, 2018

By: /s/ Claire W. Tucker
Claire W. Tucker
President and Chief Executive Officer

CERTIFICATION OF CHIEF FINANCIAL OFFICER PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of CapStar Financial Holdings, Inc. (the "Company") for the period ended September 30, 2018, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Robert B. Anderson, Chief Financial Officer and Chief Administrative Officer of the Company, certify in my capacity as an officer of the Company, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

1. The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities and Exchange Act of 1934, as amended; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 7, 2018

By: /s/ Robert B. Anderson
Robert B. Anderson
Chief Financial Officer and
Chief Administrative Officer