

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2019

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)

Registrant's telephone number, including area code (615) 732-6400

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

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
Common Stock, \$1.00 par value per share	CSTR	Nasdaq Global Select Market

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES ☐ NO ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. YES ☐ NO ☒

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

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

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

Large accelerated filer ☐ Accelerated filer ☒

Non-accelerated filer ☐ Small 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 Act). YES ☐ NO ☒

As of June 28, 2019, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the registrant's voting and non-voting common equity held by non-affiliates of the registrant was \$230,802,508, based on the closing sales price of \$15.15 per share as reported on the Nasdaq Global Select Market.

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

Common Stock, par value \$1.00 per share Shares outstanding as of March 5, 2020  
18,457,537

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's Definitive Proxy Statement relating to the 2020 Annual Meeting of Shareholders, which will be filed within 120 days after December 31, 2019, are incorporated by reference into Part III of this Annual Report on Form 10-K.

## Table of Contents

	<u>Page</u>
<b>PART I</b>	
Item 1. <a href="#">Business</a>	1
Item 1A. <a href="#">Risk Factors</a>	16
Item 1B. <a href="#">Unresolved Staff Comments</a>	34
Item 2. <a href="#">Properties</a>	34
Item 3. <a href="#">Legal Proceedings</a>	35
Item 4. <a href="#">Mine Safety Disclosures</a>	35
<b>PART II</b>	
Item 5. <a href="#">Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</a>	36
Item 6. <a href="#">Selected Financial Data</a>	39
Item 7. <a href="#">Management’s Discussion and Analysis of Financial Condition and Results of Operations</a>	40
Item 7A. <a href="#">Quantitative and Qualitative Disclosures About Market Risk</a>	59
Item 8. <a href="#">Financial Statements and Supplementary Data</a>	60
Item 9. <a href="#">Changes in and Disagreements With Accountants on Accounting and Financial Disclosure</a>	110
Item 9A. <a href="#">Controls and Procedures</a>	110
Item 9B. <a href="#">Other Information</a>	110
<b>PART III</b>	
Item 10. <a href="#">Directors, Executive Officers and Corporate Governance</a>	111
Item 11. <a href="#">Executive Compensation</a>	111
Item 12. <a href="#">Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</a>	111
Item 13. <a href="#">Certain Relationships and Related Transactions, and Director Independence</a>	111
Item 14. <a href="#">Principal Accountant Fees and Services</a>	111
<b>PART IV</b>	
Item 15. <a href="#">Exhibits and Financial Statement Schedules</a>	112
Item 16. <a href="#">Form 10-K Summary</a>	115
<a href="#">Signatures</a>	116

## TERMINOLOGY

Unless this Annual Report on Form 10-K (this “Report”) indicates otherwise or the context otherwise requires, the terms “we,” “our,” “us,” “Company,” “CapStar,” “CSTR” and “CapStar Financial,” as used herein refer to CapStar Financial Holdings, Inc., and its wholly owned subsidiary, CapStar Bank, which we sometimes refer to as “our bank subsidiary,” “the bank” or “our bank”. References herein to the fiscal years 2015, 2016, 2017, 2018 and 2019 mean our fiscal years ended on each of December 31, 2015, 2016, 2017, 2018 and 2019, respectively. References herein to our “Target Market” includes the state of Tennessee and geographical areas within a 100-mile radius of any of our branch locations.

## 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, statements relating to the Company’s assets business, cash flows, condition (financial or otherwise), credit quality, financial performance, liquidity, short and long-term performance goals, prospects, results of operations, strategic initiatives, the benefits, cost and synergies of completed acquisitions or dispositions, and the timing, benefits, costs and synergies of future acquisitions, disposition and other growth opportunities. 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,” “estimate,” “intend,” “plan,” “project,” “projection,” “forecast,” “roadmap,” “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 upon 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 and that are beyond our control. 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 Company may not capitalize on opportunities to enhance market share in certain markets and the Company’s services may not be generally accepted in new markets; the ability of the Company to meet expectations regarding the benefits, costs, synergies and financial and operational impact of the FCB Corporation (“FCB”) and the Bank of Waynesboro (“BOW”) mergers; that regulatory, shareholder or other approvals required for the FCB and BOW mergers will not be obtained or that other customary closing conditions will not be satisfied in a timely manner or at all; reputational risks and the reaction of shareholders, customers, employees or other constituents of the Company to the FCB and BOW mergers; the possibility that any of the anticipated benefits, costs, synergies and financial and operational improvements of the FCB and BOW mergers will not be realized or will not be realized as expected; the acceptance by customers of FCB and BOW of the Company’s products and services; the possibility that the FCB and BOW merger integrations will be more expensive or take more time to complete than anticipated; 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 our Target Market 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; an increase in the cost of deposits, loss of deposits or a change in the deposit mix, which could increase our cost of funding; an increase in the costs of capital, which could negatively affect our ability to borrow funds, successfully raise additional capital or participate in strategic acquisition opportunities; 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 to achieve our loan, ROAA and efficiency ratio goals, hire seasoned bankers, and achieve 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 as well as to borrowers located within our Target Market; 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 Target Market's economy and which could adversely affect the business operations of certain of our key borrowers; 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; our inability to realize operating efficiencies and tax savings from the implementation of our strategic plan; 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, as amended, 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 in 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; threats to and breaches of our information technology systems and data security, including cyber-attacks; 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; our involvement from time to time in litigation or other proceedings instituted by or against shareholders, customers, employees or third parties and the cost of legal fees associated with such litigation or proceedings; 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 the section entitled "Risk Factors" included in this Report. 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.

## **MARKET DATA**

Market data used in this Report has been obtained from government and independent industry sources and publications available to the public, sometimes with a subscription fee, as well as from research reports prepared for other purposes. Industry publications and surveys and forecasts generally state that the information contained therein has been obtained from sources believed to be reliable. The Company did not commission the preparation of any of the sources or publications referred to in this Report. The Company has not independently verified the data obtained from these sources, and, although the Company believes such data to be reliable as of the dates presented, it could prove to be inaccurate. Forward-looking information obtained from these sources is subject to the same qualifications and the additional uncertainties regarding the other forward-looking statements in this Report.

## PART I

### ITEM 1. BUSINESS

#### OVERVIEW

CapStar Financial Holdings, Inc., a Tennessee corporation, is a bank holding company that is headquartered in Nashville, Tennessee and that operates primarily through its wholly owned subsidiary, CapStar Bank, a Tennessee-chartered state bank. CapStar Bank was incorporated in the State of Tennessee in 2007 and acquired a state charter in 2008 which was accomplished through a de novo application with the Tennessee Department of Financial Institutions (“TDFI”) and the Federal Reserve Bank of Atlanta. Upon approval of its charter, CapStar Bank opened for business to the public on July 14, 2008. CapStar Financial Holdings, Inc. was incorporated in 2015 and, on February 5, 2016, completed a share exchange with CapStar Bank’s shareholders that resulted in CapStar Bank becoming a wholly owned subsidiary of the Company.

We are a bank that seeks to establish and maintain comprehensive relationships with our clients by delivering customized and creative banking solutions and superior client service. Our products and services include (i) commercial and industrial loans to small and medium sized businesses, (ii) commercial real estate loans, (iii) private banking and wealth management services for the owners and operators of our business clients and other high net worth individuals; (iv) correspondent banking services to meet the needs of Tennessee’s smaller community banks and (v) various retail and consumer products. Our operations are presently concentrated in Tennessee.

As of December 31, 2019, on a consolidated basis, we had total assets of \$2.0 billion, total deposits of \$1.7 billion, total net loans of \$1.4 billion, and shareholders’ equity of \$273 million.

#### Core Operating Principles

We operate our business in conformity with our core principles which are, in order of priority:

- Soundness - We strive to engage in safe and sound banking practices that preserve the asset quality of our balance sheet and protect our deposit base and ensure we maintain capital levels that are considered above “well capitalized” according to regulatory standards.
- Profitability - We seek to improve our core profitability metrics through optimal balance sheet management, economies of scale and expanded services.
- Strategic Growth - we seek to grow our loans, deposits and net income by building long-term relationships with our customers based on top quality service and leveraging our operating platform to facilitate acquisitive growth.

We have historically adhered to these core operating principles, and we intend to continue to emphasize the importance of these principles to the conduct of our business.

#### Recent Acquisitions and Expansion

On July 31, 2012, our bank completed its acquisition of American Security, a Tennessee banking corporation headquartered in Hendersonville, Tennessee. Our bank acquired all outstanding shares of common stock of American Security for approximately \$15.2 million in total consideration which was comprised of the issuance of approximately 1.5 million shares of common stock of our bank. At the time of the acquisition, American Security had two banking locations located in Sumner County, Tennessee. The operations of American Security are included in CapStar Bank’s financial statements beginning on July 31, 2012.

On February 3, 2014, CapStar Bank completed its acquisition of Farmington Financial Group, LLC, a Tennessee limited liability company headquartered in Nashville, Tennessee. Farmington primarily originates residential real estate loans that are sold in the secondary market. The bank acquired all the assets and liabilities of Farmington for approximately \$6.4 million in total consideration which was comprised of \$3.0 million in cash, 100,000 shares of common stock of our bank and a five year earn-out based on pre-tax income. The operations of Farmington are included in CapStar Bank’s financial statements beginning on February 3, 2014.

On October 1, 2018, we completed our acquisition of Athens Bancshares Corporation (“Athens”), the bank holding company for Athens Federal Community Bank, National Association (“Athens Federal”), headquartered in Athens, Tennessee. We acquired all of the outstanding shares of common stock of Athens for approximately \$92.9 million in total consideration which was primarily comprised of the issuance of approximately 5.2 million shares of common stock of our Company. At the time of the acquisition, Athens Federal had eight banking locations located throughout the Eastern Tennessee corridor between Chattanooga and Knoxville, Tennessee. The operations of Athens are included in our financial statements beginning October 1, 2018.

On January 23, 2020, we announced the signing of definitive merger agreements with FCB Corporation (“FCB”), its wholly owned subsidiary The First National Bank of Manchester (“FNBM”), and The Bank of Waynesboro (“BOW”) providing for FCB to merge with and into CapStar Financial Holdings, Inc. and for FNBM and BOW to merge with and into CapStar Bank. Under the terms of the merger agreements, FCB and BOW shareholders will receive 3,634,218 CapStar common shares and \$26.4 million in cash, subject to certain adjustments, totaling \$85.1 million based on the closing price of CapStar’s common stock on January 22, 2020. Pending regulatory and shareholder approvals and the satisfaction of certain other customary closing conditions, the acquisition is expected to be finalized in late second or early third quarter of 2020. As of December 31, 2019, FCB and BOW had total combined assets of \$467 million. Upon completion of the transaction, CapStar is expected to have total consolidated assets of approximately \$2.5 billion.

## **Our Products and Services**

### ***Loans***

General. Through our bank, we offer a broad range of commercial lending products to small and medium sized businesses, the owners and operators of our business clients and other high net worth individuals. Our strategy is to maintain a broadly diversified loan portfolio in terms of the type of loan product, the type of client and the industries in which our business clients are engaged.

Our commercial and industrial lending products include commercial loans, business term loans, equipment financing and lines of credit to a diversified mix of small and medium sized businesses. We offer commercial real estate loans that are collateralized by both owner-occupied and non-owner occupied properties, as well as interim construction loans.

Our consumer lending products include residential first mortgage loans which are typically thereafter sold on the secondary market. We offer second mortgage home equity mortgage loans and other consumer related loans such as loans for automobile or other recreational vehicles, which we maintain on the Bank’s balance sheet. Additionally, we offer lines of credit to facilitate investment opportunities for consumer clients whose financial characteristics support the request.

We market our lending products and services to existing clients through our client service. We seek to attract new lending clients through customized and creative lending solutions and competitive pricing. We have banking teams that are specifically dedicated to the markets in which we serve. We believe our industry-specific knowledge, product and local market expertise and engagement increase our profile within these lending verticals, enable us to identify, select and compete for qualified borrowers and attractive financing projects and manage more effectively the potential risks of our loan portfolio.

Underwriting. Disciplined underwriting is the foundation of our credit culture. We strive to adhere to thorough underwriting standards and deliver customized and creative loan solutions in a responsive and timely manner.

Philosophically, we seek loans that are prudent and desirable, not just “doable.” In considering a loan, we follow the underwriting principles in our loan and credit administration policies which include the following requirements:

- receipt of certain financial information, such as financial statements, tax returns and credit reports, to ensure that the potential borrower has sufficient recurring cash flow and liquidity to repay the loan;
- determination that the structure of the loan matches the underlying purpose of and repayment source for the loan, the potential borrower’s creditworthiness and the depreciable life of any collateral;
- verification that the potential borrower has a demonstrated propensity to repay the loan/the borrower’s indebtedness/etc.;

- consideration of the value, liquidity and marketability of the potential borrower's assets and identifying and evaluating all significant direct and contingent liabilities; and
- determination and approval of the rates and fees associated with the potential loan.

Except in very limited circumstances in which substantial equity is present, our commercial and industrial and owner-occupied commercial real estate loans are supported by personal guaranties from the principals of the borrower. In addition, we require our non-owner occupied commercial real estate loans to be secured by well- managed income producing property with adequate margins, supported by a history of profitable operations and cash flows, and proven operating stability.

Our underwriting processes collaboratively engage our bankers, credit underwriters and portfolio managers in the analysis of each loan request. We manage our credit risks by analyzing metrics in order to maintain a conservative and well-diversified loan portfolio reflective of our assessment of various subsets within our market. Based upon our aggregate exposure to any given borrower relationship, we employ tiered review of loan originations that may involve senior credit officers, our Chief Credit Officer, our bank's Credit Committee or, ultimately, our full board of directors.

**Concentrations.** We are a relationship-oriented, rather than a transaction-based, bank. Accordingly, substantially all of our loans have been made to borrowers located in our Target Market. As of December 31, 2019, approximately 94% of the loans in our loan portfolio (measured by dollar amount) were made to borrowers who live or conduct business in our Target Market, and a substantial portion of those loans are considered commercial and industrial loans, commercial real estate loans (including owner-occupied and non-owner occupied real estate), mortgage loans and construction loans. As such, a substantial majority of our loan portfolio is dependent upon the economic environment of our Target Market. We do have a limited number of loans secured by properties located outside of Tennessee, most of which are made to borrowers who are well-known to us because they are headquartered or reside within Tennessee.

In addition, we employ appropriate limits on our overall loan portfolio and requirements with respect to certain types of lending. As a general practice, we operate with an internal guideline limiting loans to any single borrowing relationship to a tiered amount based upon our internal risk rating. Many of our loans have been made to a small number of borrowers, resulting in a concentration of large loans to certain borrowers. As of December 31, 2019, our 25 largest borrowing relationships (which may include multiple loans to one borrower or loans to multiple entities that are affiliated due to common ownership) accounted for approximately 17% of our total loan portfolio.

**Credit Risk Management.** Managing credit risk is a process that involves the entire Company. Our strategy for credit risk management includes the disciplined underwriting process described above, adherence to prudent standards, and ongoing risk monitoring and review processes for all loan exposures. Our Chief Credit Officer provides bank-wide credit oversight and regularly reviews the loan portfolio to ensure that the risk identification processes are functioning properly and that our credit standards are followed. We periodically submit ourselves to review by independent third parties to validate our internal oversight. We strive to identify potential problem loans early in an effort to aggressively seek resolution of these situations before the loans become delinquent or impaired, record any necessary charge-offs promptly and maintain adequate allowance levels for probable loan losses inherent in the loan portfolio.

Credit risk management involves a partnership between our lenders and our credit administration group with credit approval processes requiring concurrence of the two. The members of our credit administration group primarily focus their efforts on credit analysis, underwriting and monitoring new credits and providing management reporting to executive management and our board of directors. Based upon size, emerging problem loans are assigned to our Special Assets Group to mitigate the risk of loss. Executive management regularly reviews the status of the watch list and classified assets portfolio as well as the larger credits in the portfolio. Our Special Assets Group is also responsible for managing the collection and foreclosure process and the disposal of other real estate owned.

### **Deposits**

Core deposits are our principal source of funds for use in lending and other general banking purposes. We solicit core deposits through our relationship-driven team of dedicated and accessible bankers and through relationship-focused marketing. We provide a full range of deposit products and services, including demand deposits, interest-bearing transaction accounts, money market accounts, time and savings deposits, certificates of deposit and CDARS® reciprocal products. Other than deposits obtained through the CDARS program, we do not rely on brokered deposits as a meaningful source of funding.

Our ability to gather deposits is an important aspect of our business franchise, and we believe this is a significant driver of our success. Our largest source of deposits is money market and savings accounts. Our transaction accounts include checking and NOW accounts, which provide us with a source of fee income, as well as a low-cost source of funds. Time accounts also provide us with a relatively stable and low-cost source of funding. Certificates of deposit in excess of \$100,000 are held primarily by clients in our Target Market.

Deposit rates are reviewed regularly by senior management as we continuously seek to price our deposit products and services competitively to promote core deposit growth. Our management believes that the rates that we offer are competitive with those offered by other institutions in our Target Market.

### ***Correspondent Banking***

We provide correspondent banking services to community banks located in our market. Services we offer include settlement, Fed Funds lines of credit, depository products, wire transfer services, bank holding company loans and loan participations on larger commercial and commercial real estate exposures. Correspondent banking loans and deposits comprised approximately \$24.2 million of our total loans and \$312.8 million of our total deposits as of December 31, 2019. Loans made to community banks related to correspondent banking comprised 6% of commercial and industrial loans as of December 31, 2019. Deposits from community banks related to correspondent banking comprised 18% of total deposits as of December 31, 2019.

Correspondent banking provides a valuable funding source for the bank. In 2013, management identified a void in the Tennessee correspondent banking market due to the instability of larger correspondent banks. Other factors leading to the expansion of correspondent banking included a need to diversify our funding base, the desire by many community banks to do business with a Tennessee-based correspondent bank, the ability to recruit well-known and respected talent for business development and risk management, and the ability to license a low cost proprietary settlement platform.

### ***Mortgage Banking***

Mortgage banking generated \$548.1 million in mortgage loan originations for the year ended December 31, 2019. Mortgage loans are typically sold in the secondary market and are underwritten by the bank. Mortgage banking has provided the bank a source of noninterest income and referrals for other banking services including home equity lines of credit and deposit products.

### ***Other Services***

Given client demand for increased convenience and account access, we offer a range of products and services, including 24-hour telephone and online banking, direct deposit, mobile banking, safe deposit boxes, remote deposit and cash management services for individuals and small and medium sized business. We also participate in a shared network of automated teller machines and a debit card system that our customers are able to use throughout Tennessee and other regions. In many cases, we reimburse our customer for any ATM fees that may be charged to the customer.

### ***Competition***

The financial services industry is highly competitive in our Target Market. In particular, the Target Market consisted of 65 financial institutions with over \$64 billion in deposits as of June 30, 2019. We held the number 11 deposit market share position at June 30, 2019 with 2.1% of the deposit market share. We compete for loans, deposits, and financial services in our Target Market. We compete directly with other bank and nonbank institutions located within our market area, Internet-based banks, out-of-market banks, and bank holding companies that advertise in or otherwise serve our market area, along with money market and mutual funds, brokerage houses, mortgage companies, and insurance companies or other commercial entities that offer financial services products. Competition involves efforts to retain current clients, obtain new loans and deposits, increase the scope and type of services offered, and offer competitive interest rates paid on deposits and charged on loans. Many of our competitors enjoy competitive advantages, including greater financial resources, a wider geographic presence, more accessible branch office locations, the ability to offer additional services, more favorable pricing alternatives, and lower origination and operating costs. Some of our competitors have been in business for a long time and have an established client base and name recognition. We believe that our experienced leadership, efficient and scalable operating model, personalized service and emphasis on attracting core deposits from our other product offerings enable us to effectively compete in the communities in which we operate.



## **Information and Technology**

We continually adapt to the changing technological needs and wants of our clients by investing in our electronic banking platform. We use a combination of online and mobile banking channels to attract and retain clients and expand the convenience of banking with us. In most cases, our clients can initiate banking transactions from the convenience of their personal computer or smart phone, reducing the number of in-branch visits necessary to conduct routine banking transactions. The remote transactions available to our clients include remote image deposit, bill payment, external and internal transfers, ACH origination and wire transfer. We believe that our investments in technology and innovation are consistent with our clients' needs and will support future migration of our clients' transactions to these and other developing electronic banking channels. Further, we closely monitor information security for trends and new threats, including cybersecurity risks, and invest significant resources to continuously improve the security and privacy of our systems and data. For more information, please see "– Supervision and Regulation - Cybersecurity and Privacy".

## **Employees**

As of December 31, 2019, we had 289 total employees. None of our employees are represented by any collective bargaining unit or are parties to a collective bargaining agreement. We believe that our relations with our employees are good.

## **SUPERVISION AND REGULATION**

### **General**

Insured banks, their holding companies and their affiliates are extensively regulated under federal and state law. As a result, our growth and earnings performance and that of our subsidiaries may be affected not only by management decisions and general economic conditions, but also by the requirements of federal and state statutes and by the regulations and policies of various bank regulatory agencies, including the TDFI, the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC") and the Consumer Financial Protection Bureau ("CFPB"). Furthermore, tax laws administered by the Internal Revenue Service ("IRS") and state taxing authorities, accounting rules developed by the Financial Accounting Standards Board ("FASB"), securities laws administered by the Securities and Exchange Commission ("SEC") and state securities authorities, anti-money laundering laws enforced by the U.S. Department of the Treasury and mortgage related rules, including with respect to loan securitizations and servicing by the U.S. Department of Housing and Urban Development and agencies such as Ginnie Mae and Freddie Mac, have an impact on our business. The effect of these statutes, regulations, regulatory policies and rules are significant to our operations and results and those of our bank, and the nature and extent of future legislative, regulatory or other changes affecting financial institutions are impossible to predict with any certainty.

Federal and state banking laws impose a comprehensive system of supervision, regulation and enforcement on the operations of insured banks, their holding companies and affiliates that are intended primarily for the protection of the depositors of banks, rather than their shareholders. These federal and state laws, and the regulations of the bank regulatory agencies issued under them, affect, among other things, the scope of business, the kinds and amounts of investments banks may make, reserve requirements, capital levels relative to operations, the nature and amount of collateral for loans, the establishment of branches, the ability to merge, consolidate and enter into acquisitions with other companies, dealings with insiders and affiliates and the payment of dividends.

This supervisory and regulatory framework subjects banks and bank holding companies to regular examination by their respective primary federal regulators, which results in examination reports and ratings that, while not publicly available, can impact the conduct and growth of their businesses. These examinations consider not only compliance with applicable laws and regulations, but also capital levels, asset quality and risk, management ability and performance, earnings, liquidity, and various other factors. The regulatory agencies generally have broad discretion to impose restrictions and limitations on the operations of a regulated entity where the agencies determine, among other things, that such operations are unsafe or unsound, fail to comply with applicable law or are otherwise inconsistent with laws and regulations or with the supervisory policies of these agencies.

The following is a summary of the material elements of the supervisory and regulatory framework applicable to us and our bank. It does not describe all of the statutes, regulations and regulatory policies that apply, nor does it restate all of the requirements of those that are described. The descriptions are qualified in their entirety by reference to the particular statutory and regulatory provision.

## **Bank Holding Company Regulation**

Since we own all of the capital stock of our bank, we are a bank holding company under the Bank Holding Company Act of 1956, as amended (“BHC Act”). As a result, we are primarily subject to the supervision, examination and reporting requirements of the BHC Act and the regulations of the Federal Reserve.

### ***Acquisition of Banks***

The BHC Act requires every bank holding company to obtain the Federal Reserve’s prior approval before:

- acquiring direct or indirect ownership or control of any voting shares of any bank if, after the acquisition, the bank holding company will, directly or indirectly, own or control 5% or more of the bank’s voting shares;
- acquiring all or substantially all of the assets of any bank; or
- merging or consolidating with any other bank holding company.

Additionally, the BHC Act provides that the Federal Reserve may not approve any of the above transactions if such transaction would result in or tend to create a monopoly or substantially lessen competition or otherwise function as a restraint of trade, unless the anti-competitive effects of the proposed transaction are clearly outweighed by the public interest in meeting the convenience and needs of the community to be served. The Federal Reserve is also required to consider the financial and managerial resources and future prospects of the bank holding companies and banks concerned and the convenience and needs of the community to be served. The Federal Reserve’s consideration of financial resources includes a focus on capital adequacy, which is discussed in the section titled “Item 1. Business—Regulation and Supervision—Capital Adequacy.” The Federal Reserve also considers the effectiveness of the institutions in combating money laundering, including a review of the anti-money laundering program of the acquiring bank holding company and the anti-money laundering compliance records of a bank to be acquired as part of the transaction. Finally, the Federal Reserve takes into consideration the extent to which the proposed transaction would result in greater or more concentrated risks to the stability of the U.S. banking or financial system.

Under the BHC Act, if well-capitalized and well-managed, we or any other bank holding company located in Tennessee may purchase a bank located outside of Tennessee without regard to whether such transaction is prohibited under state law. Conversely, a well-capitalized and well-managed bank holding company located outside of Tennessee may purchase a bank located inside Tennessee without regard to whether such transaction is prohibited under state law. In each case, however, state law may place restrictions on the acquisition of a bank that has only been in existence for a limited amount of time or will result in concentrations of deposits exceeding limits specified by statute. For example, Tennessee law currently prohibits a bank holding company from acquiring control of a Tennessee-based financial institution until the target financial institution has been in operation for at least three years.

### ***Change in Bank Control***

Subject to various exceptions, the BHC Act and the Change in Bank Control Act, together with related regulations, require Federal Reserve approval prior to any person or company acquiring “control” of a bank holding company. Under a rebuttable presumption established by the Federal Reserve pursuant to the Change in Bank Control Act, the acquisition of 10% or more of a class of voting stock of a bank holding company would constitute acquisition of “control” of the bank holding company if no other person will own, control, or hold the power to vote a greater percentage of that class of voting stock immediately after the transaction or the bank holding company has registered securities under the Exchange Act. In addition, any person or group of persons acting in concert must obtain the approval of the Federal Reserve under the BHC Act before acquiring 25% (or 5% in the case of an acquirer that is already a bank holding company) or more of the outstanding voting stock of a bank holding company, the right to control in any manner the election of a majority of the company’s directors, or otherwise obtaining control or a “controlling influence” over the bank holding company.

### ***Permitted Activities***

Under the BHC Act, a bank holding company is generally permitted to engage in or acquire direct or indirect control of the voting shares of any company engaged in the following activities:

- banking or managing or controlling banks; and
- any activity that the Federal Reserve determines to be so closely related to banking as to be a proper incident to the business of banking.

Activities that the Federal Reserve has found to be so closely related to banking as to be a proper incident to the business of banking include:

- factoring accounts receivable;
- making, acquiring, brokering or servicing loans and usual related activities in connection with the foregoing;
- leasing personal or real property under certain conditions;
- operating a non-bank depository institution, such as a savings association;
- engaging in trust company functions in a manner authorized by state law;
- financial and investment advisory activities;
- discount securities brokerage activities;
- underwriting and dealing in government obligations and money market instruments;
- providing specified management consulting and counseling activities;
- performing selected data processing services and support services;
- acting as an agent or broker in selling credit life insurance and other types of insurance in connection with credit transactions; and
- performing selected insurance underwriting activities.

The Federal Reserve may order a bank holding company or its subsidiaries to terminate any of these activities or to terminate its ownership or control of any subsidiary when it has reasonable cause to believe that the bank holding company's continued ownership, activity or control constitutes a serious risk to the financial safety, soundness, or stability of it or any of its bank subsidiaries.

### ***Support of Subsidiary Institutions***

The Federal Deposit Insurance Act and Federal Reserve policy require a bank holding company to serve as a source of financial and managerial strength to its bank subsidiaries. As a result of a bank holding company's source of strength obligation, a bank holding company may be required to provide funds to a bank subsidiary in the form of subordinate capital or other instruments which qualify as capital under bank regulatory rules. Any loans from the holding company to such subsidiary banks likely would be unsecured and subordinated to such bank's depositors and perhaps to other creditors of the bank.

### ***Repurchase or Redemption of Securities***

A bank holding company is generally required to give the Federal Reserve prior written notice of any purchase or redemption of its own then outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding 12 months, is equal to 10% or more of the company's consolidated net worth. The Federal Reserve may disapprove such a purchase or redemption if it determines that the proposal would constitute an unsafe and unsound practice, or would violate any law, regulation, Federal Reserve order or directive, or any condition imposed by, or written agreement with, the Federal Reserve. The Federal Reserve has adopted an exception to this approval requirement for well-capitalized bank holding companies that meet certain conditions.

### ***Bank Regulation and Supervision***

Our bank is subject to extensive federal and state banking laws and regulations that impose restrictions on and provide for general regulatory oversight of the operations of our bank. These laws and regulations are generally intended to protect the safety and soundness of our bank and our bank's depositors, rather than our shareholders. The following discussion describes the material elements of the regulatory framework that applies to our bank.

Since our bank is a commercial bank chartered under the laws of the state of Tennessee and is a member of the Federal Reserve System, it is primarily subject to the supervision, examination and reporting requirements of the Federal Reserve and the TDFI. The Federal Reserve and the TDFI regularly examine our bank's operations and have the authority to approve or disapprove mergers, the establishment of branches and similar corporate actions. Both regulatory agencies have the power to take enforcement action to prevent the development or continuance of unsafe or unsound banking practices or other violations of law. Our bank's deposits are insured by the FDIC to the maximum extent provided by law. Our bank is also subject to numerous federal and state statutes and regulations that affect its business, activities and operations.

### ***Branching***

Under current Tennessee law, our bank may open branch offices throughout Tennessee with the prior approval of, or prior notice to, the TDFI and the Federal Reserve. In addition, with prior regulatory approval, our bank may acquire branches of existing banks located in Tennessee. Under federal law, our bank may establish branch offices with the prior approval of the Federal Reserve. While prior law imposed various limits on the ability of banks to establish new branches in states other than their home state, the Dodd-Frank Act allows a bank to branch into a new state by setting up a new branch if, under the laws of the state in which the branch is to be located, a state bank chartered by that state would be permitted to establish the branch. This makes it much simpler for banks to open de novo branches in other states.

### ***FDIC Insurance and Other Assessments***

The Bank pays deposit insurance assessments to the Deposit Insurance Fund, which is determined through a risk-based assessment system. The Bank's deposit accounts are currently insured by the Deposit Insurance Fund, generally up to a maximum of \$250,000 per separately insured depositor. The Bank pays assessments to the FDIC for such deposit insurance. Under the current assessment system, the assessment rate is determined by the risk category assigned to an institution based on the institution's most recent supervisory and capital evaluations which are designed to measure risk, with riskier institutions paying a higher assessment rate. Under the FDIA, the FDIC may terminate a bank's deposit insurance upon a finding that the institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order, agreement or condition imposed by the FDIC.

In addition, all FDIC-insured institutions were required to pay assessments to the FDIC to fund interest payments on bonds issued by the Financing Corporation, or FICO, a federal government corporation established to recapitalize the predecessor to the Savings Association Insurance Fund. The final FICO assessment collection occurred in March 2019.

### ***Community Reinvestment Act***

The Community Reinvestment Act ("CRA") requires that, in connection with examinations of financial institutions within their respective jurisdictions, the federal banking agencies will evaluate the record of each financial institution in meeting the needs of its local community, including low- and moderate-income neighborhoods. Our bank's record of performance under the CRA is publicly available. A bank's CRA performance is also considered in evaluating applications seeking approval for mergers, acquisitions, and new offices or facilities. Failure to adequately meet these criteria could result in additional requirements and limitations being imposed on the bank. Additionally, we must publicly disclose the terms of certain CRA-related agreements. As of December 31, 2019 the Bank had a CRA rating of "Satisfactory."

### ***Interest Rate Limitations***

Interest and other charges collected or contracted for by our bank are subject to applicable state usury laws and federal laws concerning interest rates.

## ***Federal Laws Applicable to Consumer Credit and Deposit Transactions***

Our bank's loan and deposit operations are subject to a number of federal consumer protection laws, including:

- the Federal Truth in Lending Act, governing disclosures of credit terms to consumer borrowers;
- the Home Mortgage Disclosure Act, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the communities it serves;
- the Equal Credit Opportunity Act, prohibiting discrimination on the basis of race, color, religion, national origin, sex, marital status or certain other prohibited factors in all aspects of credit transactions;
- the Fair Credit Reporting Act, or FCRA, governing the use and provision of information to credit reporting agencies;
- the Fair Debt Collection Practices Act, governing the manner in which consumer debts may be collected by debt collectors;
- the Service Members Civil Relief Act, governing the repayment terms of, and property rights underlying, secured obligations of persons in military service;
- the Gramm-Leach-Bliley Act, governing the disclosure and safeguarding of sensitive non-public personal information of our clients;
- the Right to Financial Privacy Act, imposing a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;
- the Electronic Funds Transfer Act governing automatic deposits to and withdrawals from deposit accounts and clients' rights and liabilities arising from the use of automated teller machines and other electronic banking services; and
- the rules and regulations of the CFPB and various federal agencies charged with the responsibility of implementing these federal laws.

## ***Capital Adequacy***

Pursuant to the Dodd-Frank Act, under the adopted regulations, the Basel member central bank and federal bank regulators approved the Basel Capital Adequacy Accord, or Basel III. The U.S. Basel III rule's minimum capital to risk-weighted assets, or RWA, requirements are as follows: (1) a common equity Tier 1 capital ratio of 4.5%, (2) a Tier 1 capital ratio of 6.0%, and (3) a total capital ratio of 8.0%. The minimum leverage ratio (Tier 1 capital to total assets) is 4.0%. The rule also changed the definition of capital, mainly by adopting stricter eligibility criteria for regulatory capital instruments, and new constraints on the inclusion of minority interests, mortgage-servicing assets, deferred tax assets, and certain investments in the capital of unconsolidated financial institutions. In addition, the U.S. Basel III rule requires that most regulatory capital deductions be made from common equity Tier 1 capital.

Under the U.S. Basel III rule, in order to avoid limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers, a banking organization must maintain a capital conservation buffer composed of common equity Tier 1 capital above its minimum risk-based capital requirements. The buffer is measured relative to RWA. Phase-in of the capital conservation buffer requirements began on January 1, 2016, and the requirements became fully phased in on January 1, 2019. A banking organization maintaining capital levels in excess of the fully phased-in capital conservation buffer of 2.5% would not be subject to limits on capital distributions or discretionary bonus payments; however, a banking organization with a buffer of less than 2.5% would be subject to increasingly stringent limitations as the buffer approaches zero. A banking organization also would be prohibited from making distributions or discretionary bonus payments during any quarter if its eligible retained income is negative in that quarter and its capital conservation buffer ratio was less than 2.5% at the beginning of the quarter. Effectively, the Basel III framework requires us to meet minimum risk-based capital ratios of (i) 7% for common equity Tier 1 capital, (ii) 8.5% Tier 1 capital, and (iii) 10.5% total capital. The eligible retained income of a banking organization is defined as its net income for the four calendar quarters preceding the current calendar quarter, based on the organization's quarterly regulatory reports, net of any distributions and associated tax effects not already reflected in net income. With the capital conservation buffer fully phased in, the minimum capital requirements plus the capital conservation buffer will exceed the prompt corrective action, or PCA, well-capitalized thresholds.

Generally, banking organizations of our size became subject to the U.S. Basel III rule on January 1, 2015, while the capital conservation buffer and the deductions from common equity Tier 1 capital phased in over time. Failure to meet statutorily mandated capital guidelines or more restrictive ratios separately established for a banking institution could subject the institution to a variety of enforcement remedies available to federal regulatory authorities, including issuance of a capital directive, the termination of deposit insurance by the FDIC, a prohibition on accepting or renewing brokered deposits, limitations on the rates of interest that the institution may pay on its deposits, and other restrictions on its business.

#### ***Prompt Corrective Action***

The Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”) establishes a system of “prompt corrective action” (“PCA”) to resolve the problems of undercapitalized insured depository institutions. Under this system, the federal banking regulators have established five capital categories (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized) into which all insured depository institutions are placed. The federal banking agencies have specified by regulation the relevant capital thresholds and other qualitative requirements for each of those categories. For an insured depository institution to be “well capitalized” under the PCA framework, it must have a common equity Tier 1 capital ratio of 6.5%, Tier 1 capital ratio of 8.0%, a total capital ratio of 10.0%, and a Tier 1 leverage ratio of 5.0%, and must not be subject to any written agreement, order or capital directive, or prompt corrective action directive issued by its primary federal regulator to meet and maintain a specific capital level for any capital measure. As of December 31, 2019, our bank qualified for the “well capitalized” category.

Federal banking regulators are required to take various mandatory supervisory actions and are authorized to take other discretionary actions with respect to institutions in the three undercapitalized categories. The severity of the action depends upon the capital category in which the institution is placed. For example, institutions in all three undercapitalized categories are automatically restricted from paying distributions and management fees, whereas only an institution that is significantly undercapitalized or critically undercapitalized is restricted in its compensation paid to senior executive officers. Generally, subject to a narrow exception, the banking regulator must appoint a receiver or conservator for an institution that is critically undercapitalized.

An institution that is categorized as undercapitalized, significantly undercapitalized, or critically undercapitalized is required to submit an acceptable capital restoration plan to its appropriate federal banking agency. A bank holding company must guarantee that a subsidiary depository institution meets its capital restoration plan, subject to various limitations. The controlling holding company’s obligation to fund a capital restoration plan is limited to the lesser of (i) 5% of an undercapitalized subsidiary’s assets at the time it became undercapitalized and (ii) the amount required to meet regulatory capital requirements. An undercapitalized institution is also generally prohibited from increasing its average total assets, making acquisitions, establishing any branches or engaging in any new markets or product offerings, except under an accepted capital restoration plan or with Federal Reserve approval.

The regulations also establish procedures for downgrading an institution to a lower capital category based on supervisory factors other than capital.

#### ***Liquidity***

Financial institutions are subject to significant regulatory scrutiny regarding their liquidity positions. This scrutiny has increased during recent years, as the economic downturn that began in the late 2000s negatively affected the liquidity of many financial institutions. Various bank regulatory publications, including Federal Reserve SR 10-6 (Funding and Liquidity Risk Management) and FDIC Financial Institution Letter FIL-84-2008 (Liquidity Risk Management), address the identification, measurement, monitoring and control of funding and liquidity risk by financial institutions.

Any increased liquidity requirements applied to us or our bank generally would be expected to cause us or our bank to invest assets more conservatively—and therefore at lower yields—than we and our bank otherwise might invest. Such lower-yield investments likely would reduce our revenue stream, and in turn our earnings potential.

### ***Payment of Dividends***

We are a legal entity separate and distinct from our bank. Our principal source of cash flow, including cash flow to pay dividends to our shareholders, is dividends our bank pays to us as our bank's sole shareholder. Statutory and regulatory limitations apply to our bank's payment of dividends to us as well as to our payment of dividends to our shareholders. The requirement that a bank holding company must serve as a source of strength to its subsidiary banks also results in the position of the Federal Reserve that a bank holding company should not maintain a level of cash dividends to its shareholders that places undue pressure on the capital of its bank subsidiaries or that can be funded only through additional borrowings or other arrangements that may undermine the bank holding company's ability to serve as a source of strength. Our ability to pay dividends is also subject to the provisions of Tennessee corporate law which prevents payment of dividends if, after giving effect to such payment, we would not be able to pay our debts as they become due in the usual course of business or our total assets would be less than the sum of our total liabilities plus any amounts needed to satisfy any preferential rights if we were dissolving. In addition, in deciding whether or not to declare a dividend of any particular size, our board of directors must consider our and our bank's current and prospective capital, liquidity, and other needs.

The TDFI also regulates our bank's dividend payments. Under Tennessee law, a state-chartered bank may not pay a dividend without prior approval of the Commissioner of the TDFI if the total of all dividends declared by its board of directors in any calendar year will exceed (i) the total of its retained net income for that year, plus (ii) its retained net income for the preceding two years.

Our bank's payment of dividends may also be affected or limited by other factors, such as the requirement to maintain adequate capital above regulatory guidelines. The federal banking agencies have indicated that paying dividends that deplete a depository institution's capital base to an inadequate level would be an unsafe and unsound banking practice. Under FDICIA, a depository institution may not pay any dividends if payment would cause it to become undercapitalized or if it already is undercapitalized. Moreover, the federal agencies have issued policy statements providing that bank holding companies and insured banks should generally only pay dividends out of current operating earnings.

### ***Restrictions on Transactions with Affiliates and Insiders***

Our bank is subject to Section 23A of the Federal Reserve Act, which places limits on the amount of the bank's transactions with its affiliates.

Subject to various exceptions, the total amount of the bank's transactions with affiliates is limited in amount, as to any one affiliate, to 10% of a bank's capital and surplus and, as to all affiliates combined, to 20% of a bank's capital and surplus. In addition to the limitation on the amount of these transactions, transactions with affiliates also must meet specified collateral requirements and safety and soundness requirements. Our bank must also comply with provisions prohibiting the acquisition of low-quality assets from an affiliate.

Our bank is also subject to Section 23B of the Federal Reserve Act, which, among other things, prohibits a bank from engaging in transactions with affiliates, as well as other types of transactions set forth in Section 23B, unless the transactions are on terms substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with nonaffiliated companies.

Our bank is also subject to restrictions on extensions of credit to its executive officers, directors, principal shareholders and their related interests. These extensions of credit (i) must be made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions between the bank and third parties, and (ii) must not involve more than the normal risk of repayment or present other unfavorable features. There are also individual and aggregate limitations on loans to insiders and their related interests. The aggregate amount of insider loans generally cannot exceed the institution's total unimpaired capital and surplus. Insiders and banks are subject to enforcement actions for knowingly entering into insider loans in violation of applicable restrictions.

### ***Single Borrower Credit Limits***

Under Tennessee law, total loans and extensions of credit to a borrower may not exceed 15% of our bank's capital, surplus and undivided profits. However, such loans may be in excess of that percentage, but not above 25%, if each loan in excess of 15% is first submitted to and approved in advance in writing by the board of directors and a record is kept of such written approval and reported to the board of directors quarterly.

### ***Commercial Real Estate Concentration***

In December 2006, the federal banking regulators issued guidance entitled “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices” to address increased concentrations in commercial real estate, or CRE, loans. In addition, in December 2015, the federal banking agencies issued additional guidance entitled “Statement on Prudent Risk Management for Commercial Real Estate Lending.” Together, these guidelines describe the criteria the agencies will use as indicators to identify institutions potentially exposed to CRE concentration risk. An institution that has (i) experienced rapid growth in CRE lending, (ii) notable exposure to a specific type of CRE, (iii) total reported loans for construction, land development, and other land representing 100% or more of the institution’s capital, or (iv) total CRE loans representing 300% or more of the institution’s capital, and the outstanding balance of the institutions CRE portfolio has increased by 50% or more in the prior 36 months, may be identified for further supervisory analysis of the level and nature of its CRE concentration risk. As of December 31, 2019, our bank’s total CRE loans represented 297% of its capital.

### ***Privacy***

Financial institutions are required to disclose their policies for collecting and protecting non-public personal information of their clients. Clients generally may prevent financial institutions from sharing non-public personal information with nonaffiliated third parties except under certain circumstances, such as the processing of transactions requested by the consumer or when the financial institution is jointly offering a product or service with a nonaffiliated financial institution. Additionally, financial institutions generally are prohibited from disclosing consumer account numbers to any nonaffiliated third party for use in telemarketing, direct mail marketing or other marketing to consumers.

### ***Consumer Credit Reporting***

The Fair Credit Reporting Act (“FCRA”) imposes, among other things:

- requirements for financial institutions to develop policies and procedures to identify potential identity theft and, upon the request of a consumer, to place a fraud alert in the consumer’s credit file stating that the consumer may be the victim of identity theft or other fraud;
- requirements for entities that furnish information to consumer reporting agencies to implement procedures and policies regarding the accuracy and integrity of the furnished information and regarding the correction of previously furnished information that is later determined to be inaccurate;
- requirements for mortgage lenders to disclose credit scores to consumers in certain circumstances; and
- limitations on the ability of a business that receives consumer information from an affiliate to use that information for marketing purposes.

### ***Anti-Terrorism and Money Laundering Legislation***

Our bank is subject to the Bank Secrecy Act and USA Patriot Act. These statutes and related rules and regulations impose requirements and limitations on specified financial transactions and accounts and other relationships intended to guard against money laundering and terrorism financing. Our bank has established an anti-money laundering program pursuant to the Bank Secrecy Act and customer identification program pursuant to the USA Patriot Act. The bank also maintains records of cash purchases of negotiable instruments, files reports of certain cash transactions exceeding \$10,000 (daily aggregate amount), and reports suspicious activity that might signify money laundering, tax evasion, or other criminal activities pursuant to the Bank Secrecy Act. Our bank otherwise has implemented policies and procedures to comply with the foregoing requirements.

### ***Overdraft Fees***

Federal Reserve Regulation E restricts banks’ abilities to charge overdraft fees. The rule prohibits financial institutions from charging fees for paying overdrafts on ATM and one-time debit card transactions, unless a consumer consents, or opts in, to the overdraft service for those types of transactions.



### ***The Dodd-Frank Act***

As final rules and regulations implementing the Dodd-Frank Act have been adopted, this new law has significantly changed and is significantly changing the bank regulatory framework and affected the lending, deposit, investment, trading and operating activities of banks and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting the implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act will depend on the rules and regulations that implement it.

A number of the effects of the Dodd-Frank Act are described or otherwise accounted for in various parts of this “Supervision and Regulation” section. The following items provide a brief description of certain other provisions of the Dodd-Frank Act that may be relevant to us and our bank.

- The Dodd-Frank Act created the CFPB with broad powers to supervise and enforce consumer financial protection laws. The CFPB has broad rule-making authority for a wide range of consumer protection laws that apply to all banks, including the authority to prohibit “unfair, deceptive or abusive” acts and practices. The CFPB has examination and enforcement authority with respect to enumerated consumer financial protection laws over all banks with more than \$10 billion in assets. Institutions with less than \$10 billion in assets will continue to be examined for compliance with consumer financial protection laws by their primary federal regulator.
- The Dodd-Frank Act imposed new requirements regarding the origination and servicing of residential mortgage loans. The law created a variety of new consumer protections, including limitations, subject to exceptions, on the manner by which loan originators may be compensated and an obligation on the part of lenders to verify a borrower’s “ability to repay” a residential mortgage loan. Final rules implementing these latter statutory requirements became effective in 2014.
- The Dodd-Frank Act eliminated the federal prohibitions on paying interest on demand deposits effective one year after the date of its enactment, thus allowing businesses to have interest-bearing checking accounts. Depending on competitive responses, this significant change to existing law could have an adverse impact on our interest expense.
- The Dodd-Frank Act addresses many investor protection, corporate governance and executive compensation matters that will affect most U.S. publicly traded companies. The Dodd-Frank Act (i) requires publicly traded companies to give shareholders a non-binding vote on executive compensation and golden parachute payments; (ii) enhances independence requirements for compensation committee members; (iii) requires national securities exchanges to require listed companies to adopt incentive-based compensation clawback policies for executive officers; (iv) authorizes the SEC to promulgate rules that would allow shareholders to nominate their own candidates using a company’s proxy materials; and (v) directs the federal banking regulators to issue rules prohibiting incentive compensation that encourages inappropriate risks.

As noted above, many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on us. However, we expect compliance with the Dodd-Frank Act and its implementing regulations will result in additional operating and compliance costs that could have a material adverse effect on our business, financial condition and results of operations. In addition, on February 3, 2017, President Trump signed an executive order calling for his administration to review existing U.S. financial laws and regulations, including the Dodd-Frank Act. At this time, it is unclear if this executive order will result in any material changes to current laws and regulations applicable to us.

### ***The Volcker Rule***

On December 10, 2013, five U.S. financial regulators, including the Federal Reserve, adopted a final rule implementing the “Volcker Rule.” The Volcker Rule was created by Section 619 of the Dodd-Frank Act, which generally prohibits any “banking entity” from engaging in proprietary trading or retaining an ownership interest in, sponsoring, or having certain relationships with covered funds (i.e., hedge funds or private equity funds). In addition, the Volcker Rule requires each regulated entity to establish an internal compliance program that is consistent with the extent to which it engages in activities covered by the Volcker Rule.

On October 8, 2019, the agencies finalized revisions to the Volcker Rule that, among other things, simplified and streamlined compliance requirements for banking entities that do not have significant trading activities, while banking entities with significant trading activity would become subject to more stringent compliance requirements. Further, the revisions to the Volcker Rule implemented Section 203 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), which amended the definition of “banking entity” to exclude certain community banks from the definition of insured depository institution, the general result of which was to exclude such banks and their affiliates and subsidiaries from the scope of the Volcker Rule. Under EGRRCPA, a community bank and its affiliates are generally excluded from the definition of “banking entity” if the bank and all companies that control the bank have total consolidated assets equal to \$10 billion or less and trading assets and liabilities equal to five percent or less of total consolidated assets. These revisions became effective on January 1, 2020, with a required compliance date of January 1, 2021.

#### ***Limitations on Incentive Compensation***

In April 2016, the Federal Reserve and other federal financial agencies re-proposed restrictions on incentive-based compensation pursuant to Section 956 of the Dodd-Frank Act for financial institutions with \$1 billion or more in total consolidated assets. For institutions with at least \$1 billion but less than \$50 billion in total consolidated assets, such as the Company and our bank, the proposal imposes principles-based restrictions that are broadly consistent with existing interagency guidance on incentive-based compensation. Such institutions are prohibited from entering into incentive compensation arrangements that encourage inappropriate risks by the institution (1) by providing an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits, or (2) that could lead to material financial loss to the institution. The proposal also imposes certain governance and recordkeeping requirements on institutions of the Company’s and our bank’s size. The Federal Reserve reserves the authority to impose more stringent requirements on institutions of the Company’s and our bank’s size. We do not expect this proposal to significantly impact our business.

#### **Cybersecurity and Privacy**

Cybersecurity is a high-priority item for legislators and regulators at the federal and state levels, as well as internationally. State and federal banking regulators have issued various policy statements and, in some cases, regulations, emphasizing the importance of technology risk management and supervision. Such policy statements and regulations indicate that financial institutions should design multiple layers of security controls to establish lines of defense and to ensure that their risk management processes also address the risk posed by compromised customer credentials, including security measures to reliably authenticate customers accessing internet-based services of the financial institution. A financial institution’s management is expected to maintain sufficient business continuity planning processes to ensure the rapid recovery, resumption and maintenance of the institution’s operations after a cyberattack involving destructive malware. A financial institution is expected to develop appropriate processes to enable recovery of data and business operations and address rebuilding network capabilities and restoring data if the institution or its critical service providers fall victim to this type of cyberattack. These requirements, including state regulatory rules such as the detailed and extensive cybersecurity rules issued in 2016 by the New York State Department of Financial Services, may cause us to incur significant additional compliance costs and in some cases may impact our growth prospects. Additionally, if we fail to observe federal or state regulatory guidance, we could be subject to various regulatory sanctions, including financial penalties.

In the ordinary course of business, we rely on electronic communications and information systems to conduct our operations and store sensitive data. We employ an in-depth, layered, defensive approach that leverages people, processes and technology to manage and maintain cybersecurity controls. We also employ a variety of preventative and detective tools to monitor, block, and provide alerts regarding suspicious activity, as well as to report on any suspected advanced persistent threats. Notwithstanding the strength of our defensive measures, the threat from cyberattacks is severe, as attacks are sophisticated and increasing in volume and complexity, and attackers respond rapidly to changes in defensive measures. Our systems and those of our customers and third-party service providers are under constant threat, and it is possible that we or they could experience a significant event in the future that could adversely affect our business or operations. As cybersecurity threats continue to evolve, we may be required to expend significant additional resources to continue to modify or enhance our protective measures or to investigate and remediate any information security vulnerabilities. Financial expenditures may also be required to meet regulatory changes in the information security and cybersecurity domains. Risks and exposures related to cybersecurity attacks are expected to remain high for the foreseeable future due to the rapidly evolving nature and sophistication of these threats, as well as the expanding use of internet banking, mobile banking and other technology-based products and services by us and our customers. See “Item 1A. – Risk Factors” in this Annual Report for a further discussion of risks related to cybersecurity.

Federal statutes and regulations, including the Gramm-Leach-Bliley Act (“GLBA”) and the Right to Financial Privacy Act of 1978, limit our ability to disclose non-public information about consumers, customers and employees to nonaffiliated third parties. Specifically, the GLBA requires us to disclose our privacy policies and practices relating to sharing non-public information and enables retail customers to opt out of our ability to share information with unaffiliated third parties under certain circumstances. The GLBA also requires us to implement a comprehensive information security program that includes administrative, technical and physical safeguards to ensure the security and confidentiality of customer records and information and, if applicable state law is more protective of customer privacy than the GLBA, financial institutions, including our bank, will be required to comply with such state law. Other laws and regulations impact our ability to share certain information with affiliates and non-affiliates for marketing and/or non-marketing purposes. These regulations affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors. In connection with the regulations governing the privacy of consumer financial information, the federal banking agencies, including the FDIC, have adopted guidelines for establishing information security standards and programs to protect such information.

Proposed or new legislation and regulations may also significantly increase our compliance cost and impede our ability to grow into specific markets. There are a number of proposals that have either recently been adopted or are currently pending before federal, state, and foreign legislative and regulatory bodies. For example, the European Union adopted the General Data Protection Regulation (the “GDPR”), which became effective on May 25, 2018. In addition, California recently passed the California Consumer Privacy Act of 2018 (the “CCPA”) on June 28, 2018. Both the GDPR and the CCPA impose additional obligations on companies regarding the handling of personal data and provide certain individual privacy rights to persons whose data is stored. In the event of a data breach, there are mandatory reporting requirements that may hamper the ability to fully assess an incident prior to external reporting. We must maintain awareness of additional legal and regulatory requirements that apply to existing and future subsets of the customer base for protection against legal, reputational, and financial risk due to compliance failures.

#### **U.S. Tax Reform**

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 and required a one-time remeasurement of deferred taxes to reflect their value at a lower tax rate of 21%. The Tax Reform Act included other changes, including, but not limited to, a limitation of the deduction for net operating losses, elimination of net operating loss carrybacks, immediate deductions for certain new investments instead of deductions for depreciation expense over time, additional limitations on the deductibility of executive compensation and limitations on the deductibility of interest. As a result of the Tax Reform Act, we recorded a \$3.56 million increase in income tax expense for 2017.

#### **AVAILABLE INFORMATION**

We file reports with the SEC including annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and proxy statements, as well as any amendments to those reports and statements. The SEC maintains an internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC at <http://www.sec.gov>. Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements and amendments to those reports and statements filed or furnished pursuant to section 13(a) or 15(d) of the Exchange Act are also accessible at no cost on our website at <http://www.ir.capstarbank.com> after they are electronically filed with the SEC. Reference to our website does not constitute incorporation by reference of the information contained on the website and should not be considered part of this Report.

We have also posted our Corporate Governance Guidelines, Code of Ethics and Conflicts of Interest Policy for directors, officers and employees, and the charters of our Audit Committee, Nominating Governance and Community Affairs Committee, Compensation and Human Resources Committee, Credit Committee and Risk Committee of our board of directors on the Corporate Governance section of our website at [www.ir.capstarbank.com](http://www.ir.capstarbank.com). We will make any legally required disclosures regarding amendments to, or waivers of, provisions of our Corporate Governance Guidelines, Code of Ethics and Conflicts of Interest Policy, or current committee charters on our website. We will also provide a copy of our Corporate Governance Guidelines, Code of Ethics and Conflicts of Interest Policy, and any committee charters without charge upon written request sent to 1201 Demonbreun Street, Suite 700, Nashville, Tennessee 37203, Attention: Investor Relations.

## ITEM 1A. RISK FACTORS

*We are subject to numerous risks, and the material risks that management believe affect our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations are described below. Many of these risks are beyond our control, though efforts are made to manage those risks while optimizing financial and operational results. You should carefully read and consider the following risks factors. The occurrence of any of the following risks, as well as risks of which we are currently unaware or currently deem immaterial, could materially and adversely affect our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations. As a result, the trading price of shares of our common stock could decline and you could lose all or part of your investment. In addition, the following risks and other information in this Report or incorporated into this Report by reference, including our Consolidated Financial Statements and related notes and “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” should be carefully considered before investing in shares of our common stock.*

*Some statements in the following risk factors constitute forward-looking statements. Please refer to the section entitled “Cautionary Note Regarding Forward-Looking Statements” at the beginning of this Report.*

### **Risks Related To Our Business**

***As a business operating in the financial services industry, our business and operations may be adversely affected in numerous and complex ways by weak economic conditions.***

Our business and operations, which primarily consist of lending money to clients in the form of loans, borrowing money from clients in the form of deposits and investing in securities, are sensitive to general business and economic conditions in the United States. If the U.S. economy weakens, our growth and profitability from our lending, deposit and investment operations could be constrained. Uncertainty about the federal fiscal policymaking process, the medium- and long-term fiscal outlook of the federal government, and future tax rates is a concern for businesses, consumers and investors in the United States. In addition, economic and other conditions in foreign countries could affect the stability of global financial markets, which could hinder United States economic growth. As an example, the recent outbreak of a novel coronavirus in Wuhan, China may result in the extended shutdown of certain businesses in the region. Depending on future developments (including the extent of the virus’s spread and the measures, such as quarantines and travel restrictions, taken to contain such spread), the outbreak may adversely affect economic conditions in the United States generally and our markets in particular.

Weak economic conditions are characterized by numerous factors; such as deflation, fluctuations in debt and equity capital markets, a lack of liquidity and/or depressed prices in the secondary market for mortgage loans, increased delinquencies on mortgage, consumer and commercial loans, residential and commercial real estate price declines and lower home sales and commercial activity. The current economic environment is also characterized by interest rates at near historically low levels, which impacts our ability to attract deposits and to generate attractive earnings through our loan and investment portfolios. All of these factors can individually or in the aggregate be detrimental to our business, and the interplay between these factors can be complex and unpredictable. Adverse economic conditions could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***Our business and operations are concentrated in our Target Market, and we are more sensitive than our more geographically diversified competitors to adverse changes in the local economy.***

Unlike with many of our larger competitors that maintain significant operations located outside our market area, substantially all of our clients are individuals and businesses located and doing business in our Target Market. As of December 31, 2019, approximately 94% of the loans in our loan portfolio (measured by dollar amount) were made to borrowers who live or conduct business in our Target Market. Therefore, our success will depend upon the general economic conditions in this area, which we cannot predict with certainty. As a result, our operations and profitability may be more adversely affected by a local economic downturn in our Target Market than those of larger, more geographically diverse competitors. For example, the Nashville, Tennessee economy is particularly sensitive to changes in the healthcare service, music and entertainment and hospitality and tourism industries, among others. A downturn in these industries or in the local economy generally could make it more difficult for our borrowers to repay their loans and may lead to loan losses that are not offset by operations in other markets; it may also reduce the ability of depositors to make or maintain deposits with us. For these reasons, any regional or local economic downturn that affects our Target market, or existing or prospective borrowers or depositors in our Target Market could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

From time to time, our bank may provide financing to clients who own or have companies or properties located outside our Target Market. In such cases, we would face similar local market risk in those communities for these clients.

***Competition from financial institutions and other financial service providers may adversely affect our profitability.***

The banking business is highly competitive, and we experience competition in our market from many other financial institutions. We compete with commercial banks, credit unions, savings and loan associations, mortgage banking firms, internet banks, consumer finance companies, securities brokerage firms, insurance companies, money market funds, and other mutual funds, as well as other community banks and super-regional and national financial institutions that operate offices in our service area. These competitors often have far greater resources than we do and are able to conduct more intensive and broader-based promotional efforts to reach both commercial and individual clients. Our competitors may be able to offer more attractive interest rates and other financial terms than we choose or have the capability to offer. Some of our non-bank competitors are not subject to the same extensive regulations we are and, therefore, may have greater flexibility in competing for business.

We compete with these other financial institutions both in attracting deposits and in making loans. In addition, we must attract our client base from other existing financial institutions and from new residents. We expect competition to increase in the future as a result of legislative, regulatory and technological changes and the continuing trend of consolidation in the financial services industry. Our profitability depends upon our continued ability to successfully compete with an array of financial institutions in our service area.

Our ability to compete successfully will depend on a number of factors, including, among other things:

- our ability to recruit and retain experienced and talented bankers at competitive compensation levels;
- our ability to build and maintain long-term client relationships while ensuring high ethical standards and safe and sound banking practices;
- the scope, relevance and pricing of products and services that we offer;
- client satisfaction with our products and services;
- industry and general economic trends; and
- our ability to keep pace with technological advances and to invest in new technology.

Increased competition could require us to increase the rates that we pay on deposits or lower the rates that we offer on loans, which could reduce our profitability. We derive a substantial majority of our business from our Target Market, which is a highly competitive banking market. Our failure to compete effectively in our market could restrain our growth or cause us to lose market share, which could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***We are dependent on the services of our management team and board of directors, and the unexpected loss of key personnel or directors may adversely affect our business and operations.***

We are led by an experienced core management team with substantial experience in the markets that we serve, and our operating strategy focuses on providing products and services through long-term relationship managers and ensuring that our largest clients have relationships with our senior management team. Accordingly, our success depends in large part on the performance of these key personnel, as well as on our ability to attract, motivate and retain highly qualified senior and middle management. Competition for employees is intense, and the process of locating key personnel with the combination of skills and attributes required to execute our business plan may be lengthy. If any of our executive officers, other key personnel, or directors leaves us or our bank, our operations may be adversely affected. While we have employment agreements containing non-competition provisions with many of our key personnel, if any of such personnel leaves his or her position for any reason, our financial condition and results of operations may suffer because of the loss of their skills, knowledge of our market, years of industry experience and the difficulty of promptly finding qualified personnel to replace them. Additionally, our directors' community involvement and diverse and extensive local business relationships are important to our success.

***Our business strategy includes the continuation of our growth plans, and we could be negatively affected if we fail to grow or fail to manage our growth effectively.***

We intend to continue pursuing our growth strategy for our business through organic growth of our loan and deposit portfolio as well as through strategic acquisitions. Our prospects must be considered in light of the risks, expenses and difficulties that can be encountered by financial service companies in rapid growth stages, which include the risks associated with the following:

- maintaining loan quality;
- maintaining adequate management personnel and information systems to oversee such growth;
- maintaining adequate control and compliance functions;
- obtaining regulatory approvals with respect to acquisitions;
- entry into new markets, industries, and product areas; and
- the costs associated with identifying and pursuing strategic transactions; and
- securing capital and liquidity needed to support anticipated growth.

We may not be able to expand our presence in our existing market or new markets. Our ability to grow successfully will depend on a variety of factors, including the continued availability of desirable business opportunities, the competitive responses from other financial institutions in our market areas, the availability of capital to fund growth opportunities and our ability to manage our growth. Failure to manage our growth effectively could adversely affect our ability to successfully implement our business strategy, which could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***As a bank that focuses on building comprehensive banking relationships with clients, our reputation is critical to our business, and damage to it could have a material adverse effect on us.***

A key differentiating factor for our business is the strong brand we are building in our Target Market. Through our branding, we communicate to the market about our company and the products and services we offer. Maintaining a positive reputation is critical to our attracting and retaining clients and employees. Adverse perceptions of us could make it more difficult for us to execute on our strategy. Harm to our reputation can arise from many sources, including actual or perceived employee misconduct, misconduct by our outsourced service providers or other counterparties, litigation or regulatory actions, our failure to meet our standards of service and quality and compliance failures. Negative publicity regarding us or our bank, whether or not accurate, may damage our reputation, which could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***We target small and medium sized businesses as loan clients, who may have greater credit risk than larger borrowers.***

We target small and medium sized businesses as loan clients. Because of their size, these borrowers may be less able to withstand competitive, economic or financial pressures than larger borrowers in periods of economic weakness. If loan losses occur at a level where the allowance for loan losses is not sufficient to cover actual loan losses, our earnings will decrease.

***Our concentration of large loans to a limited number of borrowers may increase our credit risk.***

Our growth over the last several years has been partially attributable to our ability to originate and retain large loans. In addition to regulatory limits to which our bank is subject, we have established an internal policy limiting loans to one borrower, principal or guarantor based on “total exposure,” which represents the aggregate exposure of economically related borrowers for approval purposes; loans in excess of our internal limit require acknowledgment by our bank’s full board of directors. Many of these loans have been made to a small number of borrowers, resulting in a concentration of large loans to certain borrowers. As of December 31, 2019, our 25 largest borrowing relationships accounted for approximately 17% of our total loan portfolio. Along with other risks inherent in these loans, such as the deterioration of the underlying businesses or property securing these loans, this high concentration of borrowers presents a risk to our lending operations. If any one of these borrowers becomes unable to repay its loan obligations as a result of economic or market conditions, or personal circumstances, such as divorce or death, our non-accrual loans and our allowance for loan losses could increase significantly, which could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations. To mitigate this risk, we establish internal lending limits tied to the borrower’s risk profile, seek collateral, and involve increasing levels of senior management and board involvement in the approval of large loan relationships.

***Lack of seasoning of our loan portfolio could increase risk of credit defaults in the future.***

As a result of our growth over the past several years, as of December 31, 2019, approximately 54% of our loan portfolio had been originated since December 31, 2017, including new originations and renewals. In general, loans do not begin to show signs of credit deterioration or default until they have been outstanding for some period of time, a process referred to as “seasoning.” As a result, a portfolio of older loans will usually behave more predictably than a newer portfolio. Because a large portion of our portfolio is relatively new, the current level of delinquencies and defaults may not represent the level of delinquencies and defaults that could occur as the portfolio becomes more seasoned and may not serve as a reliable basis for predicting the health and nature of our loan portfolio. Our limited experience with these loans does not provide us with a significant payment history pattern with which to judge future collectability. As a result, it may be difficult to predict the future performance of our loan portfolio. If delinquencies and defaults increase, we may be required to increase our allowance for loan losses, which could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***We may not be able to adequately assess and limit our credit risk, which could adversely affect our profitability.***

A primary component of our business involves making loans to clients. The business of lending is inherently risky because the principal of or interest on the loan may not be repaid timely or at all or the value of any collateral supporting the loan may be insufficient to cover our outstanding exposure. These risks may be affected by the strength of the borrower’s business sector and local, regional and national market and economic conditions. Our risk management practices, such as monitoring our loan applicants and the concentration of our loans and our credit approval practices, may not adequately assess credit risk, and our credit administration personnel, policies and procedures may not adequately adapt to changes in economic or any other conditions affecting clients and the quality of the loan portfolio. A failure to effectively assess and limit the credit risk associated with our loan portfolio could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***Repayment of our leveraged loans is often dependent on the cash flows of the borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value.***

Our leveraged loans are primarily commercial in nature. Frequently, these loans have a secondary source of repayment that is directly correlated with the primary source of repayment. Leveraged borrowers may have a diminished ability to adjust to unexpected events and changes in business conditions because of a higher ratio of liabilities to capital, and in some cases, reliance is placed on enterprise value as a secondary source of repayment. The repayment of leveraged loans depends primarily on the cash flow and credit worthiness of the borrower and on enterprise value as a secondary source of repayment. To mitigate this risk, we give enhanced scrutiny to leveraged loan transactions, assess risk probabilities using benchmarks obtained from external rating agencies, and engage higher levels of senior management and board involvement in the approval and ongoing review of leveraged loan relationships.

***Our allowance for loan losses may prove to be insufficient to absorb losses inherent in our loan portfolio.***

We maintain an allowance for loan losses that represents management’s best estimate of the loan losses and risks inherent in our loan portfolio. The level of the allowance reflects management’s continuing evaluation of concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. The determination of the appropriate level of the allowance for loan losses is highly subjective and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes in a relatively short time period. Inaccurate management assumptions, continuing deterioration of economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require us to increase our allowance for loan losses. In addition, our regulators, as an integral part of their examination process, periodically review our loan portfolio and the adequacy of our allowance for loan losses and may require adjustments based upon judgments that are different than those of management. Further, if actual charge-offs in future periods exceed the amounts allocated to the allowance for loan losses, we may need to increase our provision for loan losses to restore the adequacy of our allowance for such losses. If we are required to materially increase our level of allowance for loan losses for any reason, our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations could be materially and adversely affected.

***The healthcare service industry is an integral component of the local economy, and adverse trends in the healthcare service industry could have a material adverse effect on us.***

The healthcare service industry is an integral segment of the local economy. As of December 31, 2019, approximately 9% of our loan portfolio was composed of loans to borrowers in the healthcare service industry. Adverse trends in the healthcare service industry may have a negative impact on a significant portion of the Company's borrowers and clients. The healthcare service industry may be affected by the following:

- trends in the method of delivery of healthcare services;
- competition among healthcare providers;
- consolidation of large health insurers;
- lower reimbursement rates from government and commercial payors, high uncompensated care expense, investment losses and limited admissions growth pressuring operating profit margins for healthcare providers;
- availability of capital;
- credit downgrades;
- liability insurance expense;
- regulatory and government reimbursement uncertainty resulting from changes to laws governing the delivery of healthcare services and reimbursement of providers of healthcare services;
- congressional efforts to repeal and federal court cases challenging the legality of certain aspects of the Patient Protection and Affordable Care Act and the Healthcare and Education Reconciliation Act of 2010;
- health reform initiatives to address healthcare costs through expanded value-based purchasing programs, bundled provider payments, health insurance exchanges, increased patient cost-sharing, geographic payment variations, comparative effectiveness research, lower payments for hospital readmissions, and shared risk-and-reward payment models such as accountable care organizations;
- federal and state government plans to reduce budget deficits and address debt ceiling limits by lowering healthcare provider Medicare and Medicaid payment rates, while requiring increased patient access to care;
- equalizing Medicare payment rates across different facility-type settings;
- heightened health information technology security standards and the meaningful use of electronic health records by healthcare providers; and
- Pandemics which could result in the extended shutdown or restriction of certain healthcare related businesses and services;
- potential tax law changes affecting healthcare providers.

These changes, among others, could adversely affect the economic performance of some or all of our borrowers and clients in the healthcare services industry and, in turn, have a materially negative impact on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***Our commercial real estate loan portfolio exposes us to credit risks that may be greater than the risks related to other types of loans.***

Our loan portfolio includes non-owner-occupied commercial real estate loans, or CRE loans, to individuals and businesses for various purposes, which are secured by commercial properties, as well as construction and land development loans. CRE loans typically involve repayment dependent upon income generated, or expected to be generated, by the property securing the loan in amounts sufficient to cover operating expenses and debt service. Weak economic conditions or other market factors can result in increased vacancy rates for retail, office and industrial property. The availability of such income for repayment may be adversely affected by changes in the economy or local market conditions. These loans expose us to greater credit risk than loans secured by other types of collateral because the collateral securing these loans is typically more difficult to liquidate under adverse conditions. Additionally, non-owner-occupied CRE loans generally involve relatively large balances to single borrowers or related groups of borrowers. Unexpected deterioration in the credit quality of our non-owner-occupied CRE loan portfolio could require us to increase our allowance for loan losses, which would reduce our profitability and could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations. We mitigate these risks both in our selection criteria for borrowers and project sponsors and in our general practice of requiring cash equity contributions substantially in excess of Supervisory Loan to Value limits as set forth in Appendix A of Part 365 – Interagency Guidelines for Real Estate Lending Policies.



***A prolonged downturn in the real estate market could result in losses and adversely affect our profitability.***

As of December 31, 2019, approximately 27% of our loan portfolio was composed of non-owner occupied commercial real estate loans, 12% of owner occupied commercial real estate loans, 18% consumer real estate loans, and 10% construction and land development loans. The real estate collateral in each case provides an alternate source of repayment in the event of default by the borrower and may deteriorate in value during the time the credit is extended. A decline in real estate values could further impair the value of our collateral and our ability to sell the collateral upon any foreclosure, which would likely require us to increase our allowance for loan losses. In the event of a default with respect to any of these loans, the amounts we receive upon sale of the collateral may be insufficient to recover the outstanding principal and interest on the loan. If we are required to re-value the collateral securing a loan to satisfy the debt during a period of reduced real estate values or to increase our allowance for loan losses, our profitability could be adversely affected, which could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***Regulatory requirements affecting our loans secured by commercial real estate could limit our ability to leverage our capital and adversely affect our growth and profitability.***

The federal banking agencies have indicated their view that banks with high concentrations of loans secured by commercial real estate are subject to increased risk and should implement robust risk management policies and maintain higher capital than regulatory minimums to maintain an appropriate cushion against loss that is commensurate with the perceived risk. Guidance from the Federal banking agencies identify institutions potentially exposed to CRE concentration risk as those that have (i) experienced rapid growth in CRE lending, (ii) notable exposure to a specific type of CRE, (iii) total reported loans for construction, land development and other land loans representing 100% or more of the institution's capital, or (iv) total CRE loans representing 300% or more of the institution's capital if the outstanding balance of the institution's CRE loan portfolio has increased 50% or more during the prior 36 months. Because a significant portion of our loan portfolio is dependent on commercial real estate, a change in the regulatory capital requirements applicable to us or a decline in our regulatory capital could limit our ability to leverage our capital as a result of these policies, which could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***We engage in lending secured by real estate and may be forced to foreclose on the collateral and own the underlying real estate, subjecting us to the costs and potential risks associated with the ownership of the real property.***

Since we originate loans secured by real estate, we may have to foreclose on the collateral property to protect our investment and may thereafter own and operate such property, in which case we would be exposed to the risks inherent in the ownership of real estate. The amount that we, as a mortgagee, may realize after a default is dependent upon factors outside of our control, including, but not limited to:

- general or local economic conditions;
- environmental cleanup liability;
- neighborhood assessments;
- interest rates;
- real estate tax rates;
- operating expenses of the mortgaged properties;
- supply of and demand for rental units or properties;
- ability to obtain and maintain adequate occupancy of the properties;
- zoning laws;
- governmental and regulatory rules;
- fiscal policies; and
- natural disasters.

Our inability to manage the amount of costs or size of the risks associated with the ownership of real estate, or write-downs in the value of other real estate owned, could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***We have several large depositor relationships, the loss of which could force us to fund our business through more expensive and less stable sources.***

As of December 31, 2019, our ten largest non-brokered depositors accounted for approximately 13% of our total deposits. Withdrawals of deposits by any one of our largest depositors could force us to rely more heavily on borrowings and other sources of funding for our business and withdrawal demands, adversely affecting our net interest margin and results of operations. We may also be forced, as a result of any withdrawal of deposits, to rely more heavily on other, potentially more expensive and less stable funding sources. Consequently, the occurrence of any of these events could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***Correspondent banking introduces unique risks, which could affect our liquidity.***

Although correspondent banking provides diversification of our funding base, it introduces a unique set of risks. Increases in the federal funds rate could create liquidity issues within the bank as it competes with the interest on reserves rate paid by the Federal Reserve Bank. Additionally, strong industry-wide loan demand could also create liquidity issues as excess balances held at CapStar Bank by our correspondent banks would presumably be redeployed by those banks into new loans. Further, capital inadequacy or asset quality issues at other institutions could result in increased risk to us due to the potential for large deposit withdrawals. If any of the foregoing were to occur, our liquidity could be materially and adversely affected.

***Liquidity risk could impair our ability to fund operations and meet our obligations as they become due, and our funding sources may be insufficient to fund our future growth.***

Liquidity is essential to our business. Liquidity risk is the potential that we will be unable to meet our obligations as they come due because of an inability to liquidate assets or obtain adequate funding. An inability to raise funds, at competitive rates or at all, through deposits, borrowings, the sale of loans and other sources could have a substantial negative effect on our liquidity. In particular, approximately 82% of our bank's deposits as of December 31, 2019 were checking accounts and other liquid deposits, which are payable on demand or upon several days' notice, while by comparison, 70% of the assets of our bank were loans at December 31, 2019, which cannot be called or sold in the same time frame. Our access to funding sources in amounts adequate to finance our activities or on terms that are acceptable to us could be impaired by factors that affect us specifically or the financial services industry or economy in general.

Factors that could negatively impact our access to liquidity sources include a decrease of our business activity as a result of a downturn in the markets in which our loans are concentrated, adverse regulatory action against us, or our inability to attract and retain deposits. Market conditions or other events could also negatively affect the level or cost of funding, affecting our ongoing ability to accommodate liability maturities and deposit withdrawals, meet contractual obligations and fund asset growth and new business transactions at a reasonable cost, in a timely manner and without adverse consequences. For example, we rely on deposits, federal funds purchased and advances from the Federal Home Loan Bank of Cincinnati ("FHLB") to fund our operations. Although we have historically been able to replace maturing deposits and advances if desired, we may not be able to replace such funds in the future if, among other things, our financial condition, the financial condition of the FHLB or market conditions were to change. In such a circumstance, we may seek additional borrowings to achieve our long-term business objectives; however, they may not be available to us on favorable terms or at all.

Additionally, whole loan sale agreements may require us to repurchase or substitute mortgage loans, or indemnify buyers against losses, in the event we breach representations or warranties to purchasers, guarantors and insurers, including government-sponsored entities, about the mortgage loans and the manner in which they were originated. In addition, we may be required to repurchase mortgage loans as a result of early payment default of the borrower on a mortgage loan. If repurchase and indemnity demands increase and such demands are valid claims and are in excess of our provision for potential losses, our liquidity, results of operations and financial condition may be adversely affected.

Any substantial, unexpected or prolonged change in the level or cost of liquidity could have a material adverse effect on our ability to meet deposit withdrawals and other client needs, which could have a material adverse effect on our asset growth, new business transactions, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***We are subject to interest rate risk, which could adversely affect our profits.***

Our profits, like that of most financial institutions, depends to a large extent on our net interest income, which is the difference between our interest income on interest-earning assets, such as loans and investment securities, and our interest expense on interest-bearing liabilities, such as deposits and borrowings. Our interest rate sensitivity profile was asset sensitive as of December 31, 2019, meaning that our net interest income would increase more from rising interest rates than from falling interest rates. However, many assumptions are used to model the impact of interest rate fluctuations on our net interest income. Due to the inherent use of these estimates and assumptions, our models may not be an accurate indicator of how our interest income will be affected by changes in interest rates.

Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and securities and the interest we pay on deposits and borrowings but could also affect our ability to originate loans and obtain deposits, the fair value of our financial assets and liabilities, and the average duration of our assets. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings.

In addition, an increase in interest rates could also have a negative impact on our results of operations by reducing the ability of borrowers to repay their current loan obligations. These circumstances could not only result in increased loan defaults, foreclosures and charge-offs, but also necessitate further increases to the allowance for loan losses which could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***Changes in monetary policy and government responses to adverse economic conditions such as inflation and deflation may have an adverse effect on our business, financial condition and results of operations.***

Our financial condition and results of operations are affected by credit policies of monetary authorities, particularly the Board of Governors of the Federal Reserve System. Actions by monetary and fiscal authorities, including the Federal Reserve, could lead to inflation, deflation, or other economic phenomena that could adversely affect our financial performance. The primary impact of inflation on our operations most likely will be reflected in increased operating costs. Conversely, deflation generally will tend to erode collateral values and diminish loan quality.

***Our bank's size presents multiple challenges that may restrict our growth and prevent us from effectively implementing our business strategy, such as our regulatory and internal lending limits and our ability to effectively leverage our infrastructure to implement our business strategy.***

We are limited in the amount our bank can loan in the aggregate to a single borrower or related borrowers by the amount of the bank's capital. CapStar Bank is a Tennessee-chartered bank and therefore is subject to the legal lending limits of the state of Tennessee and federal law. Tennessee and federal legal lending limits are safety and soundness measures intended to prevent one person or a relatively small and economically related group of persons from borrowing an unduly large amount of a bank's funds. They are also intended to safeguard a bank's depositors by diversifying the risk of loan losses among a relatively large number of credit-worthy borrowers engaged in various types of businesses. Under Tennessee law, total loans and extensions of credit to a borrower generally may not exceed 15% of our bank's capital, surplus and undivided profits. However, such loans may be in excess of that percentage, but not above 25%, if each loan in excess of 15% is first submitted to and approved in advance in writing by the board of directors and a record is kept of such written approval and reported to the board of directors quarterly. We have also established an internal limit on loans to one borrower to be between 7% and 15% of our risk-based capital, depending upon the underlying risk rating of the borrower. Loans in excess of our internal limit are noted as a policy exception and require acknowledgment by our bank's full board of directors. Based upon our bank's current capital levels, the amount it may lend is significantly less than that of many of our larger competitors and may discourage potential borrowers who have credit needs in excess of the bank's lending limit from doing business with us. Our bank accommodates larger loans by selling participations in those loans to other financial institutions, but this strategy may not always be available. If we are unable to compete effectively for loans from our target clients, we may not be able to effectively implement our business strategy, which could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***Our growth strategy involves strategic acquisitions, and we may not be able to overcome risks associated with such transactions.***

We plan to continue to explore opportunities to acquire other financial institutions and businesses in or around our existing Target Market or in comparable markets or that would provide scale, low cost of funds, non-interest income or products that are additive to our existing products and services. Our acquisition activities could be material to our business and involve a number of risks, including the following:

- the need to raise new capital;
- the time and expense associated with identifying and evaluating potential acquisitions and negotiating potential transactions, resulting in our management's attention being diverted from the operation of our existing business;
- the lack of history among our management team in working together on acquisitions and related integration activities;
- the time, expense, difficulty, and uncertainty of integrating the operations and personnel of the combined businesses;
- an inability to realize expected synergies or returns on investment;
- failure to discover the existence of liabilities during the due diligence process;
- exposure to unknown or contingent liabilities for which we may not be indemnified;
- potential disruption of our ongoing banking business; and
- a loss of key employees or key clients following an acquisition.

We may not be successful in overcoming these risks or any other problems encountered in connection with potential acquisitions. In addition, we may not be successful in identifying prospective transactions, making it difficult to implement our growth strategy. Our inability to overcome these risks could have an adverse effect on our ability to implement our business strategy and enhance shareholder value, which, in turn, could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***Our continued pace of growth may require us to raise additional capital in the future to fund such growth, and the unavailability of additional capital on terms acceptable to us could adversely affect us or our growth.***

We believe that we have sufficient capital to meet our capital needs for our immediate growth plans. However, we will continue to need capital to support our longer-term growth plans. If capital is not available on favorable terms when we need it, we may have to either issue common stock or other securities on less than desirable terms or reduce our rate of growth until market conditions become more favorable. Either of such events could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***The fair value of our investment securities could fluctuate because of factors outside of our control, which could have a material adverse effect on us.***

Factors beyond our control could significantly affect the fair value of our investment securities. These factors include, but are not limited to, rating agency actions in respect of the securities, defaults by the issuer or with respect to the underlying securities, and changes in market interest rates and continued instability in the capital markets. Any of these factors, among others, could cause other-than-temporary impairments, or OTTI, and realized and/or unrealized losses in future periods and declines in earnings and/or other comprehensive income (loss), which could materially and adversely affect our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations. The process for determining whether impairment of a security is OTTI usually requires complex, subjective judgments about the future financial performance and liquidity of the issuer, any collateral underlying the security as well as the Company's intent and ability to hold the security for a sufficient period of time to allow for any anticipated recovery in fair value in order to assess the probability of receiving all contractual principal and interest payments on the security. Our failure to assess any impairments or losses with respect to our securities could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***Deterioration in the fiscal position of the U.S. federal government and downgrades in the U.S. Department of the Treasury and federal agency securities could adversely affect us and our banking operations.***

The long-term outlook for the fiscal position of the U.S. federal government is uncertain, as illustrated by the 2011 downgrade by certain rating agencies of the credit rating of the U.S. government and federal agencies.

However, in addition to causing economic and financial market disruptions, any future downgrade, failure to raise the U.S. statutory debt limit, or deterioration in the fiscal outlook of the U.S. federal government, could, among other things, materially adversely affect the market value of the U.S. and other government and governmental agency securities that we hold, the availability of those securities as collateral for borrowing, and our ability to access capital markets on favorable terms. In particular, such events could increase interest rates and disrupt payment systems, money markets, and long-term or short-term fixed income markets, adversely affecting the cost and availability of funding, which could negatively affect our profitability. Also, the adverse consequences of any downgrade could extend to those to whom we extend credit and could adversely affect their ability to repay their loans. Any of these developments could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***We are subject to losses resulting from fraudulent and negligent acts on the part of loan applicants, our borrowers, other third parties, and our employees.***

When we originate loans, we rely heavily upon information supplied by third parties, including the information contained in the loan application, property appraisal, title information and employment and income documentation. If any of this information is intentionally or negligently misrepresented and such misrepresentation is not detected prior to loan funding, the fair value of the loan may be significantly lower than expected. Whether a misrepresentation is made by the loan applicant, the borrower, another third party or one of our employees, we generally bear the risk of loss associated with the misrepresentation. The persons and entities involved in such a misrepresentation are often difficult to locate, and we are often unable to collect any monetary losses that we have suffered from them.

***We may bear costs associated with the proliferation of computer theft and cyber-crime.***

We necessarily collect, use and hold sensitive data concerning individuals and businesses with whom we have a banking relationship. Threats to data security, including unauthorized access and cyber-attacks, rapidly emerge and change, exposing us to additional costs for protection or remediation and competing time constraints to secure our data in accordance with client expectations and statutory and regulatory requirements. Although we actively invest in the security of our technological infrastructure, it is not feasible to defend against every risk posed by rapid technological development and the increasing sophistication of cyber criminals. Patching and other measures to protect existing systems and servers could be inadequate, especially on systems that are being retired. Controls employed by our information technology department and third-party vendors could prove inadequate. We could also experience a breach by intentional or negligent conduct on the part of our employees or other internal sources, software bugs or other technical malfunctions, or other causes. As a result of any of these threats, our client accounts may become vulnerable to account takeover schemes or cyber-fraud. Our systems and those of our third-party vendors may also become vulnerable to damage or disruption due to circumstances beyond our or their control, such as from network failures, viruses and malware, power anomalies or outages, natural disasters and catastrophic events.

A breach of our security or the security of our third-party vendors that results in unauthorized access to our data could expose us to a disruption or challenges relating to our daily operations as well as to data loss, litigation, damages, fines and penalties, client notification requirements, significant increases in compliance costs, and reputational damage, any of which could individually or in the aggregate have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***Our risk management framework may not be effective in mitigating risks and/or losses to us.***

Our risk management framework is comprised of various processes, systems and strategies and is designed to manage the types of risk to which we are subject, including, among others, credit, liquidity, capital, financial performance, asset/liability, operational, compliance and regulatory, Community Reinvestment Act, or CRA, strategic and reputational, information technology and legal. Our framework also includes financial or other modeling methodologies that involve management assumptions and judgment. Our risk management framework may not be effective under all circumstances, including if our management fails to follow our credit policies and procedures, and thus, it may not adequately mitigate any risk or loss to us. If our framework is not effective, we could suffer unexpected losses and our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations could be materially and adversely affected. We may also be subject to potentially adverse regulatory consequences.

***We depend on our information technology and telecommunications systems, and any systems failures or interruptions could adversely affect our operations and financial condition.***

We rely heavily on communications and information systems to conduct our business. Any failure or interruption in the operation of these systems could impair or prevent the effective operation of our client relationship management, general ledger, deposit, lending or other functions. While we have policies and procedures designed to prevent or limit the effect of a failure or interruption in the operation of our information systems, there can be no assurance that any such failures or interruptions will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures or interruptions impacting our information systems could damage our reputation, result in a loss of clients, and expose us to additional regulatory scrutiny, civil litigation, and possible financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

***We are dependent upon outside third parties for the processing and handling of our records and data.***

We rely on software developed by third-party vendors to process various transactions. In some cases, we have contracted with third parties to run their proprietary software on our behalf. These systems include, but are not limited to, general ledger, payroll, employee benefits, loan and deposit processing, and securities portfolio accounting. For example, one vendor provides our core banking system through a service bureau arrangement. While we perform a review of controls instituted by the applicable vendors over these programs in accordance with industry standards and perform our own testing of user controls, we rely on the continued maintenance of controls by these third-party vendors, including safeguards over the security of client data. We may incur a temporary disruption in our ability to conduct business or process transactions, or incur damage to our reputation, if the third-party vendor fails to adequately maintain internal controls or institute necessary changes to systems. We may need to switch third-party service providers from time-to-time, which could result in disruption to our business processes, damage to our reputation and a breach of our data security measures. Such a disruption or breach of security may have a material adverse effect on our business. In addition, we may not be able to obtain or continue to obtain licenses and technologies from these third parties on reasonable terms or at all.

***We encounter technological change continually and have fewer resources than certain of our competitors to invest in technological improvements.***

The financial services industry is undergoing rapid technological changes, with frequent introductions of new technology-driven products and services. In addition to serving clients better, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our success will depend in part on our ability to address our clients' needs by using technology to provide products and services that will satisfy client demands for convenience, as well as to create additional efficiencies in our operations. Certain of our competitors have substantially greater resources to invest in technological improvements than us, and in the future, we may not be able to implement new technology-driven products and services timely, effectively or at all or be successful in marketing these products and services to our clients. As these technologies are improved in the future, we may, in order to remain competitive, be required to make significant capital expenditures, which may increase our overall expenses and have a material adverse effect on our net income. There is also no guarantee that any such investment in these products and services will create additional efficiencies in our operations.

***We may be adversely affected by the lack of soundness of other financial institutions.***

Our ability to engage in routine funding transactions could be adversely affected by the actions and soundness of other financial institutions. Financial services companies are interrelated as a result of trading, clearing, counterparty, and other relationships. We have exposure to different industries and counterparties, and through transactions with counterparties in the financial services industry, including brokers and dealers, commercial banks, investment banks, and other institutional clients. Defaults by, or even rumors or questions about, one or more financial services companies, or the financial services industry generally, have led to market-wide liquidity problems in the past and could lead to losses or defaults by us or by other institutions in the future. These losses or defaults could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***We are subject to environmental liability risk associated with our lending activities.***

In the course of our business, we may purchase real estate, or we may foreclose on and take title to real estate. As a result, we could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or to third parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination or may be required to investigate or clean up hazardous or toxic substances or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, if we are the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. Any significant environmental liabilities could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***By engaging in derivative transactions, we are exposed to additional credit and market risk.***

We use interest rate swaps to help manage our interest rate risk from recorded financial assets and liabilities when they can be demonstrated to effectively hedge a designated asset or liability and the asset or liability exposes us to interest rate risk or risks inherent in client related derivatives. Hedging interest rate risk is a complex process, requiring sophisticated models and routine monitoring, and is not a perfect science. As a result of interest rate fluctuations, hedged assets and liabilities will appreciate or depreciate in market value. The effect of this unrealized appreciation or depreciation will generally be offset by income or loss on the derivative instruments that are linked to the hedged assets and liabilities. We also have derivatives that result from a service we provide to certain qualifying clients approved through our credit process, and therefore, are not used to manage interest rate risk in our assets or liabilities. By engaging in derivative transactions, we are exposed to credit and market risk. If the counterparty fails to perform, credit risk exists to the extent of the fair value gain in the derivative. Market risk exists to the extent that interest rates change in ways that are significantly different from what we expected when we entered into the derivative transaction. The existence of credit and market risk associated with our derivative instruments could adversely affect our net interest income and, therefore, could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***We are or may become involved from time to time in suits, legal proceedings, information-gathering requests, investigations and proceedings by governmental and self-regulatory agencies that may lead to adverse consequences.***

Many aspects of our business involve substantial risk of legal liability. From time to time, we are, or may become, the subject of lawsuits and related legal proceedings, governmental and self-regulatory agency information-gathering requests, reviews, investigations and proceedings and other forms of regulatory inquiry, including by bank regulatory agencies, the Securities and Exchange Commission, or SEC, and law enforcement authorities. The results of such proceedings could lead to significant civil or criminal penalties, including monetary penalties, damages, adverse judgments, settlements, fines, injunctions, restrictions on the way in which we conduct our business, or reputational harm.

Although we establish accruals for legal proceedings when information related to the loss contingencies represented by those matters indicates both that a loss is probable and that the amount of loss can be reasonably estimated, we may not have accruals for all legal proceedings where we face a risk of loss. In addition, due to the inherent subjectivity of the assessments and unpredictability of the outcome of legal proceedings, amounts accrued may not represent the ultimate loss to us from the legal proceedings or government or other inquiries. Thus, our ultimate losses may be higher, and possibly materially so, than the amounts accrued for legal loss contingencies, which could adversely affect our financial condition and results of operations.

***Our Target Market is susceptible to floods, tornados and other natural disasters, adverse weather events, nuclear fallout from nuclear plants in East Tennessee and acts of God, which may adversely affect our business and operations.***

Substantially all of our business and operations are located in our Target Market, which is an area that has recently been damaged by floods and tornadoes and that is susceptible to other natural disasters, adverse weather events, nuclear fallout from nuclear plants in East Tennessee and acts of God. Natural disasters, adverse weather events and acts of God can disrupt our operations, cause widespread property damage, and severely depress the local economies in which we operate. Any economic decline as a result of natural disasters, adverse weather events or acts of God can reduce the demand for loans and our other client solutions as well as client ability to repay such loans. In addition, the rates of delinquencies, foreclosures, bankruptcies and losses on loan portfolios may increase substantially, as uninsured property losses or sustained job interruption or loss may materially impair the ability of borrowers to repay their loans. Moreover, the value of real estate or other collateral that secures the loans could be materially and adversely affected by natural disasters, adverse weather events or acts of God. Therefore, natural disasters, adverse weather events or acts of God could result in decreased revenue and loan losses that have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***Our internal controls over financial reporting may not be effective, and our independent registered public accounting firm may not be able to certify as to their effectiveness, which could have a significant and adverse effect on our business and reputation.***

We are not currently required to comply with SEC rules that implement Section 404 of the Sarbanes-Oxley Act and are, therefore, not required to make a formal assessment of the effectiveness of our internal controls over financial reporting for that purpose. We will be required to comply with these rules upon ceasing to be an emerging growth company, as defined in the JOBS Act.

When evaluating our internal controls over financial reporting, we may identify material weaknesses that we may not be able to remediate in time to meet the applicable deadline imposed upon us for compliance with the requirements of Section 404 of the Sarbanes-Oxley Act. Further, the cost of any such compliance with Section 404 of the Sarbanes-Oxley Act could be substantial and have a material effect on our cash flows and earnings. In addition, if we fail to achieve and maintain the adequacy of our internal controls, as such standards are modified, supplemented, or amended from time to time, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal controls over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act. We cannot be certain as to the timing of completion of our evaluation, testing, and any remediation actions or the impact of the same on our operations. If we are not able to implement the requirements of Section 404 of the Sarbanes-Oxley Act in a timely manner or with adequate compliance, our independent registered public accounting firm may issue an adverse opinion due to ineffective internal controls over financial reporting, and we may be subject to sanctions or investigations by regulatory authorities, such as the SEC. As a result, there could be a negative reaction in the financial markets due to a loss of confidence in the reliability of our financial statements. In addition, we may be required to incur costs in improving our internal control system and hiring additional personnel. Any such action could negatively affect our results of operations and cash flows.



***Uncertainties in the interpretation and application of the Tax Reform Act could materially affect our tax obligations and effective tax rate.***

The Tax Reform Act significantly changes how corporations in the United States are taxed. The Tax Reform Act requires complex computations to be performed that were not previously required by U.S. tax law, significant judgments to be made in interpretation of the provisions of the Tax Reform Act and significant estimates in calculations, and the preparation and analysis of information not previously relevant or regularly produced. The U.S. Treasury Department, the IRS, and other standard-setting bodies could interpret or issue guidance on how provisions of the Tax Reform Act will be applied or otherwise administered that is different from our interpretation. As a result, we have recorded a provisional estimate on the effect of the Tax Reform Act on our deferred tax assets in our financial statements. As additional regulatory guidance is issued by the applicable taxing authorities, as accounting treatment is clarified, as we perform additional analysis on the application of the Tax Reform Act, and as we refine estimates in calculating the effect, our final analysis, which will be recorded in the period completed, may be different from our current provisional amounts, which could materially affect our tax obligations and effective tax rate. The impact of the Tax Reform Act on our shareholders is uncertain and could be adverse. This Report does not discuss the manner in which the Tax Reform Act might affect our shareholders. Accordingly, we encourage our shareholders to consult with their own legal and tax advisors with respect to the Tax Reform Act and the potential tax consequences of investing in our common stock.

***We May Be Adversely Impacted By The Transition From LIBOR As A Reference Rate.***

In 2017, the United Kingdom's Financial Conduct Authority announced that after 2021 it would no longer compel banks to submit the rates required to calculate the London Interbank Offered Rate ("LIBOR"). This announcement indicates that the continuation of LIBOR on the current basis cannot and will not be guaranteed after 2021. Consequently, at this time, it is not possible to predict whether and to what extent banks will continue to provide submissions for the calculation of LIBOR. Similarly, it is not possible to predict whether LIBOR will continue to be viewed as an acceptable market benchmark, what rate or rates may become accepted alternatives to LIBOR, or what the effect of any such changes in views or alternatives may be on the markets for LIBOR-indexed financial instruments.

In particular, regulators, industry groups and certain committees (e.g., the Alternative Reference Rates Committee) have, among other things, published recommended fall-back language for LIBOR-linked financial instruments, identified recommended alternatives for certain LIBOR rates (e.g., the Secured Overnight Financing Rate as the recommended alternative to U.S. Dollar LIBOR), and proposed implementations of the recommended alternatives in floating rate instruments. At this time, it is not possible to predict whether these specific recommendations and proposals will be broadly accepted, whether they will continue to evolve, and what the effect of their implementation may be on the markets for floating-rate financial instruments.

We have a significant number of loans, derivative contracts, borrowings and other financial instruments with attributes that are either directly or indirectly dependent on LIBOR. The transition from LIBOR could create considerable costs and additional risk. Since proposed alternative rates are calculated differently, payments under contracts referencing new rates will differ from those referencing LIBOR. The transition will change our market risk profiles, requiring changes to risk and pricing models, valuation tools, product design and hedging strategies. Furthermore, failure to adequately manage this transition process with our customers could adversely impact our reputation. Although we are currently unable to assess what the ultimate impact of the transition from LIBOR will be, failure to adequately manage the transition could have a material adverse effect on our business, financial condition and results of operations.

***Changes in U.S. trade policies and other factors beyond our Company's control, including the imposition of tariffs and retaliatory tariffs, may adversely impact our business, financial condition and results of operations.***

There have been changes and discussions with respect to U.S. trade policies, legislation, treaties and tariffs, including trade policies and tariffs affecting other countries, including China, the European Union, Canada and Mexico and retaliatory tariffs by such countries. Tariffs and retaliatory tariffs have been imposed, and additional tariffs and retaliation tariffs have been proposed. Such tariffs, retaliatory tariffs or other trade restrictions on products and materials that our customers import or export, including among others, agricultural products, could cause the prices of our customers' products to increase which could reduce demand for such products, or reduce our customer margins, and adversely impact their revenues, financial results and ability to service debt; which, in turn, could adversely affect our financial condition and results of operations. In addition, to the extent changes in the political environment have a negative impact on us or on the markets in which we operate our business, results of operations and financial condition could be materially and adversely impacted in the future. It remains unclear what the U.S. Administration or foreign governments will or will not do with respect to tariffs already imposed, additional tariffs that may be imposed, or international trade agreements and policies. On October 1, 2018, the United States, Canada and Mexico agreed to a new trade deal to replace the North American Free Trade Agreement, which was ratified by Mexico and the United States but remains subject to ratification by the Canadian parliament, which may or may not occur by the end of 2020. The full impact of this agreement on us, our customers and on the economic conditions in our markets is currently unknown. A trade war or other governmental action related to tariffs or international trade agreements or policies has the potential to negatively impact ours and/or our customers' costs, demand for our customers' products, and/or the U.S. economy or certain sectors thereof and, thus, adversely impact our business, financial condition and results of operations.

***We are subject to risks associated with home equity products where we are in a second lien position that could materially adversely affect our performance.***

Risks associated with home equity products where we are in a second lien position could materially adversely affect our performance. Home equity products, particularly those where we are in a second lien position, and particularly those in certain geographic areas, may carry a higher risk of non-collection than other loans. Home equity lending includes both home equity loans and lines of credit. Of our \$121.1 million home equity portfolio at December 31, 2019, approximately \$117.4 million were home equity lines of credit and \$3.7 million were closed-end home equity loans (primarily originated as amortizing loans). This type of lending, which is secured by a first or second mortgage on the borrower's residence, allows customers to borrow against the equity in their home. Real estate market values at the time of origination directly affect the amount of credit extended, and, in addition, past and future changes in these values impact the depth of potential losses. Second lien position lending carries higher credit risk because any decrease in real estate pricing may result in the value of the collateral being insufficient to cover the second lien after the first lien position has been satisfied. As of December 31, 2019, approximately \$68.8 million of our home equity lines and loans were in a second lien position.

#### **Risks Related to Our Industry**

***We are subject to extensive regulation that could limit or restrict our business activities and impose financial requirements, such as minimum capital requirements, and could have a material adverse effect on our profitability.***

We operate in a highly regulated industry and are subject to examination, supervision and comprehensive regulation by various federal and state agencies including the Federal Reserve and the TDFI. Regulatory compliance is costly and restricts certain of our activities, including payment of dividends, mergers and acquisitions, investments, loans and interest rates charged, transactions with affiliates, treatment of our clients, and interest rates paid on deposits. We are also subject to financial requirements prescribed by our regulators such as minimum capitalization guidelines, which require us to maintain adequate capital to support our growth. Violations of various laws, even if unintentional, may result in significant fines or other penalties, including restrictions on branching or bank acquisitions and other activities. Recently, banks generally have faced increased regulatory sanctions and scrutiny particularly with respect to the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act, or USA Patriot Act, and other statutes relating to anti-money laundering compliance and client privacy. Recent legislation has substantially changed, and increased, federal regulation of financial institutions, and there may be significant future legislation (and regulations under existing legislation) that could have a further material effect on bank holding companies like us and banks like CapStar Bank.

The laws and regulations applicable to the banking industry could change at any time, and we cannot predict the effects of these changes on our business and profitability. Because government regulation greatly affects the business and financial results of all commercial banks and bank holding companies, our cost of compliance could adversely affect our ability to operate profitably.

***Federal and state regulators periodically examine our business and may require us to remediate adverse examination findings or may take enforcement action against us.***

The Federal Reserve and the TDFI periodically examine our business, including our compliance with laws and regulations. If, as a result of an examination, the Federal Reserve or the TDFI were to determine that our financial condition, capital resources, asset quality, earnings prospects, management, liquidity or other aspects of any of our operations had become unsatisfactory, or that we were in violation of any law or regulation, they may take a number of different remedial actions as they deem appropriate. These actions include the power to require us to remediate any such adverse examination findings.

In addition, these agencies have the power to take enforcement action against us to enjoin “unsafe or unsound” practices, to require affirmative action to correct any conditions resulting from any violation of law or regulation or unsafe or unsound practice, to issue an administrative order that can be judicially enforced, to direct an increase in our capital, to direct the sale of subsidiaries or other assets, to limit dividends and distributions, to restrict our growth, to assess civil monetary penalties against us or our officers or directors, to remove officers and directors and, if it is concluded that such conditions cannot be corrected or there is an imminent risk of loss to depositors, to terminate our deposit insurance and place us into receivership or conservatorship. Any regulatory enforcement action against us could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

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

The CRA, the Equal Credit Opportunity Act, the Fair Housing Act and other fair lending laws and regulations prohibit discriminatory lending practices by financial institutions. The U.S. Department of Justice, federal banking agencies, and other federal agencies are responsible for enforcing these laws and regulations. A successful regulatory challenge to an institution’s compliance with fair lending laws and regulations could result in a wide variety of sanctions, including damages and civil money penalties, injunctive relief, restrictions on mergers and acquisitions activity, restrictions on expansion, and restrictions on product offerings. Private parties may also have the ability to challenge an institution’s performance under fair lending laws in private class action litigation. Such actions could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

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

The Bank Secrecy Act, the USA Patriot Act and other laws and regulations require financial institutions, among other duties, to institute and maintain an effective anti-money laundering program and to file reports such as suspicious activity reports and currency transaction reports. We are required to comply with these and other anti-money laundering requirements. The federal banking agencies and Financial Crimes Enforcement Network are authorized to impose significant civil money penalties for violations of those requirements and have recently engaged in coordinated enforcement efforts against banks and other financial service providers with the U.S. Department of Justice, Drug Enforcement Administration and Internal Revenue Service, or IRS. We are also subject to increased scrutiny of compliance with the rules enforced by the Office of Foreign Assets Control, or OFAC. If our policies, procedures and systems are deemed deficient, we would be subject to liability, including fines and regulatory actions, which may include restrictions on our ability to pay dividends and the requirement to obtain regulatory approvals to proceed with certain aspects of our business plan, including our acquisition plans. Failure to maintain and implement adequate programs to combat money laundering and terrorist financing could also have serious reputational consequences for us. Any of these circumstances could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***Financial reform legislation has, among other things, tightened capital standards, created the Consumer Financial Protection Bureau and resulted in new regulations that are likely to increase our costs of operations.***

As final rules and regulations implementing the Dodd-Frank Act have been adopted, this law has significantly changed the current bank regulatory framework and affected the lending, deposit, investment, trading and operating activities of banks and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting the implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act depends on the rules and regulations that implement it.

Among many other changes, the Dodd-Frank Act eliminated the federal prohibitions on paying interest on demand deposits effective one year after the date of its enactment, thus allowing businesses to have interest-bearing checking accounts. Depending on competitive responses, this significant change to existing law could have an adverse impact on our interest expense. The Dodd-Frank Act permanently increased the maximum amount of deposit insurance for banks, savings institutions and credit unions to \$250,000 per depositor. The Dodd-Frank Act also directs the federal banking regulators to issue rules prohibiting incentive compensation that encourages inappropriate risks.

The Dodd-Frank Act created the Consumer Financial Protection Bureau, or the CFPB, with broad powers to supervise and enforce consumer financial protection laws. The CFPB has broad rule-making authority for a wide range of consumer protection laws that apply to all banks, including the authority to prohibit “unfair, deceptive or abusive” acts and practices.

As noted above, many aspects of the Dodd-Frank Act are subject to rulemaking and take effect over several years, making it difficult to anticipate the overall financial impact on us. However, compliance with the Dodd-Frank Act and its implementing regulations will result in additional operating and compliance costs that could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***We are required to act as a source of financial and managerial strength for our bank in times of stress.***

Under federal law and long-standing Federal Reserve policy, we are expected to act as a source of financial and managerial strength to our bank, and to commit resources to support our bank if necessary. We may be required to commit additional resources to our bank at times when we may not be in a financial position to provide such resources or when it may not be in our, or our shareholders’ or creditors,’ best interests to do so. A requirement to provide such support is more likely during times of financial stress for us and our bank, which may make any capital we are required to raise to provide such support more expensive than it might otherwise be. In addition, any capital loans we make to our bank are subordinate in right of repayment to deposit liabilities of our bank. In the event of our bankruptcy, any commitment by us to a federal banking regulator to maintain the capital of our bank will be assumed by the bankruptcy trustee and entitled to priority of payment over general unsecured creditor claims.

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

The deposits of our bank are insured by the FDIC up to legal limits and, accordingly, subject it to the payment of FDIC deposit insurance assessments as determined according to the calculation described in “Supervision and Regulation—Bank Regulation and Supervision—FDIC Insurance and Other Assessments.” High levels of bank failures since the financial crisis and increases in the statutory deposit insurance limits have increased resolution costs to the FDIC and put significant pressure on the Deposit Insurance Fund. In order to maintain a strong funding position and restore the reserve ratios of the Deposit Insurance Fund following the financial crisis, the FDIC increased deposit insurance assessment rates and charged special assessments to all FDIC-insured financial institutions. Further increases in assessment rates or special assessments may occur in the future, especially if there are significant additional financial institution failures. Any future special assessments, increases in assessment rates or required prepayments in FDIC insurance premiums could reduce our profitability or limit our ability to pursue certain business opportunities, which could have a material adverse effect on our assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and results of operations.

***Risks Related to Our Common Stock***

***Even though our common stock is currently traded on the Nasdaq Stock Market's Global Select Market, it has less liquidity than many other stocks quoted on a national securities exchange.***

The trading volume in our common stock on the Nasdaq Global Select Market has been relatively low when compared with larger companies listed on the Nasdaq Global Select Market or other stock exchanges. Because of this, it may be more difficult for stockholders to sell a substantial number of shares for the same price at which stockholders could sell a smaller number of shares.

We cannot predict the effect, if any, that future sales of our common stock in the market, or the availability of shares of common stock for sale in the market, will have on the market price of our common stock. We can give no assurance that sales of substantial amounts of common stock in the market, or the potential for large amounts of sales in the market, would not cause the price of our common stock to decline or impair our future ability to raise capital through sales of our common stock.

The market price of our common stock has fluctuated significantly, and may fluctuate in the future. These fluctuations may be unrelated to our performance. General market or industry price declines or overall market volatility in the future could adversely affect the price of our common stock, and the current market price may not be indicative of future market prices.

***A future issuance or future issuances of stock could dilute the value of our common stock.***

Our charter permits us to issue up to an aggregate of 25 million shares of common stock. As of December 31, 2019, 18,361,922 shares of our common stock were issued and outstanding, including 84,697 shares of restricted common stock that have yet to vest. Those shares outstanding do not include the potential issuance, as of December 31, 2019, of 271,202 shares of our common stock subject to issuance upon exercise of outstanding stock options under the Stock Incentive Plan, and 362,757 additional shares of our common stock that were reserved for issuance under the Stock Incentive Plan. A future issuance of any new shares of our common stock would, and equity-related securities could, cause further dilution in the value of our outstanding shares of common stock.

***Significant sales of our common stock by certain shareholders could affect the market value of our common stock.***

On December 21, 2018, we filed a shelf registration statement (the “Shelf Registrations Statement”) with the SEC on Form S-3 registering 3,652,094 shares of our common stock held by certain of our long-time shareholders, representing about 20.7% of our total issued and outstanding common stock. The Shelf Registration Statement was declared effective by the SEC on March 28, 2019. Accordingly, these shares represent a significant number of our issued and outstanding shares of common stock, and, if sold in the market all at once or at about the same time, could depress the market price of our common stock and could further affect our ability to raise equity capital. Further, we cannot predict the size or the effect, if any, that sales of these shares, or the perception that such sales could occur, may have on the market price of our shares of common stock or our ability to raise additional capital through the sale of equity securities. Any significant sales of these shares could have a materially adverse impact on our affairs, assets, business, cash flows, condition (financial or otherwise), credit quality, financial performance, liquidity, short- and long-term performance goals, prospects and results of operations or the trading price of our common stock.

***We have the ability to incur debt and pledge our assets, including our stock in our bank, to secure that debt.***

We have the ability to incur debt and pledge our assets to secure that debt. Absent special and unusual circumstances, a holder of indebtedness for borrowed money has rights that are superior to those of holders of our common stock. For example, interest must be paid to a lender before dividends can be paid to our shareholders, and, in the case of liquidation, our borrowings must be repaid before we can distribute any assets to our shareholders. Furthermore, we would have to make principal and interest payments on our indebtedness, which could reduce our profitability or result in net losses on a consolidated basis even if our bank were profitable.

***The rights of our common shareholders would likely be subordinate to the rights of the holders of any preferred stock that we may issue in the future.***

Our charter authorizes our board of directors to issue an aggregate of up to five million shares of preferred stock without any further action on the part of our shareholders. Our board of directors also has the power, without shareholder approval, to set the terms of any series of preferred stock that may be issued, including voting rights, dividend rights, and preferences over our common stock with respect to dividends or in the event of a dissolution, liquidation or winding up and other terms. Accordingly, you should assume that any shares of preferred stock that we may issue in the future will also be senior to our common stock. In the event that we issue preferred stock in the future that has preference over our common stock with respect to payment of dividends or upon our liquidation, dissolution or winding up, or if we issue preferred stock with voting rights that dilute the voting power of our common stock, the rights of the holders of our common stock or the market price of our common stock could be adversely affected.

***We and our bank are subject to capital and other legal and regulatory requirements which restrict our ability to pay dividends.***

We are subject to certain restrictions on the payment of cash dividends as a result of banking laws, regulations and policies. In addition, because our bank is our only material asset, our ability to pay dividends to our shareholders depends on our receipt of dividends from the bank, which is also subject to restrictions on dividends as a result of banking laws, regulations and policies.

*We are an “emerging growth company,” and the reduced regulatory and reporting requirements applicable to emerging growth companies may make our common stock less attractive to investors.*

We are an “emerging growth company,” as described in the JOBS Act. For as long as we continue to be an emerging growth company we may take advantage of reduced regulatory and reporting requirements that are otherwise generally applicable to public companies. These include, without limitation, not being required to comply with the auditor attestation requirements of Section 404(b) of the Sarbanes-Oxley Act, reduced financial reporting requirements, reduced disclosure obligations regarding executive compensation, a potential exemption from new auditing standards adopted by the Public Company Accounting Oversight Board and exemptions from the requirements of holding non-binding advisory votes on executive compensation and golden parachute payments.

We may take advantage of these provisions for up to five years, unless we earlier cease to be an emerging growth company, which would occur if our annual gross revenue exceeds \$1.07 billion, if we issue more than \$1.0 billion in non-convertible debt in a three-year period, or if the market value of our common stock held by non-affiliates exceeds \$700.0 million as of any June 30 before that time, in which case we would no longer be an emerging growth company as of the following December 31. Investors may find our common stock less attractive if we rely on these reduced regulatory and reporting requirements, which may result in a less active trading market and increased volatility in our stock price.

## **ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

## **ITEM 2. PROPERTIES**

Our headquarters and main branch office is located at 1201 Demonbreun Street, Suite 700, Nashville, Tennessee 37203. The following table summarizes pertinent details of our retail bank branch locations and mortgage origination offices as of March 6, 2020.

<b>Location</b>	<b>Owned/Leased</b>	<b>Lease Expiration</b>	<b>Type of Office</b>
CapStar Bank 1201 Demonbreun Street, Suite 700 Nashville, TN 37203	Leased	02/28/32	Headquarters and Main Retail Bank Branch
2321 Crestmoor Road Nashville, TN 37215	Building (Owned); Land (Leased)	Building: N/A Land: 02/15/28	Retail Bank Branch
2002 Richard Jones Road Nashville, TN 37215	Leased	10/31/23	Mortgage Origination Office
5500 Maryland Way, Suite 130 Brentwood, TN 37027	Leased	09/30/23	Retail Bank Branch
101 Springhouse Court Hendersonville, TN 37075	Owned	N/A	Retail Bank Branch
885 Greenlea Blvd. Gallatin, TN 37066	Owned	N/A	Retail Bank Branch
106 Washington Avenue Athens, TN 37303	Owned	N/A	Retail Bank Branch
1103 Decatur Pike Athens, TN 37303	Owned	N/A	Retail Bank Branch
523 Tennessee Avenue Etowah, TN 37331	Owned	N/A	Retail Bank Branch
215 Warren Street Madisonville, TN 37354	Owned	N/A	Retail Bank Branch
761 New Highway 68 Sweetwater, TN 37874	Owned	N/A	Retail Bank Branch
705 East Broadway Lenoir City, TN 37771	Owned	N/A	Retail Bank Branch
3855 North Ocoee Street Cleveland, TN 37312	Leased	01/31/2022	Retail Bank Branch
950 25 <sup>th</sup> Street Cleveland, TN 37311	Leased	12/31/2026	Retail Bank Branch

The Company leases certain premises and equipment under operating leases that expire at various dates, through 2032, and in most instances include options to renew or extend at market rates and terms.

### **ITEM 3. 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, results of operations, or trading price of its common stock.

#### *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 our common stock. The complaint alleges that defendants violated Section 13(d) of the Exchange Act by filing materially false and misleading Schedules 13D regarding defendants' acquisition of a minority stake (1,156,675 shares) of our common 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 our 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 our claims that defendants violated Tennessee Code Section 45-2-107 under Section 13(d) of the Exchange Act to proceed.

Mr. Lawrence also filed an Interagency Notice of Change in Control pursuant to the CBCA with the Federal Reserve on October 30, 2017 (the "Notice"), seeking permission to acquire up to 15% of the outstanding voting shares of our 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 us 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. On November 19, 2019, Mr. Lawrence filed an amended Schedule 13D in which he asserted that the Federal Reserve's determination not to disapprove his Notice has now expired, and in which Mr. Lawrence further stated that he "does not presently intend to file a new Interagency Notice of Change in Control with the [Federal Reserve]."

### **ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

CapStar Financial's common stock is traded on the Nasdaq Global Select Market under the symbol "CSTR" and has traded on that market since September 22, 2016. Prior to that time, there was no established public trading market for our stock. The following table shows the high and low sales price information for our common stock for each full quarter in 2019 and 2018 as reported on the Nasdaq Global Select Market.

	Price Per Share	
	High	Low
2019:		
First quarter	\$ 17.33	\$ 14.11
Second quarter	16.20	14.21
Third quarter	17.21	14.61
Fourth quarter	17.48	15.74
2018:		
First quarter	\$ 21.91	\$ 17.36
Second quarter	20.87	17.39
Third quarter	19.98	15.88
Fourth quarter	17.40	13.51

As of March 5, 2020 there were approximately 2,545 holders of record of shares of our common stock.

The following table shows information related to the repurchase of shares of common stock by the Company during the three months ended December 31, 2019.

	Total number of shares purchased (1)	Average price paid per share	Total number of shares purchased as part of publicly announced plan (2)	Maximum amount that may yet be purchased under the plan
October 1 - October 31	2,294	\$ 16.56	—	\$9.00 million
November 1 - November 30	221	16.91	—	\$9.00 million
December 1 - December 31	2,808	17.08	—	\$9.00 million
Total	5,323	\$ 16.85	—	\$9.00 million

- (1) Activity represents shares of common stock withheld to pay purchase price and taxes due upon vesting of restricted shares and exercise of stock options.

For information regarding securities authorized for issuance under the Company's equity compensation plans, please see "Item 12. Security Ownership of Certain Beneficial Owners and Management And Related Stockholder Matters".

- (2) On December 21, 2018, the board of directors approved the Company's share repurchase program which authorized the Company to repurchase up to \$8 million of shares of common stock (the "Repurchase Program"). On September 5, 2019, the Board approved an expansion of the Repurchase Program (the "Expanded Repurchase Program"). Under the Expanded Repurchase Program, the amount of common stock that the Company is authorized to repurchase has been increased from approximately \$2.2 million to \$11 million. The Expanded Share Repurchase Program will terminate on the date on which the Expanded Maximum Dollar Amount of Common Stock has been repurchased..

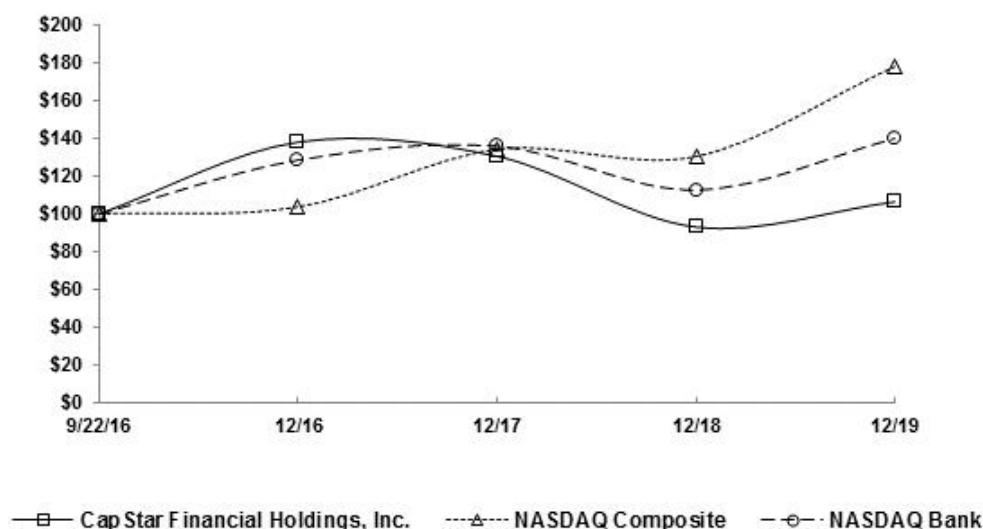


## Stock Performance Graph

The following stock performance graph compares total shareholders return on our common stock for the period beginning at the close of trading on September 22, 2016 until December 31, 2019, with the cumulative total return of the NASDAQ Composite Index and the NASDAQ Bank Index for the same period. Cumulative total return is computed by dividing the difference between the share price of our common stock at the end and the beginning of the measurement period by the share price of our common stock at the beginning of the measurement period. The performance graph assumes \$100 is invested on September 22, 2016 in shares of our common stock, the NASDAQ Composite Index and the NASDAQ Bank Index and that dividends are reinvested into additional shares of common stock at the same frequency with which dividends are paid on such shares during the applicable fiscal year. Historical stock price performance is not necessarily indicative of future stock price performance. The information in this paragraph and the following stock performance graph shall not be deemed to be “soliciting material” or to be “filed” with the SEC or subject to Regulation 14A or 14C, other than as provided in Item 201 of Regulation S-K, or to the liabilities of Section 18 of the Exchange Act, except to the extent that we specifically request that such information be treated as soliciting material or specifically incorporate it by reference into a filing under the Securities Act or the Exchange Act.

### COMPARISON OF 39 MONTH CUMULATIVE TOTAL RETURN\*

Among CapStar Financial Holdings, Inc., the NASDAQ Composite Index and the NASDAQ Bank Index



\*\$100 invested on 9/22/16 in stock or 8/31/16 in index, including reinvestment of dividends.  
Fiscal year ending December 31.

	CapStar Financial Holdings, Inc. (CSTR)	NASDAQ Composite Index (IXIC)	NASDAQ Bank Index (BKX)
09/22/2016	\$ 100	\$ 100	\$ 100
12/31/2016	138	104	129
12/31/2017	131	134	136
12/31/2018	93	131	113
12/31/2019	107	178	140

## Dividend Policy

Holders of shares of our voting and non-voting common and preferred stock are only entitled to receive dividends when, as and if declared by our board of directors out of funds legally available for dividends. As a Tennessee corporation, we are not permitted to pay dividends if, after giving effect to such payment, we would not be able to pay our debts as they become due in the usual course of business or our total assets would be less than the sum of our total liabilities plus any amounts needed to satisfy any preferential rights if we were dissolving.

Because we are a bank holding company and do not engage directly in business activities of a material nature, our ability to pay any dividends on our common stock depends, in large part, upon our receipt of dividends from our bank, which is also subject to numerous limitations on the payment of dividends under federal and state banking laws, regulations and policies. Pursuant to Tennessee law, our bank may not, without the prior approval of the Commissioner of the TDFI, pay any dividends to us in a calendar year in excess of the total of our bank's net income for that year plus the retained net income for the preceding two years. For additional information, see "Item 1. Business—Supervision and Regulation—Bank Regulation and Supervision—Payment of Dividends."

The following table shows the dividends that have been declared on our voting and non-voting common stock and preferred stock with respect to the periods indicated below. Per share amounts are presented to the nearest cent.

(dollars in thousands, except share amounts and per share data)	Amount per share	Total cash dividend
2018:		
First quarter	—	—
Second quarter	—	—
Third quarter	0.04	514
Fourth quarter	0.04	730
2019:		
First quarter	0.05	744
Second quarter	0.05	928
Third quarter	0.05	921
Fourth quarter	0.05	913

As of the date of this Report, only shares of our common stock are issued and outstanding.

Subject to the regulatory restrictions noted above and satisfactory financial results, the Company currently expects that comparable cash dividends will continue to be paid in the future. Our ability to pay dividends to our shareholders in the future will depend on regulatory restrictions and our liquidity and capital requirements, as well as our earnings and financial condition, the general economic climate, contractual restrictions, our ability to service any equity or debt obligations senior to our common stock and other factors deemed relevant by our board of directors.

## 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 \$2.1 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 or in connection with the use of IPO proceeds. Keefe, Bruyette & Woods, Inc. and Sandler O'Neill & Partners, L.P. acted as lead book-running managers for the initial public offering. 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. During 2017, the Company provided \$10.0 million of the IPO proceeds as a capital contribution to the Bank for working capital purposes.

## ITEM 6. SELECTED FINANCIAL DATA

(dollars in thousands, except per share data)

### Balance Sheet Data (at period end):

	2019	2018	2017	2016	2015
Total assets	\$ 2,037,201	\$ 1,963,883	\$ 1,344,429	\$ 1,333,675	\$ 1,206,800
Total loans, net of unearned income	1,420,102	1,429,794	947,537	935,251	808,396
Allowance for loan losses	(12,604)	(12,113)	(13,721)	(11,634)	(10,132)
Investment securities	216,442	247,542	196,380	229,219	216,477
Goodwill and core deposit intangible	44,393	46,048	6,242	6,290	6,344
Total deposits	1,729,451	1,570,008	1,119,866	1,128,723	1,038,461
FHLB advances and securities sold under repurchase agreements	10,000	126,509	70,000	55,000	48,755
Shareholders' equity	273,046	254,379	146,946	139,207	108,586

### Income Statement Data:

Interest income	\$ 91,547	\$ 67,781	\$ 51,515	\$ 45,395	\$ 40,504
Interest expense	23,799	16,089	9,652	6,931	5,731
Net interest income	67,748	51,692	41,863	38,464	34,773
Provision for loan losses	761	2,842	12,870	2,829	1,651
Net interest income after provision for loan losses	66,987	48,850	28,993	35,635	33,122
Non-interest income	24,274	15,459	10,908	11,084	8,884
Non-interest expense	61,995	53,487	33,765	33,129	30,977
Net income before income tax expense	29,266	10,822	6,136	13,590	11,029
Income tax expense	6,844	1,167	4,635	4,493	3,470
Net income	22,422	9,655	1,501	9,097	7,559

### Per Share Data:

Net income per share, basic	\$ 1.25	\$ 0.73	\$ 0.13	\$ 0.98	\$ 0.89
Cash dividends declared per share of common and preferred stock	0.20	0.08	-	-	-
Weighted average shares - basic	17,886,164	13,277,614	11,280,580	9,328,236	8,538,970
Net income per share, diluted	\$ 1.20	\$ 0.67	\$ 0.12	\$ 0.81	\$ 0.73
Weighted average shares - diluted	18,613,224	14,480,347	12,803,511	11,212,026	10,381,895
Book value per share of common stock	\$ 14.87	\$ 13.84	\$ 11.91	\$ 11.62	\$ 10.74
Tangible book value per share of common stock (1)	12.45	11.25	11.37	11.06	10.00
Total shares of common stock outstanding	18,361,922	17,724,721	11,582,026	11,204,515	8,577,051
Total shares of preferred stock outstanding	-	878,049	878,049	878,049	1,609,756

### Performance Ratios:

Return on average assets	1.12%	0.63%	0.11%	0.72%	0.66%
Return on average equity	8.49%	5.50%	1.05%	7.57%	7.08%
Net interest margin	3.64%	3.55%	3.25%	3.22%	3.24%
Non-interest income to average assets	1.21%	1.01%	0.80%	0.88%	0.78%
Efficiency ratio	67.37%	79.65%	63.98%	66.86%	70.96%

### Asset Quality Data:

Allowance for loan losses to total loans	0.89%	0.85%	1.45%	1.24%	1.25%
Allowance for loan losses to non-performing loans	861.23%	582.84%	509.08%	321.42%	376.78%
Non-performing assets to total assets	0.12%	0.16%	0.20%	0.27%	0.24%
Net charge-offs to average loans	0.02%	0.39%	1.09%	0.15%	0.38%

### Capital ratios (CapStar Financial Holdings, Inc.):

Total risk based capital	13.45%	12.84%	12.52%	12.60%	11.42%
Tier 1 risk based capital	12.73%	12.13%	11.41%	11.61%	10.41%
Common equity tier 1 capital	12.73%	11.61%	10.70%	10.90%	8.89%
Leverage	11.37%	11.06%	10.77%	10.46%	9.33%

(1) This measure is not recognized under GAAP and is therefore considered to be a non-GAAP measure. See Non-GAAP Financial Measures — Management's Discussion and Analysis of Financial Condition and Results of Operations" for a discussion and reconciliation of this measure to its most comparable GAAP measure.

On October 1, 2018, we completed our acquisition of Athens and Athens Federal. For more information, please see "Item 1.—Business—Overview—Acquisitions". The operations of Athens are included in our financial statements beginning October 1, 2018. The acquisition and incorporation of Athens into our financial statements may materially affect the comparability of the selected financial data provided for fiscal year 2018 as compared to previous years.

## ITEM 7. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion of our financial condition and our results of operations as of and for the years ended December 31, 2019, 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 appearing under the caption “Part II., Item 8—Financial Statements, Supplementary Data and Financial Statement Schedules” in this Report. The following discussion and analysis should be read together with our Consolidated Financial Statements, the notes to our Consolidated Financial Statements and the other financial information included elsewhere in this Report. In addition to historical information, this discussion and analysis contains forward-looking statements that involve risks, uncertainties, estimates and assumptions that could cause actual results to differ materially from our current expectations. Factors that could cause such differences are discussed in the sections entitled “Risk Factors” and “Cautionary Note Regarding Forward-Looking Statements” appearing elsewhere in this Report. 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. Unless specifically noted in this Report, all references in this section to the fiscal years 2017, 2018 and 2019 mean our fiscal years ended December 31, 2017, 2018, and 2019, respectively.

### Overview

We completed 2019 with net income of \$22.4 million, or \$1.20 diluted net income per share, compared to net income of \$9.7 million, or \$0.67 diluted net income per share, for 2018. Average loans for 2019 were \$1.45 billion, a 27.9% increase over 2018, and average deposits for 2019 were \$1.67 billion, a 34.2% increase over 2018. The comparability of our financial condition and performance has been impacted by our acquisition of Athens which we completed in 2018 and the passage of the Tax Cuts and Jobs Act in December 2017, in each case as discussed below.

We acquired Athens on October 1, 2018. On the acquisition date, the fair market value of Athens’ net assets was \$61.6 million, including \$344.8 million in loans and \$404.5 million in deposits. Net income for 2018 was reduced by \$9.8 million of pretax merger related charges related to this acquisition. The Athens acquisition further expanded our franchise into the East Tennessee market.

On December 22, 2017, the Tax Cuts and Jobs Act was signed into law. Among other items, the Tax Cuts and Jobs Act reduced the corporate statutory tax rate from 35% to 21%. As a result of such decrease, we recognized an increase in income tax expense of \$3.56 million in 2017 resulting from the revaluation of our deferred tax assets.

Our primary revenue source is 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 the 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 \$16.0 million, or 31.1%, to \$67.7 million for 2019 compared to \$51.7 million for 2018. The positive effects of increased volumes and yields on earning assets were partially offset by the negative effects of increasing deposit costs. Net interest margin increased to 3.64% for 2019, compared with 3.55% for 2018.

Provision for loan losses was \$0.8 million in 2019 compared to \$2.8 million in 2018, a 73.2% decrease. This decrease was primarily the result of lower charge-offs, which were \$0.8 million in 2019 compared to \$5.0 million in 2018. 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 December 31, 2019 was 0.89% of total loans, compared with 0.85% of total loans at December 31, 2018.

Total noninterest income for 2019 increased \$8.8 million, or 57.0%, to \$24.3 million compared to \$15.5 million for 2018, and comprised 21.0% of total revenues.

Total noninterest expense for 2019 increased \$8.5 million, or 15.9%, to \$62.0 million compared to \$53.5 million for 2018. Our efficiency ratio for 2019 was 67.4% compared to 79.7% for 2018. The significant decrease in efficiency ratio for 2019 is primarily attributable to \$9.8 million of merger related charges included in noninterest expense for 2018, compared to just \$2.7 million in 2019.

The Company's effective tax rate increased to 23.4% for 2019 from 10.8% for 2018. The higher effective tax rate in 2019 compared to 2018 is mainly the result of the nontaxable life insurance death benefit proceeds received in 2018 as well as a larger amount of excess tax benefits related to stock compensation in 2018.

Tangible common equity, a non-GAAP measure, is a measure of a company's capital which is useful in evaluating the quality and adequacy of capital. Our ratio of tangible common equity to total tangible assets was 11.47% as of December 31, 2019, compared with 10.39% at December 31, 2018. See "—Non-GAAP Financial Measures" for a discussion of and reconciliation to the most directly comparable U.S. GAAP measure.

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

### **Critical Accounting Policies and Estimates**

Our Consolidated Financial Statements are prepared based on the application of certain accounting policies, the most significant of which are described in Note 1 to our Consolidated Financial Statements for the year ended December 31, 2019, which are contained elsewhere in this Report. Certain of these policies require numerous estimates and strategic or economic assumptions that may prove inaccurate or subject to variation and may materially and adversely affect our reported results and financial position for the current period or future periods. The use of estimates, assumptions, and judgments are necessary when financial assets and liabilities are required to be recorded at, or adjusted to reflect, fair value. Assets carried at fair value inherently result in more financial statement volatility. Fair values and information used to record valuation adjustments for certain assets and liabilities are either based on quoted market prices or are provided by other independent third-party sources, when available. When such information is not available, management estimates valuation adjustments based upon historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Management evaluates our estimates and assumptions on an ongoing basis. Changes in underlying factors, assumptions or estimates in any of these areas could have a material impact on our future financial condition and results of operations.

We have identified the following accounting policies and estimates that, due to the difficult, subjective or complex judgments and assumptions inherent in those policies and estimates and the potential sensitivity of our financial statements to those judgments and assumptions, are critical to an understanding of our financial condition and results of operations. We believe that the judgments, estimates and assumptions used in the preparation of our financial statements are reasonable and appropriate.

#### **Allowance for Loan Losses**

We record estimated probable inherent credit losses in the loan portfolio as an allowance for loan losses. The methodologies and assumptions for determining the adequacy of the overall allowance for loan losses involve significant judgments to be made by management. Some of the more critical judgments supporting our allowance for loan losses include judgments about the credit-worthiness of borrowers, estimated value of underlying collateral, assumptions about cash flow, determination of loss factors for estimating credit losses, and the impact of current events, conditions, and other factors impacting the level of inherent losses. Under different conditions or using different assumptions, the actual or estimated credit losses ultimately realized by us may be different from our estimates. In determining the allowance, we estimate losses on individual impaired loans and on groups of loans that are not impaired, where the probable loss can be identified and reasonably estimated. On a quarterly basis, we assess the risk inherent in our loan portfolio based on qualitative and quantitative trends in the portfolio, including the internal risk classification of loans, historical loss rates, changes in the nature and volume of the loan portfolio, industry or borrower concentrations, delinquency trends, detailed reviews of significant loans with identified weaknesses, and the impacts of local, regional, and national economic factors on the quality of the loan portfolio. Based on this analysis, we may record a provision for loan losses in order to maintain the allowance at appropriate levels. For a more complete discussion of the methodology employed to calculate the allowance for loan losses, see Note 1 to our Consolidated Financial Statements for the year ended December 31, 2019, which is included elsewhere in this Report.

### Investment Securities Impairment

We assess on a quarterly basis whether there have been any events or economic circumstances to indicate that a security with respect to which there is an unrealized loss is impaired on an other-than-temporary basis. In any instance, we would consider many factors, including the severity and duration of the impairment, our intent and ability to hold the security for a period of time sufficient for a recovery in value, recent events specific to the issuer or industry, and, for debt securities, external credit ratings and recent downgrades. Securities with respect to which there is an unrealized loss that is deemed to be other-than-temporary are written down to fair value.

### Income Taxes

Deferred income tax assets and liabilities are computed using the asset and liability method, which recognizes a liability or asset representing the tax effects, based on current tax law, of future deductible or taxable amounts attributable to events recognized in the financial statements. A valuation allowance may be established to the extent necessary to reduce the deferred tax asset to a level at which it is "more likely than not" that the tax asset or benefit will be realized. Realization of tax benefits depends on having sufficient taxable income, available tax loss carrybacks or credits, the reversal of taxable temporary differences and/or tax planning strategies within the reversal period, and that current tax law allows for the realization of recorded tax benefits.

### Business Combinations

Assets purchased and liabilities assumed in a business combination are recorded at their fair value. The fair value of a loan portfolio acquired in a business combination requires greater levels of management estimates and judgment than the remainder of purchased assets or assumed liabilities. When the loans have evidence of credit deterioration since origination and it is probable at the date of acquisition that the Company will not collect all contractually required principal and interest payments, the loans are considered impaired, and the expected cash flows in excess of the amount paid are recorded as interest income over the remaining life of the loan. The excess of the loan's contractual principal and interest over expected cash flows is not recorded. We must estimate expected cash flows at each reporting date. Subsequent decreases to the expected cash flows will generally result in a provision for loan losses. Subsequent increases in cash flows result in a reversal of the provision for loan losses to the extent of prior charges and adjusted accretible yield which will have a positive impact on interest income. Purchased loans without evidence of credit deterioration are recorded at their initial fair value and adjusted as necessary for subsequent advances, pay downs, amortization or accretion of any premium or discount on purchase, charge-offs and additional provisions that may be required.

### **Results of Operations**

The following is a summary of our results of operations:

	Year ended December 31,		2019-2018 Percent Increase (Decrease)	Year ended December 31,	2018-2017 Percent Increase (Decrease)
	2019	2018		2017	
Interest income	\$ 91,547	\$ 67,781	35.1%	\$ 51,515	31.6%
Interest expense	23,799	16,089	47.9%	9,652	66.7%
Net interest income	67,748	51,692	31.1%	41,863	23.5%
Provision for loan losses	761	2,842	(73.2)%	12,870	(77.9)%
Net interest income after provision for loan losses	66,987	48,850	37.1%	28,993	68.5%
Noninterest income	24,274	15,459	57.0%	10,908	41.7%
Noninterest expense	61,995	53,487	15.9%	33,765	58.4%
Net income before income taxes	29,266	10,822	170.4%	6,136	76.4%
Income tax expense	6,844	1,167	486.5%	4,635	(74.8)%
Net income	\$ 22,422	\$ 9,655	132.2%	\$ 1,501	543.2%
Basic net income per share of common stock	\$ 1.25	\$ 0.73	71.2%	\$ 0.13	461.5%
Diluted net income per share of common stock	\$ 1.20	\$ 0.67	79.1%	\$ 0.12	458.3%

Return on average assets was 1.12%, 0.63% and 0.11% for 2019, 2018 and 2017, respectively.

Return on average shareholders' equity was 8.49%, 5.50% and 1.05% for 2019, 2018 and 2017, respectively.

The following sections provide a more detailed analysis of significant factors affecting our operating results.

### Net Interest Income

The largest component of our net income is net interest income – the difference between the income earned on loans, investment securities and other interest earning assets and interest expense on deposit accounts and other interest bearing liabilities. Net interest income calculated on a tax-equivalent basis 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 table sets 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 years ended December 31, 2019, 2018 and 2017:

	For the Year Ended December 31,								
	2019			2018			2017		
	Average Outstanding Balance	Interest Income/Expense	Average Yield/Rate	Average Outstanding Balance	Interest Income/Expense	Average Yield/Rate	Average Outstanding Balance	Interest Income/Expense	Average Yield/Rate
<b>Interest-Earning Assets</b>									
Loans (1)	\$ 1,451,821	\$ 78,557	5.41%	\$ 1,134,836	\$ 57,962	5.11%	\$ 987,710	\$ 43,531	4.41%
Loans held for sale	100,464	4,271	4.25%	58,250	2,789	4.79%	49,466	2,070	4.19%
Securities:									
Taxable investment securities (2)	176,647	5,374	3.04%	166,287	4,755	2.86%	166,538	4,092	2.46%
Investment securities exempt from federal income tax (3)	52,392	1,438	3.47%	47,270	1,201	3.22%	52,153	1,230	3.63%
Total securities	229,039	6,812	3.14%	213,557	5,956	2.94%	218,691	5,322	2.74%
Cash balances in other banks	87,305	1,881	2.15%	54,454	1,011	1.85%	49,990	551	1.10%
Funds sold	752	26	3.52%	2,483	63	2.55%	2,518	41	1.63%
Total interest-earning assets	1,869,381	91,547	4.92%	1,463,580	67,781	4.65%	1,308,375	51,515	3.99%
Noninterest-earning assets	137,947			65,336			49,419		
Total assets	<u>\$ 2,007,328</u>			<u>\$ 1,528,916</u>			<u>\$ 1,357,794</u>		
<b>Interest-Bearing Liabilities</b>									
Interest bearing deposits:									
Interest-bearing transaction accounts	\$ 499,468	7,538	1.51%	\$ 330,952	4,164	1.26%	\$ 301,411	2,447	0.81%
Savings and money market deposits	494,587	7,266	1.47%	424,052	5,446	1.28%	378,640	3,188	0.84%
Time deposits	361,956	7,542	2.08%	227,760	3,940	1.73%	194,892	2,445	1.25%
Total interest-bearing deposits	1,356,011	22,346	1.65%	982,764	13,550	1.38%	874,943	8,080	0.92%
Borrowings and repurchase agreements	48,629	1,453	2.99%	99,450	2,539	2.55%	98,289	1,572	1.60%
Total interest-bearing liabilities	1,404,640	23,799	1.69%	1,082,214	16,089	1.49%	973,232	9,652	0.99%
Noninterest-bearing deposits	315,031			262,280			232,687		
Total funding sources	1,719,671			1,344,494			1,205,919		
Noninterest-bearing liabilities	23,533			8,736			8,473		
Shareholders' equity	264,124			175,686			143,402		
Total liabilities and shareholders' equity	<u>\$ 2,007,328</u>			<u>\$ 1,528,916</u>			<u>\$ 1,357,794</u>		
Net interest spread (4)			3.22%			3.17%			3.00%
Net interest income/margin (5)		<u>\$ 67,748</u>	3.64%		<u>\$ 51,692</u>	3.55%		<u>\$ 41,863</u>	3.25%

(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 net interest income calculated on a tax equivalent basis divided by total average interest-earning assets.

The following table reflects, for the periods indicated, the changes in our net interest income due to changes in the volume of interest-earning assets and interest-bearing liabilities and the associated rates earned or paid on these assets and liabilities.

	2019 Compared to 2018 Increase (decrease) due to			2018 Compared to 2017 Increase (decrease) due to		
	Volume	Rate	Net	Volume	Rate	Net
<b>Interest-Earning Assets</b>						
Loans	\$ 16,190	\$ 4,405	\$ 20,595	\$ 6,484	\$ 7,947	\$ 14,431
Loans held for sale	2,022	(540)	1,482	368	351	719
Securities:						
Taxable investment securities	296	323	619	(6)	670	664
Investment securities exempt from federal income tax	165	72	237	(115)	85	(30)
Total securities	461	395	856	(121)	755	634
Cash Balances In Other Banks	609	261	870	49	410	459
Funds Sold	(44)	7	(37)	(1)	24	23
Total interest-earning assets	19,238	4,528	23,766	6,779	9,487	16,266
<b>Interest Bearing Liabilities</b>						
Interest-bearing transaction accounts	2,120	1,254	3,374	240	1,477	1,717
Savings and money market deposits	906	914	1,820	382	1,876	2,258
Time deposits	2,321	1,281	3,602	412	1,084	1,496
Borrowings and repurchase agreements	(1,297)	211	(1,086)	19	947	966
Total interest-bearing liabilities	4,050	3,660	7,710	1,053	5,384	6,437
<b>Net Interest Income</b>	<b>\$ 15,188</b>	<b>\$ 868</b>	<b>\$ 16,056</b>	<b>\$ 5,726</b>	<b>\$ 4,103</b>	<b>\$ 9,829</b>

#### 2019 compared to 2018

Our net interest income increased \$16.1 million, or 31.1%, from 2018 to 2019 primarily due to increasing loan volumes and interest rates rising at a faster pace than interest bearing liabilities. Our net interest margin was 3.64% and 3.55% for 2019 and 2018, respectively.

For 2019 and 2018, average loan yields increased from 5.11% to 5.41% 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, as well as realizing a full year of additional interest income related to the acquisition of Athens, including additional interest income as a result of accretable yield. The full year average LIBOR – 1 month interest rate increased from 2.02% in 2018 to 2.23% in 2019. Similarly, the full year average Bank Prime Loan Rate increased from 4.90% in 2018 to 5.28% in 2019. Approximately 55% of our loan portfolio at December 31, 2019 was variable in nature, a significant portion of which is indexed to 1 month LIBOR and the Bank Prime Loan Rate.

Average loans for 2019 increased 27.9% compared to 2018 as a result of the Athens acquisition, adding new bankers in the Nashville MSA and continued focus on attracting new clients.

Average security yields increased from 2.94% to 3.14% for 2018 and 2019, 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 27 basis points for 2019 compared to 2018.

We funded our growth in loans through an increase in funding sources of 27.9% from 2018 to 2019. The primary driver of our increased funding sources was growth in our deposits of 34.2% from 2018 to 2019 which was largely driven by the Athens acquisition. Average non-interest bearing deposits increased 20.1% from 2018 to 2019.



The average rate paid on interest-bearing liabilities was 1.69% for 2019 compared to 1.49% for 2018. The majority of this increase was due to increases in the Fed Funds rate. The full year average Fed Funds rate increased from 1.83% in 2018 to 2.16% in 2019.

#### *2018 compared to 2017*

Our net interest income increased \$9.8 million, or 23.5%, from 2017 to 2018 primarily due to increasing loan volumes and interest rates rising at a faster pace than interest bearing liabilities. Our net interest margin was 3.55% and 3.25% for 2018 and 2017, respectively.

For 2018 and 2017, average loan yields increased from 4.41% to 5.11% 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. From December 31, 2017 to December 31, 2018, the LIBOR – 1 month interest rate increased from 1.56% to 2.50%. Approximately 58% of our loan portfolio at December 31, 2018 was variable in nature and indexed to 1 month LIBOR.

Average loans for 2018 increased 14.9% compared to 2017 as a result of the Athens acquisition, adding new bankers in the Nashville MSA and continued focus on attracting new clients.

Average security yields increased from 2.74% to 2.94% for 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 66 basis points for 2018 compared to 2017.

We funded our growth in loans through an increase in funding sources of 11.5% from 2017 to 2018. The primary driver of our increased funding sources was growth in our deposits of 12.4% from 2017 to 2018 which was largely driven by the Athens acquisition. Average non-interest bearing deposits increased 12.7% from 2017 to 2018.

The average rate paid on interest-bearing liabilities was 1.49% for 2018 compared to 0.99% for 2017. The majority of this increase was due to increases in the Fed Funds rate. The Fed Funds rate increased from 1.33% at December 31, 2017 to 2.40% at December 31, 2018. We passed along 50 basis points of the rate increase to our clients.

#### Provision for Loan losses

Our policy is to maintain an allowance for loan losses at a level sufficient to absorb estimated probable losses inherent in the loan portfolio. The allowance is increased by a provision for loan losses, which is a charge to earnings, and is decreased by charge-offs and increased by loan recoveries. Our allowance for loan losses as a percentage of total loans was 0.89%, 0.85% and 1.45% at December 31, 2019, 2018 and 2017, respectively.

#### *2019 compared to 2018*

The provision for loan losses amounted to \$0.8 million and \$2.8 million for 2019 and 2018, respectively. 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 decreased for 2019 compared to 2018 due to decreased charge-offs. Charge-offs for 2019 were \$0.8 million compared to \$5.0 million for 2018. Of the \$5.0 million in charge offs during 2018, \$4.6 million was attributable to a single borrower.

Our allowance for loan losses as a percentage of total loans increased from 0.85% at December 31, 2018 to 0.89% at December 31, 2019. This increase was largely due to our assessment of risk generally related to macro-economic, geo-political conditions and asset quality. In addition, during 2019, we increased the look-back period, from which we calculate peer bank historical loss experience, from 37 to 41 quarters. Our look-back period is utilized to calculate peer historical loss experience, adjusted for current factors, to comprise the general component of the allowance for loan losses. In the current economic environment, management believes the extension of the look-back period is necessary in order to capture sufficient loss observations to develop a reliable loss estimate of credit losses. The extension of the historical look-back period to capture the historical loss experience of peer banks was applied to all classes and segments of our loan portfolio.

Based upon our evaluation of the loan portfolio, we believe the allowance for loan losses to be adequate to absorb our estimate of probable losses existing in the loan portfolio at December 31, 2019. 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 and negatively impact our asset quality and the adequacy of our allowance for loan losses and, thus, the resulting provision for loan losses.

## 2018 compared to 2017

The provision for loan losses amounted to \$2.8 million and \$12.9 million for 2018 and 2017, respectively.

Provision expense decreased for 2018 compared to 2017 due to decreased charge-offs. Charge-offs for 2018 were \$5.0 million compared to \$12.8 million for 2017. In particular, during the second quarter of 2017, we charged-off the loans associated with one specific borrower as credit quality deteriorated and issues emerged which undermined our assessment that an expedient and positive outcome was possible. This particular charge-off, net of recoveries, amounted to \$9.1 million in the aggregate. These loans experienced weakness due to the borrower's declining financial condition, which led to falling values of the collateral securing these loans. Our primary collateral for these loans was the enterprise value of the borrower as determined by an Asset Purchase Agreement that was subsequently withdrawn. As the financial condition of the borrower deteriorated, ultimate repayment became increasingly difficult. We determined that timely repayment of these loans was unlikely and charged-off the loans.

Our allowance for loan losses as a percentage of total loans decreased from 1.45% at December 31, 2017 to 0.85% at December 31, 2018. This decrease was largely due to the acquired Athens loan portfolio which was accounted for at its fair value as of the acquisition date. A preliminary fair value discount of \$4.8 million was applied to the Athens loan portfolio. In addition, during 2018, we increased the look-back period, from which we calculate peer bank historical loss experience, from 33 to 37 quarters.

## Noninterest Income

In addition to net interest income, we generate recurring noninterest income. Our banking operations generate revenue from service charges and fees on deposit accounts. We have mortgage banking activities that generates revenue from originating and selling mortgages, the origination and sale of commercial real estate loans, 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.

	Year Ended December 31,		2019-2018 Percent Increase (Decrease)	Year Ended December 31,	2018-2017 Percent Increase (Decrease)
	2019	2018		2017	
Noninterest income:					
Treasury management and other deposit service charges	\$ 3,135	\$ 2,150	45.8%	\$ 1,516	41.8%
Net gain (loss) on sale of securities	(99)	3	(3400.0)%	(66)	(104.5)%
Tri-Net fees	2,785	1,503	85.3%	1,002	50.0%
Mortgage banking income	9,467	5,653	67.5%	6,238	(9.4)%
Other noninterest income	8,986	6,150	46.1%	2,218	177.3%
Total noninterest income	<u>\$ 24,274</u>	<u>\$ 15,459</u>	<u>57.0%</u>	<u>\$ 10,908</u>	<u>41.7%</u>

## 2019 compared to 2018

The increase in treasury management and other deposit service charges for 2019 was driven primarily by the incremental increase in transaction volume related to our acquisition of Athens, as well as growth in the volume of our commercial and consumer deposit accounts.

Tri-Net fees, implemented in the fourth quarter of 2016, is derived from the origination and sale of 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 through continued growth and development.

Mortgage banking income consists of mortgage fee income from the origination and sale of mortgage loans. These mortgage fees are for loans originated in our markets that are subsequently sold to third-party investors. Mortgage origination fees will fluctuate from quarter to quarter as the rate environment changes. Mortgage banking income increased 67.5% from 2018 to 2019 primarily due to a significantly higher volume of originations. Additionally, during the second quarter of 2019, we implemented a hedging program for residential mortgage loans originated with the intent to sell. In connection with this program, we elected the fair value option for this portfolio. The fair value adjustments for applicable loans held for sale and related derivative instruments at December 31, 2019 resulted in a \$1.1 million increase to mortgage banking income for 2019 when compared to 2018.

Other noninterest income primarily consists of loan related fees, interchange income and wealth management income. The increase of \$2.8 million from 2018 to 2019 was primarily due to organic growth and our acquisition of Athens.

#### *2018 compared to 2017*

The increase in treasury management and other deposit service charges for 2018 and 2017 was driven primarily our acquisition of Athens and by transaction volume, which can fluctuate throughout and from year to year. Growth in the volume of our commercial and consumer deposit accounts was the primary contributor to the increase.

Tri-Net fees has steadily increased since it was implemented.

Mortgage banking income decreased 9.4% from 2017 to 2018 due to a lower volume of originations.

The increase in other noninterest income of \$3.9 million from 2017 to 2018 was primarily due to \$2.0 million in non-taxable life insurance death benefit proceeds recognized in 2018 and our acquisition of Athens.

#### 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.

	Year Ended December 31,		2019-2018 Percent Increase (Decrease)	Year Ended December 31,	2018-2017 Percent Increase (Decrease)
	2019	2018		2017	
Noninterest expense:					
Salaries and employee benefits	\$ 35,542	\$ 28,586	24.3%	\$ 20,400	40.1%
Data processing and software	6,961	3,835	81.5%	2,786	37.7%
Professional fees	2,102	1,608	30.7%	1,522	5.7%
Occupancy	3,345	2,336	43.2%	2,025	15.4%
Equipment	3,723	2,471	50.7%	2,071	19.3%
Regulatory fees	591	1,028	(42.5)%	1,111	(7.5)%
Merger related expenses	2,654	9,803	100.0%	—	—
Amortization of intangibles	1,655	465	255.9%	48	868.8%
Other operating	5,422	3,355	61.6%	3,802	(11.8)%
Total noninterest expense	<u>\$ 61,995</u>	<u>\$ 53,487</u>	<u>15.9%</u>	<u>\$ 33,765</u>	<u>58.4%</u>

#### *2019 compared to 2018*

The increase in salaries and employee benefits was driven primarily by the incremental increase in compensation costs related to our acquisition of Athens and 2019 being the first full year of Athens' related compensation costs being recognized. At December 31, 2019, our associate base had slightly decreased to 289 compared to 295 at December 31, 2018.

Data processing and software expense increased from 2018 to 2019 primarily due to an increase in the volume of transactions from organic growth, costs associated with running dual systems related to our acquisition of Athens and insourcing certain IT related functions. The Athens related systems conversion was successfully completed during the second quarter of 2019.

The increase in occupancy and equipment expense from 2018 to 2019 was largely attributable to increased depreciation and other facilities related expenses associated with our acquisition of Athens as well as the increasing cost of managing our IT network.

Amortization of intangibles increased from 2018 to 2019 due to the new core deposit intangible recorded in connection with the Athens acquisition.

Our efficiency ratio was 67.4% and 79.7% for 2019 and 2018, respectively. The efficiency ratio is the ratio of noninterest expense to the sum of net interest income and noninterest income and measures the amount of expense that is incurred to generate a dollar of revenue. As expected, the efficiency ratio improved in 2019 due to the majority of the non-recurring merger expenses incurred in 2018.

#### *2018 compared to 2017*

The increase in salaries and employee benefits was primarily the result of an increase in the number of employees in 2018 over 2017. At December 31, 2018, our associate base had expanded to 295 compared to 175 at December 31, 2017. Included in salaries and benefits are stock compensation and cash incentives, which increased over the prior year by approximately \$3.8 million due to retention of key employees and improved financial performance of the Company.

Data processing and software expense increased from 2017 to 2018 primarily due to an increase in the volume of transactions from organic growth and costs associated with running dual systems related to our acquisition of Athens. We expect the Athens related systems conversion to occur during the second quarter of 2019.

The increase in equipment expense from 2017 to 2018 was related to the increasing cost of managing our IT network.

Merger related expenses relate to our acquisition of Athens. Amortization of intangibles increased from 2017 to 2018 due to the new core deposit intangible recorded in connection with the Athens acquisition.

Our efficiency ratio was 79.7% and 64.0% for 2018 and 2017, respectively. The efficiency ratio was negatively impacted by merger expenses in 2018.

#### *Income Taxes*

##### *2019 compared to 2018*

We recorded income tax expense of \$6.8 million and \$1.2 million in 2019 and 2018, respectively. Our effective income tax rate for 2019 and 2018 was 23.4% and 10.8%, respectively. 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. The higher effective tax rate in 2019 compared to 2018 is mainly the result of the nontaxable life insurance death benefit proceeds received in 2018 as well as a larger amount of excess tax benefits related to stock compensation in 2018.

##### *2018 compared to 2017*

We recorded income tax expense of \$1.2 million and \$4.6 million in 2018 and 2017, respectively. Our effective income tax rate for 2018 and 2017 was 10.8% and 75.5%, respectively. 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 and the 2017 tax law change. During 2018, the Company received \$2.0 million in nontaxable life insurance death benefit proceeds resulting in a lower effective tax rate for 2018 compared to 2017.

On December 22, 2017, 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 U.S. federal tax rate for corporations was reduced from 35% to 21%, for U.S. taxable income and requires a one-time re-measurement of deferred taxes to reflect their value at a lower tax rate of 21%. Accordingly, the Company re-measured its deferred tax assets based on the rates at which they are expected to reverse in the future, which is generally 21%. As a result of the reduction in the corporate income tax rate, the Company is required to revalue its net deferred tax assets to account for the future impact of lower corporate tax rates on this deferred amount and record any change in the value of such assets as a one-time, non-cash charge on its income statement.

As a result of the Tax Reform Act, we recorded a \$3.6 million increase in income tax expense for 2017. If we were to adjust this \$3.6 million write-down out of income tax expense, our adjusted effective tax rate for 2017 would have been 17.5%.

## **Financial Condition**

### *2019 compared to 2018*

Total assets increased \$73.3 million, or 3.7%, from December 31, 2018 to December 31, 2019. Loans decreased from \$1.430 billion at December 31, 2018 to \$1.420 billion at December 31, 2019, a 0.7% decrease. Loans held for sale increased \$110.6 million, or 192.0%, during 2019 which is primarily related to transaction volume of selling residential and commercial real estate loans as a result of continued strong growth. Securities decreased \$31.1 million, or 12.6%.

Total liabilities increased \$54.7 million, or 3.2%, from December 31, 2018 to December 31, 2019. Deposits increased from \$1.570 billion at December 31, 2018 to \$1.729 billion at December 31, 2019, a 10.2% increase. We paid down our Federal Home Loan Bank advances \$115.0 million, or 92.0%, from December 31, 2018 to December 31, 2019 as we were able to rely more on deposit funding.

### *2018 compared to 2017*

Total assets increased \$619.5 million, or 46.1%, from December 31, 2017 to December 31, 2018. Loans grew from \$947.5 million at December 31, 2017 to \$1.430 billion at December 31, 2018, a 50.9% increase. Loans held for sale decreased \$16.5 million, or 22.2%, during 2018 which is primarily related to the timing of selling residential and commercial real estate loans. Securities increased \$51.2 million, or 26.1%. Included in these changes is growth from our acquisition of Athens which included \$473.0 million in total assets, primarily made up of \$344.8 million in loans and \$67.4 million in securities.

Total liabilities increased \$512.0 million, or 42.8%, from December 31, 2017 to December 31, 2018. Deposits increased from \$1.120 billion at December 31, 2017 to \$1.570 billion at December 31, 2018, a 40.2% increase. We increased our Federal Home Loan Bank advances \$55.0 million, or 78.6%, from December 31, 2017 to December 31, 2018 to help fund loan growth. Total liabilities and deposits from our Athens acquisition were \$411.4 million and \$404.5 million, respectively.

### Investment Securities

The primary purpose of our investment portfolio is to provide another source of interest income, as well as liquidity management. In managing the composition of the balance sheet, we seek a balance between earnings sources and credit and liquidity considerations. We manage our investment portfolio according to a written investment policy approved by our board of directors. Balances in our investment portfolio are subject to change over time based on our funding needs and interest rate risk management objectives. Our liquidity levels take into account anticipated future cash flows and all available sources of credit, and are maintained at levels we believe are appropriate to assure future flexibility in meeting our anticipated funding needs.

Our investment portfolio consists primarily of securities issued by U.S. government-sponsored agencies, obligations of states and political subdivisions, mortgage-backed securities, asset-backed securities and other debt securities, all with varying contractual maturities. However, these maturities do not necessarily represent the expected life of the securities as some of these securities may be called or paid down without penalty prior to their stated maturities. The investment portfolio is regularly reviewed by the Asset Liability Management committee, or ALCO, of the bank to ensure an appropriate risk and return profile as well as for adherence to the investment policy.

Our investment portfolio totaled \$216.4 million, \$247.5 million, and \$196.4 million at December 31, 2019, 2018 and 2017, respectively. Excluding investment securities acquired in our acquisition of Athens, our investment portfolio has trended down over the past several years as we have redeployed these funds into higher-earning loans. See “Note 3 to our Consolidated Financial Statements” for additional information on our investment securities.

The following table presents the fair value of our securities as of December 31, 2019 by their stated maturities (this maturity schedule excludes security prepayment and call features), as well as the weighted average yields for each maturity range.

	Due in one year or less		Due in one year to five years		Due in five years to ten years		Due after ten years	
	Fair Value	Weighted Average Yield	Fair Value	Weighted Average Yield	Fair Value	Weighted Average Yield	Fair Value	Weighted Average Yield
Securities available for sale:								
U. S. government agency securities	\$ 2,000	2.3%	\$ —	0.0%	\$ 7,170	2.3%	\$ 1,161	2.6%
State and municipal securities	6,898	3.6%	21,071	3.3%	17,796	4.1%	195	2.8%
Mortgage-backed securities	614	1.0%	87,949	2.6%	33,861	3.2%	16,255	2.8%
Asset-backed securities	—	0.0%	—	0.0%	3,197	2.6%	—	
Other debt securities	1,010	5.2%	8,159	5.0%	5,793	4.3%	—	
Total securities available for sale	<u>\$ 10,522</u>	<u>3.4%</u>	<u>\$ 117,179</u>	<u>2.9%</u>	<u>\$ 67,817</u>	<u>3.4%</u>	<u>\$ 17,611</u>	<u>2.8%</u>
Securities held to maturity:								
State and municipal securities	\$ 884	2.4%	\$ 2,527	3.2%	\$ —	0.0%	\$ —	0.0%
Total securities held to maturity	<u>\$ 884</u>	<u>2.4%</u>	<u>\$ 2,527</u>	<u>3.2%</u>	<u>\$ —</u>	<u>0.0%</u>	<u>\$ —</u>	<u>0.0%</u>

### Loans and Leases

Loans and leases are our largest category of earning assets and typically provide higher yields than other types of earning assets. Associated with the higher loan yields are the inherent credit and liquidity risks that we attempt to control and counterbalance.

The composition of gross loans and leases at December 31 for each of the past five years and the percentage of each classification to total loans are summarized as follows:

	December 31, 2019		December 31, 2018		December 31, 2017		December 31, 2016		December 31, 2015	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Commercial real estate - owner occupied	\$ 172,456	12.1%	\$ 141,864	9.9%	\$ 101,132	10.7%	\$ 106,735	11.4%	\$ 108,132	13.4%
Commercial real estate - non-owner occupied	387,443	27.3%	408,582	28.6%	249,490	26.3%	195,587	20.9%	143,065	17.7%
Consumer real estate	256,097	18.0%	253,562	17.7%	102,581	10.8%	97,015	10.4%	93,785	11.6%
Construction and land development	143,111	10.1%	174,670	12.2%	82,586	8.7%	94,491	10.1%	52,522	6.5%
Commercial and industrial	394,408	27.8%	404,600	28.3%	373,248	39.4%	379,620	40.6%	353,442	43.7%
Consumer	28,426	2.0%	25,615	1.8%	6,862	0.7%	5,974	0.6%	8,668	1.1%
Other	38,161	2.7%	20,901	1.5%	31,638	3.3%	55,829	6.0%	48,782	6.0%
Total gross loans and leases	<u>\$ 1,420,102</u>	<u>100.0%</u>	<u>\$ 1,429,794</u>	<u>100.0%</u>	<u>\$ 947,537</u>	<u>100.0%</u>	<u>\$ 935,251</u>	<u>100.0%</u>	<u>\$ 808,396</u>	<u>100.0%</u>

Over the past five years, we have experienced significant growth in our loan portfolio. During 2015 and continuing through 2019, we recognized growth in the commercial real estate loan classifications reflecting the development of the Target Market in which we operate. The acquisition of Athens increased all loan classifications and provided further diversity in our loan portfolio through more consumer oriented loan products.

Our primary focus has been on commercial and industrial and commercial real estate lending, which constituted 56% of our loan portfolio as of December 31, 2019. Although we expect continued growth with respect to our loan portfolio, we do not expect any significant changes over the foreseeable future in the composition of our loan portfolio or in our emphasis on commercial lending. Our loan growth since inception has been reflective of the Target Market in which we serve. The commercial real estate category includes owner-occupied commercial real estate 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 affiliated business rather than on the valuation and cash flows of the real estate from unaffiliated tenants. Since 2009, our commercial and industrial and commercial real estate portfolios have continued to experience strong growth, primarily due to implementation of our relationship-based banking model and the success of our relationship managers in transitioning commercial banking relationships from other local financial institutions and in competing for new business from attractive small to mid-sized commercial clients. Many of our larger commercial clients have lengthy relationships with members of our senior management team or our relationship managers that date back to their employment by other financial institutions.

The repayment of loans is a source of additional liquidity for us. The following table details maturities and sensitivity to interest rate changes for our loan portfolio at December 31, 2019.

	December 31, 2019			
	Due in 1 year or less	Due in 1-5 years	Due after 5 years	Total
Commercial real estate	\$ 47,648	\$ 361,295	\$ 150,956	\$ 559,899
Consumer real estate	12,443	36,332	207,322	256,097
Construction and land development	37,175	64,182	41,754	143,111
Commercial and industrial	113,032	233,402	47,974	394,408
Consumer	10,856	17,074	496	28,426
Other	5,343	25,553	7,265	38,161
Total gross loans	<u>\$ 226,497</u>	<u>\$ 737,838</u>	<u>\$ 455,767</u>	<u>\$ 1,420,102</u>
<b>Interest rate sensitivity</b>				
Fixed interest rates	39,789	408,017	186,967	634,773
Floating or adjustable interest rates	186,708	329,821	268,800	785,329
Total gross loans	<u>\$ 226,497</u>	<u>\$ 737,838</u>	<u>\$ 455,767</u>	<u>\$ 1,420,102</u>

The information presented in the table above is based upon the contractual maturities of the individual loans, which may be subject to renewal at their contractual maturity. Renewal of such loans is subject to review and credit approval, as well as modification of terms at their maturity. Consequently, we believe that this treatment presents fairly the maturity structure of the loan portfolio.

#### Asset Quality

One of our key objectives is to maintain a high level of asset quality in our loan portfolio. We utilize disciplined and thorough underwriting processes that collaboratively engage our seasoned and experienced business bankers, credit underwriters and portfolio managers in the analysis of each loan request. Based upon our aggregate exposure to any given borrower relationship, we employ scaled review of loan originations that may involve senior credit officers, our Chief Credit Officer, our bank's Credit Committee or, ultimately, our full board of directors. In addition, we have adopted underwriting guidelines to be followed by our lending officers that require senior management review of proposed extensions of credit exceeding certain thresholds. When delinquencies exist, we monitor the levels of such delinquencies for any negative or adverse trends. Our loan review procedures include approval of lending policies and underwriting guidelines by the board of directors of our bank, an independent loan review, approval of larger credit relationships by our bank's Credit Committee and loan quality documentation procedures. Like other financial institutions, we are subject to the risk that our loan portfolio will be subject to increasing pressures from deteriorating borrower credit due to general economic conditions.

We target small and medium sized businesses, the owners and operators of such businesses and other consumers and high net worth individuals as loan clients. Because of their size, these borrowers may be less able to withstand competitive or economic pressures than larger borrowers in periods of economic weakness. If loan losses occur at a level where the allowance for loan losses is not sufficient to cover actual loan losses, our earnings will decrease. We use an independent consulting firm to review our loans for quality in addition to the reviews that may be conducted internally and by bank regulatory agencies as part of their examination process. Our bank has procedures and processes in place intended to assess whether losses exceed the potential amounts documented in our bank's impairment analyses and to reduce potential losses in the remaining performing loans within our loan portfolio. These procedures and processes include the following:

- we monitor the past due and overdraft reports on a weekly basis to identify deterioration as early as possible and the placement of identified loans on the watch list;
- we perform quarterly credit reviews for all watch list/classified loans, including formulation of action plans. When a workout is not achievable, we move to collection/foreclosure proceedings to obtain control of the underlying collateral as rapidly as possible to minimize the deterioration of collateral and/or the loss of its value;
- we require updated financial information, global inventory aging and interest carry analysis where appropriate for existing borrowers to help identify potential future loan payment problems; and
- we generally limit loans for new construction to established builders and developers that have an established record of turning their inventories, and we restrict our funding of undeveloped lots and land.

Our bank 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. Our bank analyzes loans individually by classifying each loan as to credit risk. This analysis includes all commercial loans and consumer relationships with an outstanding balance greater than \$500,000, individually. This analysis is performed on a regular basis by the relationship managers and credit department personnel. On at least a semi-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 risk rating of each loan in the sample. See "Note 4 to our Consolidated Financial Statements" for a table that provides the risk category of loans by applicable class of loans.

#### Non-Performing Loans and Assets

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

	December 31,				
	2019	2018	2017	2016	2015
Non-accrual loans	\$ 1,464	\$ 2,078	\$ 2,695	\$ 3,619	\$ 2,689
Troubled debt restructurings	2,717	1,391	1,206	1,272	125
Loans past due greater than 89 days and still accruing	38	214	231	—	—
Non-performing loans	1,464	2,078	2,695	3,619	2,689
Foreclosed real estate	1,044	988	—	—	216
Non-performing assets	\$ 2,508	\$ 3,066	\$ 2,695	\$ 3,619	\$ 2,905
Non-performing loans as a percentage of total loans	0.10%	0.15%	0.28%	0.39%	0.33%
Non-performing assets as a percentage of total assets	0.12%	0.16%	0.20%	0.27%	0.24%



The balance of non-performing assets can fluctuate due to changes in economic conditions. We have established a policy to discontinue accruing interest on loans (that is, place the loans on non-accrual status) after they have become 90 days delinquent as to payment of principal or interest, unless the loans are considered to be well-collateralized and are in the process of collection. Consumer loans and any accrued interest are typically charged off no later than 180 days past due. In addition, a loan will not be placed on non-accrual status before it becomes 90 days delinquent unless management believes that the collection of all principal and interest is not expected in a timely manner. Interest previously accrued but uncollected on such loans is reversed and charged against interest income when the receivable is determined to be uncollectible. If we believe that a loan will not be collected in full, we will increase the allowance for loan losses to reflect management's estimate of any potential exposure or loss. Generally, payments received on non-accrual loans are applied directly to principal. As of December 31, 2019, there were not any loans, outside of those included in the table above, that cause management to have serious doubts as to the ability of borrowers to comply with present repayment terms.

Due to the weakening credit status of a borrower, we may elect to formally restructure certain loans to facilitate a repayment plan that seeks to minimize the potential losses, if any, that we might incur. The effect of these changes is assessed to determine if the loan should be classified as a Troubled Debt Restructure. Loans that have been restructured that are on non-accruing status as of the date of restructuring, are included in the nonperforming loan balances as discussed above and are classified as impaired loans. Loans that have been restructured that are on accrual status as of the restructure date are not included in nonperforming loans; however, such loans are still considered impaired.

#### Allowance for Loan Losses (allowance).

Our allowance for loan losses represents our estimate of probable inherent credit losses in the loan portfolio. We determine the allowance based on an ongoing evaluation of risk as it correlates to potential losses within the portfolio. Increases in the allowance are made by charges to the provision for loan losses. Loans deemed to be uncollectible are charged against the allowance. Recoveries of previously charged-off amounts are credited to our allowance. The judgments and estimates associated with our allowance determination are described under "Critical Accounting Policies and Estimates" above and in Notes 1 and 4 to the "Notes to Consolidated Financial Statements."

The following table presents a summary of changes in the allowance for loan losses for the periods and dates indicated.

	Year ended December 31,				
	2019	2018	2017	2016	2015
Total loans outstanding, net of unearned income	\$ 1,420,102	\$ 1,429,794	\$ 947,537	\$ 935,251	\$ 808,396
Average loans outstanding, net of unearned income	1,451,821	1,134,836	987,710	888,541	744,151
Allowance for loan and lease losses at beginning of period	12,113	13,721	11,634	10,132	11,282
Charge-offs:					
Commercial real estate	—	—	—	350	—
Consumer real estate	39	—	—	—	173
Construction and land development	—	—	—	—	—
Commercial and industrial	455	4,831	12,769	956	3,033
Consumer	164	84	—	146	—
Other	140	39	—	—	—
Total charge-offs	798	4,954	12,769	1,452	3,206
Recoveries:					
Commercial real estate	23	22	9	52	31
Consumer real estate	20	4	—	—	68
Construction and land development	—	—	—	—	—
Commercial and industrial	380	395	1,865	23	299
Consumer	82	75	112	50	7
Other	23	8	—	—	—
Total recoveries	528	504	1,986	125	405
Net charge-offs	270	4,450	10,783	1,327	2,801
Provision for loan and lease losses	761	2,842	12,870	2,829	1,651
Allowance for loan and lease losses at period end	\$ 12,604	\$ 12,113	\$ 13,721	\$ 11,634	\$ 10,132
Allowance for loan and lease losses to period end loans	0.89%	0.85%	1.45%	1.24%	1.25%
Net charge-offs to average loans	0.02%	0.39%	1.09%	0.15%	0.38%

See “Provision for Loan losses” above for discussion of the changes in the provision for loan losses.

While no portion of our allowance is in any way restricted to any individual loan or group of loans and the entire allowance is available to absorb losses from any and all loans, the following tables represent management’s allocation of our allowance to specific loan categories for the periods indicated.

	December 31, 2019		December 31, 2018		December 31, 2017		December 31, 2016		December 31, 2015	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Commercial real estate	\$ 3,599	28.6%	\$ 3,309	27.3%	\$ 3,324	24.2%	\$ 2,655	22.8%	\$ 2,879	28.4%
Consumer real estate	1,231	9.8%	1,005	8.3%	1,063	7.7%	1,013	8.7%	968	9.6%
Construction and land development	2,058	16.3%	2,431	20.1%	1,628	11.9%	1,574	13.5%	914	9.0%
Commercial and industrial	5,074	40.3%	5,036	41.6%	7,209	52.5%	5,618	48.3%	4,693	46.3%
Consumer	222	1.8%	105	0.9%	91	0.7%	76	0.7%	103	1.0%
Other	420	3.3%	227	1.9%	406	3.0%	698	6.0%	575	5.7%
Total allowance for loan and lease losses	<u>\$ 12,604</u>	<u>100.0%</u>	<u>\$ 12,113</u>	<u>100.0%</u>	<u>\$ 13,721</u>	<u>100.0%</u>	<u>\$ 11,634</u>	<u>100.0%</u>	<u>\$ 10,132</u>	<u>100.0%</u>

Changes in the allocation of the allowance from year to year in various categories are influenced by the level of net charge-offs in respective categories and other factors including, but not limited to, an evaluation of the impact of current economic conditions and trends, risk allocations tied to specific loans or groups of loans and changes in qualitative allocations. Management believes that allocations for each loan category are reasonable and reflective of risk inherent in the portfolio.

### Deposits

Client deposits are the primary funding source for our loan growth. The following table presents the average balance and average rate paid on deposits for each of the following categories for the periods indicated.

	Year ended December 31,					
	2019		2018		2017	
	Average Balance	Average Rate Paid	Average Balance	Average Rate Paid	Average Balance	Average Rate Paid
Types of Deposits:						
Noninterest-bearing demand deposits	\$ 315,031	0.00%	\$ 262,280	0.00%	\$ 232,687	0.00%
Interest-bearing demand deposits	499,468	1.51%	330,952	1.26%	301,411	0.81%
Money market accounts	444,685	1.62%	409,055	1.33%	375,688	0.85%
Savings accounts	49,902	0.08%	14,997	0.09%	2,952	0.15%
Time deposits, \$100,000 and over	267,509	2.21%	177,366	1.76%	155,788	1.13%
Time deposits, less than \$100,000	94,447	1.72%	50,395	1.63%	39,104	1.76%
Total deposits	<u>\$ 1,671,042</u>	<u>1.34%</u>	<u>\$ 1,245,045</u>	<u>1.09%</u>	<u>\$ 1,107,630</u>	<u>0.73%</u>

Total average deposits increased 34.2% in 2019 compared to 2018 and increased 12.4% in 2018 compared to 2017. Much of the growth in deposits in 2018 is related to our acquisition of Athens. However, we have been able to increase average noninterest-bearing demand deposits each year as we focus on building and expanding client relationships. The Target Market is a competitive market for deposits and we experienced some run-off in rate sensitive deposits during 2018 and 2019.

The following table presents the maturities of our certificates of deposit as of December 31, 2019.

	December 31, 2019				
	Three months or less	Over three through six months	Over six through twelve months	Over twelve months	Total
\$100,000 or more	\$ 64,132	\$ 34,462	\$ 76,885	\$ 54,543	\$ 230,022
Less than \$100,000	14,728	11,410	20,546	26,746	73,430
Total	<u>\$ 78,860</u>	<u>\$ 45,872</u>	<u>\$ 97,431</u>	<u>\$ 81,289</u>	<u>\$ 303,452</u>

### Capital Adequacy

As of December 31, 2019, CapStar Financial's capital ratios were as follows.

	Well Capitalized Guidelines	December 31, 2019
Total risk-based capital	10.0%	13.5%
Tier 1 risk-based capital	8.0%	12.7%
Common equity tier 1 capital	6.5%	12.7%
Tier 1 leverage	5.0%	11.4%

See Note 15 to the "Notes to Consolidated Financial Statements" for additional information related to our capital position.

### **Market and Liquidity Risk Management**

Our objective is to manage assets and liabilities to provide a satisfactory, consistent level of profitability within the framework of our established liquidity, loan, investment, borrowing, and capital policies. Our ALCO is charged with the responsibility of monitoring these policies, which are designed to ensure an acceptable composition of asset/liability mix. Two critical areas of focus for ALCO are interest rate sensitivity and liquidity risk management.

### Interest Rate Simulation Sensitivity Analysis

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.

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 products, 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 December 31, 2019, 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 and an unfavorable impact to net interest income when market interest rates decline. 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.

	<u>Net interest income change</u>
Increase 200bp	1.9%
Increase 100bp	1.0
Decrease 100bp	(4.1)
Decrease 200bp	(8.3)

#### Liquidity Risk Management

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 optimizing financial results within our corporate guidelines. 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 \$213.1 million at December 31, 2019. We pledge portions of our investment securities portfolio to secure public fund deposits, derivative positions and Federal Home Loan Bank ("FHLB") advances. At December 31, 2019, total investment securities pledged for these purposes comprised 32% of the estimated fair value of the entire investment portfolio, leaving \$146.2 million of unpledged securities.

We have a large base of non-maturity customer deposits, defined as demand, savings, and money market deposit accounts. At December 31, 2019, such deposits totaled \$1.4 billion 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 December 31, 2019, available credit from the FHLB totaled \$201.4 million. Additionally, we had available federal funds purchased lines with correspondent banks totaling \$107.5 million at December 31, 2019.

The principal source of cash for CapStar Financial is dividends paid to it as the sole shareholder of the Bank. At December 31, 2019, the Bank was able to pay up to \$35.8 million in dividends to CapStar Financial 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.

### Contractual Obligations

The following table presents additional information about contractual obligations as of December 31, 2019, which by their terms have contractual maturity and termination dates subsequent to December 31, 2019.

Contractual Obligations:	Due in 1 year or less	Due after 1 through 3 years	Due after 3 through 5 years	Due after 5 years	Total
FHLB advances	\$ 10,000	\$ —	\$ —	\$ —	\$ 10,000
Certificates of deposits \$100,000 or more	175,479	47,382	6,560	601	230,022
Certificates of deposits less than \$100,000	46,684	21,950	4,784	12	73,430
Lease liabilities	1,562	3,066	2,555	7,710	14,893
Total	<u>\$ 233,725</u>	<u>\$ 72,398</u>	<u>\$ 13,899</u>	<u>\$ 8,323</u>	<u>\$ 328,345</u>

### Borrowings

The following table outlines our sources of short-term borrowed funds during the year ended December 31, 2019, and the amount outstanding at the end of each period, the maximum amount, average amount and average interest rate that we paid for each borrowing source during the period. The maximum month end balance represents the high indebtedness of borrowed funds at any time during each of the periods shown. Stated period end rates are contractual rates.

	As of or for the year ended December 31, 2019				
	Ending balance	Stated period end rate	Maximum month end balance	Average for the period	
				Balance	Rate
Short-term borrowed funds:					
Short-term FHLB advances	<u>\$ 10,000</u>	<u>2.05%</u>	<u>\$ 170,000</u>	<u>\$ 49,000</u>	<u>2.45%</u>

### 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 sheets. 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 the following table for the periods indicated.

	Contract or notional amount		
	December 31, 2019	December 31, 2018	December 31, 2017
Financial instruments whose contract amounts represent credit risk:			
Unused commitments to extend credit	\$ 672,933	\$ 707,675	\$ 584,494
Standby letters of credit	9,634	12,273	11,552
Total	<u>\$ 682,567</u>	<u>\$ 719,948</u>	<u>\$ 596,046</u>

### 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 book value per share of common stock to the most directly comparable GAAP financial measures.

	December 31, 2019	December 31, 2018	December 31, 2017	December 31, 2016	December 31, 2015
Total equity	\$ 273,046	\$ 254,379	\$ 146,946	\$ 139,207	\$ 108,586
Less core deposit intangible	(6,883)	(8,538)	(23)	(71)	(125)
Less goodwill	(37,510)	(37,510)	(6,219)	(6,219)	(6,219)
Less preferred equity	—	(9,000)	(9,000)	(9,000)	(16,500)
Tangible common equity	<u>\$ 228,653</u>	<u>\$ 199,331</u>	<u>\$ 131,704</u>	<u>\$ 123,917</u>	<u>\$ 85,742</u>
Total assets	\$ 2,037,201	\$ 1,963,883	\$ 1,344,429	\$ 1,333,675	\$ 1,206,800
Less core deposit intangible	(6,883)	(8,538)	(23)	(71)	(125)
Less goodwill	(37,510)	(37,510)	(6,219)	(6,219)	(6,219)
Total tangible assets	<u>\$ 1,992,808</u>	<u>\$ 1,917,835</u>	<u>\$ 1,338,187</u>	<u>\$ 1,327,385</u>	<u>\$ 1,200,456</u>
Total shareholders' equity to total assets	13.40%	12.95%	10.93%	10.44%	9.00%
Tangible common equity ratio	11.47%	10.39%	9.84%	9.34%	7.14%
Total shares of common stock outstanding	18,361,922	17,724,721	11,582,026	11,204,515	8,577,051
Book value per share of common stock	\$ 14.87	\$ 13.84	\$ 11.91	\$ 11.62	\$ 10.74
Tangible book value per share of common stock	12.45	11.25	11.37	11.06	10.00

**Recently Issued Accounting Pronouncements**

Recently issued accounting pronouncements are discussed in Note 1 to the “Notes to Consolidated Financial Statements” in this Report.

**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 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Information required by this item is included in Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Market and Liquidity Risk Management – Interest Rate Simulation Sensitivity Analysis” and is incorporated herein by reference.

ITEM 8. FINANCIAL STATEMENTS, SUPPLEMENTARY DATA AND FINANCIAL STATEMENT SCHEDULES

INDEX TO FINANCIAL STATEMENTS

	<u>Page(s)</u>
<a href="#">Report of Independent Registered Public Accounting Firm</a>	61
Consolidated Financial Statements:	
<a href="#">Consolidated Balance Sheets</a>	62
<a href="#">Consolidated Statements of Income</a>	63
<a href="#">Consolidated Statements of Comprehensive Income</a>	64
<a href="#">Consolidated Statements of Changes in Shareholders' Equity</a>	65
<a href="#">Consolidated Statements of Cash Flows</a>	66
<a href="#">Notes to Consolidated Financial Statements</a>	67



## Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of CapStar Financial Holdings, Inc.:

### Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of CapStar Financial Holdings, Inc. and its subsidiary (the “Company”) as of December 31, 2019 and 2018, and the related consolidated statements of income, comprehensive income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2019, and the related notes to the consolidated financial statements and schedules (collectively, the “consolidated financial statements”). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2019 and 2018, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2019, in conformity with accounting principles generally accepted in the United States of America.

### Basis for Opinion

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

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting under PCAOB standards. As part of our audits we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Elliott Davis, LLC

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

Franklin, Tennessee  
March 6, 2020

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

	December 31, 2019	December 31, 2018
<b>Assets</b>		
Cash and due from banks	\$ 17,726	\$ 17,967
Interest-bearing deposits in financial institutions	83,368	76,714
Federal funds sold	175	10,762
Total cash and cash equivalents	101,269	105,443
Securities available-for-sale, at fair value	213,129	243,808
Securities held-to-maturity, fair value of \$3,411 and \$3,785 at December 31, 2019 and 2018, respectively	3,313	3,734
Loans held for sale (includes \$30,740 and \$0 measured at fair value at December 31, 2019 and 2018, respectively)	168,222	57,618
Loans	1,420,102	1,429,794
Less allowance for loan losses	(12,604)	(12,113)
Loans, net	1,407,498	1,417,681
Premises and equipment, net	19,184	18,821
Restricted equity securities	13,689	12,038
Accrued interest receivable	5,792	5,964
Goodwill	37,510	37,510
Core deposit intangible, net	6,883	8,538
Other real estate owned, net	1,044	988
Other assets	59,668	51,740
Total assets	\$ 2,037,201	\$ 1,963,883
<b>Liabilities and Shareholders' Equity</b>		
Deposits:		
Non-interest-bearing	\$ 312,096	\$ 289,552
Interest-bearing	607,211	434,921
Savings and money market accounts	506,692	497,108
Time	303,452	348,427
Total deposits	1,729,451	1,570,008
Federal Home Loan Bank advances	10,000	125,000
Other liabilities	24,704	14,496
Total liabilities	1,764,155	1,709,504
Shareholders' equity:		
Series A Nonvoting Noncumulative Perpetual Convertible Preferred Stock, \$1 par value; 5,000,000 shares authorized; 0 and 878,048 shares issued and outstanding at December 31, 2019 and 2018, respectively	—	878
Common stock, voting, \$1 par value; 20,000,000 shares authorized; 18,361,922 and 17,592,160 shares issued and outstanding at December 31, 2019 and 2018, respectively	18,362	17,592
Common stock, nonvoting, \$1 par value; 5,000,000 shares authorized; 0 and 132,561 shares issued and outstanding at December 31, 2019 and 2018, respectively	—	133
Additional paid-in capital	207,083	211,789
Retained earnings	46,218	27,303
Accumulated other comprehensive loss, net of income tax	1,383	(3,316)
Total shareholders' equity	273,046	254,379
Total liabilities and shareholders' equity	\$ 2,037,201	\$ 1,963,883

See accompanying notes to consolidated financial statements.

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

	Year Ended December 31,		
	2019	2018	2017
Interest income:			
Loans, including fees	\$ 82,828	\$ 60,751	\$ 45,601
Securities:			
Taxable	4,619	4,184	3,696
Tax-exempt	1,438	1,201	1,230
Federal funds sold	26	63	41
Restricted equity securities	755	571	396
Interest-bearing deposits in financial institutions	1,881	1,011	551
Total interest income	91,547	67,781	51,515
Interest expense:			
Interest-bearing deposits	7,538	4,164	2,447
Savings and money market accounts	7,266	5,446	3,188
Time deposits	7,542	3,940	2,445
Federal funds purchased	4	3	13
Securities sold under agreements to repurchase	5	3	—
Federal Home Loan Bank advances	1,444	2,533	1,559
Total interest expense	23,799	16,089	9,652
Net interest income	67,748	51,692	41,863
Provision for loan losses	761	2,842	12,870
Net interest income after provision for loan losses	66,987	48,850	28,993
Noninterest income:			
Treasury management and other deposit service charges	3,135	2,150	1,516
Net gain (loss) on sale of securities	(99)	3	(66)
Tri-Net fees, net	2,785	1,503	1,002
Mortgage banking income	9,467	5,653	6,238
Other noninterest income	8,986	6,150	2,218
Total noninterest income	24,274	15,459	10,908
Noninterest expense:			
Salaries and employee benefits	35,542	28,586	20,400
Data processing and software	6,961	3,835	2,786
Professional fees	2,102	1,608	1,522
Occupancy	3,345	2,336	2,025
Equipment	3,723	2,471	2,071
Regulatory fees	591	1,028	1,111
Merger related expenses	2,654	9,803	—
Amortization of intangibles	1,655	465	48
Other operating	5,422	3,355	3,802
Total noninterest expense	61,995	53,487	33,765
Income before income taxes	29,266	10,822	6,136
Income tax expense	6,844	1,167	4,635
Net income	\$ 22,422	\$ 9,655	\$ 1,501
Per share information:			
Basic net income per share of common stock	\$ 1.25	\$ 0.73	\$ 0.13
Diluted net income per share of common stock	\$ 1.20	\$ 0.67	\$ 0.12
Weighted average shares outstanding:			
Basic	17,886,164	13,277,614	11,280,580
Diluted	18,613,224	14,480,347	12,803,511

See accompanying notes to consolidated financial statements.

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

	Year Ended December 31,		
	2019	2018	2017
Net income	\$ 22,422	\$ 9,655	\$ 1,501
Other comprehensive income (loss):			
Unrealized gains (losses) on securities available-for-sale:			
Unrealized holding gains (losses) arising during the period	6,321	(2,491)	4,855
Reclassification adjustment for losses (gains) included in net income	99	(3)	66
Tax effect	(1,678)	652	(1,884)
Net of tax	4,742	(1,842)	3,037
Unrealized losses on securities transferred to held-to-maturity:			
Reclassification adjustment for losses included in net income	—	14	190
Tax effect	—	(4)	(73)
Net of tax	—	10	117
Unrealized (losses) gains on cash flow hedges:			
Unrealized holding (losses) gains arising during the period	(702)	263	(72)
Reclassification adjustment for losses included in net income	878	920	863
Tax effect	(219)	(140)	(62)
Net of tax	(43)	1,043	729
Other comprehensive income (loss)	4,699	(789)	3,883
Comprehensive income	\$ 27,121	\$ 8,866	\$ 5,384

See accompanying notes to consolidated financial statements.

**CAPSTAR FINANCIAL HOLDINGS INC. & SUBSIDIARY**  
**Consolidated Statements of Changes in Shareholders' Equity**  
(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
Net issuance of restricted common stock	—	35,714	36	—	—	(280)	—	—	(244)
Stock-based compensation expense	—	—	—	—	—	1,061	—	—	1,061
Excess tax benefit from stock compensation	—	154,050	154	—	—	857	—	—	1,011
Net exercise of common stock options	—	55,186	55	132,561	133	339	—	—	527
Reclassification of accumulated other comprehensive income due to tax rate change	—	—	—	—	—	—	259	(259)	—
Net income	—	—	—	—	—	—	1,501	—	1,501
Other comprehensive income	—	—	—	—	—	—	—	3,883	3,883
Balance December 31, 2017	\$ 878	11,449,465	\$ 11,450	132,561	\$ 133	\$ 118,120	\$ 18,892	\$ (2,527)	\$ 146,946
Net issuance of restricted common stock	—	107,640	107	—	—	(552)	—	—	(445)
Stock-based compensation expense	—	—	—	—	—	2,079	—	—	2,079
Net exercise of common stock options	—	666,964	667	—	—	2,986	—	—	3,653
Exercise of common stock warrants	—	186,175	186	—	—	1,420	—	—	1,606
Issuance of common stock in conjunction with Athens acquisition, net of issuance costs	—	5,181,916	5,182	—	—	87,736	—	—	92,918
Common and preferred stock dividends declared (\$0.04 per share)	—	—	—	—	—	—	(1,244)	—	(1,244)
Net income	—	—	—	—	—	—	9,655	—	9,655
Other comprehensive loss	—	—	—	—	—	—	—	(789)	(789)
Balance December 31, 2018	\$ 878	17,592,160	\$ 17,592	132,561	\$ 133	\$ 211,789	\$ 27,303	\$ (3,316)	\$ 254,379
Net issuance of restricted common stock	—	(8,721)	(9)	—	—	(295)	—	—	(304)
Stock-based compensation expense	—	—	—	—	—	1,262	—	—	1,262
Net exercise of common stock options	—	272,660	273	—	—	1,658	—	—	1,931
Conversion of preferred stock to common stock	(878)	878,048	878	—	—	—	—	—	—
Conversion of non-voting common stock to common stock	—	132,561	133	(132,561)	(133)	—	—	—	—
Repurchase of common stock	—	(504,786)	(505)	—	—	(7,331)	—	—	(7,836)
Common and preferred stock dividends declared (\$0.05 per share)	—	—	—	—	—	—	(3,507)	—	(3,507)
Net income	—	—	—	—	—	—	22,422	—	22,422
Other comprehensive income	—	—	—	—	—	—	—	4,699	4,699
Balance December 31, 2019	\$ —	18,361,922	\$ 18,362	—	\$ —	\$ 207,083	\$ 46,218	\$ 1,383	\$ 273,046

See accompanying notes to consolidated financial statements.

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

	Year Ended December 31,		
	2019	2018	2017
Cash flows from operating activities:			
Net income	\$ 22,422	\$ 9,655	\$ 1,501
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Provision for loan losses	761	2,842	12,870
Accretion of discounts on acquired loans and deferred fees	(3,737)	(2,978)	(1,533)
Depreciation and amortization	2,883	1,028	450
Net amortization of premiums on investment securities	807	1,007	1,259
Net loss (gain) on sale of securities	99	(3)	66
Mortgage banking income	(9,467)	(5,653)	(6,238)
Tri-Net fees	(2,785)	(1,503)	(1,002)
Net gain on sale of loans	(803)	(248)	(113)
Net loss on disposal of premises and equipment	—	—	137
Net gain on sale of other real estate owned	(3)	—	—
Stock-based compensation	1,262	2,079	1,061
Deferred income tax expense	2,585	1,175	4,385
Origination of loans held for sale	(824,021)	(516,341)	(565,372)
Proceeds from loans held for sale	725,669	540,448	540,123
Cash payments arising from operating leases	(1,786)	—	—
Net (increase) decrease in accrued interest receivable and other assets	(10,461)	1,395	(1,760)
Net increase (decrease) in accrued interest payable and other liabilities	11,887	682	(2,448)
Net cash provided by (used in) operating activities	(84,688)	33,585	(16,614)
Cash flows from investing activities:			
Activities in securities available-for-sale:			
Purchases	(59,473)	(44,787)	(30,525)
Sales	68,068	38,322	46,762
Maturities, prepayments and calls	27,624	19,245	18,828
Activities in securities held-to-maturity:			
Maturities, prepayments and calls	395	—	1,560
Purchase of restricted equity securities	(1,651)	(12)	(2,774)
Net increase (decrease) in loans	13,782	(139,124)	(20,916)
Purchase of premises and equipment	(1,582)	(4,244)	(1,075)
Proceeds from sale of other real estate owned	127	—	—
Proceeds from sale of premises and equipment	—	—	3
Proceeds from BOLI death benefit	—	3,416	—
Cash received from acquisitions, net	—	12,053	—
Net cash provided by (used in) investing activities	47,290	(115,131)	11,863
Cash flows from financing activities:			
Net increase (decrease) in deposits	159,443	45,622	(8,857)
Proceeds from Federal Home Loan Bank advances	75,000	125,000	135,000
Payments on Federal Home Loan Bank advances	(190,000)	(70,000)	(120,000)
Repurchase of common stock	(7,836)	—	—
Exercise of common stock options and warrants, net of repurchase of restricted shares	1,627	4,814	1,294
Termination of interest rate swap agreement	(1,503)	—	—
Common and preferred stock dividends paid	(3,507)	(1,244)	—
Net cash provided by financing activities	33,224	104,192	7,437
Net increase (decrease) in cash and cash equivalents	(4,174)	22,646	2,686
Cash and cash equivalents at beginning of period	105,443	82,797	80,111
Cash and cash equivalents at end of period	\$ 101,269	\$ 105,443	\$ 82,797
Supplemental disclosures of cash paid:			
Interest paid	\$ 24,216	\$ 15,378	\$ 9,540
Income taxes	716	1,716	1,047
Supplemental disclosures of noncash transactions:			
Transfer of loans to other real estate	\$ 180	\$ —	\$ —
Loans charged off to the allowance for loan and lease losses	\$ 798	\$ 4,954	\$ 12,769
Conversion of preferred stock and non-voting common stock	\$ 1,011	\$ —	\$ —
Lease liabilities arising from obtaining right-of-use assets	\$ 13,512	\$ —	\$ —
Securities transferred from held-to-maturity to available-for-sale	\$ —	\$ —	\$ 41,665
Loans transferred from held-for-sale to held-for-investment	\$ —	\$ —	\$ 507

See accompanying notes to consolidated financial statements.

## CAPSTAR FINANCIAL HOLDINGS INC. & SUBSIDIARY

### Notes to Consolidated Financial Statements

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

##### Basis of Presentation

The consolidated financial statements as of December 31, 2019 and 2018 and for each of the three years in the period ended December 31, 2019 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. On February 5, 2016, CapStar Financial Holdings, Inc. acquired all of the Bank’s issued and outstanding shares of common stock, preferred stock, common stock options and warrants, and the Bank became the wholly owned subsidiary of CapStar Financial Holdings, Inc. (the “Share Exchange”).

The consolidated financial statements of the Company have been prepared in conformity with U.S. generally accepted accounting principles (“GAAP”) and conform to general practices within the banking industry.

##### Business Combinations

The Company accounts for business combinations using the acquisition method of accounting. The accounts of an acquired entity are included as of the date of acquisition, and any excess of purchase price over the fair value of the net assets acquired is capitalized as goodwill. Under this method, all identifiable assets acquired, including purchased loans, and liabilities assumed are recorded at fair value.

The Company typically issues common stock and/or pays cash for an acquisition, depending on the terms of the acquisition agreement. The value of shares of common stock issued is determined based on the market price of the stock as of the closing of the acquisition.

##### Nature of Operations

Through the Bank, the Company provides full banking services to consumer and corporate customers located primarily in Tennessee. The Bank operates under a state bank charter and is a member of the Federal Reserve System. As a state member bank, the Bank is subject to regulations of the Tennessee Department of Financial Institutions, the Board of Governors of the Federal Reserve System (the “Federal Reserve”), and the Federal Deposit Insurance Corporation.

##### Estimates

The preparation of financial statements in conformity with 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 and deferred tax assets.

##### Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, interest-bearing deposits in financial institutions and federal funds sold. Generally, federal funds sold are purchased and sold for one-day periods. The Company maintains deposits in excess of the federal insurance amounts with other financial institutions. Management makes deposits only with financial institutions it considers to be financially sound.

## Notes to Consolidated Financial Statements

Securities

The Bank accounts for securities under the provisions of Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 320, *Investments – Debt and Equity Securities*. Under the provisions of FASB ASC 320, securities are to be classified in three categories and accounted for as follows:

*Securities Held-to-Maturity* - Debt securities are classified as held to maturity securities when the Bank has the positive intent and ability to hold the securities to maturity. Securities held to maturity are carried at amortized cost.

*Trading Securities* - Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings. No securities have been classified as trading securities.

*Securities Available-for-Sale* - Debt securities not classified as either held to maturity securities or trading securities are classified as available for sale securities. Securities available for sale are carried at estimated fair value with unrealized gains and losses excluded from earnings and reported as a separate component of shareholders’ equity in other comprehensive income (loss).

Interest income includes amortization of purchase premiums or discounts. Premiums and discounts on securities are amortized on the level-yield method without anticipating prepayments, except for mortgage-backed securities where prepayments are anticipated. Realized gains and losses from the sales of securities are recorded on the trade date and determined using the specific-identification method.

Management evaluates securities for other-than-temporary impairment (“OTTI”) on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, the financial condition and near-term prospects of the issuer and any collateral underlying the relevant security. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: (1) OTTI related to credit loss, which must be recognized in the income statement and (2) OTTI related to other factors, which is recognized in other comprehensive income (loss). The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis.

Loans Held For Sale and Fair Value Option

The Company classifies loans as loans held for sale when originated with the intent to sell. As of April 1, 2019, the Company elected the fair value option for all residential mortgage loans originated with the intent to sell. This election allows for a more effective offset of the changes in fair values of the loans and the derivative instruments used to economically hedge them without the burden of complying with the requirements for hedge accounting. The Company has not elected the fair value option for other loans held for sale primarily because they are not economically hedged using derivative instruments. The fair value of residential mortgage loans originated with the intent to sell is based on traded market prices of similar assets. Other loans held for sale that are recorded at lower of cost or fair value may be carried at fair value on a nonrecurring basis when the fair value is less than cost. For further information, see Note 24 - Fair Value. The Company does not securitize mortgage loans. If the Company sells loans with servicing rights retained, the carrying value of the mortgage loan sold is reduced by the amount allocated to the servicing right. Fair values of residential mortgage loans held for sale are based on traded market prices of similar assets. The changes in fair value are recorded as a component of mortgage banking income and included gains of \$0.6 million for the year ended December 31, 2019. There were no loans held for sale recorded at fair value as of December 31, 2018. The following table summarizes the difference between the fair value and the aggregate unpaid principal balance for residential real estate loans held for sale as of December 31, 2019 (dollars in thousands):

	Fair Value	Aggregate Unpaid Principal Balance	Difference
<b>December 31, 2019</b>			
Residential mortgage loans held for sale	\$ 30,740	\$ 30,178	\$ 562



## Notes to Consolidated Financial Statements

Tri-Net Fees

Tri-Net fees are derived from the origination, with the intent to sell, commercial real estate loans to third-party investors. All of these loan sales transfer servicing rights to the buyer. Realized gains and losses are recognized when legal title of the loan has transferred to the investor and sales proceeds have been received and are reflected in the accompanying statements of income in Tri-Net fees, net of related costs such as commission expenses. Loans that have not been sold at period end are classified as held for sale on the balance sheet and recorded at the lower of aggregate cost or fair value. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings.

Loans

The Company has six classes of loans for financial reporting purposes: commercial real estate, consumer real estate, construction and land development, commercial and industrial, consumer and other. The appropriate classification is determined based on the underlying collateral utilized to secure each loan.

*Commercial real estate* loans are categorized as such based on investor exposures where repayment is largely dependent upon the operation, refinance, or sale of the underlying real estate. Commercial real estate also includes owner occupied commercial real estate.

*Consumer real estate* consists primarily of 1-4 family residential properties including home equity lines of credit.

*Construction and land development* loans include loans where the repayment is dependent on the successful completion and operation and/or sale of the related real estate project. Construction and land development loans include 1-4 family construction projects and commercial construction endeavors such as warehouses, apartments, office and retail space and land acquisition and development.

*Commercial and industrial* loans include loans to business enterprises issued for commercial, industrial and/or other professional purposes.

*Consumer* loans include all loans issued to individuals not included in the consumer real estate class.

*Other* loans include all loans not included in the classes of loans above and leases.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of purchase premiums and discounts, deferred loan fees and costs, and an allowance for loan losses. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income using the level-yield method without anticipating prepayments.

The accrual of interest on loans is discontinued at the time the loan is 90 days past due unless the credit is well secured and in process of collection. Consumer loans and any accrued interest is typically charged off no later than 180 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful and collection is highly questionable. Amortization of deferred loan fees is discontinued when a loan is placed on nonaccrual status.

All interest accrued but not received for loans placed on nonaccrual is reversed against interest income. Interest received on such loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual status. Under the cost-recovery method, interest income is not recognized until the loan balance is reduced to zero. Under the cash-basis method, interest income is recorded when the payment is received in cash. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. Loans can also be returned to accrual status when they become well secured and in the process of collection.

## Notes to Consolidated Financial Statements

Acquired Loans

Acquired loans are accounted for under the acquisition method of accounting. The acquired loans are recorded at their estimated fair values as of the acquisition date. Fair value of acquired loans is determined using a discounted cash flow model based on assumptions regarding the amount and timing of principal and interest payments, estimated prepayments, estimated default rates, estimated loss severity in the event of defaults, and current market rates. Estimated credit losses are included in the determination of fair value; therefore, an allowance for loan losses is not recorded on the acquisition date.

An acquired loan is considered purchased credit impaired when there is evidence of credit deterioration since origination and it is probable at the date of acquisition that the Bank will be unable to collect all contractually required payments.

Purchased credit impaired loans are accounted for individually or aggregated into pools of loans based on common risk characteristics such as loan type and risk rating. The Company estimates the amount and timing of expected cash flows for each loan or pool, and the expected cash flows in excess of amount paid (fair value) is recorded as interest income over the remaining life of the loan or pool (accretable yield). The excess of the loan's or pool's contractual principal and interest over expected cash flows is not recorded (nonaccretable difference). Over the life of the loan or pool, expected cash flows continue to be estimated. If the present value of expected cash flows is less than the carrying amount, a loss is recorded as a provision for loan losses. If the present value of expected cash flows is greater than the carrying amount, it is recognized as part of future interest income.

Acquired non-impaired loans are recorded at their initial fair value and adjusted for subsequent advances, pay downs, amortization or accretion of any premium or discount on purchase, charge-offs and additional provisioning that may be required.

Allowance for Loan Losses

The allowance for loan losses ("ALL") is maintained at a level that management believes to be adequate to absorb expected loan losses inherent in the loan portfolio as of the balance sheet date. The allowance for loan losses is a valuation allowance for estimated credit losses inherent in the loan and lease portfolio, increased by the provision for loan losses and decreased by charge-offs, net of recoveries. Quarterly, the Company estimates the allowance required using peer group loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. The Company's historical loss experience is based on the actual loss history by class of loan for comparable peer institutions due to the Company's limited loss history. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged off. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries are credited to the allowance for loan losses.

The Company also considers the results of the external independent loan review when assessing the adequacy of the allowance and incorporates relevant loan review results in the loan impairment and overall adequacy of allowance determinations. Furthermore, regulatory agencies periodically review the Company's allowance for loan losses and may require the Company to record adjustments to the allowance based on their judgment of information available to them at the time of their examinations.

Additional considerations are included in the determination of the adequacy of the allowance based on the continuous review conducted by relationship managers and credit department personnel. The Company's loan policy requires that each customer relationship wherein total exposure exceeds \$1.5 million be subject to a formal credit review at least annually. Should these reviews identify potential collection concerns, appropriate adjustments to the allowance may be made.

The allowance consists of specific and general components as discussed below. While the allowance consists of separate components, these terms are primarily used to describe a process. Both portions of the allowance are available to provide for inherent losses in the entire portfolio.

## Notes to Consolidated Financial Statements

*Specific Component*

The specific component relates to loans that are individually determined to be impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loans for which the terms have been modified resulting in a concession, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings ("TDRs") and classified as impaired.

Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

Loans meeting any of the following criteria are individually evaluated for impairment: risk rated substandard (as defined in Note 4), on non-accrual status or past due greater than 90 days. If a loan is impaired, a portion of the allowance is allocated based on the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral less costs to sell if repayment is expected solely from the collateral. Changes to the valuation allowance are recorded as a component of the provision for loan losses.

TDRs are individually evaluated for impairment and included in the separately identified impairment disclosures. TDRs are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a TDR is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral less costs to sell.

*General Component*

The general component of the allowance for loan losses covers loans that are collectively evaluated for impairment. Large groups of homogeneous loans are collectively evaluated for impairment, and accordingly, they are not included in the separately identified impairment disclosures. The general allowance component also includes loans that are individually identified for impairment evaluation but are not considered impaired. The general component is based on historical loss experience adjusted for current factors. Due to the Company's limited loss history, the historical loss experience is based on the actual loss history by class of loan for comparable peer institutions.

The Company utilized a 33 quarter look-back period as of December 31, 2017. Subsequently, the Company increased its look-back period for a total of 37 quarters and 41 quarters as of December 31, 2018 and 2019, respectively. In the current economic environment, management believes the extension of the look-back period was necessary in order to capture sufficient loss observations to develop a reliable loss estimate of credit losses. This extension of the historical look-back period to capture the historical loss experience of peer banks was applied to all classes and segments of our loan portfolio.

The actual loss experience is supplemented with other environmental factors that capture changes in trends, conditions, and other relevant factors that may cause estimated credit losses as of the evaluation date to differ from historical loss experience. The allocation for environmental factors is by nature subjective. These amounts represent estimated probable inherent credit losses, which exist but have not been captured in the historical loss experience. The environmental factors 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.

*Servicing Rights*

When mortgage loans are sold with servicing retained, servicing rights are initially recorded at fair value with the income statement effect recorded in other noninterest income. Fair value is based on market prices for comparable mortgage servicing contracts, when available or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. All classes of servicing assets are subsequently measured using the amortization method which requires servicing rights to be amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans.

## Notes to Consolidated Financial Statements

Servicing rights are evaluated for impairment based upon the fair value of the rights as compared to carrying amount. Impairment is determined by stratifying rights into groupings based on predominant risk characteristics, such as interest rate, loan type and investor type. Impairment is recognized through a valuation allowance for an individual grouping, to the extent that fair value is less than the carrying amount. If the Company later determines that all or a portion of the impairment no longer exists for a particular grouping, a reduction of the allowance may be recorded as an increase to income. Changes in valuation allowances are reported with other noninterest income on the income statement and the associated asset is included in other assets on the Consolidated Balance Sheet. The fair values of servicing rights are subject to significant fluctuations as a result of changes in estimated and actual prepayment speeds and default rates and losses.

Servicing fee income, which is reported on the income statement within other noninterest income, is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal; or a fixed amount per loan and are recorded as income when earned. The amortization of mortgage servicing rights is netted against loan servicing fee income. Net servicing fees totaled \$340,000 and \$102,000 for the years ended December 31, 2019 and 2018, respectively. There were no servicing fees for the year ended December 31, 2017. Late fees and ancillary fees related to loan servicing are not material.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is computed principally by the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized by the straight-line method based on the shorter of the asset lives or the expected lease terms. Useful lives for premises and equipment range from one to thirty-nine years.

These assets are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value.

Leases

In February 2016, the FASB issued a new accounting standard update (ASU 2016-02, Leases (Topic 842)), which requires for all operating leases the recognition of a right-of-use ("ROU") asset and a corresponding lease liability, in the Consolidated Balance Sheet. For short term leases (term of 12 months or less), a lessee is permitted to make an accounting election not to recognize lease assets and lease liabilities. The lease cost will be allocated over the lease term on a straight-line basis. There were further amendments, including practical expedients, with the issuance of ASU 2018-01, "Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842" in January 2018. In July 2018, the FASB issued ASU No. 2018-11, "Leases (Topic 842): Targeted Improvements", which provides for the option to apply the new leasing standard to all open leases as of the adoption date, on a prospective basis.

On January 1, 2019, the Company adopted the new accounting standard ASU 2016-02, Leases (Topic 842) and all the related amendments ("new lease standard", "ASC 842" or "ASU 2016-02") utilizing the practical expedient to apply the new lease standard as of January 1, 2019 on a prospective basis. The Company also elected the "package of expedients" and elected as an accounting policy to exclude recording ROU assets and lease liabilities for leases that meet the definition of short-term leases. In addition to excluding short-term leases, the Company has implemented an accounting policy in which non-lease components are not separated from lease components in the measurement of ROU assets and lease liabilities for all lease contracts. The Company recognized \$12.8 million in ROU assets and \$13.4 million in lease liabilities as a result of applying the new lease standard as an adjustment to the opening consolidated balance sheet on January 1, 2019. The ROU assets and lease liabilities are included in other assets and other liabilities, respectively on the Consolidated Balance Sheet. The comparative information has not been restated and continues to be reported under the accounting standards in effect for those periods. See Note 7—Leases for additional disclosures related to leases.

Bank Owned Life Insurance

The Bank has purchased life insurance policies on certain key executives. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement. Bank owned life insurance is included in other assets on the Consolidated Balance Sheet.

## Notes to Consolidated Financial Statements

Securities Sold under Agreements to Repurchase

The Bank enters into sales of securities under agreements to repurchase at a specified future date. Such repurchase agreements are considered financing arrangements and, accordingly, the obligation to repurchase assets sold is reflected as a liability in the balance sheets of the Bank. Repurchase agreements are collateralized by debt securities which are owned and under the control of the Bank and are included in other liabilities on the Consolidated Balance Sheet.

Goodwill and Other Intangible Assets

Goodwill resulting from business combinations is generally determined as the excess of the fair value of the consideration transferred, plus the fair value of any noncontrolling interests in the acquiree, over the fair value of the net assets acquired and liabilities assumed as of the acquisition date. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually or more frequently if events and circumstances exists that indicate that a goodwill impairment test should be performed. The Company has selected October 31st as the date to perform the annual impairment test. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Goodwill is the only intangible asset with an indefinite life on the balance sheet.

Other intangible assets consist of core deposit intangible assets arising from whole bank acquisitions and are amortized on an accelerated method over their estimated useful lives, which range from six to ten years.

Other Real Estate Owned

Other real estate owned ("OREO") includes assets that have been acquired in satisfaction of debt through foreclosure and are recorded at estimated fair value less the estimated cost of disposition. Fair value is based on independent appraisals and other relevant factors. Valuation adjustments required at foreclosure are charged to the allowance for loan losses. Subsequent to foreclosure, additional losses resulting from the periodic revaluation of the property are charged to other real estate expense. Costs of operating and maintaining the properties and any gains or losses recognized on disposition are also included in other real estate expense. Improvements made to properties are capitalized if the expenditures are expected to be recovered upon the sale of the properties.

Restricted Equity Securities

The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest additional amounts. FHLB stock is carried at cost, classified as a restricted equity security, and periodically evaluated for impairment based on an assessment of the ultimate recovery of par value. Both cash and stock dividends are reported as interest income.

The Bank is also a member of the Federal Reserve System, and as such, holds stock of the Federal Reserve Bank of Atlanta ("Federal Reserve Bank"). Federal Reserve Bank stock is carried at cost, classified as a restricted equity security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as interest income.

Income Taxes

Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. The Company's tax returns remain open to audit under the statute of limitations by the IRS and various states for the years ended December 31, 2016 through 2019. It is the Company's policy to recognize interest and/or penalties related to income tax matters in income tax expense.

## Notes to Consolidated Financial Statements

Stock-Based Compensation

Stock-based compensation expense is recognized based on the fair value of the portion of stock-based payment awards that are ultimately expected to vest, reduced for estimated forfeitures. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods, if actual forfeitures differ from those estimates. A Black-Scholes model is utilized to estimate the fair value of stock options, while the market price of the Company's common stock at the date of grant is used for restricted stock awards. Compensation expense is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation expense is recognized on a straight-line basis over the requisite service period for the entire award. For awards with performance vesting criteria, anticipated performance is projected to determine the number of awards expected to vest, and the corresponding aggregate expense is adjusted to reflect the elapsed portion of the performance period.

Advertising Costs

Advertising costs are expensed as incurred. Advertising expense was approximately \$370,000, \$383,000 and \$310,000 for the years ended December 31, 2019, 2018 and 2017, respectively and is included in other operating expenses on the Consolidated Statements of Income.

Off-Balance Sheet Financial Instruments

In the ordinary course of business, the Bank has entered into off-balance-sheet financial instruments consisting of commitments to extend credit and standby letters of credit. Such financial instruments are recorded in the financial statements when they are funded or related fees are incurred or received.

Derivative Instruments

Derivative instruments are recorded on the balance sheet at their respective fair values. The accounting for changes in fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship. If the derivative instrument is not designated as a hedge, the gain or loss on the derivative instrument is recognized in earnings in the period of change.

The Bank enters into interest rate swaps ("swaps") to facilitate customer transactions and meet their financing needs. Upon entering into these arrangements to meet customer needs, the Bank enters into offsetting positions with large U.S. financial institutions in order to minimize risk to the Bank. These swaps are derivatives, but are not designated as hedging instruments.

The Bank may also utilize forward starting cash flow hedges to manage its future interest rate exposure. These derivative contracts are designated as hedges and, as such, changes in the fair value of these derivative instruments are recorded in other comprehensive income (loss). The Bank prepares written hedge documentation for all derivatives which are designated as hedges. The written hedge documentation includes identification of, among other items, the risk management objective, hedging instrument, hedged item and methodologies for assessing and measuring hedge effectiveness and ineffectiveness, along with support for management's assertion that the hedge will be highly effective.

The effective portion of the changes in the fair value of a derivative that is highly effective and that has been designated and qualifies as a cash flow hedge are initially recorded in accumulated other comprehensive income (loss) and subsequently reclassified into earnings in the same period during which the hedged item affects earnings. The ineffective portion, if any, would be recognized in current period earnings.

The Bank discontinues hedge accounting when it determines that the derivative is no longer effective in offsetting changes in the cash flows of the hedged item, the derivative is settled or terminates, or treatment of the derivative as a hedge is no longer appropriate or intended. When hedge accounting is discontinued, subsequent changes in fair value of the derivative are recorded as non-interest income. When a cash flow hedge is discontinued but the hedged cash flows or forecasted transactions are still expected to occur, gains or losses that were accumulated in other comprehensive income (loss) are amortized into earnings over the same periods which the hedged transactions will affect earnings.

Cash flows resulting from the derivative financial instruments that are accounted for as hedges are classified in the cash flow statement in the same category as the cash flows of the items being hedged.

**Notes to Consolidated Financial Statements**

Commitments to fund mortgage loans “interest rate locks” to be sold into the secondary market and forward commitments for the sale of mortgage-backed securities are accounted for as free standing derivatives. The fair value of the interest rate lock is recorded at the time the commitment to fund the mortgage loan is executed and is adjusted for the expected exercise of the commitment before the loan is funded. Fair values of these mortgage derivatives are estimated based on changes in mortgage interest rates from the date the interest rate on the loan is locked. The Company enters into forward commitments for the sale of mortgage-backed securities when interest rate locks are entered into, in order to hedge the change in interest rates resulting from its commitments to fund the loans. Changes in the fair values of these derivatives are included in mortgage banking income.

**Comprehensive Income**

Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income includes unrealized gains and losses on securities available for sale, unrealized gains and losses on securities transferred to held to maturity and unrealized gains and losses on cash flow hedges which are also recognized as separate components of equity. The Bank’s policy is to release the income tax effects of items in accumulated other comprehensive income (loss) when the item is realized.

**Fair Value Measurements**

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

**Restriction on Cash Balances**

Regulation D of the Federal Reserve Act requires that banks maintain reserve balances with their applicable Federal Reserve Bank based principally on the type and amount of their deposits. The Bank was required to have a reserve balance of \$73,444,000, \$63,890,000, and \$43,940,000 at December 31, 2019, 2018 and 2017, respectively. The reserve balance that the Bank must maintain at the Federal Reserve Bank of Atlanta is included in interest-bearing deposits in financial institutions as of December 31, 2019, 2018 and 2017.

**Subsequent Events**

The Company has evaluated subsequent events for recognition and disclosure through March \_\_, 2020, which is the date the financial statements were available to be issued.

**Income Per Common Share**

Basic net income per share available to common stockholders (“EPS”) is computed by dividing net income available to common stockholders by the weighted average shares of common stock outstanding for the period. Diluted EPS reflects the dilution that could occur if securities or other contracts to issue common stock were exercised or converted. The difference between basic and diluted weighted average shares outstanding is attributable to convertible preferred stock, common stock options and warrants. The dilutive effect of outstanding convertible preferred stock, common stock options and warrants is reflected in diluted EPS by application of the treasury stock method.

No antidilutive stock options were excluded from calculation for the years ended December 31, 2019, 2018 or December 31, 2017.

## Notes to Consolidated Financial Statements

The following is a summary of the basic and diluted earnings per share calculation for each of the following years (in thousands except share data):

	Year Ended December 31,		
	2019	2018	2017
Basic net income per share calculation:			
Numerator – Net income	\$ 22,422	\$ 9,655	\$ 1,501
Denominator – Average common shares outstanding	17,886,164	13,277,614	11,280,580
Basic net income per share	\$ 1.25	\$ 0.73	\$ 0.13
Diluted net income per share calculation:			
Numerator – Net income	\$ 22,422	\$ 9,655	\$ 1,501
Denominator – Average common shares outstanding	17,886,164	13,277,614	11,280,580
Dilutive shares contingently issuable	727,060	1,202,733	1,522,931
Average diluted common shares outstanding	18,613,224	14,480,347	12,803,511
Diluted net income per share	\$ 1.20	\$ 0.67	\$ 0.12

#### 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.

The Company applied the guidance using a modified retrospective approach. 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 our revenues will not be affected. The Company performed an assessment of our revenue contracts related to revenue streams that are within the scope of the standard. Our accounting policies did not change materially since the principles of revenue recognition from the ASU were largely consistent with existing guidance and current practices applied by our businesses. We did not identify material changes to the timing or amount of revenue recognition.

The Company records revenue from contracts with customers in accordance with Accounting Standards Codification Topic 606, "Revenue from Contracts with Customers" ("Topic 606"). Under Topic 606, the Company must identify the contract with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when (or as) the Company satisfies a performance obligation. Significant revenue has not been recognized in the current reporting period that results from performance obligations satisfied in previous periods.

The Company's primary sources of revenue are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of Topic 606. The Company evaluated the nature of its contracts with customers and determined that further disaggregation of revenue from contracts with customers into more granular categories beyond what is presented in the Consolidated Statements of Income was not necessary. The Company generally fully satisfies its performance obligations on its contracts with customers as services are rendered and the transaction prices are typically fixed; charged either on a periodic basis or based on activity. Our accounting policies did not change materially since the principles of revenue recognition from the Accounting Standards Update were largely consistent with existing guidance and current practices applied by our business.



## Notes to Consolidated Financial Statements

A description of the Company's revenue streams accounted for under Topic 606 follows:

*Treasury management and other deposit service charges:* The Company earns fees from its deposit customers for transaction based, account maintenance, and overdraft services. Transaction based fees are recognized at the time the transaction is executed as that is the point in time the Company fulfills the customer's request. Account maintenance fees are earned over the course of a month, representing the period over which the Company satisfies its performance obligation. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges on deposits are withdrawn from the customer's account balance.

*Interchange income:* Included in other noninterest income are interchange fees, which the Company earns from debit cardholder transactions conducted through various payment networks. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing series provided to the cardholder.

*Gains/Losses on Sales of OREO:* The Company records a gain or loss from the sale of OREO when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. When the Company finances the sale of OREO to the buyer, the Company assesses whether the buyer is committed to perform their obligation under the contract and whether collectability of the transaction price is probable. Once these criteria are met, the OREO asset is derecognized and the gain or loss on sale is recorded upon the transfer of control of the property to the buyer. In determining the gain or loss on the sale, the Company adjusts the transaction price and related gain (loss) on sale if a significant financing component is present.

#### 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 were effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

The Company adopted the guidance using the modified retrospective method and practical expedients for transition. The practical expedients allow the Company to largely account for our existing leases consistent with current guidance except for the incremental balance sheet recognition for lessees. The Company evaluated the new guidance and its impact on the Company's financial statements. Based on leases outstanding at December 31, 2018, the impact of adoption on January 1, 2019 was recording a lease liability of approximately \$13.4 million, a right-of-use asset of approximately \$12.8 million, and elimination of deferred rent of approximately \$0.6 million.

#### ASU 2016-13, Financial Instruments – Credit Losses

In June 2016, the FASB issued guidance to change the accounting for credit losses and modify the impairment model for certain debt securities. The amendments were originally supposed to be effective for the Company for reporting periods beginning after December 15, 2019 with early adoption permitted for all organizations for periods beginning after December 15, 2018. However, in November 2019, the FASB issued ASU 2019-10, *Financial Instruments — Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*, which finalizes effective date delays for private companies, not-for-profit organizations, and certain smaller reporting companies applying the credit losses standard. The Company has elected to delay implementation of the new standard until 2023.

#### 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. The Company does not expect these amendments to have a material effect on its financial statements.

## Notes to Consolidated Financial Statements

*ASU 2017-12, Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities*

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 were effective for the Company for interim and annual periods beginning after December 15, 2018. Early adoption was 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. The Company opted to early adopt this pronouncement on December 31, 2017, by retrospective application to each period in which the effect of the change in the tax rate under the Tax Cuts and Jobs 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 is included in the Statement of Changes in Shareholders' Equity.

*ASU 2018-07, Compensation – Stock Compensation*

In June 2018, the FASB amended the Compensation—Stock Compensation Topic of the Accounting Standards Codification. The amendments expand the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from nonemployees. The guidance was effective for the Company for reporting periods beginning after December 15, 2018. There was no material effect on the financial statements.

*ASU 2019-04 — Applicable to entities that hold financial instruments:*

In April 2019, the FASB issued guidance that clarifies and improves areas of guidance related to the recently issued standards on credit losses, hedging, and recognition and measurement of financial instruments. The amendments related to credit losses will be effective for the Company for reporting periods beginning after December 15, 2019. The amendments related to hedging were effective for the Company for interim and annual periods beginning after December 15, 2018. The amendments related to recognition and measurement of financial instruments will be effective for the Company for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The Company does not expect these amendments to have a material effect on its financial statements.

*ASU 2019-05 — Applicable to entities that hold financial instruments:*

In May 2019, the FASB issued guidance to provide entities with an option to irrevocably elect the fair value option, applied on an instrument-by-instrument basis for eligible instruments, upon adoption of ASU 2016-13, *Measurement of Credit Losses on Financial Instruments*. The amendments will be effective for the Company upon adoption of ASU 2016-13 in fiscal year 2023. The Company does not expect these amendments to have a material effect on its financial statements.

*ASU 2019-12 — Applicable to entities within the scope of Topic 740, Income Taxes:*

In December 2019, the FASB issued guidance to simplify accounting for income taxes by removing specific technical exceptions that often produce information investors have a hard time understanding. The amendments also improve consistent application of and simplify GAAP for other areas of Topic 740 by clarifying and amending existing guidance. The amendments are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

**NOTE 2 – ACQUISITIONS**

On October 1, 2018, the Company acquired 100% of the outstanding common shares of Athens Bancshares Company ("Athens"), the bank holding company for Athens Federal Community Bank, National Association ("Athens Federal"). Under the terms of the acquisition, Athens common shareholders received 2,864 shares of the Company's common stock in exchange for each share of Athens common stock. With the acquisition, the Company further expanded its franchise into the East Tennessee market. Athens' results of operations were included in the Company's results beginning October 1, 2018. Acquisition related costs of \$9,803,000 are included in the Company's income statement for the year ended December 31, 2018. The fair value of the common shares issued as part of the consideration paid for Athens was determined by the closing price of the Company's common shares immediately preceding the acquisition date.

## Notes to Consolidated Financial Statements

Goodwill of \$31,291,000 arising from the acquisition consisted largely of synergies and the cost savings resulting from the combining of the operations of the companies. Goodwill associated with the Athens acquisition is not amortizable for book or tax purposes. The following table summarizes the consideration paid for Athens and the amounts of the assets acquired and liabilities assumed recognized at the acquisition date (in thousands):

	As recorded by Athens Bancshares	Initial fair value adjustments	Measurement period adjustments	As recorded by CapStar Financial Holdings
<b>Assets:</b>				
Cash and cash equivalents	\$ 12,053	\$ —	\$ —	\$ 12,053
Securities	67,342	84 (a)	—	67,426
Loans, gross	349,597	(4,764) (b)	—	344,833
Allowance for loan losses	(4,039)	4,039 (c)	—	—
Premises and equipment, net	7,637	1,571 (d)	—	9,208
Core deposit intangible	2,758	6,222 (e)	—	8,980
Other	29,566	944 (f)	—	30,510
Total	<u>\$ 464,914</u>	<u>\$ 8,096</u>	<u>\$ —</u>	<u>\$ 473,010</u>
<b>Liabilities:</b>				
Deposits	\$ 404,027	\$ 493 (g)	\$ —	\$ 404,520
Other	5,363	1,500 (h)	—	6,863
Total	<u>\$ 409,390</u>	<u>\$ 1,993</u>	<u>\$ —</u>	<u>\$ 411,383</u>
Net identifiable assets acquired				\$ 61,627
<b>Total cost of acquisition:</b>				
Value of stock issued		\$ 86,538		
Value of rolled stock options		6,380		
Total cost of acquisition		<u>\$ 92,918</u>		<u>\$ 92,918</u>
Goodwill recorded related to acquisition				<u>\$ 31,291</u>

- (a) The amount represents the fair value adjustment of securities that were subsequently sold.
- (b) The amount represents the adjustment of the net book value of Athens' loans to their estimated fair value based on interest rates and expected cash flows at the date of acquisition.
- (c) The amount represents the removal of Athens' existing allowance for loan losses.
- (d) The amount represents the adjustment of the net book value of Athens' premises and equipment to their estimated fair value.
- (e) The amount represents the net adjustment of removing Athens' existing core deposit intangible from prior acquisitions and recording the fair value of the core deposit intangible representing the intangible value of the deposit base acquired and the fair value of the customer relationship.
- (f) The amount represents the net adjustment of the fair value of mortgage servicing rights acquired and the deferred tax asset recognized on the fair value adjustments on Athens acquired assets and assumed liabilities.
- (g) The amount represents the adjustment necessary because the weighted average interest rate of Athens' time deposits exceeded the cost of similar funding at the time of acquisition. The fair value adjustment will be amortized to reduce future interest expense over the life of the portfolio.
- (h) The amount represents the liability assumed in connection with the merger agreement whereby the Company will make a \$1,500,000 charitable contribution to the Athens Foundation over a three year period.

## Notes to Consolidated Financial Statements

The following unaudited pro forma financial information presents the combined results of the Company and Athens as if the acquisition had occurred as of January 1, 2017, after giving effect to certain adjustments, including amortization of the core deposit intangible, and related income tax effects. The pro forma financial information does not necessarily reflect the results of operations that would have occurred had the Company and Athens constituted a single entity during such periods (in thousands, except share data):

	Pro forma combined twelve months ended December 31, 2018	Pro forma combined twelve months ended December 31, 2017
Net interest income	\$ 66,935	\$ 59,148
Noninterest income	20,692	17,540
Total revenue	87,627	76,688
Net income	21,167	5,851
Per share information:		
Basic net income per share of common stock	\$ 1.24	\$ 0.36
Diluted net income per share of common stock	\$ 1.14	\$ 0.32

## NOTE 3 – INVESTMENT SECURITIES

Investment securities have been classified in the balance sheet according to management's intent. The Company's classification of securities at December 31, 2019 and 2018 was as follows (in thousands):

	December 31, 2019				December 31, 2018			
	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	\$ 10,421	\$ 4	\$ (94)	\$ 10,331	\$ 11,053	\$ —	\$ (347)	\$ 10,706
State and municipal securities	44,053	1,927	(20)	45,960	62,142	765	(981)	61,926
Mortgage-backed securities	137,305	1,834	(460)	138,679	146,547	776	(3,165)	144,158
Asset-backed securities	3,325	—	(128)	3,197	15,437	4	(157)	15,284
Other debt securities	14,839	141	(18)	14,962	11,863	71	(200)	11,734
Total	<u>\$ 209,943</u>	<u>\$ 3,906</u>	<u>\$ (720)</u>	<u>\$ 213,129</u>	<u>\$ 247,042</u>	<u>\$ 1,616</u>	<u>\$ (4,850)</u>	<u>\$ 243,808</u>
Securities held-to-maturity:								
State and municipal securities	\$ 3,313	\$ 98	\$ —	\$ 3,411	\$ 3,734	\$ 54	\$ (3)	\$ 3,785
Total	<u>\$ 3,313</u>	<u>\$ 98</u>	<u>\$ —</u>	<u>\$ 3,411</u>	<u>\$ 3,734</u>	<u>\$ 54</u>	<u>\$ (3)</u>	<u>\$ 3,785</u>

During the third quarter of 2013, approximately \$36,789,000 of available for sale securities were transferred to the held to maturity category. The transfers of the securities into the held to maturity category from the available for sale category were made at fair value at the date of transfer. The unrealized holding loss at the date of the transfer continues to be reported in a separate component of shareholders' equity and is being amortized over the remaining life of the securities as an adjustment of yield in a manner consistent with the amortization of the premiums and discounts.

During the fourth quarter of 2017, approximately \$41,665,000 of held to maturity securities were transferred to the available for sale category. The Company was able to make the transfer due to early adoption of ASU 2017-12, *Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities*. The transfers of the securities into the available for sale category from the held to maturity category were made at fair value at the date of transfer.

## Notes to Consolidated Financial Statements

The amortized cost and fair value of debt and equity securities at December 31, 2019, by contractual maturity, are shown below (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	\$ 9,805	\$ 9,909	\$ 881	\$ 884
Due one to five years	28,593	29,230	2,432	2,527
Due five to ten years	29,545	30,758	—	—
Due beyond ten years	1,370	1,356	—	—
Mortgage-backed securities	137,305	138,679	—	—
Asset-backed securities	3,325	3,197	—	—
	<u>\$ 209,943</u>	<u>\$ 213,129</u>	<u>\$ 3,313</u>	<u>\$ 3,411</u>

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

	Year ended December 31		
	2019	2018	2017
Proceeds	\$ 68,068	\$ 38,322	\$ 46,762
Gross gains	49	116	124
Gross losses	(148)	(113)	(190)

The table above does not include activity from maturities, prepayments or calls on debt or equity securities.

Securities with a market value of \$70,350,000 and \$171,542,000 at December 31, 2019 and 2018, respectively, were pledged to collateralize public deposits, derivative positions and Federal Home Loan Bank advances.

At December 31, 2019 and 2018 there were no holdings of securities of any one issuer, other than the U.S. Government and its agencies, in an amount greater than 10% of shareholders' equity.

The following tables show the Company's securities with unrealized losses, aggregated by major security type and length of time in a continuous unrealized loss position (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
<u>December 31, 2019</u>						
U. S. government agency securities	\$ 6,694	\$ (51)	\$ 1,637	\$ (43)	\$ 8,331	\$ (94)
State and municipal securities	2,356	(12)	814	(8)	3,170	(20)
Mortgage-backed securities	30,570	(136)	21,364	(324)	51,934	(460)
Asset-backed securities	—	—	3,197	(128)	3,197	(128)
Other debt securities	3,012	(16)	1,502	(2)	4,514	(18)
Total temporarily impaired securities	<u>\$ 42,632</u>	<u>\$ (215)</u>	<u>\$ 28,514</u>	<u>\$ (505)</u>	<u>\$ 71,146</u>	<u>\$ (720)</u>
<u>December 31, 2018</u>						
U. S. government agency securities	\$ —	\$ —	\$ 10,706	\$ (347)	\$ 10,706	\$ (347)
State and municipal securities	13,455	(212)	17,376	(772)	30,831	(984)
Mortgage-backed securities	7,075	(17)	87,232	(3,148)	94,307	(3,165)
Asset-backed securities	8,262	(145)	2,439	(12)	10,701	(157)
Other debt securities	5,362	(200)	—	—	5,362	(200)
Total temporarily impaired securities	<u>\$ 34,154</u>	<u>\$ (574)</u>	<u>\$ 117,753</u>	<u>\$ (4,279)</u>	<u>\$ 151,907</u>	<u>\$ (4,853)</u>

## Notes to Consolidated Financial Statements

Declines in the fair value of securities below their cost that are deemed to be other-than-temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of the impairment of available for sale securities related to other factors is recognized in other comprehensive income (loss). In estimating other-than-temporary impairment losses, management considers, among other things, the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer and the intent and ability of the Company to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value. The unrealized losses shown above are primarily due to increases in market rates over the yields available at the time of purchase of the underlying securities and not credit quality. Because the Company does not intend to sell these securities and it is more likely than not that the Company will not be required to sell the securities before recovery of their amortized cost bases, which may be maturity, the Company does not consider these securities to be other than temporarily impaired at December 31, 2019. There were no other-than-temporary impairments for the years ended December 31, 2019, 2018 or 2017.

**NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES**

Loans at December 31, 2019 and 2018 were as follows (in thousands):

	December 31, 2019	December 31, 2018
Commercial real estate	\$ 559,899	\$ 550,446
Consumer real estate	256,097	253,562
Construction and land development	143,111	174,670
Commercial and industrial	394,408	404,600
Consumer	28,426	25,615
Other	38,161	20,901
Total	1,420,102	1,429,794
Allowance for loan losses	(12,604)	(12,113)
Total loans, net	\$ 1,407,498	\$ 1,417,681

At December 31, 2019, variable-rate and fixed-rate loans totaled \$785,329,000 and \$634,773,000, respectively. At December 31, 2018, variable-rate and fixed-rate loans totaled \$827,491,000 and \$602,404,000, respectively.

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.

## Notes to Consolidated Financial Statements

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 table provides the risk category of loans by applicable class of loans as of December 31, 2019 and 2018 (in thousands):

	Non-impaired Loans				Total Impaired Loans	Total
	Pass	Special Mention	Substandard	Total Non-impaired		
<u>December 31, 2019</u>						
Commercial real estate	\$ 551,929	\$ 915	\$ 4,438	\$ 557,282	\$ 2,617	\$ 559,899
Consumer real estate	252,952	503	1,551	255,006	1,091	256,097
Construction and land development	142,978	—	16	142,994	117	143,111
Commercial and industrial	370,475	14,341	8,241	393,057	1,351	394,408
Consumer	28,382	6	15	28,403	23	28,426
Other	38,161	—	—	38,161	—	38,161
Total	<u>\$ 1,384,877</u>	<u>\$ 15,765</u>	<u>\$ 14,261</u>	<u>\$ 1,414,903</u>	<u>\$ 5,199</u>	<u>\$ 1,420,102</u>
<u>December 31, 2018</u>						
Commercial real estate	\$ 547,616	\$ 177	\$ 1,262	\$ 549,055	\$ 1,391	\$ 550,446
Consumer real estate	249,273	1,676	1,691	252,640	922	253,562
Construction and land development	174,591	52	19	174,662	8	174,670
Commercial and industrial	388,719	7,790	6,545	403,054	1,546	404,600
Consumer	25,556	1	27	25,584	31	25,615
Other	20,901	—	—	20,901	—	20,901
Total	<u>\$ 1,406,656</u>	<u>\$ 9,696</u>	<u>\$ 9,544</u>	<u>\$ 1,425,896</u>	<u>\$ 3,898</u>	<u>\$ 1,429,794</u>

None of the Company's loans had a risk rating of "Doubtful" as of December 31, 2019 or 2018.

The following tables detail the changes in the ALL for the years ending December 31, 2019, 2018 and 2017 by loan classification (in thousands):

	Commercial real estate	Consumer real estate	Construction and land development	Commercial and industrial	Consumer	Other	Total
<u>Year ended December 31, 2019</u>							
Balance, beginning of period	\$ 3,309	\$ 1,005	\$ 2,431	\$ 5,036	\$ 105	\$ 227	\$ 12,113
Charged-off loans	—	(39)	—	(455)	(164)	(140)	(798)
Recoveries	23	20	—	380	82	23	528
Provision for loan losses	267	245	(373)	113	199	310	761
Balance, end of period	<u>\$ 3,599</u>	<u>\$ 1,231</u>	<u>\$ 2,058</u>	<u>\$ 5,074</u>	<u>\$ 222</u>	<u>\$ 420</u>	<u>\$ 12,604</u>
<u>Year ended December 31, 2018</u>							
Balance, beginning of period	\$ 3,324	\$ 1,063	\$ 1,628	\$ 7,209	\$ 91	\$ 406	\$ 13,721
Charged-off loans	—	—	—	(4,831)	(84)	(39)	(4,954)
Recoveries	22	4	—	395	75	8	504
Provision for loan losses	(37)	(62)	803	2,263	23	(148)	2,842
Balance, end of period	<u>\$ 3,309</u>	<u>\$ 1,005</u>	<u>\$ 2,431</u>	<u>\$ 5,036</u>	<u>\$ 105</u>	<u>\$ 227</u>	<u>\$ 12,113</u>
<u>Year ended December 31, 2017</u>							
Balance, beginning of period	\$ 2,655	\$ 1,013	\$ 1,574	\$ 5,618	\$ 76	\$ 698	\$ 11,634
Charged-off loans	—	—	—	(12,769)	—	—	(12,769)
Recoveries	9	—	—	1,865	112	—	1,986
Provision for loan losses	660	50	54	12,495	(97)	(292)	12,870
Balance, 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>

## Notes to Consolidated Financial Statements

A breakdown of the ALL and the loan portfolio by loan category at December 31, 2019 and 2018 follows (in thousands):

	Commercial real estate	Consumer real estate	Construction and land development	Commercial and industrial	Consumer	Other	Total
<b>December 31, 2019</b>							
Allowance for Loan Losses:							
Collectively evaluated for impairment	\$ 3,599	\$ 1,231	\$ 2,058	\$ 5,074	\$ 222	\$ 420	\$ 12,604
Individually evaluated for impairment	—	—	—	—	—	—	—
Acquired with deteriorated credit quality	—	—	—	—	—	—	—
Balances, end of period	<u>\$ 3,599</u>	<u>\$ 1,231</u>	<u>\$ 2,058</u>	<u>\$ 5,074</u>	<u>\$ 222</u>	<u>\$ 420</u>	<u>\$ 12,604</u>
Loans:							
Collectively evaluated for impairment	\$ 557,282	\$ 255,006	\$ 142,994	\$ 393,057	\$ 28,403	\$ 38,161	\$ 1,414,903
Individually evaluated for impairment	2,507	483	112	487	5	—	3,594
Acquired with deteriorated credit quality	110	608	5	864	18	—	1,605
Balances, end of period	<u>\$ 559,899</u>	<u>\$ 256,097</u>	<u>\$ 143,111</u>	<u>\$ 394,408</u>	<u>\$ 28,426</u>	<u>\$ 38,161</u>	<u>\$ 1,420,102</u>
<b>December 31, 2018</b>							
Allowance for Loan Losses:							
Collectively evaluated for impairment	\$ 3,309	\$ 1,005	\$ 2,431	\$ 5,036	\$ 105	\$ 227	\$ 12,113
Individually evaluated for impairment	—	—	—	—	—	—	—
Loans acquired with deteriorated credit quality	—	—	—	—	—	—	—
Balances, end of period	<u>\$ 3,309</u>	<u>\$ 1,005</u>	<u>\$ 2,431</u>	<u>\$ 5,036</u>	<u>\$ 105</u>	<u>\$ 227</u>	<u>\$ 12,113</u>
Loans:							
Collectively evaluated for impairment	\$ 549,055	\$ 252,640	\$ 174,662	\$ 403,054	\$ 25,584	\$ 20,901	\$ 1,425,896
Individually evaluated for impairment	1,278	183	—	817	—	—	2,278
Acquired with deteriorated credit quality	113	739	8	729	31	—	1,620
Balances, end of period	<u>\$ 550,446</u>	<u>\$ 253,562</u>	<u>\$ 174,670</u>	<u>\$ 404,600</u>	<u>\$ 25,615</u>	<u>\$ 20,901</u>	<u>\$ 1,429,794</u>

The following table presents the allocation of the ALL for each respective loan category with the corresponding percentage of loans in each category to total loans, net of deferred fees as of December 31, 2019 and 2018 (dollars in thousands):

	December 31, 2019		December 31, 2018	
	Amount	Percent of total loans	Amount	Percent of total loans
Commercial real estate	\$ 3,599	0.25%	\$ 3,309	0.23%
Consumer real estate	1,231	0.09%	1,005	0.07%
Construction and land development	2,058	0.14%	2,431	0.17%
Commercial and industrial	5,074	0.36%	5,036	0.35%
Consumer	222	0.02%	105	0.01%
Other	420	0.03%	227	0.02%
Total allowance for loan and lease losses	<u>\$ 12,604</u>	<u>0.89%</u>	<u>\$ 12,113</u>	<u>0.85%</u>



## Notes to Consolidated Financial Statements

The following table presents information related to impaired loans as of and for the years ended December 31, 2019 and 2018 (in thousands):

	December 31, 2019			December 31, 2018		
	Recorded investment	Unpaid principal balance	Related allowance	Recorded investment	Unpaid principal balance	Related allowance
With no related allowance recorded:						
Commercial real estate	\$ 2,617	\$ 2,621	\$ —	\$ 1,391	\$ 1,775	\$ —
Consumer real estate	1,091	1,327	—	922	1,204	—
Construction and land development	117	132	—	8	18	—
Commercial and industrial	1,351	2,173	—	1,546	6,350	—
Consumer	23	41	—	31	56	—
Other	—	—	—	—	—	—
Subtotal	5,199	6,294	—	3,898	9,403	—
With an allowance recorded:						
Commercial real estate	—	—	—	—	—	—
Consumer real estate	—	—	—	—	—	—
Construction and land development	—	—	—	—	—	—
Commercial and industrial	—	—	—	—	—	—
Consumer	—	—	—	—	—	—
Other	—	—	—	—	—	—
Subtotal	—	—	—	—	—	—
Total	\$ 5,199	\$ 6,294	\$ —	\$ 3,898	\$ 9,403	\$ —

The recorded investment in loans excludes accrued interest receivable and loan origination fees, net due to immateriality. For purposes of this disclosure, the unpaid principal balance is not reduced for partial charge-offs.

The following table presents information related to the average recorded investment and interest income recognized on impaired loans for the years ended December 31, 2019, 2018 and 2017 (in thousands):

	Year Ended December 31, 2019		Year Ended December 31, 2018		Year Ended December 31, 2017	
	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	\$ 2,574	\$ 313	\$ 1,198	\$ 158	\$ 1,258	\$ —
Consumer real estate	1,037	105	185	—	—	—
Construction and land development	119	4	94	2	—	—
Commercial and industrial	824	440	5,557	121	—	—
Consumer	23	2	7	—	—	—
Other	—	—	—	—	—	—
Subtotal	4,577	864	7,041	281	1,258	—
With an allowance recorded:						
Commercial real estate	—	—	—	—	—	—
Consumer real estate	—	—	—	—	—	—
Construction and land development	—	—	—	—	—	—
Commercial and industrial	—	—	—	—	2,077	—
Consumer	—	—	—	—	—	—
Other	—	—	—	—	—	—
Subtotal	—	—	—	—	2,077	—
Total	\$ 4,577	\$ 864	\$ 7,041	\$ 281	\$ 3,335	\$ —

There was no interest income recognized on a cash basis for impaired loans for the years ended December 31, 2019, 2018 or 2017.

## Notes to Consolidated Financial Statements

Non-accrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans. Impaired loans include commercial loans that are individually evaluated for impairment and deemed impaired (i.e., individually classified impaired loans) as well as TDRs for all loan classifications.

The following table presents the aging of the recorded investment in past-due loans as of December 31, 2019 and 2018 by class of loans (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
<u>December 31, 2019</u>						
Commercial real estate	\$ 372	\$ —	\$ —	\$ 372	\$ 559,527	\$ 559,899
Consumer real estate	3,642	474	643	4,759	251,338	256,097
Construction and land development	653	15	—	668	142,443	143,111
Commercial and industrial	1,277	8	440	1,725	392,683	394,408
Consumer	67	—	33	100	28,326	28,426
Other	—	—	—	—	38,161	38,161
Total	<u>\$ 6,011</u>	<u>\$ 497</u>	<u>\$ 1,116</u>	<u>\$ 7,624</u>	<u>\$ 1,412,478</u>	<u>\$ 1,420,102</u>
<u>December 31, 2018</u>						
Commercial real estate	\$ 300	\$ 227	\$ —	\$ 527	\$ 549,919	\$ 550,446
Consumer real estate	69	75	775	919	252,643	253,562
Construction and land development	—	—	—	—	174,670	174,670
Commercial and industrial	54	—	—	54	404,546	404,600
Consumer	52	—	43	95	25,520	25,615
Other	—	—	—	—	20,901	20,901
Total	<u>\$ 475</u>	<u>\$ 302</u>	<u>\$ 818</u>	<u>\$ 1,595</u>	<u>\$ 1,428,199</u>	<u>\$ 1,429,794</u>

The following table presents the recorded investment in non-accrual loans, past due loans over 89 days and accruing and troubled debt restructurings by class of loans as of December 31, 2019 and 2018 (in thousands):

	Non-Accrual	Past Due Over 89 Days and Accruing	Troubled Debt Restructurings
<u>December 31, 2019</u>			
Commercial real estate	\$ —	\$ —	\$ 2,446
Consumer real estate	894	12	—
Construction and land development	117	—	—
Commercial and industrial	440	—	271
Consumer	13	26	—
Other	—	—	—
Total	<u>\$ 1,464</u>	<u>\$ 38</u>	<u>\$ 2,717</u>
<u>December 31, 2018</u>			
Commercial real estate	\$ —	\$ —	\$ 1,391
Consumer real estate	1,187	214	—
Construction and land development	19	—	—
Commercial and industrial	817	—	—
Consumer	55	—	—
Other	—	—	—
Total	<u>\$ 2,078</u>	<u>\$ 214</u>	<u>\$ 1,391</u>

As of December 31, 2019 and 2018 all loans classified as nonperforming were deemed to be impaired.

## Notes to Consolidated Financial Statements

As of December 31, 2019 and 2018 the Company had recorded investments in TDR of \$2.7 million and \$1.4 million, respectively. The Company did not allocate a specific allowance for those loans at December 31, 2019 or 2018 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 Company's loan policy. Loans accounted for as TDR are individually evaluated for impairment.

The following table presents loans by class modified as TDR that occurred during the year ended December 31, 2019 (in thousands). There were no TDR identified during the years ended December 31, 2018 or 2017.

	Year Ended December 31, 2019		
	Number of contracts	Pre modification outstanding recorded investment	Post modification outstanding recorded investment, net of related allowance
Commercial real estate	1	\$ 1,228	\$ 1,228
Consumer real estate	—	—	—
Construction and land development	—	—	—
Commercial and industrial	1	271	271
Consumer	—	—	—
Other	—	—	—
Total	2	\$ 1,499	\$ 1,499

There were no TDR for which there was a payment default within the twelve months following the modification during the years ended December 31, 2019, 2018 or 2017.

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

Acquired Loans

On October 1, 2018, the Company acquired Athens (see Note 2 for more information). As a result of the acquisition, the Company recorded loans with a fair value of \$344.8 million. Of those loans, \$1.7 million were considered to be purchased credit impaired ("PCI") loans, which are loans for which it is probable at the acquisition date that all contractually required payments will not be collected. The remaining loans are considered to be purchased non-impaired loans and their related fair value discount or premium is recognized as an adjustment to yield over the remaining life of each loan.

The following table relates to acquired Athens PCI loans and summarizes the contractually required payments, which includes principal and interest, expected cash flows to be collected, and the fair value of acquired PCI loans at the acquisition date (in thousands):

	Athens Bancshares acquisition on October 1, 2018
Contractually required payments	\$ 3,151
Nonaccretable difference	(1,049)
Cash flows expected to be collected at acquisition	2,102
Accretable yield	(436)
Fair value of PCI loans at acquisition date	\$ 1,666

## Notes to Consolidated Financial Statements

The following table relates to acquired Athens purchased non-impaired loans and provides the contractually required payments, fair value, and estimate of contractual cash flows not expected to be collected at the acquisition date (in thousands):

	Athens Bancshares acquisition on October 1, 2018
Contractually required payments	\$ 404,692
Fair value of acquired loans at acquisition date	343,167
Contractual cash flows not expected to be collected	1,807

The following table presents changes in the carrying value of PCI loans (in thousands):

	For the year ended December 31, 2019
Balance at beginning of period	\$ 1,620
Change due to payments received and accretion	(15)
Change due to loan charge-offs	—
Other	—
Balance at end of period	\$ 1,605

The following table presents changes in the accretable yield for PCI loans (in thousands):

	For the year ended December 31, 2019
Balance at beginning of period	\$ 440
Accretion	(570)
Reclassification from (to) nonaccretable difference	1,045
Other, net	—
Balance at end of period	\$ 915

PCI loans had no impact on the ALL for the years ended December 31, 2019, 2018 or 2017.

Leases

The Company has entered into various direct finance leases. The leases are reported as part of other loans. The lease terms vary from five years to six years. The components of the direct financing leases as of December 31, 2019 and 2018 were as follows (in thousands):

	December 31, 2019	December 31, 2018
Total minimum lease payments receivable	\$ 59	\$ 379
Less:		
Unearned income	(1)	(19)
Net leases	\$ 58	\$ 360

The future minimum lease payments receivable under the direct financing leases as of December 31, 2019 were as follows (in thousands):

Year ending December 31:	
2020	\$ 58
2021	—
2022	—
2023	—
2024	—
	\$ 58

## Notes to Consolidated Financial Statements

## NOTE 5 – LOAN SERVICING

Mortgage loans serviced for the Federal Home Loan Mortgage Corporation (“FHLMC”) are not reported as assets. The principal balance of these loans at December 31, 2019 and 2018 was \$196.9 million and \$170.1 million, respectively. These servicing rights were acquired in our acquisition of Athens. Custodial escrow balances maintained in connection with serviced loans was \$324,000 and \$462,000 at December 31, 2019 and 2018, respectively.

Activity for loan servicing rights and the related valuation allowance are summarized as follows (in thousands):

	For the year ended December 31, 2019
<b>Loan servicing rights:</b>	
Balance at beginning of period	\$ 1,736
Additions	381
Disposals	—
Amortized to offset other noninterest income	(362)
Change in valuation allowance	(211)
Balance at end of period	<u>\$ 1,544</u>
<b>Valuation allowance:</b>	
Balance at beginning of period	\$ —
Additions expensed	—
Reductions credited to other noninterest income	—
Direct write-downs	(211)
Balance at end of period	<u>\$ (211)</u>

## NOTE 6 – PREMISES AND EQUIPMENT

Premises and equipment at December 31, 2019 and 2018 are summarized as follows (in thousands):

	Range of useful lives	December 31, 2019	December 31, 2018
Land	Not applicable	\$ 4,303	\$ 2,997
Buildings	39 years	13,331	9,965
Leasehold improvements	1 to 17 years	939	939
Furniture and equipment	1 to 7 years	4,633	3,730
Fixed assets in process	Not applicable	—	4,023
		23,206	21,654
Less accumulated depreciation and amortization		(4,022)	(2,833)
		<u>\$ 19,184</u>	<u>\$ 18,821</u>

Premises and equipment depreciation and amortization expense for the years ended December 31, 2019, 2018 and 2017 totaled \$1,219,000, \$516,000 and \$401,000, respectively.

## NOTE 7 – LEASES

The Company leases certain premises and equipment under operating leases that expire at various dates, through 2032, and in most instances, include options to renew or extend at market rates and terms. At December 31, 2019, the Company had lease liabilities totaling \$12.5 million and right-of-use assets totaling \$11.7 million related to these leases. Lease liabilities and right-of-use assets are reflected in other liabilities and other assets, respectively. At December 31, 2019, the weighted average remaining lease term for operating leases was 10.7 years and the weighted average discount rate used in the measurement of operating lease liabilities was 3.52%.

## Notes to Consolidated Financial Statements

Lease costs were as follows (in thousands):

	December 31, 2019
Operating lease cost	\$ 1,868
Short-term lease cost	—
Variable least cost	—
Total lease cost	\$ 1,868

Rent expense for the year ended December 31, 2018, prior to the adoption of ASU 2016-02 was \$1,677,000.

There were no sale and leaseback transactions, leveraged leases, or lease transactions with related parties during the year ended December 31, 2019 or 2018.

A maturity analysis of operating lease liabilities and reconciliation of the undiscounted cash flows to the total operating lease liability is as follows (in thousands):

	December 31, 2019
Lease payments due:	
2020	\$ 1,562
2021	1,590
2022	1,476
2023	1,425
2024	1,130
2025 and thereafter	7,710
Total undiscounted cash flows	14,893
Discount on cash flows	(2,442)
Total lease liability	\$ 12,451

#### NOTE 8 – GOODWILL AND INTANGIBLE ASSETS

##### Goodwill

The change in goodwill during the years ended December 31, 2019 and 2018 was as follows (in thousands):

	2019	2018
Beginning of year	\$ 37,510	\$ 6,219
Acquired goodwill	—	31,291
Impairment	—	—
End of year	\$ 37,510	\$ 37,510

Impairment exists when a reporting unit's carrying value of goodwill exceeds its fair value. At October 31, 2019, the Company's reporting unit had positive equity and the Company elected to perform a qualitative assessment to determine if it was more likely than not that the fair value of the reporting unit exceeded its carrying value, including goodwill. The qualitative assessment indicated that it was more likely than not that the fair value of the reporting unit exceeded its carrying value, resulting in no impairment.

##### Acquired Intangible Assets

Acquired intangible assets at December 31, 2019 and 2018 were as follows (in thousands):

	December 31, 2019		December 31, 2018	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortized intangible assets:				
Core deposit intangibles	\$ 9,267	\$ (2,384)	\$ 9,267	\$ (729)

## Notes to Consolidated Financial Statements

Aggregate amortization expense was \$1,655,000 for 2019, \$465,000 for 2018 and \$48,000 for 2017.

Estimated amortization expense for each of the next five years is as follows (in thousands):

Year ending December 31:		
2020	\$	1,477
2021		1,299
2022		1,121
2023		943
2024		764
Thereafter		1,279
Total	\$	<u>6,883</u>

**NOTE 9 – OTHER REAL ESTATE OWNED**

Other real estate owned activity was as follows (in thousands):

	2019	2018	2017
Beginning balance	\$ 988	\$ —	\$ —
Additions due to acquisition of Athens Bancshares	—	988	—
Loans transferred to other real estate owned	180	—	—
Direct write-downs	—	—	—
Sales of other real estate owned	(124)	—	—
End of year	<u>\$ 1,044</u>	<u>\$ 988</u>	<u>\$ —</u>

There was no valuation allowance allocated to properties held for the years ended December 31, 2019, 2018 and 2017.

Expenses related to other real estate owned during the years ended December 31, 2019, 2018 and 2017, respectively include (in thousands):

	2019	2018	2017
Net (gain) loss on sales	\$ (3)	\$ —	\$ —
Provision for unrealized losses	—	—	—
Operating expenses, net of rental income	—	—	—
Total	<u>\$ (3)</u>	<u>\$ —</u>	<u>\$ —</u>

**NOTE 10 – DEPOSITS**

Time deposits that exceed the FDIC deposit insurance limit of \$250,000 at December 31, 2019 and 2018 were \$53,481,000 and \$98,086,000, respectively.

Scheduled maturities of time deposits for the next five years and thereafter are as follows (in thousands):

Maturity:		
2020	\$	222,163
2021		53,077
2022		16,255
2023		8,369
2024		2,975
Thereafter		613
	\$	<u>303,452</u>

At December 31, 2019 and 2018, the Company had \$148,000 and \$193,000, respectively of deposit accounts in overdraft status that were reclassified to loans in the accompanying balance sheets.

## Notes to Consolidated Financial Statements

**NOTE 11 – FEDERAL HOME LOAN BANK ADVANCES**

The Company had outstanding borrowings totaling \$10,000,000 and \$125,000,000 at December 31, 2019 and 2018, 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	December 31, 2019		December 31, 2018	
	Amount	Interest Rates	Amount	Interest Rates
2019	—	—	125,000	2.48%
2020	10,000	2.05%	—	—
2021	—	—	—	—
2022	—	—	—	—
2023	—	—	—	—
2024	—	—	—	—
Thereafter	—	—	—	—
Total	<u>\$ 10,000</u>	<u>2.05%</u>	<u>\$ 125,000</u>	<u>2.48%</u>

Advances from the FHLB are collateralized by investment securities with a market value of \$4.1 million, FHLB stock and certain commercial and residential real estate mortgage loans totaling \$683.1 million under a blanket mortgage collateral agreement. At December 31, 2019, the amount of available credit from the FHLB totaled \$201.4 million.

**NOTE 12 – ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)**

The following were changes in accumulated other comprehensive income (loss) by component, net of tax, for the years ended December 31, 2019 and 2018 (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
<u>Year Ended December 31, 2019</u>				
Beginning Balance	\$ (2,636)	\$ (680)	\$ —	\$ (3,316)
Other comprehensive income (loss) before reclassification, net of tax	826	4,815	—	5,641
Amounts reclassified from accumulated other comprehensive income (loss), net of tax	(869)	(73)	—	(942)
Net current period other comprehensive income (loss)	(43)	4,742	—	4,699
Ending Balance	<u>\$ (2,679)</u>	<u>\$ 4,062</u>	<u>\$ —</u>	<u>\$ 1,383</u>
<u>Year Ended December 31, 2018</u>				
Beginning Balance	\$ (3,679)	\$ 1,162	\$ (10)	\$ (2,527)
Other comprehensive income (loss) before reclassification, net of tax	1,891	(1,844)	20	67
Amounts reclassified from accumulated other comprehensive income (loss), net of tax	(848)	2	(10)	(856)
Net current period other comprehensive income (loss)	1,043	(1,842)	10	(789)
Ending Balance	<u>\$ (2,636)</u>	<u>\$ (680)</u>	<u>\$ —</u>	<u>\$ (3,316)</u>



## Notes to Consolidated Financial Statements

The following were significant amounts reclassified out of each component of accumulated other comprehensive income (loss) for the years ended December 31, 2019, 2018 and 2017 (in thousands):

Details about Accumulated Other Comprehensive Income Components	Year Ended December 31, 2019	Year Ended December 31, 2018	Year Ended December 31, 2017	Affected Line Item in the Statement Where Net Income is Presented
Unrealized losses on cash flow hedges	\$ (635)	\$ (441)	\$ (430)	Interest expense - money market
	(243)	(479)	(429)	Interest expense - Federal Home Loan Bank advances
	9	72	89	Income tax benefit
	<u>\$ (869)</u>	<u>\$ (848)</u>	<u>\$ (770)</u>	Net of tax
Unrealized gains and (losses) on available-for-sale securities	\$ (99)	\$ 3	\$ (66)	Net gain (loss) on sale of securities
	26	(1)	25	Income tax (expense) benefit
	<u>\$ (73)</u>	<u>\$ 2</u>	<u>\$ (41)</u>	Net of tax
Unrealized losses on securities transferred to held-to-maturity	\$ —	\$ (14)	\$ (190)	Interest income - securities
	—	4	73	Income tax benefit
	<u>\$ —</u>	<u>\$ (10)</u>	<u>\$ (117)</u>	Net of tax

## NOTE 13 – INCOME TAXES

The components of income tax expense are summarized as follows (in thousands):

	2019	2018	2017
Current:			
Federal	\$ 3,215	\$ 15	\$ 214
State	1,044	(23)	36
	<u>4,259</u>	<u>(8)</u>	<u>250</u>
Deferred:			
Federal	2,039	872	4,218
State	546	303	167
	<u>2,585</u>	<u>1,175</u>	<u>4,385</u>
Total	<u>\$ 6,844</u>	<u>\$ 1,167</u>	<u>\$ 4,635</u>

A reconciliation of actual income tax expense in the financial statements to the “expected” tax expense (computed by applying the statutory federal income tax rate of 21% to income before income taxes) for the years ended December 31, 2019, 2018 and 2017 is as follows (in thousands):

	2019	2018	2017
Computed "expected" tax expense	\$ 6,146	\$ 2,272	\$ 2,086
State income taxes, net of effect of federal income taxes	1,256	221	134
Tax-exempt interest income	(302)	(298)	(418)
Earnings on bank owned life insurance contracts	(173)	(559)	(197)
Disallowed expenses	84	93	86
Excess tax benefits related to stock compensation	(57)	(857)	(632)
Write-down of deferred tax assets due to tax reform	—	—	3,562
Nondeductible merger expenses	—	281	—
Other	(110)	14	14
Total	<u>\$ 6,844</u>	<u>\$ 1,167</u>	<u>\$ 4,635</u>

## Notes to Consolidated Financial Statements

As a result of the Tax Cuts and Jobs Act of 2017 that was signed into law December 2017, the Company revalued its net deferred tax asset position. This revaluation resulted in a \$3.6 million decrease in net deferred tax assets and a corresponding increase to income tax expense for the year ended December 31, 2017.

Significant items that gave rise to deferred taxes at December 31, 2019 and 2018 were as follows (in thousands):

	December 31, 2019	December 31, 2018
<b>Deferred tax assets:</b>		
Allowance for loan losses	\$ 2,935	\$ 2,795
Net operating loss carryforward	738	2,002
Organization and preopening costs	359	457
Stock-based compensation	200	835
Acquired loans	871	1,319
Unrealized loss on securities available-for-sale	—	845
Accrued contributions	247	207
Other	189	685
Deferred tax assets	5,539	9,145
<b>Deferred tax liabilities:</b>		
Depreciation	804	645
Goodwill	154	81
Unrealized gain on securities available-for-sale	833	—
Amortization of core deposit intangible	1,052	1,398
Other	568	411
Deferred tax liabilities	3,411	2,535
Net deferred tax asset	\$ 2,128	\$ 6,610

At December 31, 2019, the Company had federal net operating loss carryforwards of approximately \$3,011,000, which expire at various dates from 2030 to 2032. Deferred tax assets are fully recognized because the benefits are more likely than not to be realized based on management's estimation of future taxable earnings.

There were no significant unrecognized income tax benefits as of December 31, 2019 or 2018. As of December 31, 2019 and 2018 the Company had no accrued interest or penalties related to uncertain tax positions.

**NOTE 14 – 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 December 31, 2019 and 2018 (in thousands):

	Contract or notional amount	
	December 31, 2019	December 31, 2018
<b>Financial instruments whose contract amounts represent credit risk:</b>		
Unused commitments to extend credit	\$ 672,933	\$ 707,675
Standby letters of credit	9,634	12,273
Total	\$ 682,567	\$ 719,948

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 December 31, 2019, will not have a material impact on the financial statements of the Company.

**NOTE 15 – CONCENTRATION OF CREDIT RISK**

Substantially all of the Company's loans, commitments, and standby letters of credit have been granted to customers in the Company's market areas. The concentrations of credit by type of loan are set forth in Note 4 to the financial statements.

At December 31, 2019 and 2018, the Company's cash and due from banks, federal funds sold and interest-bearing deposits in financial institutions aggregated \$86,000,000 and \$89,000,000, respectively, in excess of insured limits.

**NOTE 16 – REGULATORY MATTERS AND RESTRICTIONS ON DIVIDENDS**

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 Company 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 December 31, 2019, the Company and the Bank met all regulatory capital adequacy requirements to which they are subject.

The Federal Deposit Insurance Corporation Improvement Act of 1991 establishes a system of "prompt corrective action" to resolve the problems of undercapitalized insured depository institutions. Under this system, federal banking regulators have established five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. Federal banking regulators are required to take various mandatory supervisory actions and are authorized to take other discretionary actions with respect to institutions in the three undercapitalized categories. The severity of the action depends upon the capital category in which the institution is placed. For example, institutions in all three undercapitalized categories are automatically restricted from paying distributions and management fees, whereas only an institution that is significantly undercapitalized or critically undercapitalized is restricted in its compensation paid to senior executive officers. Generally, subject to a narrow exception, the banking regulator must appoint a receiver or conservator for an institution that is critically undercapitalized.

At December 31, 2019 and 2018, the Company and the Bank were well capitalized under the regulatory framework for prompt corrective action. There have been no conditions or events since that notification that management believes have changed the Company's or the Bank's category.

## Notes to Consolidated Financial Statements

The Company's and the Bank's capital amounts and ratios 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
<b>At December 31, 2019:</b>						
Total capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	\$ 237,857	13.45%	\$ 141,436	8.0%	N/A	N/A
CapStar Bank	224,443	12.70	141,388	8.0	176,735	10.0
Tier I capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	225,074	12.73	106,077	6.0	N/A	N/A
CapStar Bank	211,660	11.98	106,041	6.0	141,388	8.0
Common equity Tier 1 capital to risk weighted assets:						
CapStar Financial Holdings, Inc.	225,074	12.73	79,558	4.5	N/A	N/A
CapStar Bank	195,160	11.04	79,531	4.5	114,878	6.5
Tier I capital to average assets:						
CapStar Financial Holdings, Inc.	225,074	11.37	79,201	4.0	N/A	N/A
CapStar Bank	211,660	10.70	79,150	4.0	98,938	5.0
<b>At December 31, 2018:</b>						
Total capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	\$ 222,030	12.84%	\$ 138,336	8.0%	N/A	N/A
CapStar Bank	201,972	11.68	138,294	8.0	172,868	10.0
Tier I capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	209,738	12.13	103,752	6.0	N/A	N/A
CapStar Bank	189,680	10.97	103,721	6.0	138,294	8.0
Common equity Tier 1 capital to risk weighted assets:						
CapStar Financial Holdings, Inc.	200,738	11.61	77,814	4.5	N/A	N/A
CapStar Bank	173,180	10.02	77,791	4.5	112,364	6.5
Tier I capital to average assets:						
CapStar Financial Holdings, Inc.	209,738	11.06	75,867	4.0	N/A	N/A
CapStar Bank	189,680	10.01	75,828	4.0	94,785	5.0

- (1) For the calendar year 2019, the Company was required to 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.

Under Tennessee banking law, the Bank is subject to restrictions on the payment of dividends. Banking regulations limit the amount of dividends that may be paid without prior approval of the Tennessee Department of Financial Institutions. Under these regulations, the amount of dividends that may be paid in any calendar year without prior approval of the Tennessee Department of Financial Institutions is limited to the current year's net income, combined with the retained net income of the preceding two years, subject to the capital requirements described above. The Bank's payment of dividends may also be affected or limited by other factors, such as the requirement to maintain adequate capital above regulatory guidelines. The federal banking agencies have indicated that paying dividends that deplete a depository institution's capital base to an inadequate level would be an unsafe and unsound banking practice. Under the Federal Deposit Insurance Corporation Improvement Act of 1991, a depository institution may not pay any dividends if payment would cause it to become undercapitalized or if it already is undercapitalized. Moreover, the federal agencies have issued policy statements that provide that Company holding companies and insured banks should generally only pay dividends out of current operating earnings.

Based on these regulations, the Bank was eligible to pay \$35.8 million and \$22.2 million of dividends as of December 31, 2019 and 2018, respectively. The Bank paid the Company \$3.5 million of dividends during 2019 and this amount was paid out to shareholders by the Company during 2019.

**NOTE 17 – NONVOTING AND SERIES A PREFERRED STOCK AND STOCK WARRANTS***Nonvoting Common Stock*

The Company has authorized 5,000,000 shares of its common stock as nonvoting common stock. The nonvoting common stock has the same rights and privileges as the common stock other than the nonvoting designation. Under certain conditions, as outlined in the Company's charter, the nonvoting stock may be converted, on a one-to-one basis, to common stock. In conjunction with the Company's initial public offering, 79,166 shares of nonvoting common stock were issued and simultaneously converted to common stock on a one-to-one basis as further described under "Warrants" below. During 2019, 132,561 shares of nonvoting common stock were converted to common stock. As a result, at December 31, 2019, there were no shares of nonvoting common stock outstanding.

*Preferred Stock*

In conjunction with its initial capital issuance in 2008, the Bank issued 1,609,756 shares of Series A Preferred Stock to certain shareholders. During 2016, coinciding with the Company's initial public offering, 731,707 preferred shares were converted to common shares. During 2019, 878,048 preferred shares were converted to common shares. As a result, at December 31, 2019, there was no Series A Preferred Stock outstanding.

*Warrants*

In conjunction with the issuance of the 1,609,756 shares of the Series A Preferred Stock, the holders of such stock were issued 500,000 warrants to purchase shares of the Company's nonvoting common stock at a purchase price of \$10.25 per share. The warrants were exercisable at any time and expired ten years from the date of grant of July 14, 2008. As of December 31, 2019, all of these warrants have been exercised and none of these warrants remain outstanding.

As part of the initial capital issuance in 2008, each organizer of the Company ("Organizers") who became a director of the Company received a warrant to purchase, at the purchase price of \$10.00 per share, 10,000 shares of the Company's common stock. These warrants were issued in compliance with the FDIC's policy on noncash compensation in recognition of the Organizers considerable contribution of time, expertise, and capital. The Company issued warrants to purchase 60,000 shares of common stock to these organizers. The warrants expired ten years from date of grant of July 14, 2008. As of December 31, 2019, all of these warrants have been exercised and no warrants remain outstanding.

In addition, each subscriber for shares who is a Tennessee resident or any entity controlled by a Tennessee resident and invested a minimum of \$500,000 in the offering, received a warrant to purchase additional shares of common stock equal to 5% of accepted subscriptions at the purchase price of \$10.00 per share. The Company issued warrants to purchase 238,319 shares of common stock to these subscribers. The warrants expired ten years from date of grant of July 14, 2008. As of December 31, 2019, all of these warrants have been exercised and no warrants remain outstanding.

**NOTE 18 – SHAREHOLDERS' AGREEMENT**

On August 22, 2016, the Company entered into the Second Amended and Restated Shareholders' Agreement (the "SARSA") with certain of its shareholders. Other than with respect to registration rights and rights and obligations with respect to indemnification, the SARSA will remain in effect until June 30, 2018 unless earlier terminated by the shareholders that are party to the SARSA. Among other matters, the SARSA (i) permits Corsair III Financial Services Capital Partners, L.P. and Corsair III Financial Services Offshore 892 Partners, L.P. (the "Corsair Funds") to recommend one nominee to the Nominating, Governance and Community Affairs Committee of the boards of directors of the Company and our bank for election to such boards, subject to any required regulatory and shareholder approvals, (ii) provides "demand" registration rights to the Corsair Funds and those shareholders, other than the Corsair Funds, that hold, individually or in the aggregate, at least 500,000 shares of registrable securities and (iii) provides "piggyback" registration rights to all shareholders that are parties to the SARSA.

Pursuant to the terms of the SARSA, we received a request from certain shareholders party to the SARSA to register 3,652,094 shares of our common stock on a registration statement on Form S-3 (the "Registration Statement") in December 2018. The Registration Statement was filed with the SEC on December 21, 2018. Subsequently, during 2019, the Corsair Funds exited their positions in the Company's shares.

## Notes to Consolidated Financial Statements

**NOTE 19 – STOCK OPTIONS AND RESTRICTED SHARES**

During 2008, the board of directors of the Company 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 Stock Incentive Plan (the “Plan”), which the board of directors adopted in 2016. The 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. Stock incentives include both restricted stock and stock option grants. During 2018 the board of directors approved the addition of 400,000 shares of stock for issuance of stock incentives under the Plan. Total shares issuable under the plan were 362,757 at December 31, 2019.

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 (in thousands):

	For the year ended December 31,		
	2019	2018	2017
Stock-based compensation expense before income taxes	\$ 1,262	\$ 2,079	\$ 1,061
Less: deferred tax benefit	(330)	(543)	(406)
Reduction of net income	<u>\$ 932</u>	<u>\$ 1,536</u>	<u>\$ 655</u>

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 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 2019 follows:

Nonvested Shares	Restricted Shares	Weighted Average Grant Date Fair Value
Nonvested at beginning of period	157,616	\$ 17.00
Granted	31,683	15.86
Vested	(83,062)	15.93
Forfeited	(21,540)	17.72
Nonvested at end of period	<u>84,697</u>	<u>\$ 17.44</u>

As of December 31, 2019, there was \$1,564,000 of total unrecognized compensation cost related to nonvested shares granted under the Plan. The cost is expected to be recognized over a weighted-average period of 1.6 years. The total fair value of shares vested during the years ended December 31, 2019, 2018 and 2017 was \$1,352,000, \$2,804,000 and \$1,174,000, respectively.

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 three 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 that uses the assumptions noted in the table below. Expected volatility is based on calculations performed by management using industry data. The expected term of options granted was calculated using the “simplified” method for plain vanilla options as permitted under authoritative literature. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

## Notes to Consolidated Financial Statements

The fair value of options granted was determined using the following weighted average assumptions as of the grant date. The Company granted 50,000 options during 2019. There were no options granted during 2018.

	2019
Dividend yield	1.35 %
Expected term (in years)	6.50
Expected stock price volatility	29.55 %
Risk-free interest rate	2.25 %

A summary of the activity in stock options for 2019 follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)
Outstanding at beginning of period	507,903	\$ 8.66	
Granted	50,000	14.84	
Exercised	(286,701)	7.33	
Forfeited or expired	—	—	
Outstanding at end of period	271,202	\$ 11.22	4.9
Fully vested and expected to vest	271,086	\$ 11.22	4.9
Exercisable at end of period	214,952	\$ 10.32	3.8

Information related to stock options during 2019, 2018 and 2017 follows:

	2019	2018	2017
Intrinsic value of options exercised	\$ 2,478,086	\$ 7,654,738	\$ 2,010,536
Cash received from option exercises	1,930,737	6,897,845	2,013,840
Tax benefit realized from option exercises	103,847	846,725	774,056
Weighted average fair value of options granted	5.35	—	—

As of December 31, 2019, there was \$216,000 of total 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 2.4 years.

#### NOTE 20 – EMPLOYMENT CONTRACTS

The Company has entered into employment contracts with certain senior executives with various expiration dates. Most of the contracts have an option for annual renewal by mutual agreement. The agreements specify that in certain terminating events the Company will be obligated to provide certain benefits and pay each of the senior executives severance based on their annual salaries. These terminating events include termination of employment without “Cause” (as defined in the agreements) or in certain other circumstances specified in the agreements.

#### NOTE 21 – EMPLOYEE BENEFIT PLANS

The Company has a Retirement Savings 401(k) Plan in which employees may participate. The Company has elected a safe harbor 401(k) plan and as such is required to make an annual contribution of 3% of the employees’ salaries annually. An employee does not have to contribute to receive the employer contribution. In addition, the Company may make an additional discretionary contribution up to 6% of the employees’ salaries annually. For the years ended December 31, 2019, 2018 and 2017, the Company contributed \$874,000, \$639,000 and \$550,000, respectively, to the 401(k) Plan.

The Company also has a Health Reimbursement Plan in place to offset the cost of healthcare deductibles for employees. At the end of the year, up to one-half of the unused balance in the employee’s account will be available for the following year up to a maximum of the deductible for that employee.

## Notes to Consolidated Financial Statements

## NOTE 22 – DERIVATIVE INSTRUMENTS

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

There were no interest rate swaps designated as cash flow hedges as of December 31, 2019. A forward starting interest rate swap with a notional amount totaling \$20 million as of December 31, 2018 was designated as a cash flow hedge of certain liabilities and was determined to be fully effective during all periods presented. As such, no amount of ineffectiveness was included in net income. Therefore, the aggregate fair value of the swaps was recorded in other liabilities with changes in fair value recorded in other comprehensive income. The Company terminated the interest rate swap during 2019, which resulted in a termination fee of \$1.5 million. Cash flow swaps that have been terminated resulting in cash settlement equal to previously unrealized gains or losses are included in accumulated other comprehensive income and are being amortized to net income over the remaining contractual terms of the swaps.

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

	December 31, 2019	December 31, 2018
Notional amounts	\$ —	\$ 20,000
Weighted average pay rates	—	3.54%
Weighted average receive rates	—	3 month LIBOR
Weighted average maturity	—	4.5 years
Fair value	\$ —	\$ (836)
Amount of unrealized loss recognized in accumulated other comprehensive income, net of tax	\$ —	\$ (617)

Pursuant to its interest rate swap agreements, the Company pledged collateral to the counterparties in the form of investment securities with a carrying value of \$2,038,000 at December 31, 2018. There was no collateral posted to or from the counterparties as of December 31, 2019.

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 is as follows (in thousands):

	December 31, 2019		December 31, 2018	
	Notional amount	Estimated fair value	Notional amount	Estimated fair value
Interest rate swap agreements:				
Pay fixed/receive variable swaps	\$ 45,053	\$ (926)	\$ 29,126	\$ 24
Pay variable/receive fixed swaps	45,053	926	29,126	(24)
Total	<u>\$ 90,106</u>	<u>\$ —</u>	<u>\$ 58,252</u>	<u>\$ —</u>

Mortgage Banking Derivatives

The Company enters into various derivative agreements with customers in the form of interest-rate lock commitments which are commitments to originate mortgage loans whereby the interest rate on the loan is determined prior to funding and the customers have locked into that interest rate. The derivatives are valued using a model that utilizes market interest rates and other unobservable inputs. Changes in the fair value of these commitments due to fluctuations in interest rates that are to be originated to our loans held for sale portfolio are economically hedged through the use of forward sale commitments of mortgage-backed securities. The gains and losses arising from this derivative activity are reflected in current period earnings under mortgage banking income. Interest rate lock commitments are valued using a model with significant unobservable market parameters. Forward sale commitments are valued based on quoted prices for similar assets in an active market with inputs that are observable.



## Notes to Consolidated Financial Statements

The net gains (losses) relating to mortgage banking derivative instruments included in mortgage banking income were as follows (dollars in thousands):

	For the year ended December 31, 2019
Mortgage loan interest rate lock commitments	\$ 648
Mortgage-backed securities forward sales commitments	(148)
Total	\$ 500

There were no gains or losses relating to mortgage banking derivative instruments for the years ended December 31, 2018 and 2017.

The amount and fair value of mortgage banking derivatives included in the consolidated balance sheets was as follows (dollars in thousands):

	December 31, 2019		December 31, 2018	
	Notional amount	Estimated fair value	Notional amount	Estimated fair value
Included in other assets:				
Mortgage loan interest rate lock commitments	\$ 44,694	\$ 648	\$ —	\$ —
Included in other liabilities:				
Mortgage-backed securities forward sales commitments	\$ 38,500	\$ 148	\$ —	\$ —

## NOTE 23 – RELATED PARTY

The Company may enter into loan transactions with certain directors, executive officers, significant shareholders, and their affiliates. Such transactions were made in the ordinary course of business on substantially the same terms, including interest rates and collateral, as those prevailing at the same time for comparable transactions with persons not affiliated with the Company, and did not, in the opinion of management, involve more than normal credit risk or present other unfavorable features. None of these loans were impaired at December 31, 2019 or 2018. Activity within these loans during the years ended December 31, 2019 and 2018 was as follows (in thousands):

	Total commitment	Total funded commitment
<u>Year ended December 31, 2019</u>		
Beginning of period	\$ 44,812	\$ 15,445
New commitments/draw downs	9,336	2,515
Repayments	(32,333)	(7,287)
End of period	\$ 21,815	\$ 10,673
<u>Year ended December 31, 2018</u>		
Beginning of period	\$ 49,409	\$ 21,890
New commitments/draw downs	3,631	1,038
Repayments	(8,228)	(7,483)
End of period	\$ 44,812	\$ 15,445

Deposits from directors, executive officers, significant shareholders and their affiliates at December 31, 2019 and 2018 were \$13.7 million and \$11.4 million, respectively.

## Notes to Consolidated Financial Statements

## NOTE 24 – 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 Company 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 Company'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 carried at fair value at December 31, 2019 or 2018.

## Notes to Consolidated Financial Statements

**Loans Held For Sale:** Loans held for sale are carried at either fair value, if elected, or the lower of cost or fair value on a pool-level basis. Origination fees and costs for loans held for sale recorded at lower of cost or market are capitalized in the basis of the loan and are included in the calculation of realized gains and losses upon sale. Origination fees and costs are recognized in earnings at the time of origination for loans held for sale that are recorded at fair value. Fair value 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 December 31, 2018.

**Derivatives-Mortgage Loan Interest Rate Lock Commitments:** Interest rate lock commitments that relate to the origination of mortgage loans that will be held for sale are recorded at fair value, determined as the amount that would be required to settle each derivative instrument at the balance sheet date. The fair value of the interest rate lock commitment is derived from the fair value of related mortgage loans, which is based on observable market data and includes the expected net future cash flows related to servicing of the loans. In estimating the fair value of an interest rate lock commitment, the Company assigns a probability to the interest rate lock commitment based on an expectation that it will be exercised and the loan will be funded (a “pull through” rate). The expected pull through rates are applied to the fair value of the unclosed mortgage pipeline, resulting in a Level 3 fair value classification. The pull through rate is a statistical analysis of our actual rate lock fallout history to determine the sensitivity of the residential mortgage loan pipeline compared to interest rate changes and other deterministic values. New market prices are applied based on updated loan characteristics and new fallout ratios (i.e., the inverse of the pull through rate) are applied accordingly. Significant increases (decreases) in the pull through rate in isolation result in a significantly higher (lower) fair value measurement. Changes to the fair value of interest rate lock commitments are recognized based on interest rate changes, changes in the probability that the commitment will be exercised, and the passage of time.

**Derivatives-Mortgage-Backed Securities Forward Sales Commitments:** The Company utilizes mortgage-backed securities forward sales commitments to hedge mortgage loan interest rate lock commitments. Mortgage-backed securities forward sales commitments are recorded at fair value based on quoted prices for similar assets in an active market with inputs that are observable, resulting in a Level 2 fair value classification.

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

	Fair value measurements at December 31, 2019			
	Carrying Value	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
<b>Assets:</b>				
Securities available-for-sale:				
U.S. government-sponsored agencies	\$ 10,331	\$ —	\$ 10,331	\$ —
Obligations of states and political subdivisions	45,960	—	45,960	—
Mortgage-backed securities-residential	138,679	—	138,679	—
Asset-backed securities	3,197	—	3,197	—
Other debt securities	14,962	—	14,962	—
Loans held for sale	168,222	—	168,222	—
<b>Derivative assets:</b>				
Non-hedging derivatives:				
Interest rate swaps - customer related	926	—	926	—
Mortgage loan interest rate lock commitments	648	—	—	648
<b>Liabilities:</b>				
Derivative liabilities:				
Non-hedging derivatives:				
Interest rate swaps - customer related	(926)	—	(926)	—
Mortgage-backed securities forward sales commitments	(148)	—	(148)	—

## Notes to Consolidated Financial Statements

Fair value measurements at December 31, 2018				
	Carrying Value	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
<b>Assets:</b>				
Securities available-for-sale:				
U.S. government-sponsored agencies	\$ 10,706	\$ —	\$ 10,706	\$ —
Obligations of states and political subdivisions	61,926	—	61,926	—
Mortgage-backed securities-residential	144,158	—	144,158	—
Asset-backed securities	15,284	—	15,284	—
Other debt securities	11,734	—	11,734	—
Derivatives:				
Interest rate swaps - customer related	494	—	494	—
<b>Liabilities:</b>				
Derivatives:				
Interest rate swaps - customer related	(494)	—	(494)	—
Interest rate swaps - cash flow hedges	(836)	—	(836)	—

The table below presents a reconciliation of all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the nine months ended December 31, 2019 and 2018 (dollars in thousands):

	Mortgage Loan Interest Rate Lock Commitments	
	2019	2018
Balance of recurring Level 3 assets at January 1st	\$ —	\$ —
Total gains or losses for the period:		
Included in mortgage banking income	648	—
Balance of recurring Level 3 assets at December 31st	<u>\$ 648</u>	<u>\$ —</u>

The following table presents quantitative information about recurring Level 3 fair value measurements at December 31, 2019 (dollars in thousands). There were no Level 3 fair value measurements at December 31, 2018.

December 31, 2019	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted-Average)
<b>Assets:</b>				
Non-hedging derivatives:				
Mortgage loan interest rate lock commitments	\$ 648	Consensus pricing	Origination pull-through rate	68% - 95% (83%)

There were no assets measured at fair value on a nonrecurring basis at December 31, 2019 and 2018.

## Notes to Consolidated Financial Statements

Fair Value of Financial Instruments

The carrying value and estimated fair values of the Company's financial instruments at December 31, 2019 and 2018 were as follows (in thousands):

	December 31, 2019		December 31, 2018		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	\$ 101,094	\$ 101,094	\$ 94,681	\$ 94,681	Level 1
Federal funds sold	175	175	10,762	10,762	Level 1
Securities available-for-sale	213,129	213,129	243,808	243,808	Level 2
Securities held-to-maturity	3,313	3,411	3,734	3,785	Level 2
Loans held for sale	168,222	169,072	57,618	58,596	Level 2
Restricted equity securities	13,689	N/A	12,038	N/A	N/A
Loans	1,420,102	1,414,757	1,429,794	1,442,082	Level 3
Accrued interest receivable	5,792	5,792	5,964	5,964	Level 2
Other assets	36,393	36,393	34,489	34,489	Level 2 / Level 3
Financial liabilities:					
Deposits	1,729,451	1,730,206	1,570,008	1,572,880	Level 3
Federal Home Loan Bank advances	10,000	10,014	125,000	126,548	Level 2
Other liabilities	1,394	1,394	2,753	2,753	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*

In accordance with the adoption of ASU 2016-01, the fair value of loans is measured using an exit price notion. Fair values for impaired loans are estimated using discounted cash flow models or based on the fair value of the underlying collateral.

(e) *Accrued interest receivable*

The carrying amount of accrued interest approximates fair value.

(f) *Other Assets*

Included in other assets are bank owned life insurance and certain interest rate swap agreements. The fair values of interest rate swap agreements 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.

## Notes to Consolidated Financial Statements

(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 and certain interest rate swap agreements. The fair values of interest rate swap agreements are based on independent pricing services that utilize pricing models with observable market 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 Company's entire holdings of a particular instrument. Because no market exists for a significant portion of the Company'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 25 – PARENT COMPANY ONLY FINANCIAL INFORMATION**

The following information presents the condensed balance sheet, statement of income, and cash flows of CapStar Financial Holdings, Inc. as of and for the year ended December 31, 2019 and 2018 (in thousands).

**Condensed Balance Sheets**

	December 31, 2019	December 31, 2018
<b>Assets</b>		
Cash and cash equivalents	\$ 12,874	\$ 19,918
Investment in consolidated subsidiary	259,632	234,263
Other assets	578	499
<b>Total assets</b>	<b>\$ 273,084</b>	<b>\$ 254,680</b>
<b>Liabilities and Shareholders' Equity</b>		
Other liabilities	\$ 38	301
Total shareholders' equity	273,046	254,379
<b>Total liabilities and shareholders' equity</b>	<b>\$ 273,084</b>	<b>\$ 254,680</b>

## Notes to Consolidated Financial Statements

## Condensed Income Statements

	Year Ended December 31, 2019	Year Ended December 31, 2018
Income - dividends from subsidiary	\$ 3,530	\$ 1,225
Expenses	1,083	1,054
Income before income taxes and equity in undistributed net income of subsidiary	2,447	171
Income tax benefit	(262)	(242)
Income before equity in undistributed net income of subsidiary	2,709	413
Equity in undistributed net income of subsidiary	19,713	9,242
Net income	\$ 22,422	\$ 9,655

## Condensed Statements of Cash Flows

	Year Ended December 31, 2019	Year Ended December 31, 2018
Cash flows from operating activities:		
Net income	\$ 22,422	\$ 9,655
Adjustments to reconcile net income to net cash provided by operating activities:		
Increase in other assets	(78)	(221)
Increase (Decrease) in other liabilities	(263)	181
Equity in undistributed net income of subsidiary	(19,713)	(9,242)
Net cash provided by operating activities	2,368	373
Cash flows from investing activities:		
Cash received from acquisitions, net	—	1,421
Net cash provided by investing activities	—	1,421
Cash flows from financing activities:		
Repurchase of common stock	(7,836)	—
Exercise of common stock options and warrants	1,931	5,260
Common and preferred stock dividends paid	(3,507)	(1,244)
Net cash provided by (used in) financing activities	(9,412)	4,016
Net increase (decrease) in cash and cash equivalents	(7,044)	5,810
Cash and cash equivalents at beginning of period	19,918	14,108
Cash and cash equivalents at end of period	\$ 12,874	\$ 19,918

## Notes to Consolidated Financial Statements

## NOTE 26 – QUARTERLY FINANCIAL RESULTS (UNAUDITED)

The following is a summary of quarterly financial results (unaudited) for 2019, 2018 and 2017:

	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>
2019				
Interest income	\$ 22,967	\$ 23,158	\$ 23,216	\$ 22,205
Interest expense	5,965	6,150	6,060	5,624
Net interest income	17,002	17,008	17,156	16,581
Provision for loan losses	886	—	(125)	—
Net interest income after provision for loan losses	16,116	17,008	17,281	16,581
Noninterest income	4,735	7,032	6,788	5,719
Noninterest expense	14,725	16,470	15,531	15,266
Net income before income tax expense	6,126	7,570	8,538	7,034
Income tax expense	1,346	1,814	2,072	1,613
Net income	\$ 4,780	\$ 5,756	\$ 6,466	\$ 5,421
Net income per share, basic	\$ 0.27	\$ 0.33	\$ 0.36	\$ 0.30
Net income per share, diluted	\$ 0.25	\$ 0.31	\$ 0.35	\$ 0.29
2018				
Interest income	\$ 13,744	\$ 15,354	\$ 15,782	\$ 22,900
Interest expense	2,898	3,767	4,239	5,184
Net interest income	10,846	11,587	11,543	17,716
Provision for loan losses	678	169	481	1,514
Net interest income after provision for loan losses	10,168	11,418	11,062	16,202
Noninterest income	3,088	2,765	3,218	6,387
Noninterest expense	9,580	10,005	10,070	23,832
Net income (loss) before income tax expense	3,676	4,178	4,210	(1,243)
Income tax expense (benefit)	483	665	554	(535)
Net income (loss)	\$ 3,193	\$ 3,513	\$ 3,656	\$ (708)
Net income (loss) per share, basic	\$ 0.27	\$ 0.30	\$ 0.30	\$ (0.04)
Net income (loss) per share, diluted	\$ 0.25	\$ 0.27	\$ 0.28	\$ (0.04)
2017				
Interest income	\$ 11,979	\$ 12,891	\$ 13,521	\$ 13,124
Interest expense	2,047	2,320	2,678	2,606
Net interest income	9,932	10,571	10,843	10,518
Provision for loan losses	3,405	9,690	(195)	(30)
Net interest income after provision for loan losses	6,527	881	11,038	10,548
Noninterest income	2,133	2,666	3,372	2,736
Noninterest expense	8,376	8,217	8,475	8,699
Net income (loss) before income tax expense	284	(4,670)	5,935	4,585
Income tax expense (benefit)	(47)	(1,328)	1,516	4,494
Net income (loss)	\$ 331	\$ (3,342)	\$ 4,419	\$ 91
Net income (loss) per share, basic	\$ 0.03	\$ (0.30)	\$ 0.39	\$ 0.01
Net income (loss) per share, diluted	\$ 0.03	\$ (0.26)	\$ 0.35	\$ 0.01



**NOTE 27 – SUBSEQUENT EVENTS**

On January 23, 2020, we announced the signing of definitive merger agreements with FCB Corporation (“FCB”), its wholly owned subsidiary The First National Bank of Manchester (“FNBM”), and The Bank of Waynesboro (“BOW”) providing for FCB to merge with and into CapStar Financial Holdings, Inc. and for FNBM and BOW to merge with and into CapStar Bank. Under the terms of the merger agreements, FCB and BOW shareholders will receive 3,634,218 CapStar common shares and \$26.4 million in cash, subject to certain adjustments, totaling \$85.1 million based on the closing price of CapStar’s common stock on January 22, 2020. Pending regulatory and shareholder approvals and the satisfaction of certain other customary closing conditions, the acquisition is expected to be finalized in late second or early third quarter of 2020. As of December 31, 2019, FCB and BOW had total combined assets of \$467 million.

## **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES**

Not applicable.

## **ITEM 9A. CONTROLS AND PROCEDURES**

### **Evaluation of Disclosure Controls and Procedures**

As of the end of the period covered by this Report, the Company carried out an evaluation, under the supervision and with the participation of its management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management was required to apply judgment in evaluating its controls and procedures. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act), were effective as of the end of the period covered by this Report.

### **Changes in Internal Control over Financial Reporting**

There were no changes in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the quarter ended December 31, 2019, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

### **Management's Annual Report on Internal Control over Financial Reporting**

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control system was designed to provide reasonable assurance to the Company's management and Board of Directors regarding the preparation and fair presentation of the financial statements. As of December 31, 2019, management assessed the effectiveness of the Company's internal control over financial reporting based on the criteria for effective internal control over financial reporting established in "Internal Control-Integrated Framework," issued by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission in 2013. This assessment included controls over the preparation of the schedules equivalent to the basic financial statements in accordance with the instructions for the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C) to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act. Based on the assessment, management determined that there were no material weaknesses in the Company's internal control over financial reporting and that the Company maintained effective internal control over financial reporting as of December 31, 2019.

### **Attestation Report of the Registered Public Accounting Firm**

Elliott Davis, LLC, the Company's independent registered public accounting firm, audited the consolidated financial statements of the Company included in this Report. Their report is included in "Part II, Item 8.—Financial Statements, Supplementary Data and Financial Statement Schedules" under the heading "Report of Independent Registered Public Accounting Firm." This Annual Report does not include an attestation report of the Company's independent registered public accounting firm on the Company's internal control over financial reporting due to a transition period established by rules of the Securities and Exchange Commission for an Emerging Growth Company.

## **ITEM 9B. OTHER INFORMATION**

Not applicable.

## PART III

### ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this Item will be presented in, and is incorporated herein by reference to, CapStar Financial's Definitive Proxy Statement for the 2020 Annual Meeting of Shareholders which will be filed with the SEC within 120 days of December 31, 2019.

### ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item will be presented in, and is incorporated herein by reference to, CapStar Financial's Definitive Proxy Statement for the 2020 Annual Meeting of Shareholders which will be filed with the SEC within 120 days of December 31, 2019.

### ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The following table summarizes information concerning the Company's equity compensation plans at December 31, 2019:

Plan Category	Number of shares to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of shares remaining available for future issuances under equity compensation plans (excluding shares reflected in column (a)) (c)
Equity compensation plans approved by shareholders:			
CapStar Financial Holdings, Inc. Stock Incentive Plan	271,202	(1)\$ 11.22	362,757
Equity compensation plans not approved by shareholders	—	—	—
Total	271,202	(1)\$ 11.22	362,757

(1) Represents 271,202 shares of common stock subject to issuance upon exercise of issued and outstanding stock options.

The other information required by this Item will be presented in, and is incorporated herein by reference to, CapStar Financial's Definitive Proxy Statement for the 2020 Annual Meeting of Shareholders which will be filed with the SEC within 120 days of December 31, 2019.

### ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this Item will be presented in, and is incorporated herein by reference to, CapStar Financial's Definitive Proxy Statement for the 2020 Annual Meeting of Shareholders which will be filed with the SEC within 120 days of December 31, 2019.

### ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item will be presented in, and is incorporated herein by reference to, CapStar Financial's Definitive Proxy Statement for the 2020 Annual Meeting of Shareholders which will be filed with the SEC within 120 days of December 31, 2019.

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

(a) The following is a list of documents filed as a part of this Report:

(1) Financial Statements

The following consolidated financial statements of CapStar and its subsidiary and related reports of our independent registered public accounting firm are incorporated into this Item 15 by reference from Part II - Item 8, pages 60 through 109.

[Consolidated Balance Sheets as of December 31, 2019 and 2018](#)

[Consolidated Statements of Income for the years ended December 2019, 2018, and 2017](#)

[Consolidated Statements of Comprehensive Income for the years ended December 31, 2019, 2018 and 2017](#)

[Consolidated Statements of Cash Flows for the years ended December 31, 2019, 2018, 2017](#)

[Notes to Consolidated Financial Statements](#)

(2) Financial Statement Schedules

All schedules for which provision is made in Regulation S-X are either not required to be included herein under the related instructions, are inapplicable, or the related information is included in the footnotes to the applicable financial statements, and, therefore, have been omitted.

(3) Exhibits

See Item 15(b) of this Report.

(b) Exhibits

The exhibits required to be filed by Item 601 of Regulation S-K are listed in the Exhibit Index at the end of this Item 15.

(c) Financial Statement Schedules.

See Item 15(a)(2) of this Report.

## EXHIBIT INDEX

Exhibit Number	Description
2.1	<a href="#"><u>Agreement and Plan of Share Exchange, dated as of December 1, 2015, between CapStar Bank and CapStar Financial Holdings, Inc. (incorporated by reference herein to Exhibit 2.1 to the Company's Registration Statement on Form S-1 (File Number 333-213367) filed on August 29, 2016).</u></a>
2.2	<a href="#"><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></a>
2.3	<a href="#"><u>Agreement and Plan of Merger, dated as of January 23, 2020, by and between CapStar Financial Holdings, Inc. and FCB Corporation (incorporated by reference herein to Exhibit 2.1 to the Company's Current Report on Form 8-K filed on January 29, 2020)</u></a>
2.4	<a href="#"><u>Plan of Bank Merger, dated as of January 23, 2020, by and among CapStar Financial Holdings, Inc., CapStar Bank and The Bank of Waynesboro (incorporated by reference herein to Exhibit 2.2 to the Company's Current Report on Form 8-K filed on January 29, 2020)</u></a>
3.1	<a href="#"><u>Charter of CapStar Financial Holdings, Inc. (incorporated by reference herein to Exhibit 3.1 to the Company's Registration Statement on Form S-1 (File Number 333-213367) filed on August 29, 2016)</u></a>
3.2	<a href="#"><u>Amended and Restated Bylaws of Capstar Financial Holdings, Inc. (incorporated by reference herein to Exhibit 3.1 to the Company's Current Report on Form 8-K on October 28, 2019)</u></a>
4.1	<a href="#"><u>Form of Common Stock Certificate (incorporated by reference herein to Exhibit 4.1 to Amendment No. 2 to the Company's Registration Statement on Form S-1 (File Number 333-213367) filed on September 20, 2016)</u></a>
4.2	<a href="#"><u>Second Amended and Restated Shareholders' Agreement, dated as of August 22, 2016, among CapStar Financial Holdings, Inc., CapStar Bank, Corsair III Financial Services Capital Partners, L.P., Corsair III Financial Services Offshore 892 Partners, L.P., North Dakota Investors, LLC and certain other persons named therein (incorporated by reference herein to Exhibit 4.2 to the Company's Registration Statement on Form S-1 (File Number 333-213367) filed on August 29, 2016)</u></a>
4.3	<a href="#"><u>Description of Registrant's Securities, registered pursuant to Section 12 of the Securities Exchange Act of 1934*</u></a>
10.1†	<a href="#"><u>Executive Employment Agreement, dated May 13, 2019, between CapStar Financial Holdings, Inc., CapStar Bank, and Timothy K. Schools (incorporated by reference herein to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on May 17, 2019)</u></a>
10.2†	<a href="#"><u>Non-Qualified Stock Option Agreement, dated May 22, 2019, between CapStar Financial Holdings, Inc., CapStar Bank, and Timothy K. Schools (incorporated by reference herein to Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q filed on August 7, 2019)</u></a>
10.3†	<a href="#"><u>Fourth Amended and Restated Executive Employment Agreement between CapStar Financial Holdings, Inc., CapStar Bank and Robert B. Anderson, dated as of December 28, 2018 (incorporated by reference herein to Exhibit 10.2 to the Company's Current Report on Form 8-K filed on January 4, 2019)</u></a>
10.4†	<a href="#"><u>CapStar Financial Holdings, Inc. Restricted Stock Agreement between CapStar Financial Holdings, Inc. and Robert B. Anderson, dated as of December 28, 2018 (incorporated by reference herein to Exhibit 10.3 to the Company's Current Report on Form 8-K filed on January 4, 2019)</u></a>
10.5†	<a href="#"><u>Promissory Note between CapStar Bank and Robert B. Anderson, dated December 28, 2018 (incorporated by reference to Exhibit 10.4 to the Company's Current Report on Form 8-K filed on January 4, 2019)</u></a>

- 10.6† [Second Amended and Restated Executive Employment Agreement between CapStar Bank and Christopher Tietz, dated as of December 28, 2018 \(incorporated by reference herein to Exhibit 10.5 to the Company's Current Report on Form 8-K filed on January 4, 2019\).](#)
- 10.7† [CapStar Financial Holdings, Inc. Restricted Stock Agreement between CapStar Financial Holdings, Inc. and Christopher Tietz, dated as of December 28, 2018 \(incorporated by reference herein to Exhibit 10.6 to the Company's Current Report on Form 8-K filed on January 4, 2019\)](#)
- 10.8† [Promissory Note between CapStar Bank and Christopher Tietz, dated December 28, 2018 \(incorporated by reference to Exhibit 10.7 to the Company's Current Report on Form 8-K filed on January 4, 2019\).](#)
- 10.9† [Eighth Amended and Restate Executive Employment Agreement, dated May 13, 2019, between CapStar Financial Holdings, Inc., CapStar Bank, and Claire W. Tucker \(incorporated by reference herein to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on May 17, 2019\)](#)
- 10.10† [CapStar Financial Holdings, Inc. Stock Incentive Plan \(incorporated by reference herein to Exhibit 10.5 to the Company's Registration Statement on Form S-1 \(File Number 333-213367\) filed on August 29, 2016\)](#)
- 10.11† [First Amendment to the CapStar Financial Holdings, Inc. Stock Incentive Plan \(incorporated by reference herein to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on May 30, 2017\).](#)
- 10.12† [Second Amendment to the CapStar Financial Holdings, Inc. Stock Incentive Plan \(incorporated by reference herein to Appendix A to the Company's Definitive Proxy Statement filed on March 19, 2018\).](#)
- 10.13† [CapStar Financial Holdings, Inc. form of Restricted Stock Agreement \(incorporated by reference herein to Exhibit 10.6 to the Company's Registration Statement on Form S-1 \(File Number 333-213367\) filed on August 29, 2016\)](#)
- 10.14† [CapStar Financial Holdings, Inc. form of Restricted Stock Agreement to replace awards of CapStar Bank Restricted Stock \(incorporated by reference herein to Exhibit 10.8 to the Company's Registration Statement on Form S-1 \(File Number 333-213367\) filed on August 29, 2016\)](#)
- 10.15† [CapStar Financial Holdings, Inc. form of Non-Qualified Stock Option Agreement \(incorporated by reference herein to Exhibit 10.7 to the Company's Registration Statement on Form S-1 \(File Number 333-213367\) filed on August 29, 2016\).](#)
- 10.16† [CapStar Financial Holdings, Inc. form of Non-Qualified Stock Option Agreement to replace awards of CapStar Bank Options \(incorporated by reference herein to Exhibit 10.9 to the Company's Registration Statement on Form S-1 \(File Number 333-213367\) filed on August 29, 2016\)](#)
- 10.17 [Termination Agreement, dated April 26, 2017, by and between CapStar Financial Holdings, Inc. and Dale W. Polley \(incorporated by reference herein to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on April 26, 2017\).](#)
- 10.18† [Athens Bancshares Corporation 2010 Equity Incentive Plan and related form agreement \(incorporated by reference herein to Exhibit 4.5 to the Company's Registration Statement on Form S-8 \(File Number 333-227625\) filed on October 1, 2018\).](#)
- 10.19 [Securities Purchase Agreement, dated September 9, 2019, between CapStar Financial Holdings, Corsair III Financial Services Capital Partners, L.P., and Corsair III Financial Services Offshore 892 Partners, L.P. \(incorporated by reference herein to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on September 9, 2019\)](#)

21.1	<a href="#"><u>Subsidiaries of CapStar Financial Holdings, Inc.*</u></a>
23.1	<a href="#"><u>Consent of Elliott Davis, LLC*</u></a>
31.1	<a href="#"><u>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, as amended.*</u></a>
31.2	<a href="#"><u>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, as amended.*</u></a>
32.1	<a href="#"><u>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, as amended.**</u></a>
32.2	<a href="#"><u>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, as amended.**</u></a>
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 Annual Report on Form 10-K.

\*\* Furnished with this Annual Report on Form 10-K.

† Represents a management contract or a compensatory plan or arrangement.

#### **ITEM 16. FORM 10-K SUMMARY**

None.

## SIGNATURES

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

CAPSTAR FINANCIAL HOLDINGS, INC.

Date: March 6, 2020

By: /s/ Timothy K. Schools  
Timothy K. Schools  
President and Chief Executive Officer

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

Signature	Title	Date
<u>/s/ Timothy K. Schools</u> Timothy K. Schools	Director, President and Chief Executive Officer (Principal Executive Officer)	March 6, 2020
<u>/s/ Robert B. Anderson</u> Robert B. Anderson	Chief Financial Officer and Chief Administrative Officer (Principal Financial Officer and Principal Accounting Officer)	March 6, 2020
<u>/s/ Dennis C. Bottorff</u> Dennis C. Bottorff	Chairman	March 6, 2020
<u>/s/ L. Earl Bentz</u> L. Earl Bentz	Director	March 6, 2020
<u>/s/ Jeffrey L. Cunningham</u> Jeffrey L. Cunningham	Director	March 6, 2020
<u>/s/ Thomas R. Flynn</u> Thomas R. Flynn	Director	March 6, 2020
<u>/s/ Julie D. Frist</u> Julie D. Frist	Vice Chair	March 6, 2020
<u>/s/ Louis A. Green III</u> Louis A. Green III	Director	March 6, 2020
<u>/s/ Myra NanDora Jenne</u> Myra NanDora Jenne	Director	March 6, 2020
<u>/s/ Dale W. Polley</u> Dale W. Polley	Vice Chair	March 6, 2020
<u>/s/ Stephen B. Smith</u> Stephen B. Smith	Director	March 6, 2020
<u>/s/ James S. Turner, Jr.</u> James S. Turner, Jr.	Director	March 6, 2020
<u>/s/ Toby S. Wilt</u> Toby S. Wilt	Director	March 6, 2020



**DESCRIPTION OF REGISTRANT’S SECURITIES  
REGISTERED PURSUANT TO SECTION 12 OF THE  
SECURITIES EXCHANGE ACT OF 1934**

The following description sets forth certain material terms and provisions of CapStar Financial Holdings, Inc.’s (the “Company”) securities that are registered under Section 12 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). As of the date of the Annual Report on Form 10-K into which this exhibit is incorporated by reference, the registrant has one class of securities registered under Section 12 of the Exchange Act: the Company’s common stock, par value \$1.00 per share (the “Common Stock”).

**General Description of the Company’s Capitalization**

The Company’s Charter currently authorizes the issuance of 30,000,000 shares of capital stock, with 25,000,000 shares being Common Stock and 5,000,000 shares being preferred stock, \$1.00 par value per share. Of the 5,000,000 shares of preferred stock, 1,609,800 shares are designated as Series A Nonvoting Noncumulative Perpetual Convertible Preferred Stock (“Series A Preferred Stock”). The authorized but unissued shares of the Company’s capital stock are available for future issuance without shareholder approval, unless otherwise required by applicable law or the rules of the NASDAQ Global Select Market (“NASDAQ”).

**The Company’s Common Stock**

*Governing Documents*

Holders of the Company’s shares of Common Stock have the rights set forth in in the Company’s Charter, the Company’s Amended and Restated Bylaws and the Tennessee Business Corporation Act, as amended (the “TBCA”). Certain holders of our Common Stock have registration rights pursuant to that certain Second Amended and Restated Shareholders’ Agreement, dated August 22, 2016, between us and certain of the Company’s shareholders.

*Ranking*

Common Stock, with respect to dividend rights, ranks on a parity with, and with respect to rights upon a liquidation, dissolution and winding up of the Company, ranks junior to, the Series A Preferred Stock, any other series of preferred stock that may be designated, issued and outstanding and any indebtedness of the Company.

*Dividends and Other Distributions*

Subject to certain regulatory restrictions to which we are subject, holders of Common Stock are entitled to receive cash dividends, when, as and if declared by the Company’s Board of Directors, out of funds legally available for the payment of dividends.

*Voting*

Each outstanding share of Common Stock is entitled to one vote on each matter voted on at a shareholders’ meeting. Common Stock does not have cumulative voting rights. A majority of the voting power of the outstanding shares entitled to vote at a shareholders’ meeting, present in person or represented by proxy, will constitute a quorum at a meeting of shareholders. If a quorum exists, except with respect to the election of directors, action on a matter is approved if the votes cast in favor of an action exceed the votes cast in opposition to the action, unless the Company’s Charter or the TBCA requires a greater number of affirmative votes. Directors of the Company are elected by a plurality of the votes cast by the shares entitled to vote in the election at a shareholders’ meeting at which a quorum is present. The Company’s directors are elected annually by the Company’s shareholders at the Company’s annual meeting of shareholders for one-year terms and the Company’s directors serve until their successors are duly elected and qualified or until their earlier death, resignation or removal.

In any case where the TBCA or other applicable law requires shareholder approval of any merger or share exchange of the Company with or into any other corporation, or any sale, lease, exchange or other disposition of substantially all of the assets of the Company to any other corporation, person or other entity, approval of such transaction shall require either: (1) the affirmative vote of two-thirds (2/3) of the directors of the Company then in office and the affirmative vote of a majority of the issued and outstanding shares of the Company entitled to vote; or (2) the affirmative vote of a majority of the directors of the Company then in office and the affirmative vote of the holders of at least two-thirds (2/3) of the issued and outstanding shares of the Company entitled to vote.

*Liquidation Rights*

In the event of a liquidation, dissolution or winding up of the Company, whether voluntary or involuntary, and subject to the payment of all debts and other liabilities of the Company and the prior rights of any holders of shares of preferred stock then outstanding, including the right of holders of any shares of Series A Preferred Stock to receive \$10.25 per share plus any declared but unpaid dividends, the holders of shares of Common Stock are entitled to receive, *pro rata*, the Company's assets which are legally available for distribution.

*Conversion Rights.*

Common Stock is not convertible into any other shares of the Company's capital stock.

*Preemptive Rights.*

Holders of Common Stock do not have any preemptive rights.

*Redemption.*

We have no obligation or right to redeem Common Stock. The Company's Board of Directors may fix from time to time the terms and conditions of any redemptions of Common Stock, including the date or dates upon or after which they shall be redeemable, the event or events upon or after which they shall be redeemable and the amount per share payable in case of a redemption.

*Fully Paid and Non-Assessable*

The issued and outstanding shares of Common Stock are fully paid and non-assessable.

*Listing and Trading*

Common Stock is listed on the NASDAQ under the symbol "CSTR".

**Charter and Amended and Restated Bylaws**

The Company's Charter and the Amended and Restated Bylaws currently contain provisions that may be deemed to be "antitakeover" in nature. Among other provisions, the Company's Charter and Amended and Restated Bylaws:

- provide that special meetings of shareholders, unless otherwise prescribed by the TBCA, may be called only by the Company's Board of Directors, by the Chairman of the Company's Board of Directors, by the President and Chief Executive Officer or by the Secretary acting under the instructions of any of the foregoing;
- enable the Company's Board of Directors by a majority vote to increase the number of persons serving as directors up to the maximum of 25 and to fill the vacancies created as a result of the increase by a majority vote of the directors then in office;
- require no more than 120 days' and no less than 75 days' advance notice of nominations for the election of directors and the presentation of shareholder proposals at meetings of shareholders;
- enable the Company's Board of Directors to amend the Company's Amended and Restated Bylaws without shareholder approval;
- require:
  - either (i) the affirmative vote of two-thirds of the Company's directors then in office and the affirmative vote of a majority of the Company's outstanding shares entitled to vote or (ii) the affirmative vote of a majority of the Company's directors then in office and the affirmative vote of two-thirds of the Company's outstanding shares entitled to vote, if the TBCA or other applicable law requires shareholder approval of a merger, share exchange or sale, lease, exchange or other disposition of all or substantially all of the Company's assets;
  - either (i) the affirmative vote of two-thirds of the Company's directors then in office or (ii) the affirmative vote of two-thirds of the Company's outstanding shares entitled to vote to amend or rescind the immediately preceding provision; and

- do not provide for cumulative voting rights (therefore prohibiting shareholders from giving more than one vote per share to any single director nominee).

In addition, the Company's Charter and Amended and Restated Bylaws and the TBCA enable the Company's Board of Directors to issue, from time to time and at its discretion, but subject to limits imposed by applicable law and by any exchange on which the Company's securities may be listed, any authorized but unissued shares of Common Stock or preferred stock. The additional authorized shares could be used by the Company's Board of Directors, if consistent with its fiduciary responsibilities, to discourage persons from attempting to gain control of us by diluting the voting power of shares then outstanding or increasing the voting power of persons that would support the Board of Directors in a potential takeover situation, including by preventing or delaying a proposed business combination that is opposed by the Board of Directors although perceived to be desirable by some shareholders.

#### ***Tennessee Law***

We are a Tennessee corporation and consequently are also subject to certain anti-takeover provisions of the following Tennessee statutes.

The TBCA generally prohibits a "business combination" by us or the Company's subsidiary, CapStar Bank, with an "interested shareholder" within five years after the shareholder becomes an interested shareholder. The Company or CapStar Bank can, however, enter into a business combination within that period if, before the interested shareholder became such, the Company's Board of Directors approved the business combination or the transaction in which the interested shareholder became an interested shareholder. After that five-year moratorium, the business combination with the interested shareholder can be consummated only if it satisfies certain fair price criteria or is approved by at least two-thirds of the Company's shares of Common Stock held by holders other than the interested shareholder.

For purposes of these provisions of the TBCA, a "business combination" includes mergers, share exchanges, sales and leases of assets, issuances of securities, and similar transactions. An "interested shareholder" is generally any person or entity that beneficially owns 10% or more of the voting power of any outstanding class or series of the Company's stock.

The Tennessee Greenmail Act applies to a Tennessee corporation that has a class of voting stock registered or traded on a national securities exchange or registered with the SEC pursuant to Section 12(g) of the Exchange Act. Under the Tennessee Greenmail Act, a company may not purchase any of its shares at a price above the market value of such shares from any person who holds more than 3% of the class of securities to be purchased if such person has held such shares for less than two years, unless the purchase has been approved by the affirmative vote of a majority of the outstanding shares of each class of voting stock issued by the Company or the Company makes an offer, or at least equal value per share, to all shareholders of such class.

SUBSIDIARY LIST

CapStar Bank, a Tennessee chartered banking corporation

**Consent of Independent Registered Public Accounting Firm**

We consent to incorporation by reference in the Registration Statement No. 333-215351 on Form S-8, the Registration Statement No. 333-224559 on Form S-8, the Registration Statement No. 333-227625 on Form S-8, and the Registration Statement No. 333-228990 on Form S-3 of CapStar Financial Holdings, Inc. of our report dated March 6, 2020, relating to the consolidated financial statements and the financial statement schedules of CapStar Financial Holdings, Inc. and subsidiary, which appear in this Annual Report on Form 10-K of CapStar Financial Holdings, Inc. for the year ended December 31, 2019.

/s/ Elliott Davis, LLC

Franklin, Tennessee  
March 6, 2020

**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, Timothy K. Schools, certify that:

1. I have reviewed this Annual Report on Form 10-K 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: March 6, 2020

By: /s/ Timothy K. Schools  
 Timothy K. Schools  
 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 Annual Report on Form 10-K 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: March 6, 2020

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 Annual Report on Form 10-K of CapStar Financial Holdings, Inc. (the “Company”) for the year ended December 31, 2019, as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Timothy K. Schools, 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 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: March 6, 2020

By: /s/ Timothy K. Schools  
Timothy K. Schools  
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 Annual Report on Form 10-K of CapStar Financial Holdings, Inc. (the “Company”) for the year ended December 31, 2019, 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 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: March 6, 2020

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