

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, 2018

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 001-37886

**CAPSTAR FINANCIAL HOLDINGS, INC.**

(Exact name of Registrant as specified in its Charter)

Tennessee  
(State or other jurisdiction of  
incorporation or organization)  
1201 Demonbreun Street, Suite 700  
Nashville, Tennessee  
(Address of principal executive office)

81-1527911  
(IRS Employer  
Identification No.)

37203  
(zip code)

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

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

Title of each class:	Name of each exchange on which Registered:
Common Stock, par value \$1.00 per share	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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405) is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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	<input type="checkbox"/>	Accelerated filer	<input checked="" type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Small reporting company	<input type="checkbox"/>
		Emerging growth company	<input checked="" type="checkbox"/>

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 29, 2018, 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 \$221,083,857, based on the closing sales price of \$18.53 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 11, 2019
Non-voting Common Stock, par value \$1.00 per share	17,719,816
	132,561

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant's Definitive Proxy Statement relating to the 2019 Annual Meeting of Shareholders, which will be filed within 120 days after December 31, 2018, are incorporated by reference into Part III of this Annual Report on Form 10-K.

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## 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 2014, 2015, 2016, 2017 and 2018 mean our fiscal years ended December 31, 2014, 2015, 2016, 2017 and 2018, respectively. References herein to our “target market” includes Tennessee and within a 100-mile radius of any of our branch locations.

## CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). These forward-looking statements reflect our current views with respect to, among other things, future events and our financial performance. These statements are often, but not always, made through the use of words or phrases such as “may,” “should,” “could,” “predict,” “potential,” “believe,” “will likely result,” “expect,” “continue,” “will,” “anticipate,” “seek,” “aspire,” “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 acceptance by customers of Athens of the Company’s products and services; the ability of the Company to meet expectations regarding the benefits, costs, synergies and financial and operational impact of the Athens merger; the possibility that any of the anticipated benefits, costs, synergies and financial and operational improvements of the Athens merger will not be realized or will not be realized as expected; the possibility that the Athens merger integration will be more expensive or take more time to complete than anticipated; the opportunities to enhance market share in certain markets and the acceptance of the Company generally in new markets; economic conditions (including interest rate environment, government economic and monetary policies, the strength of global financial markets and inflation and deflation) that impact the financial services industry as a whole and/or our business; the concentration of our business in 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 market’s economy; our management of risks inherent in our commercial real estate loan portfolio, and the risk of a prolonged downturn in the real estate market, which could impair the value of our collateral and our ability to sell collateral upon any foreclosure; governmental legislation and regulation, including changes in the nature and timing of the adoption and effectiveness

of new requirements under the Dodd-Frank Act of 2010, as amended, the Tax Cuts and Jobs Act of 2017, 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, with a particular focus on businesses operating in the healthcare industry, (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, 2018, on a consolidated basis, we had total assets of \$2.0 billion, total deposits of \$1.6 billion, total net loans of \$1.4 billion, and shareholders’ equity of \$254 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 continuously seek to improve our core profits by growing our revenue faster than our expenses in order to increase net income and improve our profitability metrics.
- Strategic Growth - We seek to grow our total loans and deposits by leveraging our operating platform to facilitate organic and 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.

#### Acquisitions

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.

## **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. As a general practice, we originate substantially all of our loans, and we limit the amount of participations we purchase to loans originated by lead banks with which we have a close relationship and which share our credit philosophies.

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 our lines of business, including a team that is dedicated to the healthcare sector. 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 by the bank’s Asset Liability Management Committee (“ALCO”) 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 related to our lines of business in order to maintain a conservative and well-diversified loan portfolio reflective of our assessment of various subsets within these lines of business. 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, lender. Accordingly, substantially all of our loans have been made to borrowers located in our Target Market. As of December 31, 2018, approximately 93% 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 (including loans to businesses operating in the healthcare industry), 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, 2018, 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 18% 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 Tennessee. 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 \$9.8 million of our total loans and \$152.0 million of our total deposits as of December 31, 2018. We include the amount of total loans and total deposits from our correspondent banking line of business in the amounts of our total loans and total deposits for our commercial and industrial line of business. Loans made to community banks operating in the correspondent banking line of business comprised 2% of commercial and industrial loans as of December 31, 2018. Deposits from community banks operating in the correspondent banking line of business comprised 10% of total deposits as of December 31, 2018.

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***

Our mortgage banking line of business generated \$407.8 million in mortgage loan originations for the year ended December 31, 2018. Mortgage loans are typically sold in the secondary market and are underwritten by the investor. This line of business 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 Nashville MSA banking market consisted of 63 financial institutions with over \$61 billion in deposits as of June 30, 2018. We held the number 13 deposit market share position at June 30, 2018 with 1.9% 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.

## **Employees**

As of December 31, 2018, we had 295 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") 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 securitization 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 is 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 regulatory agencies, 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 FDIC assigns an institution to a risk category based on the institution's most recent supervisory and capital evaluations, which are designed to measure risk. 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 are 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. These assessments will continue until the FICO bonds mature in 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. At December 31, 2018 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***

In July 2013, the federal banking regulators, in response to the statutory requirements of the Dodd-Frank Act, adopted regulations implementing the Basel Capital Adequacy Accord, or Basel III, which had been approved by the Basel member central bank governors in 2010 as an agreement among the countries' central banks and bank regulators on the amount of capital banks and their holding companies must maintain as a cushion against losses and insolvency. The U.S. Basel III rule's minimum capital to risk-weighted assets, or RWA, requirements are a common equity Tier 1 capital ratio of 4.5%, a Tier 1 capital ratio of 6.0%, and a total capital ratio of 8.0%. The minimum leverage ratio (Tier 1 capital to total assets) is 4.0%. The rule also changes 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 will be fully phased in on January 1, 2019. A banking organization with a buffer greater than 2.5% once the capital conservation buffer is fully phased in 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 will require 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, once it is fully phased in. 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. When the rule is 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 will phase 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 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. At December 31, 2018, 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 line of business, 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 such 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 bank 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, 2018, our bank's total CRE loans represented 301% 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 Bureau 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 bank 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 and prohibits “banking entities” from engaging in “proprietary trading.” Banking entities also are prohibited from sponsoring or investing in private equity or hedge funds, or extending credit to or engaging in other covered transactions with affiliated private equity or hedge funds. The fundamental prohibitions of the Volcker Rule generally apply to banking entities of any size, including us, the bank and any other “affiliate” under the BHC Act.

#### ***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 would impose principles-based restrictions that are broadly consistent with existing interagency guidance on incentive-based compensation. Such institutions would be 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 would also impose certain governance and recordkeeping requirements on institutions of the Company’s and our bank’s size. The Federal Reserve would reserve the authority to impose more stringent requirements on institutions of the Company’s and our bank’s size. We are evaluating the expected impact of the proposal on our business.

#### **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.

## 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.

Weak economic conditions are characterized by numerous factors, including 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, 2018, approximately 93% 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 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
- 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 markets. 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, 2018, our 25 largest borrowing relationships accounted for approximately 18% 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, 2018, approximately 54% of our loan portfolio had been originated since December 31, 2016, 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 within specific lines of business 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 and often contained within our healthcare portfolio. 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 within our lines of business, 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, 2018, approximately 12% 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
- 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, 2018, approximately 10% of our loan portfolio was composed of non-owner occupied commercial real estate loans, 29% of owner occupied commercial real estate loans, 18% consumer real estate loans, and 12% 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 bank regulatory 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. Federal bank regulatory guidelines 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, 2018, 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, 2018 were checking accounts and other liquid deposits, which are payable on demand or upon several days' notice, while by comparison, 76% of the assets of our bank were loans at December 31, 2018, 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 assets, business, 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, 2018, 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 between 7% and 15% of our risked based capital, depending upon the underlying risk rating. 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 lines of business 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. 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.

**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 entering new lines of business. 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, 2018, 17,724,721 shares of our common stock were issued and outstanding, including 157,616 shares of restricted common stock that have yet to vest. Those shares outstanding do not include the potential issuance, as of December 31, 2018, of 878,049 shares of our common stock that are issuable upon conversion of shares of our Series A Preferred Stock. 507,903 shares of our common stock subject to issuance upon exercise of outstanding stock options under the Stock Incentive Plan, and 422,900 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 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 shares of issued and outstanding common stock. 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 are subordinate to the rights of the holders of our Series A Preferred Stock and any debt securities that we may issue and may be subordinate to the holders of any other class of preferred stock that we may issue in the future.***

As of December 31, 2018, we have 878,049 shares of Series A Preferred Stock outstanding. These shares have certain rights that are senior to our common stock. Holders of our Series A Preferred Stock are entitled to receive, when, as and if declared by our board of directors, cash dividends to the same extent and on the same basis as cash dividends as declared by our board of directors with respect to common stock. Such dividends on shares of Series A Preferred Stock are payable on the same dates as dividends on shares of common stock but prior to the payment of any dividends on shares of common stock. In the event of our bankruptcy, dissolution or liquidation, the holders of our Series A Preferred Stock are entitled to receive a liquidation preference of \$10.25 per share of Series A Preferred Stock, plus any amount equal to all dividends declared and unpaid thereon, before any distributions can be made to the holders of our common stock.

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 \$1.0 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, Nashville, Tennessee 37203. The following table summarizes pertinent details of our retail bank branch locations and mortgage origination offices as of March 5, 2019.

<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

### 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 and/or results of operations.

#### *Litigation Against Gaylon M. Lawrence & The Lawrence Group*

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

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

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

### ITEM 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 2018 and 2017 as reported on the Nasdaq Global Select Market.

	Price Per Share	
	High	Low
<b>2018:</b>		
First quarter	\$ 19.84	\$ 19.12
Second quarter	19.54	18.96
Third quarter	18.20	17.84
Fourth quarter	15.74	15.21
<b>2017:</b>		
First quarter	\$ 22.05	\$ 18.52
Second quarter	19.53	16.96
Third quarter	19.62	16.00
Fourth quarter	22.22	18.73

As of March 11, 2019 there were 2,022 holders of record of shares of our common stock and one holder of record of shares of our non-voting 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, 2018.

	Total number of shares purchased (1)	Average price paid per share	Total number of shares purchased as part of publicly announced plan	Maximum number of shares that may yet be purchased under the plan
October 1 - October 31	476	\$ 14.84	—	—
November 1 - November 30	2,900	14.78	—	—
December 1 - December 31	1,218	14.75	—	—
<b>Total</b>	<b>4,594</b>	<b>\$ 14.78</b>	<b>—</b>	<b>—</b>

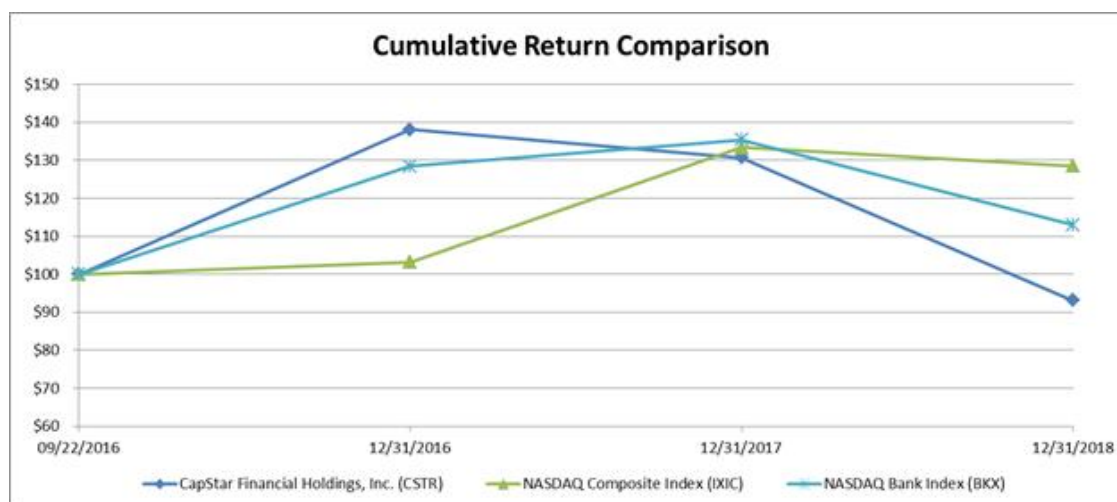
(1) Activity represents shares of common stock withheld to pay purchase price and taxes due upon vesting of restricted shares and exercise of stock options.

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.

On December 21, 2018, the Company announced that its board of directors approved a share repurchase program (the “Repurchase Program”) pursuant to which the Company may purchase up to the lesser of \$8,000,000 or 250,000 shares of its issued and outstanding shares of common stock. As of December 31, 2018, the Company had not yet repurchased any shares of common stock under the terms of the Repurchase Program.

## 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, 2018, 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. 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.



	CapStar Financial Holdings, Inc. (CSTR)	NASDAQ Composite Index (IXIC)	NASDAQ Bank Index (BKX)
09/22/2016	\$ 100	\$ 100	\$ 100
12/31/2016	138	103	128
12/31/2017	131	133	135
12/31/2018	93	128	113

## 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)

	<u>Amount per share</u>	<u>Total cash dividend</u>
2017:		
First quarter	\$ —	\$ —
Second quarter	—	—
Third quarter	—	—
Fourth quarter	—	—
2018:		
First quarter	—	—
Second quarter	—	—
Third quarter	0.04	514
Fourth quarter	0.04	730

Subject to the regulatory restrictions noted above, 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)

	2018	2017	2016	2015	2014
<b>Balance Sheet Data (at period end):</b>					
Total assets	\$ 1,963,883	\$ 1,344,429	\$ 1,333,675	\$ 1,206,800	\$ 1,128,395
Total loans, net of unearned income	1,429,794	947,537	935,251	808,396	713,077
Allowance for loan losses	(12,113)	(13,721)	(11,634)	(10,132)	(11,282)
Investment securities	247,542	196,380	229,219	216,477	280,449
Goodwill and core deposit intangible	46,048	6,242	6,290	6,344	6,398
Total deposits	1,570,008	1,119,866	1,128,723	1,038,461	981,057
FHLB advances and securities sold under repurchase agreements	126,509	70,000	55,000	48,755	34,837
Shareholders' equity	254,379	146,946	139,207	108,586	102,651
<b>Income Statement Data:</b>					
Interest income	\$ 67,781	\$ 51,515	\$ 45,395	\$ 40,504	\$ 38,287
Interest expense	16,089	9,652	6,931	5,731	5,871
Net interest income	51,692	41,863	38,464	34,773	32,416
Provision for loan losses	2,842	12,870	2,829	1,651	3,869
Net interest income after provision for loan losses	48,850	28,993	35,635	33,122	28,547
Non-interest income	15,459	10,908	11,084	8,884	7,419
Non-interest expense	53,487	33,765	33,129	30,977	28,562
Net income before income tax expense	10,822	6,136	13,590	11,029	7,404
Income tax expense	1,167	4,635	4,493	3,470	2,412
Net income	9,655	1,501	9,097	7,559	4,992
<b>Per Share Data:</b>					
Net income per share, basic	0.73	0.13	0.98	0.89	0.59
Cash dividends declared per share of common and preferred stock	0.08	-	-	-	-
Weighted average shares - basic	13,277,614	11,280,580	9,328,236	8,538,970	8,456,386
Net income per share, diluted	0.67	0.12	0.81	0.73	0.49
Weighted average shares - diluted	14,480,347	12,803,511	11,212,026	10,381,895	10,281,044
Book value per share of common stock	13.84	11.91	11.62	10.74	10.17
Tangible book value per share of common stock (1)	11.25	11.37	11.06	10.00	9.41
Total shares of common stock outstanding	17,724,721	11,582,026	11,204,515	8,577,051	8,471,516
Total shares of preferred stock outstanding	878,049	878,049	878,049	1,609,756	1,609,756
<b>Performance Ratios:</b>					
Return on average assets	0.63%	0.11%	0.72%	0.66%	0.47%
Return on average equity	5.50%	1.05%	7.57%	7.08%	4.94%
Net interest margin	3.55%	3.25%	3.22%	3.24%	3.25%
Non-interest income to average assets	1.01%	0.80%	0.88%	0.78%	0.70%
Efficiency ratio	79.65%	63.98%	66.86%	70.96%	71.70%
<b>Asset Quality Data:</b>					
Allowance for loan losses to total loans	0.85%	1.45%	1.24%	1.25%	1.58%
Allowance for loan losses to non-performing loans	582.84%	509.08%	321.42%	376.78%	145.80%
Non-performing assets to total assets	0.16%	0.20%	0.27%	0.24%	0.74%
Net charge-offs to average loans	0.39%	1.09%	0.15%	0.38%	0.15%
<b>Capital ratios (CapStar Financial Holdings, Inc.):</b>					
Total risk based capital	12.84%	12.52%	12.60%	11.42%	11.54%
Tier 1 risk based capital	12.13%	11.41%	11.61%	10.41%	10.32%
Common equity tier 1 capital	11.61%	10.70%	10.90%	8.89%	8.55%
Leverage	11.06%	10.77%	10.46%	9.33%	8.56%

(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, 2018, 2017 and 2016. 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 and Supplementary Data" 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 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 2016, 2017 and 2018 mean our fiscal years ended December 31, 2016, 2017, and 2018, respectively.

### Overview

We completed 2018 with net income of \$9.7 million, or \$0.67 diluted net income per share, compared to net income of \$1.5 million, or \$0.12 diluted net income per share for 2017. Average loans for 2018 were \$1.13 billion, a 14.9% increase over 2017, and average deposits for 2018 were \$1.25 billion, a 12.4% increase over 2017. 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 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 \$9.8 million, or 23.5%, to \$51.7 million for 2018 compared to \$41.9 million for 2017. 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 3.55% for 2018, compared with 3.25% for 2017.

Provision for loan losses was \$2.8 million in 2018 compared to \$12.9 million in 2017, a 77.9% decrease. This decrease was primarily the result of lower charge-offs, which were \$5.0 million in 2018 compared to \$12.8 million in 2017. 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, 2018 was 0.85% of total loans, compared with 1.45% of total loans at December 31, 2017. Our acquisition of Athens, specifically Athens' loan portfolio, significantly impacted the comparability of our allowance for loan loss ratios between periods. On October 1, 2018, we acquired \$344.8 million in loans, which includes a preliminary fair value discount of \$4.8 million. At December 31, 2018, these acquired loans do not have a significant amount of allowance for loan losses associated with them.

Total noninterest income for 2018 increased \$4.6 million, or 41.7%, to \$15.5 million compared to \$10.9 million for 2017, and comprised 19% of total revenues.

Total noninterest expense for 2018 increased \$19.7 million, or 58.4%, to \$53.5 million compared to \$33.8 million for 2017. Included in noninterest expense for 2018 is \$9.8 million of merger related charges. Our efficiency ratio for 2018 was 79.7% compared to 64.0% for 2017.

The Company's effective tax rate decreased to 10.8% for 2018 from 75.5% for 2017. The decrease in the effective tax rate is primarily due to a \$3.6 million write-down of our deferred tax assets resulting from the Tax Reform Act in 2017.

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 10.39% as of December 31, 2018, compared with 9.84% at December 31, 2017. 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, 2018, 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, 2018, 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,		2018-2017 Percent Increase (Decrease)	Year ended December 31,	2017-2016 Percent Increase (Decrease)
	2018	2017		2016	
Interest income	\$ 67,781	\$ 51,515	31.6%	\$ 45,395	13.5%
Interest expense	16,089	9,652	66.7%	6,931	39.3%
Net interest income	51,692	41,863	23.5%	38,464	8.8%
Provision for loan losses	2,842	12,870	(77.9)%	2,829	354.9%
Net interest income after provision for loan losses	48,850	28,993	68.5%	35,635	(18.6)%
Noninterest income	15,459	10,908	41.7%	11,084	(1.6)%
Noninterest expense	53,487	33,765	58.4%	33,129	1.9%
Net income before income taxes	10,822	6,136	76.4%	13,590	(54.8)%
Income tax expense	1,167	4,635	(74.8)%	4,493	3.2%
Net income	\$ 9,655	\$ 1,501	543.2%	\$ 9,097	(83.5)%
Basic net income per share of common stock	\$ 0.73	\$ 0.13	461.5%	\$ 0.98	(86.7)%
Diluted net income per share of common stock	\$ 0.67	\$ 0.12	458.3%	\$ 0.81	(85.2)%

Return on average assets was 0.63%, 0.11% and 0.72% for 2018, 2017 and 2016, respectively.

Return on average shareholders' equity was 5.50%, 1.05% and 7.57% for 2018, 2017 and 2016, 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 interest-earning assets and the interest paid on deposits and borrowed funds used to support our assets. Net interest income divided by total average interest-earning assets represents our net interest margin. The major factors that affect net interest income and net interest margin are changes in volumes, the yield on interest-earning assets and the cost of interest-bearing liabilities. Our margin can also be affected by economic conditions, the competitive environment, loan demand and deposit flow. Our ability to respond to changes in these factors by using effective asset-liability management techniques is critical to maintaining the stability of the net interest margin and our net interest income.

The following 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, 2018, 2017 and 2016:

	For the Year Ended December 31,								
	2018			2017			2016		
	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)	\$ 1,134,836	\$ 57,962	5.11%	\$ 987,710	\$ 43,531	4.41%	\$ 888,541	\$ 38,450	4.33%
Loans held for sale	58,250	2,789	4.79%	49,466	2,070	4.19%	47,303	1,763	3.73%
Securities:									
Taxable investment securities (2)	166,287	4,755	2.86%	166,538	4,092	2.46%	176,974	3,729	2.11%
Investment securities exempt from federal income tax (3)	47,270	1,201	3.22%	52,153	1,230	3.63%	47,356	1,158	3.76%
Total securities	213,557	5,956	2.94%	218,691	5,322	2.74%	224,330	4,887	2.46%
Cash balances in other banks	54,454	1,011	1.85%	49,990	551	1.10%	51,147	276	0.54%
Funds sold	2,483	63	2.55%	2,518	41	1.63%	2,153	19	0.89%
Total interest-earning assets	1,463,580	67,781	4.65%	1,308,375	51,515	3.99%	1,213,474	45,395	3.79%
Noninterest-earning assets	65,336			49,419			49,289		
Total assets	<u>\$ 1,528,916</u>			<u>\$ 1,357,794</u>			<u>\$ 1,262,763</u>		
<b>Interest-Bearing Liabilities</b>									
Interest bearing deposits:									
Interest-bearing transaction accounts	\$ 330,952	4,164	1.26%	\$ 301,411	2,447	0.81%	\$ 269,113	1,489	0.55%
Savings and money market deposits	424,052	5,446	1.28%	378,640	3,188	0.84%	445,873	2,859	0.64%
Time deposits	227,760	3,940	1.73%	194,892	2,445	1.25%	193,881	2,085	1.08%
Total interest-bearing deposits	982,764	13,550	1.38%	874,943	8,080	0.92%	908,867	6,433	0.71%
Borrowings and repurchase agreements	99,450	2,539	2.55%	98,289	1,572	1.60%	32,371	498	1.54%
Total interest-bearing liabilities	1,082,214	16,089	1.49%	973,232	9,652	0.99%	941,238	6,931	0.74%
Noninterest-bearing deposits	262,280			232,687			189,270		
Total funding sources	1,344,494			1,205,919			1,130,508		
Noninterest-bearing liabilities	8,736			8,473			12,132		
Shareholders' equity	175,686			143,402			120,123		
Total liabilities and shareholders' equity	<u>\$ 1,528,916</u>			<u>\$ 1,357,794</u>			<u>\$ 1,262,763</u>		
Net interest spread (4)			3.17%			3.00%			3.06%
Net interest income/margin (5)		<u>\$ 51,692</u>	3.55%		<u>\$ 41,863</u>	3.25%		<u>\$ 38,464</u>	3.22%

- (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 paid or earned on these assets and liabilities.

	2018 Compared to 2017 Increase (decrease) due to			2017 Compared to 2016 Increase (decrease) due to		
	Volume	Rate	Net	Volume	Rate	Net
<b>Interest-Earning Assets</b>						
Loans	\$ 6,484	\$ 7,947	\$ 14,431	\$ 4,291	\$ 790	\$ 5,081
Loans held for sale	368	351	719	81	227	308
Securities:						
Taxable investment securities	(6)	670	664	(219)	568	349
Investment securities exempt from federal income tax	(115)	85	(30)	117	(31)	86
Total securities	(121)	755	634	(102)	537	435
Cash Balances In Other Banks	49	410	459	(6)	280	274
Funds Sold	(1)	24	23	3	19	22
Total interest-earning assets	6,779	9,487	16,266	4,267	1,853	6,120
<b>Interest Bearing Liabilities</b>						
Interest-bearing transaction accounts	240	1,477	1,717	179	779	958
Savings and money market deposits	382	1,876	2,258	(431)	760	329
Time deposits	412	1,084	1,496	11	348	359
Borrowings and repurchase agreements	19	947	966	1,015	60	1,075
Total interest-bearing liabilities	1,053	5,384	6,437	774	1,947	2,721
<b>Net Interest Income</b>	<b>\$ 5,726</b>	<b>\$ 4,103</b>	<b>\$ 9,829</b>	<b>\$ 3,493</b>	<b>\$ (94)</b>	<b>\$ 3,399</b>

#### 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 September 30, 2016 to December 31, 2018, the LIBOR – 1 month interest rate increased from 0.53% to 2.52%. Approximately 58% of our loan portfolio at December 31, 2018 is 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 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 0.50% at September 30, 2016 to 2.50% at December 31, 2018. We passed along 50 basis points of the 200 basis point rate increase to our clients.

#### *2017 compared to 2016*

Our net interest income increased \$3.4 million, or 8.8%, from 2016 to 2017 primarily due to increasing loan volumes, partially offset by the negative effects of increasing interest-bearing liabilities volumes and costs.

Our net interest margin was 3.25% and 3.22% for 2017 and 2016, respectively. The increase in net interest margin was primarily due to growth of our interest-earning assets at a higher pace than our interest-bearing liabilities.

For 2017 and 2016, average loan yields increased from 4.33% to 4.41% 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. From September 30, 2016 to December 31, 2017, the LIBOR – 1 month interest rate increased from 0.53% to 1.56%. Approximately 65% of our loan portfolio at December 31, 2017 was variable in nature and indexed to 1 month LIBOR.

Average loans for 2017 increased 11.2% compared to 2016 as a result of adding new bankers in the Nashville MSA and continued focus on attracting new clients.

Average security yields increased from 2.32% to 2.46% for 2016 and 2017, 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 22 basis points for 2017 compared to 2016.

#### Provision for Loan losses

Our policy is to maintain an allowance for loan losses at a level sufficient to absorb estimated probable incurred 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 0.85%, 1.45% and 1.24% at December 31, 2018, 2017 and 2016, respectively.

#### *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 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 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. As a result, our provision expense decreased during 2018 compared to 2017.



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. 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, 2018. While our policies and procedures used to estimate the allowance for loan losses, as well as the resultant provision for loan losses charged to operations, are considered adequate by management, they are necessarily approximate and imprecise. There are factors beyond our control, such as conditions in the local and national economy, local real estate markets, or particular industry or borrower-specific conditions, which may materially and negatively impact our asset quality and the adequacy of our allowance for loan losses and, thus, the resulting provision for loan losses.

#### *2017 compared to 2016*

The provision for loan losses amounted to \$12.9 million and \$2.8 million for 2017 and 2016, respectively.

Provision expense increased for 2017 compared to 2016 due to increased charge-offs. Charge-offs for 2017 were \$12.8 million compared to \$1.5 million for 2016. This increase was caused primarily by deterioration in the credit quality of commercial and industrial loans to one borrower as described above. As a result, our provision expense increased during 2017 compared to 2016.

Our allowance for loan losses as a percentage of total loans increased from 1.24% at December 31, 2016 to 1.45% at December 31, 2017. This increase was largely due to our assessment of risk inherent in the commercial and industrial loan portfolio generally related to macro-economic, geo-political conditions and, in particular, uncertainty in the healthcare industry. In addition, during 2017, we increased the look-back period, from which we calculate peer bank historical loss experience, from 28 to 33 quarters.

#### *Noninterest Income*

In addition to net interest margin, we generate recurring noninterest income from our lines of business. Our banking operations generate revenue from service charges and fees on deposit accounts. We have a mortgage banking line of business that generates revenue from originating and selling mortgages, a line of business that originates and sells commercial real estate loans, 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,		2018-2017 Percent Increase (Decrease)	Year Ended December 31, 2016	2017-2016 Percent Increase (Decrease)
	2018	2017			
<b>Noninterest income:</b>					
Treasury management and other deposit service charges	\$ 2,150	\$ 1,516	41.8%	\$ 1,108	36.8%
Net gain (loss) on sale of securities	3	(66)	(104.5)%	121	(154.5)%
Tri-Net fees	1,503	1,002	50.0%	125	701.6%
Mortgage banking income	5,653	6,238	(9.4)%	7,375	(15.4)%
Bank owned life insurance income	2,660	578	360.2%	601	(3.8)%
Other noninterest income	3,490	1,640	112.8%	1,754	(6.5)%
<b>Total noninterest income</b>	<b>\$ 15,459</b>	<b>\$ 10,908</b>	<b>41.7%</b>	<b>\$ 11,084</b>	<b>(1.6)%</b>

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

Mortgage banking income consists of mortgage fee income from the origination and sale of mortgage loans. These mortgage fees are for loans 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 decreased 9.4% from 2017 to 2018 due to a lower volume of originations.

The increase of \$2.0 million in bank owned life insurance income from 2017 to 2018 was due to \$2.0 million in non-taxable life insurance death benefit proceeds recognized in 2018.

Other noninterest income primarily consists of loan related fees, interchange income and wealth management income. The increase of \$1.9 million from 2017 to 2018 was primarily due to organic growth and our acquisition of Athens.

### 2017 compared to 2016

The increase in treasury management and other deposit service charges for 2017 and 2016 was driven primarily by transaction volume, which can fluctuate throughout and from year to year. Growth in the volume of our commercial deposit accounts was the primary contributor to the increase.

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

Mortgage banking income decreased 15.4% from 2016 to 2017 due to lower profit margins on loans sold and a lower volume of originations.

### 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,		2018-2017 Percent Increase (Decrease)	Year Ended December 31, 2016	2017-2016 Percent Increase (Decrease)
	2018	2017			
<b>Noninterest expense:</b>					
Salaries and employee benefits	\$ 28,586	\$ 20,400	40.1%	\$ 20,461	(0.3)%
Data processing and software	3,835	2,786	37.7%	2,373	17.4%
Professional fees	1,608	1,522	5.7%	1,554	(2.1)%
Occupancy	2,336	2,025	15.4%	1,498	35.2%
Equipment	2,471	2,071	19.3%	1,743	18.8%
Regulatory fees	1,028	1,111	(7.5)%	1,091	1.8%
Merger related expenses	9,803	—	100.0%	—	—
Amortization of intangibles	465	48	868.8%	54	(11.1)%
Other operating	3,355	3,802	(11.8)%	4,355	(12.7)%
<b>Total noninterest expense</b>	<b>\$ 53,487</b>	<b>\$ 33,765</b>	<b>58.4%</b>	<b>\$ 33,129</b>	<b>1.9%</b>

### 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 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. The efficiency ratio was negatively impacted by merger expenses.

#### *2017 compared to 2016*

The largest increase between 2016 and 2017 within noninterest expense was related to the new lease of our corporate headquarters which we moved into in the first quarter of 2017. This new lease resulted in an increase in occupancy expense of 35.2%.

Data processing and software expense increased from 2016 to 2017 due to an increase in the volume of transactions and implementation of new software in our mortgage banking line of business.

The increase in equipment expense from 2016 to 2017 was related to the increasing cost of managing our IT network.

A decrease in other operating expense of 12.7%, in 2017 compared to 2016 was primarily due to the fact that we did not have to significantly adjust contingent consideration expense in 2017. Our contingent consideration expense was the result of our acquisition of Farmington Financial Group, LLC in 2014. As mortgage origination volumes change from our original estimates the resulting increase or decrease in contingent consideration is recorded in other operating expense.

Our efficiency ratio was 64.0% and 66.9% for 2017 and 2016, respectively. The efficiency ratio was positively impacted by growth in our net interest income and noninterest income that outpaced our increases in expenses. For 2017, our revenue base (net interest income plus noninterest income) grew at rate of approximately three times our noninterest expense.

#### Income Taxes

##### *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%.

### *2017 compared to 2016*

We recorded income tax expense of \$4.6 million and \$4.5 million in 2017 and 2016, respectively. Our effective income tax rate for 2017 and 2016 was 75.5% and 33.1%, respectively. 2017 income tax expense was reduced by \$0.7 million as a result of implementing the new accounting guidance related to share-based payment award transactions referred to in the preceding paragraph.

In March 2016, the FASB issued guidance to simplify several aspects of the accounting for share-based payment award transactions, including income tax consequences. In addition to other changes, the guidance changes the accounting for excess tax benefits and tax deficiencies from generally being recognized in additional paid-in capital to recognition as income tax expense or benefit in the period they occur. We adopted the new guidance in the first quarter of 2017. As a result, our income tax expense was reduced by \$1.1 million in 2018 and \$0.7 million in 2017.

### **Financial Condition**

#### *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.

#### *2017 compared to 2016*

Total assets increased \$10.7 million, or 0.8%, from December 31, 2016 to December 31, 2017. Loans and leases grew from \$935.3 million at December 31, 2016 to \$947.5 million at December 31, 2017, a 1.3% increase. Loans held for sale increased \$32.0 million, or 75.9%, during 2017 as we implemented a new line of business related to originating and selling commercial real estate loans. These increases were offset by a decrease in securities of \$32.8 million, or 14.3%, as we sold out of lower yielding securities to fund loan growth.

Total liabilities increased \$3.0 million, or 0.3%, from December 31, 2016 to December 31, 2017. Deposits decreased from \$1.129 billion at December 31, 2016 to \$1.120 billion at December 31, 2017, a 0.8% decrease, due primarily to decreases in money market deposits. Growth in non-interest bearing deposits was \$104.0 million between December 31, 2016 and December 31, 2017, or 52.6%, as we continue to become the primary bank for our customers. We increased our Federal Home Loan Bank advances \$15.0 million, or 27.3%, from December 31, 2016 to December 31, 2017 to help fund loan growth.

### 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 \$247.5 million, \$196.4 million and \$229.2 million at December 31, 2018, 2017 and 2016 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, 2018 by their stated maturities (this maturity schedule excludes security prepayment and call features), as well as the weighted average yields for each maturity range.

	<u>Due in one year or less</u>		<u>Due in one year to five years</u>		<u>Due in five years to ten years</u>		<u>Due after ten years</u>	
	<u>Fair Value</u>	<u>Weighted Average Yield</u>	<u>Fair Value</u>	<u>Weighted Average Yield</u>	<u>Fair Value</u>	<u>Weighted Average Yield</u>	<u>Fair Value</u>	<u>Weighted Average Yield</u>
Securities available for sale:								
U. S. government agency securities	\$ —	0.0%	\$ —	0.0%	\$ 10,706	2.4%	\$ —	0.0%
State and municipal securities	3,573	2.9%	17,934	3.3%	28,467	3.6%	11,952	3.1%
Mortgage-backed securities	—	0.0%	77,290	2.5%	52,755	3.1%	14,113	3.1%
Asset-backed securities	—	0.0%	7,021	2.0%	8,263	2.6%	—	0.0%
Other debt securities	—	0.0%	5,538	4.9%	6,196	4.6%	—	0.0%
<b>Total securities available for sale</b>	<b>\$ 3,573</b>	<b>2.9%</b>	<b>\$ 107,783</b>	<b>2.7%</b>	<b>\$ 106,387</b>	<b>3.2%</b>	<b>\$ 26,065</b>	<b>3.1%</b>
Securities held to maturity:								
State and municipal securities	\$ 396	3.2%	\$ 3,389	3.0%	\$ —	0.0%	\$ —	0.0%
<b>Total securities held to maturity</b>	<b>\$ 396</b>	<b>3.2%</b>	<b>\$ 3,389</b>	<b>3.0%</b>	<b>\$ —</b>	<b>0.0%</b>	<b>\$ —</b>	<b>0.0%</b>

### 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:

	<u>December 31, 2018</u>		<u>December 31, 2017</u>		<u>December 31, 2016</u>		<u>December 31, 2015</u>		<u>December 31, 2014</u>	
	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Commercial real estate - owner occupied	\$ 141,864	9.9%	\$ 101,132	10.7%	\$ 106,735	11.4%	\$ 108,132	13.4%	\$ 93,096	13.0%
Commercial real estate - non-owner occupied	408,582	28.6%	249,490	26.3%	195,587	20.9%	\$ 143,065	17.7%	\$ 126,697	17.7%
Consumer real estate	253,562	17.7%	102,581	10.8%	97,015	10.4%	93,785	11.6%	82,167	11.5%
Construction and land development	174,670	12.2%	82,586	8.7%	94,491	10.1%	52,522	6.5%	46,193	6.5%
Commercial and industrial	404,600	28.3%	373,248	39.4%	379,620	40.5%	353,442	43.6%	332,914	46.6%
Consumer	25,615	1.8%	6,862	0.7%	5,974	0.6%	8,668	1.1%	7,910	1.1%
Other	21,002	1.5%	31,983	3.4%	56,796	6.1%	50,197	6.2%	25,615	3.6%
<b>Total gross loans and leases</b>	<b>\$ 1,429,895</b>	<b>100.0%</b>	<b>\$ 947,882</b>	<b>100.0%</b>	<b>\$ 936,218</b>	<b>100.0%</b>	<b>\$ 809,811</b>	<b>100.0%</b>	<b>\$ 714,592</b>	<b>100.0%</b>

Over the past five years, we have experienced significant growth in our loan portfolio. During 2016 and continuing through 2018, we recognized growth in the construction and land development and commercial real estate loan classifications reflecting the development of the Nashville MSA 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 67% of our loan portfolio as of December 31, 2018. 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 markets 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, 2018.

	December 31, 2018			
	Due in 1 year or less	Due in 1-5 years	Due after 5 years	Total
Commercial real estate	\$ 57,749	\$ 301,993	\$ 190,704	\$ 550,446
Consumer real estate	13,477	32,179	207,906	253,562
Construction and land development	47,404	87,562	39,704	174,670
Commercial and industrial	92,260	265,202	47,138	404,600
Consumer	6,101	19,185	329	25,615
Other	2,640	12,368	5,994	21,002
<b>Total gross loans</b>	<b>\$ 219,631</b>	<b>\$ 718,489</b>	<b>\$ 491,775</b>	<b>\$ 1,429,895</b>
<b>Interest rate sensitivity</b>				
Fixed interest rates	30,512	376,291	200,028	606,831
Floating or adjustable interest rates	189,119	342,198	291,747	823,064
<b>Total gross loans</b>	<b>\$ 219,631</b>	<b>\$ 718,489</b>	<b>\$ 491,775</b>	<b>\$ 1,429,895</b>

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,				
	2018	2017	2016	2015	2014
Non-accrual loans	\$ 2,078	\$ 2,695	\$ 3,619	\$ 2,689	\$ 7,738
Troubled debt restructurings	1,391	1,206	1,272	125	2,618
Loans past due greater than 89 days and still accruing	214	231	—	—	—
Non-performing loans	2,078	2,695	3,619	2,689	7,738
Foreclosed real estate	988	—	—	216	575
Non-performing assets	\$ 3,066	\$ 2,695	\$ 3,619	\$ 2,905	\$ 8,313
Non-performing loans as a percentage of total loans	0.15%	0.28%	0.39%	0.33%	1.09%
Non-performing assets as a percentage of total assets	0.16%	0.20%	0.27%	0.24%	0.74%

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, 2018, 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,				
	2018	2017	2016	2015	2014
Total loans outstanding, net of unearned income	\$ 1,429,794	\$ 947,537	\$ 935,251	\$ 808,396	\$ 713,077
Average loans outstanding, net of unearned income	1,134,836	987,710	888,541	744,151	682,218
Allowance for loan and lease losses at beginning of period	13,721	11,634	10,132	11,282	8,459
Charge-offs:					
Commercial real estate	—	—	350	—	92
Consumer real estate	—	—	—	173	57
Construction and land development	—	—	—	—	—
Commercial and industrial	4,831	12,769	956	3,033	816
Consumer	84	—	146	—	182
Other	39	—	—	—	—
Total charge-offs	4,954	12,769	1,452	3,206	1,147
Recoveries:					
Commercial real estate	22	9	52	31	—
Consumer real estate	4	—	—	68	21
Construction and land development	—	—	—	—	—
Commercial and industrial	395	1,865	23	299	52
Consumer	75	112	50	7	28
Other	8	—	—	—	—
Total recoveries	504	1,986	125	405	101
Net charge-offs	4,450	10,783	1,327	2,801	1,046
Provision for loan and lease losses	2,842	12,870	2,829	1,651	3,869
Allowance for loan and lease losses at period end	<u>\$ 12,113</u>	<u>\$ 13,721</u>	<u>\$ 11,634</u>	<u>\$ 10,132</u>	<u>\$ 11,282</u>
Allowance for loan and lease losses to period end loans	0.85%	1.45%	1.24%	1.25%	1.58%
Net charge-offs to YTD average loans	0.39%	1.09%	0.15%	0.38%	0.15%



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, 2018		December 31, 2017		December 31, 2016		December 31, 2015		December 31, 2014	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Commercial real estate	\$ 3,309	27.3%	\$ 3,324	24.2%	\$ 2,655	22.8%	\$ 2,879	28.4%	\$ 1,535	13.6%
Consumer real estate	1,005	8.3%	1,063	7.7%	1,013	8.7%	968	9.6%	621	5.5%
Construction and land development	2,431	20.1%	1,628	11.9%	1,574	13.5%	914	9.0%	408	3.6%
Commercial and industrial	5,036	41.6%	7,209	52.5%	5,618	48.3%	4,693	46.3%	8,540	75.7%
Consumer	105	0.9%	91	0.7%	76	0.7%	103	1.0%	75	0.7%
Other	227	1.9%	406	3.0%	698	6.0%	575	5.7%	103	0.9%
Total allowance for loan and lease losses	<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>	<u>\$ 11,282</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,					
	2018		2017		2016	
	Average Balance	Average Rate Paid	Average Balance	Average Rate Paid	Average Balance	Average Rate Paid
Types of Deposits:						
Noninterest-bearing demand deposits	\$ 262,280	0.00%	\$ 232,687	0.00%	\$ 189,270	0.00%
Interest-bearing demand deposits	330,952	1.26%	301,411	0.81%	269,113	0.55%
Money market accounts	409,055	1.33%	375,688	0.85%	443,378	0.64%
Savings accounts	14,997	0.09%	2,952	0.15%	2,495	0.15%
Time deposits, \$100,000 and over	177,366	1.76%	155,788	1.13%	149,674	0.89%
Time deposits, less than \$100,000	50,395	1.63%	39,104	1.76%	44,207	1.69%
Total deposits	<u>\$ 1,245,045</u>	<u>1.09%</u>	<u>\$ 1,107,630</u>	<u>0.73%</u>	<u>\$ 1,098,137</u>	<u>0.59%</u>

Total average deposits increased 12.4% in 2018 compared to 2017 and decreased 0.9% in 2017 compared to 2016. 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 Nashville MSA is a competitive market for deposits and we experienced some run-off in rate sensitive deposits during 2017 and 2018.

The following table presents the maturities of our certificates of deposit as of December 31, 2018.

	December 31, 2018				
	Three months or less	Over three through six months	Over six through twelve months	Over twelve months	Total
\$100,000 or more	\$ 125,849	\$ 33,303	\$ 47,725	\$ 61,117	\$ 267,994
Less than \$100,000	15,389	13,270	19,303	32,471	80,433
Total	<u>\$ 141,238</u>	<u>\$ 46,573</u>	<u>\$ 67,028</u>	<u>\$ 93,588</u>	<u>\$ 348,427</u>

## Capital Adequacy

As of December 31, 2018, CapStar Financial's capital ratios were as follows.

	<u>Well Capitalized</u>	<u>December 31, 2018</u>
Total risk-based capital	10.0%	12.8%
Tier 1 risk-based capital	8.0%	12.1%
Common equity tier 1 capital	6.5%	11.6%
Tier 1 leverage	5.0%	11.1%

On September 21, 2016, the SEC declared effective our registration statement on Form S-1 registering shares of our common stock. On September 27, 2016, we completed the initial public offering of 2,972,750 shares of our common stock. Of the 2,972,750 shares sold, 1,688,049 shares were sold by us and 1,284,701 shares were sold by certain selling shareholders. Of the 1,284,701 shares sold by certain selling shareholders, 731,707 were from preferred shares converted to common shares and 79,166 from the cashless exercise of 250,000 common share warrants. We received net proceeds of approximately \$21.6 million from the offering, after deducting the underwriting discounts and offering expenses. We did not receive any proceeds from the sale of shares by the selling shareholders.

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 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 lines of business, new business, and changes in management and client behavior. By estimating the effects of interest rate increases and decreases, the model can reveal approximate interest rate risk exposure. The simulation model is used by management to gauge approximate results given a specific change in interest rates at a given point in time. The model is therefore a tool to indicate earnings trends in given interest rate scenarios and does not indicate actual expected results.

At December 31, 2018, our EAR static simulation results indicated that our balance sheet is asset sensitive to parallel shifts in interest rates. This indicates that our assets generally reprice faster than our liabilities, which results in a favorable impact to net interest income when market interest rates increase 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	0.3%
Increase 100bp	0.0
Decrease 100bp	(2.9)
Decrease 200bp	(10.3)

### 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 \$243.8 million at December 31, 2018. 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, 2018, total investment securities pledged for these purposes comprised 69% of the estimated fair value of the entire investment portfolio, leaving \$76.1 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, 2018, such deposits totaled \$1.2 billion and represented 78% 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, 2018, available credit from the FHLB totaled \$71.9 million. Additionally, we had available federal funds purchased lines with correspondent banks totaling \$110.0 million at December 31, 2018.

The principal source of cash for CapStar Financial is dividends paid to it as the sole shareholder of the Bank. At December 31, 2018, the Bank was able to pay up to \$22.2 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, 2018, which by their terms have contractual maturity and termination dates subsequent to December 31, 2018.

<b>Contractual Obligations:</b>	<b>Due in 1 year or less</b>	<b>Due after 1 through 3 years</b>	<b>Due after 3 through 5 years</b>	<b>Due after 5 years</b>	<b>Total</b>
FHLB advances	\$ 125,000	\$ —	\$ —	\$ —	\$ 125,000
Certificates of deposits \$100,000 or more	206,877	48,995	12,015	107	267,994
Certificates of deposits less than \$100,000	47,962	23,972	8,347	152	80,433
Operating leases	1,538	3,106	2,855	8,821	16,320
<b>Total</b>	<b>\$ 381,377</b>	<b>\$ 76,073</b>	<b>\$ 23,217</b>	<b>\$ 9,080</b>	<b>\$ 489,747</b>

### Borrowings

The following table outlines our sources of short-term borrowed funds during the year ended December 31, 2018, 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.

	<b>As of or for the year ended December 31, 2018</b>				
	<b>Ending balance</b>	<b>Stated period end rate</b>	<b>Maximum month end balance</b>	<b>Average for the period</b>	
				<b>Balance</b>	<b>Rate</b>
<b>Short-term borrowed funds:</b>					
Short-term FHLB advances	\$ 125,000	2.43%-2.89%	\$ 150,000	\$ 99,000	2.07%

### 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, 2018	December 31, 2017	December 31, 2016
Financial instruments whose contract amounts represent credit risk:			
Unused commitments to extend credit	\$ 707,675	\$ 584,494	\$ 508,990
Standby letters of credit	12,273	11,552	10,886
Total	<u>\$ 719,948</u>	<u>\$ 596,046</u>	<u>\$ 519,876</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, 2018	December 31, 2017	December 31, 2016	December 31, 2015	December 31, 2014
Total equity	\$ 254,379	\$ 146,946	\$ 139,207	\$ 108,586	\$ 102,651
Less core deposit intangible	(8,538)	(23)	(71)	(125)	(179)
Less goodwill	(37,510)	(6,219)	(6,219)	(6,219)	(6,219)
Less preferred equity	(9,000)	(9,000)	(9,000)	(16,500)	(16,500)
Tangible common equity	<u>\$ 199,331</u>	<u>\$ 131,704</u>	<u>\$ 123,917</u>	<u>\$ 85,742</u>	<u>\$ 79,753</u>
Total assets	\$ 1,963,883	\$ 1,344,429	\$ 1,333,675	\$ 1,206,800	\$ 1,128,395
Less core deposit intangible	(8,538)	(23)	(71)	(125)	(179)
Less goodwill	(37,510)	(6,219)	(6,219)	(6,219)	(6,219)
Total tangible assets	<u>\$ 1,917,835</u>	<u>\$ 1,338,187</u>	<u>\$ 1,327,385</u>	<u>\$ 1,200,456</u>	<u>\$ 1,121,997</u>
Total shareholders' equity to total assets	12.95%	10.93%	10.44%	9.00%	9.10%
Tangible common equity ratio	10.39%	9.84%	9.34%	7.14%	7.11%
Total shares of common stock outstanding	17,724,721	11,582,026	11,204,515	8,577,051	8,471,516
Book value per share of common stock	\$ 13.84	\$ 11.91	\$ 11.62	\$ 10.74	\$ 10.17
Tangible book value per share of common stock	11.25	11.37	11.06	10.00	9.41

### 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

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## 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, 2018 and 2017, 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, 2018, 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, 2018 and 2017, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2018, 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 15, 2019



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

	December 31, 2018	December 31, 2017
<b>Assets</b>		
Cash and due from banks	\$ 17,967	\$ 9,506
Interest-bearing deposits in financial institutions	76,714	68,572
Federal funds sold	10,762	4,719
Total cash and cash equivalents	<u>105,443</u>	<u>82,797</u>
Securities available-for-sale, at fair value	243,808	192,621
Securities held-to-maturity, fair value of \$3,785, and \$3,848 at December 31, 2018 and 2017, respectively	3,734	3,759
Loans held for sale	57,618	74,093
Loans, net of unearned income	1,429,794	947,537
Less allowance for loan losses	(12,113)	(13,721)
Loans, net	<u>1,417,681</u>	<u>933,816</u>
Premises and equipment, net	18,821	5,884
Restricted equity securities	12,038	8,806
Accrued interest receivable	5,964	4,084
Goodwill	37,510	6,219
Core deposit intangible, net	8,538	23
Other real estate owned, net	988	—
Other assets	51,740	32,327
Total assets	<u>\$ 1,963,883</u>	<u>\$ 1,344,429</u>
<b>Liabilities and Shareholders' Equity</b>		
<b>Deposits:</b>		
Non-interest-bearing	\$ 289,552	\$ 301,742
Interest-bearing	434,921	274,681
Savings and money market accounts	497,108	367,246
Time	348,427	176,197
Total deposits	<u>1,570,008</u>	<u>1,119,866</u>
Federal Home Loan Bank advances	125,000	70,000
Other liabilities	14,496	7,617
Total liabilities	<u>1,709,504</u>	<u>1,197,483</u>
<b>Shareholders' equity:</b>		
Series A convertible preferred stock, \$1 par value; 5,000,000 shares authorized; 878,049 shares issued and outstanding at December 31, 2018 and 2017	878	878
Common stock, voting, \$1 par value; 20,000,000 shares authorized; 17,592,160 and 11,449,465 shares issued and outstanding at December 31, 2018 and 2017, respectively	17,592	11,450
Common stock, nonvoting, \$1 par value; 5,000,000 shares authorized; 132,561 shares issued and outstanding at December 31, 2018 and 2017	133	133
Additional paid-in capital	211,789	118,120
Retained earnings	27,303	18,892
Accumulated other comprehensive loss, net of income tax	(3,316)	(2,527)
Total shareholders' equity	<u>254,379</u>	<u>146,946</u>
Total liabilities and shareholders' equity	<u>\$ 1,963,883</u>	<u>\$ 1,344,429</u>

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,		
	2018	2017	2016
<b>Interest income:</b>			
Loans, including fees	\$ 60,751	\$ 45,601	\$ 40,213
<b>Securities:</b>			
Taxable	4,184	3,696	3,448
Tax-exempt	1,201	1,230	1,158
Federal funds sold	63	41	19
Restricted equity securities	571	396	281
Interest-bearing deposits in financial institutions	1,011	551	276
Total interest income	<u>67,781</u>	<u>51,515</u>	<u>45,395</u>
<b>Interest expense:</b>			
Interest-bearing deposits	4,164	2,447	1,489
Savings and money market accounts	5,446	3,188	2,859
Time deposits	3,940	2,445	2,085
Federal funds purchased	3	13	22
Securities sold under agreements to repurchase	3	—	1
Federal Home Loan Bank advances	2,533	1,559	475
Total interest expense	<u>16,089</u>	<u>9,652</u>	<u>6,931</u>
Net interest income	<u>51,692</u>	<u>41,863</u>	<u>38,464</u>
Provision for loan losses	2,842	12,870	2,829
Net interest income after provision for loan losses	<u>48,850</u>	<u>28,993</u>	<u>35,635</u>
<b>Noninterest income:</b>			
Treasury management and other deposit service charges	2,150	1,516	1,108
Net gain (loss) on sale of securities	3	(66)	121
Tri-Net fees	1,503	1,002	125
Mortgage banking income	5,653	6,238	7,375
Bank owned life insurance income	2,660	578	601
Other noninterest income	3,490	1,640	1,754
Total noninterest income	<u>15,459</u>	<u>10,908</u>	<u>11,084</u>
<b>Noninterest expense:</b>			
Salaries and employee benefits	28,586	20,400	20,461
Data processing and software	3,835	2,786	2,373
Professional fees	1,608	1,522	1,554
Occupancy	2,336	2,025	1,498
Equipment	2,471	2,071	1,743
Regulatory fees	1,028	1,111	1,091
Merger related expenses	9,803	—	—
Amortization of intangibles	465	48	54
Other operating	3,355	3,802	4,355
Total noninterest expense	<u>53,487</u>	<u>33,765</u>	<u>33,129</u>
Income before income taxes	10,822	6,136	13,590
Income tax expense	1,167	4,635	4,493
Net income	<u>\$ 9,655</u>	<u>\$ 1,501</u>	<u>\$ 9,097</u>
<b>Per share information:</b>			
Basic net income per share of common stock	<u>\$ 0.73</u>	<u>\$ 0.13</u>	<u>\$ 0.98</u>
Diluted net income per share of common stock	<u>\$ 0.67</u>	<u>\$ 0.12</u>	<u>\$ 0.81</u>
<b>Weighted average shares outstanding:</b>			
Basic	<u>13,277,614</u>	<u>11,280,580</u>	<u>9,328,236</u>
Diluted	<u>14,480,347</u>	<u>12,803,511</u>	<u>11,212,026</u>

See accompanying notes to consolidated financial statements.

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

	Year Ended December 31,		
	2018	2017	2016
Net income	\$ 9,655	\$ 1,501	\$ 9,097
Other comprehensive income (loss):			
Unrealized gains (losses) on securities available-for-sale:			
Unrealized holding gains (losses) arising during the period	(2,491)	4,855	(1,181)
Reclassification adjustment for (gains) losses included in net income	(3)	66	(121)
Tax effect	652	(1,884)	499
Net of tax	(1,842)	3,037	(803)
Unrealized losses on securities transferred to held-to-maturity:			
Reclassification adjustment for losses included in net income	14	190	167
Tax effect	(4)	(73)	(64)
Net of tax	10	117	103
Unrealized gains (losses) on cash flow hedges:			
Unrealized holding gains (losses) arising during the period	263	(72)	(330)
Reclassification adjustment for losses included in net income	920	863	416
Tax effect	(140)	(62)	(623)
Net of tax	1,043	729	(537)
Other comprehensive income (loss)	(789)	3,883	(1,237)
Comprehensive income	\$ 8,866	\$ 5,384	\$ 7,860

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, 2015	\$ 1,610	8,577,051	\$ 8,577	—	\$ —	\$ 95,278	\$ 8,035	\$ (4,914)	\$ 108,586
Issuance of restricted common stock, net of forfeitures and withholdings to satisfy employee tax obligations	—	99,560	100	—	—	(133)	—	—	(33)
Stock-based compensation expense	—	—	—	—	—	842	—	—	842
Excess tax benefit from stock compensation	—	—	—	—	—	61	—	—	61
Exercise of common stock options, net of withholdings to satisfy employee tax obligations	—	8,125	8	—	—	88	—	—	96
Issuance of common stock	—	1,688,049	1,688	—	—	19,875	—	—	21,563
Conversion of preferred stock	(732)	731,707	732	—	—	—	—	—	—
Exercise of common stock warrants	—	100,023	100	—	—	132	—	—	232
Net income	—	—	—	—	—	—	9,097	—	9,097
Other Comprehensive loss	—	—	—	—	—	—	—	(1,237)	(1,237)
Balance December 31, 2016	\$ 878	11,204,515	\$ 11,205	—	\$ —	\$ 116,143	\$ 17,132	\$ (6,151)	\$ 139,207
Issuance of restricted common stock, net of forfeitures and withholdings to satisfy employee tax obligations	—	35,714	36	—	—	(280)	—	—	(244)
Stock-based compensation expense	—	—	—	—	—	1,061	—	—	1,061
Exercise of common stock options, net of withholdings to satisfy employee tax obligations	—	154,050	154	—	—	857	—	—	1,011
Exercise of common stock warrants	—	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
Issuance of restricted common stock, net of forfeitures and withholdings to satisfy employee tax obligations	—	107,640	107	—	—	(552)	—	—	(445)
Stock-based compensation expense	—	—	—	—	—	2,079	—	—	2,079
Exercise of common stock options, net of withholdings to satisfy employee tax obligations	—	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

See accompanying notes to consolidated financial statements.

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

	Year Ended December 31,		
	2018	2017	2016
<b>Cash flows from operating activities:</b>			
Net income	\$ 9,655	\$ 1,501	\$ 9,097
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Provision for loan losses	2,842	12,870	2,829
Accretion of discounts on acquired loans and deferred fees	(2,978)	(1,533)	(1,677)
Depreciation and amortization	1,028	450	422
Net amortization of premiums on investment securities	1,007	1,259	1,527
Securities (gains) losses, net	(3)	66	(121)
Mortgage banking income	(5,653)	(6,238)	(7,375)
Tri-Net fees	(1,503)	(1,002)	(125)
Net (gain) loss on sale of loans	(248)	(113)	—
Net (gain) loss on disposal of premises and equipment	—	137	—
Net (gain) loss on sale of other real estate owned	—	—	(157)
Stock-based compensation	2,079	1,061	842
Excess tax benefit from stock compensation	—	—	(61)
Deferred income tax (benefit) expense	1,175	4,385	(295)
Origination of loans held for sale	(516,341)	(565,372)	(522,038)
Proceeds from loans held for sale	540,448	540,123	523,156
Net (increase) decrease in accrued interest receivable and other assets	1,395	(1,760)	(1,537)
Net increase (decrease) in accrued interest payable and other liabilities	461	(2,448)	1,814
Net cash provided by (used in) operating activities	<u>33,364</u>	<u>(16,614)</u>	<u>6,301</u>
<b>Cash flows from investing activities:</b>			
Activities in securities available-for-sale:			
Purchases	(44,787)	(30,525)	(81,946)
Sales	38,322	46,762	46,700
Maturities, prepayments and calls	19,245	18,828	23,644
Activities in securities held-to-maturity:			
Purchases	—	—	(5,337)
Maturities, prepayments and calls	—	1,560	1,656
Purchase of restricted equity securities	(12)	(2,774)	(618)
Net increase in loans	(139,124)	(20,916)	(126,505)
Purchase of premises and equipment	(4,244)	(1,075)	(814)
Proceeds from the sale of premises and equipment	—	3	—
Proceeds from BOLI death benefit	3,416	—	—
Cash received from acquisitions, net	12,053	—	—
Proceeds from sale of other real estate	—	—	373
Net cash provided by (used in) investing activities	<u>(115,131)</u>	<u>11,863</u>	<u>(142,847)</u>
<b>Cash flows from financing activities:</b>			
Net increase (decrease) in deposits	45,622	(8,857)	90,262
Proceeds from Federal Home Loan Bank advances	125,000	135,000	55,000
Payments on Federal Home Loan Bank advances	(70,000)	(120,000)	(45,000)
Proceeds from issuance of common stock	—	—	21,563
Exercise of common stock options and warrants, net of repurchase of restricted shares	4,814	1,294	295
Excess tax benefit from stock compensation	—	—	61
Termination of interest rate swap agreement	—	—	(1,954)
Common and preferred stock dividends paid	(1,244)	—	—
Net increase (decrease) in repurchase agreements	221	—	(3,755)
Net cash provided by financing activities	<u>104,413</u>	<u>7,437</u>	<u>116,472</u>
Net increase (decrease) in cash and cash equivalents	22,646	2,686	(20,074)
Cash and cash equivalents at beginning of period	82,797	80,111	100,185
Cash and cash equivalents at end of period	<u>\$ 105,443</u>	<u>\$ 82,797</u>	<u>\$ 80,111</u>
<b>Supplemental disclosures of cash paid:</b>			
Interest paid	\$ 15,378	\$ 9,540	\$ 6,897
Income taxes	1,716	1,047	4,114
<b>Supplemental disclosures of noncash transactions:</b>			
Loans charged off to the allowance for loan and lease losses	\$ 4,954	\$ 12,769	\$ 1,452
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, 2018 and 2017 and for each of the three years in the period ended December 31, 2018 include CapStar Financial Holdings, Inc. and its wholly owned subsidiary, CapStar Bank (the “Bank”, together referred to as the “Company”). Significant intercompany transactions and accounts are eliminated in consolidation. 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.

##### Initial Public Offering

On September 21, 2016, the Securities and Exchange Commission (“SEC”) declared effective our registration statement on Form S-1 registering shares of our common stock. On September 27, 2016, we completed the initial public offering of 2,972,750 shares of our common stock. Of the 2,972,750 shares sold, 1,688,049 shares were sold by us and 1,284,701 shares were sold by certain selling shareholders. Of the 1,284,701 shares sold by certain selling shareholders, 731,707 were from shares of preferred stock converted to shares of common stock and 79,166 from the cashless exercise of 250,000 common stock warrants. We received net proceeds of approximately \$21.6 million from the offering, after deducting the underwriting discounts and offering expenses. We did not receive any proceeds from the sale of shares by the selling shareholders.

##### 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 and equity 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. For equity securities, the entire amount of impairment is recognized through earnings.

Loans Held for Sale

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings. 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 statement of income in gain on sale of loans, net of related costs such as commission expenses. 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.

Tri-Net Fees

Tri-Net fees represent a line of business, implemented in the fourth quarter of 2016, which originates, 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.

## Notes to Consolidated Financial Statements

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.

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.



## Notes to Consolidated Financial Statements

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.

*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.

## Notes to Consolidated Financial Statements

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 28 quarter look-back period as of December 31, 2016 and 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 as of December 31, 2018. 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.

## Notes to Consolidated Financial Statements

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.

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. 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 \$102,000 for the year ended December 31, 2018. There were no servicing fees for the years ended December 31, 2017 or 2016. Late fees and ancillary fees related to loan servicing are not material.

Transfers of Financial Assets

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

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 three 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.

The Company is the lessee with respect to several office locations. All such leases are accounted for as operating leases within the accompanying financial statements. These leases include rent escalation clauses. The Company expenses the costs associated with these escalating payments over the life of the expected lease term using the straight-line method. As of December 31, 2018, the deferred liability associated with these escalating rentals was approximately \$639,000 and is included in other liabilities in the accompanying balance sheets.

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.

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.

## Notes to Consolidated Financial Statements

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 exist 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 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 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, 2015 through 2018. It is the Company’s policy to recognize interest and/or penalties related to income tax matters in income tax expense.

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.

## Notes to Consolidated Financial Statements

Advertising Costs

Advertising costs are expensed as incurred. Advertising expense was approximately \$383,000, \$310,000 and \$252,000 for the years ended December 31, 2018, 2017 and 2016, respectively.

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 also has forward starting cash flow hedges to manage its future interest rate exposure. These derivative contracts have been 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.

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.

## Notes to Consolidated Financial Statements

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 \$63,890,000, \$43,940,000, and \$40,902,000 at December 31, 2018, 2017 and 2016, 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, 2018, 2017 and 2016.

Subsequent Events

The Company has evaluated subsequent events for recognition and disclosure through March 15, 2019, 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, 2018, 2017 or December 31, 2016.

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,		
	2018	2017	2016
<b>Basic net income per share calculation:</b>			
Numerator – Net income	\$ 9,655	\$ 1,501	\$ 9,097
Denominator – Average common shares outstanding	13,277,614	11,280,580	9,328,236
Basic net income per share	<u>\$ 0.73</u>	<u>\$ 0.13</u>	<u>\$ 0.98</u>
<b>Diluted net income per share calculation:</b>			
Numerator – Net income	\$ 9,655	\$ 1,501	\$ 9,097
Denominator – Average common shares outstanding	13,277,614	11,280,580	9,328,236
Dilutive shares contingently issuable	1,202,733	1,522,931	1,883,790
Average diluted common shares outstanding	<u>14,480,347</u>	<u>12,803,511</u>	<u>11,212,026</u>
Diluted net income per share	<u>\$ 0.67</u>	<u>\$ 0.12</u>	<u>\$ 0.81</u>

Recently Issued Accounting PronouncementsASU 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 has performed an assessment of our revenue contracts related to revenue streams that are within the scope of the standard. Our accounting policies will not change materially since the principles of revenue recognition from the ASU are 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.

## Notes to Consolidated Financial Statements

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 has 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 will not change materially since the principles of revenue recognition from the Accounting Standards Update are largely consistent with existing guidance and current practices applied by our business.

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 will be effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted.

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.

## Notes to Consolidated Financial Statements

*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 will be effective for the Company for reporting periods beginning after December 15, 2019. Early adoption is permitted for all organizations for periods beginning after December 15, 2018.

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

*ASU 2017-04, Simplifying the Test of Goodwill Impairment*

In January 2017, the FASB amended the Goodwill and Other Topic of the Accounting Standards Codification to simplify the accounting for goodwill impairment for public business entities and other entities that have goodwill reported in their financial statements and have not elected the private company alternative for the subsequent measurement of goodwill. The amendment removes Step 2 of the goodwill impairment test. A goodwill impairment will now be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. The effective date and transition requirements for the technical corrections will be effective for the Company for reporting periods beginning after December 15, 2019. The Company does not expect these amendments to have a material effect on its 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 will be effective for the Company for interim and annual periods beginning after December 15, 2018. Early adoption is permitted. The Company adopted this standard December 1, 2017. However, 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 has opted to early adopt this pronouncement by retrospective application to each period in which the effect of the change in the tax rate under the Tax 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 amendments are effective for years beginning after December 15, 2018, including interim periods within that year. Early adoption is permitted, but no earlier than an entity's adoption date of Topic 606. The Company does not expect these amendments to have a material effect on its financial statements.



## Notes to Consolidated 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.

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 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, 2018 and 2017 was as follows (in thousands):

	December 31, 2018				December 31, 2017			
	Amortized Cost	Gross unrealized gains	Gross unrealized (losses)	Estimated fair value	Amortized Cost	Gross unrealized gains	Gross unrealized (losses)	Estimated fair value
Securities available-for-sale:								
U. S. government agency securities	\$ 11,053	\$ —	\$ (347)	\$ 10,706	\$ 11,433	\$ 12	\$ (168)	\$ 11,277
State and municipal securities	62,142	765	(981)	61,926	51,790	1,430	(222)	52,998
Mortgage-backed securities	146,547	776	(3,165)	144,158	108,236	40	(1,714)	106,562
Asset-backed securities	15,437	4	(157)	15,284	16,575	—	(198)	16,377
Other debt securities	11,863	71	(200)	11,734	5,326	81	—	5,407
Total	<u>\$ 247,042</u>	<u>\$ 1,616</u>	<u>\$ (4,850)</u>	<u>\$ 243,808</u>	<u>\$ 193,360</u>	<u>\$ 1,563</u>	<u>\$ (2,302)</u>	<u>\$ 192,621</u>
Securities held-to-maturity:								
State and municipal securities	\$ 3,734	\$ 54	\$ (3)	\$ 3,785	\$ 3,759	\$ 89	\$ —	\$ 3,848
Total	<u>\$ 3,734</u>	<u>\$ 54</u>	<u>\$ (3)</u>	<u>\$ 3,785</u>	<u>\$ 3,759</u>	<u>\$ 89</u>	<u>\$ —</u>	<u>\$ 3,848</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, 2018, 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	\$ 3,561	\$ 3,573	\$ 395	\$ 396
Due one to five years	23,294	23,472	3,339	3,389
Due five to ten years	45,662	45,367	—	—
Due beyond ten years	12,541	11,954	—	—
Mortgage-backed securities	146,547	144,158	—	—
Asset-backed securities	15,437	15,284	—	—
	<u>\$ 247,042</u>	<u>\$ 243,808</u>	<u>\$ 3,734</u>	<u>\$ 3,785</u>

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

	Year ended December 31		
	2018	2017	2016
Proceeds	\$ 38,322	\$ 46,762	\$ 46,700
Gross gains	116	121	216
Gross losses	(113)	(190)	(146)

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

Securities with a market value of \$171,542,000 and \$111,970,000 at December 31, 2018 and 2017, respectively, were pledged to collateralize public deposits, derivative positions and Federal Home Loan Bank advances.

At December 31, 2018 and 2017 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, 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>
<u>December 31, 2017</u>						
U. S. government agency securities	\$ 7,375	\$ (90)	\$ 1,912	\$ (78)	\$ 9,287	\$ (168)
State and municipal securities	7,490	(106)	5,798	(116)	13,288	(222)
Mortgage-backed securities	29,832	(322)	67,813	(1,392)	97,645	(1,714)
Asset-backed securities	—	—	16,377	(198)	16,377	(198)
Other debt securities	—	—	—	—	—	—
Total temporarily impaired securities	<u>\$ 44,697</u>	<u>\$ (518)</u>	<u>\$ 91,900</u>	<u>\$ (1,784)</u>	<u>\$ 136,597</u>	<u>\$ (2,302)</u>

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

## Notes to Consolidated Financial Statements

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, 2018. There were no other-than-temporary impairments for the years ended December 31, 2018 or 2017.

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

Loans at December 31, 2018 and 2017 were as follows (in thousands):

	December 31, 2018	December 31, 2017
Commercial real estate	\$ 550,446	\$ 350,622
Consumer real estate	253,562	102,581
Construction and land development	174,670	82,586
Commercial and industrial	404,600	373,248
Consumer	25,615	6,862
Other	21,002	31,983
Total	<u>1,429,895</u>	<u>947,882</u>
Less net unearned income	(101)	(345)
Total loans	<u>1,429,794</u>	<u>947,537</u>
Allowance for loan losses	(12,113)	(13,721)
Total loans, net	<u>\$ 1,417,681</u>	<u>\$ 933,816</u>

At December 31, 2018, variable-rate and fixed-rate loans totaled \$827,491,000 and \$602,404,000, respectively. At December 31, 2017, variable-rate and fixed-rate loans totaled \$608,128,000 and \$339,754,000, 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, 2018 and 2017 (in thousands):

	Non-impaired Loans			Total Non-impaired	Total Impaired Loans	Total
	Pass	Special Mention	Substandard			
<b>December 31, 2018</b>						
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	21,002	—	—	21,002	—	21,002
<b>Total</b>	<b>\$ 1,406,757</b>	<b>\$ 9,696</b>	<b>\$ 9,544</b>	<b>\$ 1,425,997</b>	<b>\$ 3,898</b>	<b>\$ 1,429,895</b>
<b>December 31, 2017</b>						
Commercial real estate	\$ 349,415	\$ —	\$ —	\$ 349,415	\$ 1,207	\$ 350,622
Consumer real estate	102,571	—	10	102,581	—	102,581
Construction and land development	82,586	—	—	82,586	—	82,586
Commercial and industrial	349,494	11,193	11,073	371,760	1,488	373,248
Consumer	6,849	—	13	6,862	—	6,862
Other	31,983	—	—	31,983	—	31,983
<b>Total</b>	<b>\$ 922,898</b>	<b>\$ 11,193</b>	<b>\$ 11,096</b>	<b>\$ 945,187</b>	<b>\$ 2,695</b>	<b>\$ 947,882</b>

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

The following tables detail the changes in the ALL for the years ending December 31, 2018, 2017 and 2016 by loan classification (in thousands):

	Commercial real estate	Consumer real estate	Construction and land development	Commercial and industrial	Consumer	Other	Total
<b>Year ended December 31, 2018</b>							
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>
<b>Year ended December 31, 2017</b>							
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>
<b>Year ended December 31, 2016</b>							
Balance, beginning of period	\$ 2,879	\$ 968	\$ 914	\$ 4,693	\$ 103	\$ 575	\$ 10,132
Charged-off loans	(350)	—	—	(956)	(146)	—	(1,452)
Recoveries	52	—	—	23	50	—	125
Provision for loan losses	74	45	660	1,858	69	123	2,829
Balance, end of period	<u>\$ 2,655</u>	<u>\$ 1,013</u>	<u>\$ 1,574</u>	<u>\$ 5,618</u>	<u>\$ 76</u>	<u>\$ 698</u>	<u>\$ 11,634</u>

## Notes to Consolidated Financial Statements

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

	Commercial real estate	Consumer real estate	Construction and land development	Commercial and industrial	Consumer	Other	Total
<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	—	—	—	—	—	—	—
Balances, end of period	\$ 3,309	\$ 1,005	\$ 2,431	\$ 5,036	\$ 105	\$ 227	\$ 12,113
Loans:							
Collectively evaluated for impairment	\$ 549,055	\$ 252,640	\$ 174,662	\$ 403,054	\$ 25,584	\$ 21,002	\$ 1,425,997
Individually evaluated for impairment	1,391	922	8	1,546	31	—	3,898
Balances, end of period	\$ 550,446	\$ 253,562	\$ 174,670	\$ 404,600	\$ 25,615	\$ 21,002	\$ 1,429,895
<b>December 31, 2017</b>							
Allowance for Loan Losses:							
Collectively evaluated for impairment	\$ 3,324	\$ 1,063	\$ 1,628	\$ 7,109	\$ 91	\$ 406	\$ 13,621
Individually evaluated for impairment	—	—	—	100	—	—	100
Balances, end of period	\$ 3,324	\$ 1,063	\$ 1,628	\$ 7,209	\$ 91	\$ 406	\$ 13,721
Loans:							
Collectively evaluated for impairment	\$ 349,415	\$ 102,581	\$ 82,586	\$ 371,760	\$ 6,862	\$ 31,983	\$ 945,187
Individually evaluated for impairment	1,207	—	—	1,488	—	—	2,695
Balances, end of period	\$ 350,622	\$ 102,581	\$ 82,586	\$ 373,248	\$ 6,862	\$ 31,983	\$ 947,882

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, 2018 and 2017 (dollars in thousands):

	December 31, 2018		December 31, 2017	
	Amount	Percent of total loans, net of deferred fees	Amount	Percent of total loans, net of deferred fees
Commercial real estate	\$ 3,309	0.23%	\$ 3,324	0.35%
Consumer real estate	1,005	0.07	1,063	0.11
Construction and land development	2,431	0.17	1,628	0.17
Commercial and industrial	5,036	0.35	7,209	0.76
Consumer	105	0.01	91	0.01
Other	227	0.02	406	0.04
Total allowance for loan and lease losses	\$ 12,113	0.85%	\$ 13,721	1.45%

## Notes to Consolidated Financial Statements

The following table presents information related to impaired loans as of and for the years ended December 31, 2018 and 2017 (in thousands):

	December 31, 2018			December 31, 2017		
	Recorded investment	Unpaid principal balance	Related allowance	Recorded investment	Unpaid principal balance	Related allowance
With no related allowance recorded:						
Commercial real estate	\$ 1,391	\$ 1,775	\$ —	\$ 1,207	\$ 1,645	\$ —
Consumer real estate	922	1,204	—	—	—	—
Construction and land development	8	18	—	—	—	—
Commercial and industrial	1,546	6,350	—	—	—	—
Consumer	31	56	—	—	—	—
Other	—	—	—	—	—	—
Subtotal	3,898	9,403	—	1,207	1,645	—
With an allowance recorded:						
Commercial real estate	—	—	—	—	—	—
Consumer real estate	—	—	—	—	—	—
Construction and land development	—	—	—	—	—	—
Commercial and industrial	—	—	—	1,488	2,770	100
Consumer	—	—	—	—	—	—
Other	—	—	—	—	—	—
Subtotal	—	—	—	1,488	2,770	100
Total	\$ 3,898	\$ 9,403	\$ —	\$ 2,695	\$ 4,415	\$ 100

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, 2018, 2017 and 2016 (in thousands):

	Year Ended December 31, 2018		Year Ended December 31, 2017		Year Ended December 31, 2016	
	Average recorded investment	Interest income recognized	Average recorded investment	Interest income recognized	Average recorded investment	Interest income recognized
With no related allowance recorded:						
Commercial real estate	\$ 1,198	\$ 158	\$ 1,258	\$ —	\$ 655	\$ —
Consumer real estate	185	—	—	—	302	—
Construction and land development	94	2	—	—	—	—
Commercial and industrial	5,557	121	—	—	—	—
Consumer	7	—	—	—	63	—
Other	—	—	—	—	—	—
Subtotal	7,041	281	1,258	—	1,020	—
With an allowance recorded:						
Commercial real estate	—	—	—	—	974	—
Consumer real estate	—	—	—	—	—	—
Construction and land development	—	—	—	—	—	—
Commercial and industrial	—	—	2,077	—	1,155	44
Consumer	—	—	—	—	—	—
Other	—	—	—	—	—	—
Subtotal	—	—	2,077	—	2,129	44
Total	\$ 7,041	\$ 281	\$ 3,335	\$ —	\$ 3,149	\$ 44

There was no interest income recognized on a cash basis for impaired loans for the years ended December 31, 2018, 2017 or 2016.

## 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, 2018 and 2017 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
<b>December 31, 2018</b>						
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	—	—	—	—	21,002	21,002
Total	\$ 475	\$ 302	\$ 818	\$ 1,595	\$ 1,428,300	\$ 1,429,895
<b>December 31, 2017</b>						
Commercial real estate	\$ —	\$ —	\$ —	\$ —	\$ 350,622	\$ 350,622
Consumer real estate	—	—	218	218	102,363	102,581
Construction and land development	—	—	—	—	82,586	82,586
Commercial and industrial	1,967	209	—	2,176	371,072	373,248
Consumer	—	—	13	13	6,849	6,862
Other	—	—	—	—	31,983	31,983
Total	\$ 1,967	\$ 209	\$ 231	\$ 2,407	\$ 945,475	\$ 947,882

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

	Non-Accrual	Past Due Over 89 Days and Accruing	Troubled Debt Restructurings
<b>December 31, 2018</b>			
Commercial real estate	\$ —	\$ —	\$ 1,391
Consumer real estate	1,187	214	—
Construction and land development	19	—	—
Commercial and industrial	817	—	—
Consumer	55	—	—
Other	—	—	—
Total	\$ 2,078	\$ 214	\$ 1,391
<b>December 31, 2017</b>			
Commercial real estate	\$ 1,207	\$ —	\$ 1,206
Consumer real estate	—	218	—
Construction and land development	—	—	—
Commercial and industrial	1,488	—	—
Consumer	—	13	—
Other	—	—	—
Total	\$ 2,695	\$ 231	\$ 1,206

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



## Notes to Consolidated Financial Statements

As of December 31, 2018 and 2017 the Company had recorded investments in TDR of \$2.1 million and \$1.2 million, respectively. The Company did not allocate a specific allowance for those loans at December 31, 2018 or 2017 and there were no commitments to lend additional amounts. Loans accounted for as TDR include modifications from original terms such as those due to bankruptcy proceedings, certain modifications of amortization periods or extended suspension of principal payments due to customer financial difficulties. In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the 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, 2016 (in thousands). There were no TDR identified during the years ended December 31, 2018 or 2017.

	Year Ended December 31, 2016		
	Number of contracts	Pre modification outstanding recorded investment	Post modification outstanding recorded investment, net of related allowance
Commercial real estate	1	\$ 1,948	\$ 1,170
Consumer real estate	—	—	—
Construction and land development	—	—	—
Commercial and industrial	—	—	—
Consumer	—	—	—
Other	—	—	—
Total	1	\$ 1,948	\$ 1,170

The following table presents loans by class modified as TDR for which there was a payment default within twelve months following the modification during the year ended December 31, 2016 (in thousands). There were no TDR for which there was a payment default within the twelve months following the modification during the years ended December 31, 2018 or 2017.

	Year Ended December 31, 2016	
	Number of contracts	Recorded investment
Commercial real estate	—	\$ —
Consumer real estate	—	—
Construction and land development	—	—
Commercial and industrial	—	—
Consumer	1	124
Other	—	—
Total	1	\$ 124

The consumer loan TDR that subsequently defaulted during the year ended December 31, 2016 had no specific reserve in the ALL and resulted in a \$0.1 million charge-off.

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.

## Notes to Consolidated Financial Statements

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):

	<b>Athens Bancshares acquisition on October 1, 2018</b>	
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	\$	<u>1,666</u>

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):

	<b>Athens Bancshares acquisition on October 1, 2018</b>	
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):

	<b>For the year ended December 31, 2018</b>	
Balance at beginning of period	\$	—
Additions due to acquisition of Athens Bancshares		1,666
Change due to payments received and accretion		(46)
Change due to loan charge-offs		—
Other		—
Balance at end of period	\$	<u>1,620</u>

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

	<b>For the year ended December 31, 2018</b>	
Balance at beginning of period	\$	—
Additions due to acquisition of Athens Bancshares		436
Accretion		(9)
Reclassification from (to) nonaccretable difference		—
Other, net		13
Balance at end of period	\$	<u>440</u>

PCI loans had no impact on the ALL for the years ended December 31, 2018, 2017 or 2016.

Leases

The Company has entered into various direct finance leases. The leases are reported as part of other loans. The lease terms vary from two to six years. The components of the direct financing leases as of December 31, 2018 and 2017 were as follows (in thousands):

	<b>December 31, 2018</b>		<b>December 31, 2017</b>	
Total minimum lease payments receivable	\$	379	\$	714
Less:				
Unearned income		(19)		(49)
Net leases	\$	<u>360</u>	\$	<u>665</u>

## Notes to Consolidated Financial Statements

The future minimum lease payments receivable under the direct financing leases as of December 31, 2018 were as follows (in thousands):

Year ending December 31:		
2019	\$	178
2020		167
2021		34
2022		—
2023		—
	\$	<u>379</u>

**NOTE 5 – LOAN SERVICING**

Mortgage loans serviced for FHLMC are not reported as assets. The principal balance of these loans at December 31, 2018 was \$170.1 million. These servicing rights were acquired in our acquisition of Athens. There were no mortgage loans serviced for others as of December 31, 2017. Custodial escrow balances maintained in connection with serviced loans was \$462,000 at December 31, 2018.

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

	<b>For the year ended December 31, 2018</b>	
Loan servicing rights:		
Balance at beginning of period	\$	—
Additions		1,809
Disposals		—
Amortized to offset other noninterest income		(73)
Change in valuation allowance		—
Balance at end of period	\$	<u>1,736</u>
Valuation allowance:		
Balance at beginning of period	\$	—
Additions expensed		—
Reductions credited to other noninterest income		—
Direct write-downs		—
Balance at end of period	\$	<u>—</u>

**NOTE 6 – PREMISES AND EQUIPMENT**

Premises and equipment at December 31, 2018 and 2017 are summarized as follows (in thousands):

	<b>Range of useful lives</b>	<b>December 31, 2018</b>	<b>December 31, 2017</b>
Land	Not applicable	\$ 2,997	\$ 1,180
Buildings	39 years	9,965	3,586
Leasehold improvements	1 to 17 years	939	777
Furniture and equipment	1 to 7 years	3,730	2,659
Fixed assets in process	Not applicable	4,023	—
		<u>21,654</u>	<u>8,202</u>
Less accumulated depreciation and amortization		<u>(2,833)</u>	<u>(2,318)</u>
		<u>\$ 18,821</u>	<u>\$ 5,884</u>

Premises and equipment depreciation and amortization expense for the years ended December 31, 2018, 2017 and 2016 totaled \$516,000, \$401,000 and \$360,000, respectively.

## Notes to Consolidated Financial Statements

The Company leases certain properties under noncancelable lease arrangements. The leases have various terms, and maturity dates, including extensions through 2032. The leases have various other terms including payments for common area maintenance, escalation increases over the term of the lease and various renewal options. Rent expense related to these leases for 2018, 2017 and 2016 totaled \$1,677,000, \$1,521,000 and \$1,016,000 respectively.

Future minimum payments under these operating leases as of December 31, 2018 are as follows (in thousands):

Year ending December 31:	
2019	\$ 1,538
2020	1,539
2021	1,567
2022	1,453
2023	1,402
Thereafter	8,821
	<u>\$ 16,320</u>

## NOTE 7 – GOODWILL AND INTANGIBLE ASSETS

Goodwill

The change in goodwill during the years ended December 31, 2018 and 2017 was as follows (in thousands):

	<u>2018</u>	<u>2017</u>
Beginning of year	\$ 6,219	\$ 6,219
Acquired goodwill	31,291	—
Impairment	—	—
End of year	<u>\$ 37,510</u>	<u>\$ 6,219</u>

Impairment exists when a reporting unit's carrying value of goodwill exceeds its fair value. At October 31, 2018, 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, 2018 and 2017 were as follows (in thousands):

	<u>December 31, 2018</u>		<u>December 31, 2017</u>	
	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>
Amortized intangible assets:				
Core deposit intangibles	\$ 9,267	\$ (729)	\$ 287	\$ (264)

Aggregate amortization expense was \$465,000 for 2018, \$48,000 for 2017 and \$54,000 for 2016.

## Notes to Consolidated Financial Statements

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

Year ending December 31:		
2019	\$	1,655
2020		1,477
2021		1,299
2022		1,121
2023		943
Thereafter		2,043
Total	\$	<u>8,538</u>

**NOTE 8 – OTHER REAL ESTATE OWNED**

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

	2018	2017	2016
Beginning balance	\$ —	\$ —	\$ 216
Additions due to acquisition of Athens Bancshares	988	—	—
Loans transferred to other real estate owned	—	—	—
Direct write-downs	—	—	—
Sales of other real estate owned	—	—	(216)
End of year	<u>\$ 988</u>	<u>\$ —</u>	<u>\$ —</u>

Other real estate owned is presented net of the valuation allowance which is allocated to the specific properties held.

Activity in the valuation allowance was as follows during the years ended December 31, 2018, 2017 and 2016, respectively (in thousands):

	2018	2017	2016
Beginning balance	\$ —	\$ —	\$ 450
Additions/(recoveries) charged/(credited) to expense	—	—	—
Reductions from sales of other real estate owned	—	—	(450)
Direct write-downs	—	—	—
End of year	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

Expenses related to other real estate owned during the years ended December 31, 2018, 2017 and 2016, respectively include (in thousands):

	2018	2017	2016
Net (gain) loss on sales	\$ —	\$ —	\$ (157)
Provision for unrealized losses	—	—	—
Operating expenses, net of rental income	—	—	14
Total	<u>\$ —</u>	<u>\$ —</u>	<u>\$ (143)</u>

## Notes to Consolidated Financial Statements

**NOTE 9 – DEPOSITS**

Time deposits that exceed the FDIC deposit insurance limit of \$250,000 at December 31, 2018 and 2017 were \$98,086,000 and \$54,460,000, respectively.

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

Maturity:		
2019	\$	254,839
2020		57,800
2021		15,167
2022		12,068
2023		8,294
Thereafter		259
	<u>\$</u>	<u>348,427</u>

At December 31, 2018 and 2017, the Company had \$193,000 and \$19,000, respectively of deposit accounts in overdraft status that were reclassified to loans in the accompanying balance sheets.

**NOTE 10 – FEDERAL HOME LOAN BANK ADVANCES**

The Company had outstanding borrowings totaling \$125,000,000 and \$70,000,000 at December 31, 2018 and 2017, respectively, via various advances. These advances are non-callable; interest payments are due monthly, with principal due at maturity.

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

Year	December 31, 2018		December 31, 2017	
	Amount	Interest Rates	Amount	Interest Rates
2017	\$ —	—	\$ —	—
2018	—	—	70,000	1.66%
2019	125,000	2.48%	—	—
2020	—	—	—	—
2021	—	—	—	—
2022	—	—	—	—
2023	—	—	—	—
Thereafter	—	—	—	—
Total	<u>\$ 125,000</u>	<u>2.48%</u>	<u>\$ 70,000</u>	<u>1.66%</u>

Advances from the FHLB are collateralized by investment securities with a market value of \$3.9 million, FHLB stock and certain commercial and residential real estate mortgage loans totaling \$665.7 million under a blanket mortgage collateral agreement. At December 31, 2018, the amount of available credit from the FHLB totaled \$71.9 million.

## Notes to Consolidated Financial Statements

**NOTE 11 – 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, 2018 and 2017 (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
<b>Year Ended December 31, 2018</b>				
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>
<b>Year Ended December 31, 2017</b>				
Beginning Balance	\$ (4,241)	\$ (698)	\$ (1,212)	\$ (6,151)
Other comprehensive income (loss) before reclassification, net of tax	1,499	3,077	235	4,811
Amounts reclassified for securities transferred from held-to-maturity to available-for-sale	—	(1,086)	1,086	—
Amounts reclassified from accumulated other comprehensive income (loss), net of tax	(770)	(41)	(117)	(928)
Net current period other comprehensive income (loss)	729	1,950	1,204	3,883
Reclassification of accumulated other comprehensive income due to tax rate change	(167)	(90)	(2)	(259)
Ending Balance	<u>\$ (3,679)</u>	<u>\$ 1,162</u>	<u>\$ (10)</u>	<u>\$ (2,527)</u>

The following were significant amounts reclassified out of each component of accumulated other comprehensive income (loss) for the years ended December 31, 2018, 2017 and 2016 (in thousands):

Details about Accumulated Other Comprehensive Income Components	Year Ended December 31, 2018	Year Ended December 31, 2017	Year Ended December 31, 2016	Affected Line Item in the Statement Where Net Income is Presented
Unrealized losses on cash flow hedges	\$ (441)	\$ (430)	\$ (151)	Interest expense - money market
	(479)	(429)	(265)	Interest expense - Federal Home Loan Bank advances
	72	89	—	Income tax benefit
	<u>\$ (848)</u>	<u>\$ (770)</u>	<u>\$ (416)</u>	Net of tax
Unrealized gains and (losses) on available-for-sale securities	\$ 3	\$ (66)	\$ 121	Net gain (loss) on sale of securities
	(1)	25	(46)	Income tax (expense) benefit
	<u>\$ 2</u>	<u>\$ (41)</u>	<u>\$ 75</u>	Net of tax
Unrealized losses on securities transferred to held-to-maturity	\$ (14)	\$ (190)	\$ (167)	Interest income - securities
	4	73	64	Income tax benefit
	<u>\$ (10)</u>	<u>\$ (117)</u>	<u>\$ (103)</u>	Net of tax

## Notes to Consolidated Financial Statements

## NOTE 12 – INCOME TAXES

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

	2018	2017	2016
<b>Current:</b>			
Federal	\$ 15	\$ 214	\$ 4,029
State	(23)	36	759
	(8)	250	4,788
<b>Deferred:</b>			
Federal	872	4,218	(395)
State	303	167	100
	1,175	4,385	(295)
<b>Total</b>	<u>\$ 1,167</u>	<u>\$ 4,635</u>	<u>\$ 4,493</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, 2018, 2017 and 2016 is as follows (in thousands):

	2018	2017	2016
Computed “expected” tax expense	\$ 2,272	\$ 2,086	\$ 4,621
State income taxes, net of effect of federal income taxes	221	134	567
Tax-exempt interest income	(298)	(418)	(394)
Earnings on bank owned life insurance contracts	(559)	(197)	(204)
Disallowed expenses	93	86	60
Excess tax benefits related to stock compensation	(857)	(632)	—
Write-down of deferred tax assets due to tax reform	—	3,562	—
Nondeductible merger expenses	281	—	—
Other	14	14	(157)
<b>Total</b>	<u>\$ 1,167</u>	<u>\$ 4,635</u>	<u>\$ 4,493</u>

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.



## Notes to Consolidated Financial Statements

Significant items that gave rise to deferred taxes at December 31, 2018 and 2017 were as follows (in thousands):

	December 31, 2018	December 31, 2017
<b>Deferred tax assets:</b>		
Allowance for loan losses	\$ 2,795	\$ 3,227
Depreciation	—	—
Net operating loss carryforward	2,002	843
Organization and preopening costs	457	557
Stock-based compensation	835	672
Acquired loans	1,319	124
Acquired deposits	106	22
Nonaccrual interest	75	25
Accrued incentive compensation	97	—
Reserve for contingencies	143	496
Accrued contributions	207	169
Unrealized loss on securities available-for-sale	845	193
Unrealized loss on securities held-to-maturity	—	4
Cash flow hedge	219	359
Accrued vacation	45	45
Other	—	134
Deferred tax assets	<u>9,145</u>	<u>6,870</u>
<b>Deferred tax liabilities:</b>		
Prepaid expenses	77	134
Depreciation	645	39
Goodwill	81	138
Amortization of core deposit intangible	1,398	6
Other	334	—
Deferred tax liabilities	<u>2,535</u>	<u>317</u>
Net deferred tax asset	<u>\$ 6,610</u>	<u>\$ 6,553</u>

At December 31, 2018, the Company had federal net operating loss carryforwards of approximately \$8,561,000, which expire at various dates from 2030 to 2032. Approximately \$4,548,000 of the net operating loss carryforwards can be carried forward indefinitely. 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, 2018 or 2017. As of December 31, 2018 and 2017, the Company had no accrued interest or penalties related to uncertain tax positions.

**NOTE 13 – 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.

## Notes to Consolidated Financial Statements

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

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

The Company is party to litigation and claims arising in the normal course of business. Management believes that the liabilities, if any, arising from such litigation and claims as of December 31, 2018, will not have a material impact on the financial statements of the Company.

**NOTE 14 – 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, 2018 and 2017, the Company's cash and due from banks, federal funds sold and interest-bearing deposits in financial institutions aggregated \$89,000,000 and \$38,000,000, respectively, in excess of insured limits.

**NOTE 15 – 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, 2018, 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, 2018 and 2017, 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, 2018:</b>						
Total capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	\$ 222,030	12.8%	\$ 138,336	8.0%	\$ N/A	N/A
CapStar Bank	201,972	11.7	138,294	8.0	172,868	10.0
Tier I capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	209,738	12.1	103,752	6.0	N/A	N/A
CapStar Bank	189,680	11.0	103,721	6.0	138,294	8.0
Common equity Tier 1 capital to risk weighted assets:						
CapStar Financial Holdings, Inc.	200,738	11.6	77,814	4.5	N/A	N/A
CapStar Bank	173,180	10.0	77,791	4.5	112,364	6.5
Tier I capital to average assets:						
CapStar Financial Holdings, Inc.	209,738	11.1	75,867	4.0	N/A	N/A
CapStar Bank	189,680	10.0	75,828	4.0	94,785	5.0
<b>At December 31, 2017:</b>						
Total capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	\$ 156,176	12.5%	\$ 99,932	8.0%	\$ N/A	N/A
CapStar Bank	142,138	11.4	99,928	8.0	124,909	10.0
Tier I capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	142,276	11.4	74,949	6.0	N/A	N/A
CapStar Bank	128,238	10.3	74,946	6.0	99,928	8.0
Common equity Tier 1 capital to risk weighted assets:						
CapStar Financial Holdings, Inc.	133,445	10.7	56,212	4.5	N/A	N/A
CapStar Bank	111,907	9.0	56,209	4.5	81,191	6.5
Tier I capital to average assets:						
CapStar Financial Holdings, Inc.	142,276	10.7	53,218	4.0	N/A	N/A
CapStar Bank	128,238	9.6	53,215	4.0	66,519	5.0

- (1) For the calendar year 2018, 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 \$22.2 million and \$19.3 million of dividends as of December 31, 2018 and 2017, respectively. The Bank paid the Company \$1.2 million of dividends during 2018 and this amount was paid out to shareholders by the Company during 2018.

**NOTE 16 – 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. At December 31, 2018 and 2017 there were 132,561 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.

The Series A Preferred Stock contains a liquidation preference and certain antidilution provisions. Holders of Series A Preferred Stock also have certain consent rights with respect to changes to the Company's charter or bylaws that would materially adversely affect the preferences, rights and powers of such stock and the right to receive certain financial reports. The Series A Preferred Stock is noncumulative, perpetual and, except as otherwise provided below or pursuant to Tennessee law, nonvoting. Holders of Series A Preferred Stock participate equally in dividends paid on the common stock on an as converted basis. In addition, the Series A Preferred Stock is convertible to nonvoting common stock upon the occurrence of certain underwritten public offerings and certain transfers or proposed transfers by the Company's organizing shareholders.

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, 2018, 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, 2018, 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, 2018, all of these warrants have been exercised and no warrants remain outstanding.

## Notes to Consolidated Financial Statements

**NOTE 17 – 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.

**NOTE 18 – 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 are 422,900 at December 31, 2018.

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

	<b>For the year ended December 31,</b>		
	<b>2018</b>	<b>2017</b>	<b>2016</b>
Stock-based compensation expense before income taxes	\$ 2,079	\$ 1,061	\$ 842
Less: deferred tax benefit	(543)	(406)	(322)
Reduction of net income	<u>\$ 1,536</u>	<u>\$ 655</u>	<u>\$ 520</u>

## Notes to Consolidated Financial Statements

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 2018 follows:

Nonvested Shares	Restricted Shares	Weighted Average Grant Date Fair Value
Nonvested at beginning of period	187,253	\$ 14.21
Granted	140,131	16.73
Vested	(161,604)	13.54
Forfeited	(8,164)	15.92
Nonvested at end of period	157,616	\$ 17.00

As of December 31, 2018, there was \$1,814,000 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 2.1 years. The total fair value of shares vested during the years ended December 31, 2018, 2017 and 2016 was \$2,804,000, \$1,174,000 and \$513,000, 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. At the time of issuance, the Company's expected dividend yield was 0.00% because the Company had no current plan to pay dividends and historically had not paid dividends. 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.

The fair value of options granted was determined using the following weighted average assumptions as of the grant date. There were no options granted during 2018 or 2017.

	2016
Dividend yield	—
Expected term (in years)	7.48
Expected stock price volatility	17.20%
Risk-free interest rate	1.66%
Pre-vest forfeiture rate	10.25%

## Notes to Consolidated Financial Statements

A summary of the activity in stock options for 2018 follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)
Outstanding at beginning of period	756,050	\$ 10.50	
Additions due to acquisition of Athens Bancshares	548,051	\$ 5.06	
Granted	—	—	
Exercised	(796,198)	8.16	
Forfeited or expired	—	—	
Outstanding at end of period	<u>507,903</u>	<u>\$ 8.66</u>	<u>4.0</u>
Fully vested and expected to vest	<u>506,783</u>	<u>\$ 8.66</u>	<u>4.1</u>
Exercisable at end of period	<u>480,403</u>	<u>\$ 8.46</u>	<u>4.0</u>

Information related to stock options during 2018, 2017 and 2016 follows:

	2018	2017	2016
Intrinsic value of options exercised	\$ 7,654,738	\$ 2,010,536	\$ 53,756
Cash received from option exercises	6,897,845	2,013,840	96,306
Tax benefit realized from option exercises	846,725	774,056	20,583
Weighted average fair value of options granted	—	—	3.16

As of December 31, 2018, there was \$32,000 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 0.9 years.

#### NOTE 19 – 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 20 – 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, 2018, 2017 and 2016, the Company contributed \$639,000, \$550,000 and \$536,000, 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.

#### NOTE 21 – 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.

## Notes to Consolidated Financial Statements

Interest Rate Swaps Designated as Cash Flow Hedges

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

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

	<u>December 31, 2018</u>	<u>December 31, 2017</u>
Notional amounts	\$ 20,000	\$ 20,000
Weighted average pay rates	3.54%	3.54%
Weighted average receive rates	3 month LIBOR	3 month LIBOR
Weighted average maturity	4.5 years	5.5 years
Fair value	\$ (836)	\$ (1,375)
Amount of unrealized loss recognized in accumulated other comprehensive income, net of tax	\$ (617)	\$ (849)

Cash flows began on these forward starting interest rate swaps in 2017. As such, \$275,000 and \$233,000 of interest expense was recorded on these swap transactions during 2018 and 2017, respectively.

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 from the counterparties to the Company as of December 31, 2018. It is possible that the Company may need to post additional collateral in the future or that the counterparties may be required to post collateral to the Company in the future.

Other Interest Rate Swaps

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

	<u>December 31, 2018</u>		<u>December 31, 2017</u>	
	<u>Notional amount</u>	<u>Estimated fair value</u>	<u>Notional amount</u>	<u>Estimated fair value</u>
Interest rate swap agreements:				
Pay fixed/receive variable swaps	\$ 29,126	\$ 24	\$ 41,863	\$ 55
Pay variable/receive fixed swaps	29,126	(24)	41,863	(55)
Total	<u>\$ 58,252</u>	<u>\$ —</u>	<u>\$ 83,726</u>	<u>\$ —</u>



## Notes to Consolidated Financial Statements

**NOTE 22 – 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, 2018 or 2017. Activity within these loans during the years ended December 31, 2018 and 2017 was as follows (in thousands):

	<b>Total commitment</b>	<b>Total funded commitment</b>
<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	<u>\$ 44,812</u>	<u>\$ 15,445</u>
<u>Year ended December 31, 2017</u>		
Beginning of period	\$ 31,076	\$ 20,325
New commitments/draw downs	21,203	4,320
Repayments	(2,870)	(2,755)
End of period	<u>\$ 49,409</u>	<u>\$ 21,890</u>

Deposits from directors, executive officers, significant shareholders and their affiliates at December 31, 2018 and 2017 were \$11.4 million and \$10.8 million, respectively.

**NOTE 23 – 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.

## Notes to Consolidated Financial Statements

**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, 2018 or 2017.

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

## Notes to Consolidated Financial Statements

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

	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	—
Total securities available-for-sale	\$ 243,808	\$ —	\$ 243,808	\$ —
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)	—
Total derivatives	\$ (1,330)	\$ —	\$ (1,330)	\$ —

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

## Notes to Consolidated Financial Statements

Assets measured at fair value on a nonrecurring basis are summarized below (in thousands). There were no assets measured at fair value on a nonrecurring basis at December 31, 2018:

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

The following table presents quantitative information about Level 3 fair value measurements for assets measured at fair value on a nonrecurring basis (dollars in thousands). There were no assets measured at fair value on a nonrecurring basis at December 31, 2018:

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

Fair Value of Financial Instruments

The carrying value and estimated fair values of the Company's financial instruments at December 31, 2018, 2017 and 2016 were as follows (in thousands):

	December 31, 2018		December 31, 2017		Fair value level of input
	Carrying amount	Fair value	Carrying amount	Fair value	
Financial assets:					
Cash and due from banks, interest-bearing deposits in financial institutions	\$ 94,681	\$ 94,681	\$ 78,078	\$ 78,078	Level 1
Federal funds sold	10,762	10,762	4,719	4,719	Level 1
Securities available-for-sale	243,808	243,808	192,621	192,621	Level 2
Securities held-to-maturity	3,734	3,785	3,759	3,848	Level 2
Loans held for sale	57,618	58,596	74,093	75,549	Level 2
Restricted equity securities	12,038	N/A	8,806	N/A	N/A
Loans, net of unearned income	1,429,794	1,442,082	947,537	944,037	Level 3
Accrued interest receivable	5,964	5,964	4,084	4,084	Level 2
Other assets	34,489	34,489	22,663	22,663	Level 2
Financial liabilities:					
Deposits	1,570,008	1,504,101	1,119,866	1,065,669	Level 3
Federal Home Loan Bank advances	125,000	126,548	70,000	69,980	Level 2
Other liabilities	2,753	2,753	3,672	3,672	Level 3

## Notes to Consolidated Financial Statements

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

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

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

(b) *Federal Funds Sold*

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

(c) *Restricted Equity Securities*

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

(d) *Loans, net*

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

As of December 31, 2018, the technique used by the Company to estimate the exit price of the loan portfolio consists of similar procedures to those used as of December 31, 2017 and 2016, but with added emphasis on both illiquidity risk and credit risk not captured by the previously applied entry price notion. The fair value of the Company's loan portfolio has always included a credit risk assumption in the determination of the fair value of its loans. This credit risk assumption is intended to approximate the fair value that a market participant would realize in a hypothetical orderly transaction. The Company's loan portfolio is initially fair valued using a segmented approach. The Company divides its loan portfolio into the following categories: variable rate loans, impaired loans and all other loans. The results are then adjusted to account for credit risk as described above. However, under the new guidance, the Company believes a further credit risk discount must be applied through the use of a discounted cash flow model to compensate for illiquidity risk, based on certain assumptions included within the discounted cash flow model, primarily the use of discount rates that better capture inherent credit risk over the lifetime of a loan. This consideration of enhanced credit risk provides an estimated exit price for the Company's loan portfolio.

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

As of December 31, 2018, the fair value of the Company's loan portfolio includes a credit risk assumption in the determination of the fair value of its loans. This credit risk assumption is intended to approximate the fair value that a market participant would realize in a hypothetical orderly transaction. The Company's loan portfolio is initially fair valued using a segmented approach. The Company divides its loan portfolio into the following categories: variable rate loans, impaired loans and all other loans. The results are then adjusted to account for credit risk. For variable-rate loans that reprice frequently and have no significant change in credit risk, fair values approximate carrying values. Fair values for impaired loans are estimated using discounted cash flow models or based on the fair value of the underlying collateral. For other loans, fair values are estimated using discounted cash flow models, using current market interest rates offered for loans with similar terms to borrowers of similar credit quality. The values derived from the discounted cash flow approach for each of the above portfolios are then further discounted to incorporate credit risk. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price as of December 31, 2017.

## Notes to Consolidated Financial Statements

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

*(g) Deposits*

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

*(h) Federal Home Loan Bank Advances*

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

*(i) Other Liabilities*

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

*(j) Off-Balance Sheet Instruments*

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

*(k) Limitations*

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instruments. These estimates do not reflect any premium or discount that could result from offering for sale at one time the 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.

## Notes to Consolidated Financial Statements

## NOTE 24 – 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, 2018 and 2017 (in thousands).

## Condensed Balance Sheets

	December 31, 2018	December 31, 2017
Assets		
Cash and cash equivalents	\$ 19,918	\$ 14,108
Investment in consolidated subsidiary	234,263	132,909
Other assets	499	61
<b>Total assets</b>	<b>\$ 254,680</b>	<b>\$ 147,078</b>
Liabilities and Shareholders' Equity		
Other liabilities	\$ 301	132
Total shareholders' equity	254,379	146,946
<b>Total liabilities and shareholders' equity</b>	<b>\$ 254,680</b>	<b>\$ 147,078</b>

## Condensed Income Statements

	Year Ended December 31, 2018	Year Ended December 31, 2017
Income - dividends from subsidiary	\$ 1,225	\$ —
Expenses	1,054	879
Income before income taxes and equity in undistributed net income of subsidiary	171	(879)
Income tax benefit	(242)	(256)
Income (loss) before equity in undistributed net income of subsidiary	413	(623)
Equity in undistributed net income of subsidiary	9,242	2,124
<b>Net income</b>	<b>\$ 9,655</b>	<b>\$ 1,501</b>

## Condensed Statements of Cash Flows

	Year Ended December 31, 2018	Year Ended December 31, 2017
Cash flows from operating activities:		
Net income	\$ 9,655	\$ 1,501
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Increase in other assets	(221)	(62)
Increase in other liabilities	169	77
Equity in undistributed net income of subsidiary	(9,242)	(2,124)
Net cash provided by (used in) operating activities	361	(608)
Cash flows from investing activities:		
Investments in subsidiary	—	(10,000)
Cash received from acquisitions, net	1,421	—
Net cash provided by (used in) investing activities	1,421	(10,000)
Cash flows from financing activities:		
Issuance of common stock	—	—
Exercise of common stock options and warrants, net of repurchase of restricted shares	5,260	1,764
Common and preferred stock dividends paid	(1,232)	—
Net cash provided by financing activities	4,028	1,764
Net increase (decrease) in cash and cash equivalents	5,810	(8,844)
Cash and cash equivalents at beginning of period	14,108	22,952
<b>Cash and cash equivalents at end of period</b>	<b>\$ 19,918</b>	<b>\$ 14,108</b>

## Notes to Consolidated Financial Statements

## NOTE 25 – QUARTERLY FINANCIAL RESULTS (UNAUDITED)

The following is a summary of quarterly financial results (unaudited) for 2018, 2017 and 2016:

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
<b>2018</b>				
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)
<b>2017</b>				
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
<b>2016</b>				
Interest income	\$ 10,598	\$ 10,915	\$ 11,875	\$ 12,007
Interest expense	1,642	1,714	1,749	1,827
Net interest income	8,956	9,201	10,126	10,180
Provision for loan losses	937	183	1,639	70
Net interest income after provision for loan losses	8,019	9,018	8,487	10,110
Noninterest income	2,371	2,568	3,191	2,954
Noninterest expense	8,010	7,951	8,527	8,642
Net income before income tax expense	2,380	3,635	3,151	4,422
Income tax expense	796	1,159	1,042	1,495
Net income	\$ 1,584	\$ 2,476	\$ 2,109	\$ 2,927
Net income per share, basic	\$ 0.18	\$ 0.29	\$ 0.24	\$ 0.26
Net income per share, diluted	\$ 0.15	\$ 0.23	\$ 0.20	\$ 0.23



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**Athens Bancshares Corporation & Subsidiary**  
**Unaudited Consolidated Balance Sheet**  
(Dollars in thousands, except share data)  
**September 30, 2018**

Assets			
Cash and due from banks	\$	6,489	
Interest-bearing deposits in financial institutions		4,495	
Federal funds sold		1,069	
Total cash and cash equivalents		12,053	
Securities available-for-sale, at fair value		67,342	
Loans held for sale		476	
Loans		349,121	
Less allowance for loan losses		(4,039)	
Loans, net		345,082	
Premises and equipment, net		7,637	
Restricted equity securities		3,220	
Accrued interest receivable		1,410	
Core deposit intangible, net		2,758	
Other real estate owned, net		988	
Other assets		23,948	
Total assets	\$	464,914	
Liabilities and Shareholders' Equity			
Deposits:			
Non-interest-bearing	\$	58,523	
Interest-bearing		114,988	
Savings and money market accounts		115,327	
Time		115,189	
Total deposits		404,027	
Other liabilities		5,363	
Total liabilities		409,390	
Shareholders' equity:			
Preferred stock, \$.01 par value; 10,000,000 shares authorized; none issued		—	
Common stock, voting, \$.01 par value; 50,000,000 shares authorized; 1,809,358 shares issued and outstanding		18	
Additional paid-in capital		21,788	
Retained earnings		35,273	
Accumulated other comprehensive loss, net of income tax		(1,555)	
Total shareholders' equity		55,524	
Total liabilities and shareholders' equity	\$	464,914	

See accompanying notes to consolidated financial statements.

**Athens Bancshares Corporation & Subsidiary**  
**Unaudited Consolidated Statement of Income**  
**(Dollars in thousands, except share data)**  
**For the Nine Months Ended September 30, 2018**

Interest income:	
Loans, including fees	\$ 13,443
Securities:	
Taxable	772
Tax-exempt	593
Federal funds sold	135
Restricted equity securities	339
Interest-bearing deposits in financial institutions	183
Total interest income	<u>15,465</u>
Interest expense:	
Interest-bearing deposits	386
Savings and money market accounts	27
Time deposits	990
Note payable to bank	9
Total interest expense	<u>1,412</u>
Net interest income	14,053
Provision for loan losses	146
Net interest income after provision for loan losses	<u>13,907</u>
Noninterest income:	
Treasury management and other deposit service charges	2,184
Mortgage banking income	842
Other noninterest income	2,207
Total noninterest income	<u>5,233</u>
Noninterest expense:	
Salaries and employee benefits	7,065
Data processing and software	1,138
Professional fees	532
Occupancy	1,112
Equipment	568
Regulatory fees	269
Merger related expenses	4,731
Amortization of intangibles	273
Other operating	2,074
Total noninterest expense	<u>17,762</u>
Income before income taxes	1,378
Income tax expense	753
Net income	<u>\$ 625</u>
Per share information:	
Basic net income per share of common stock	<u>\$ 0.36</u>
Diluted net income per share of common stock	<u>\$ 0.35</u>
Weighted average shares outstanding:	
Basic	<u>1,725,105</u>
Diluted	<u>1,802,595</u>

See accompanying notes to consolidated financial statements.

**Athens Bancshares Corporation & Subsidiary**  
**Unaudited Consolidated Statement of Comprehensive Loss**  
**(Dollars in thousands)**  
**For the Nine Months Ended September 30, 2018**

Net income	\$	625
Other comprehensive loss:		
Unrealized losses on securities available-for-sale:		
Unrealized holding losses arising during the period		(1,912)
Tax effect		500
Other comprehensive loss		(1,412)
Comprehensive loss	\$	<u>(787)</u>

See accompanying notes to consolidated financial statements.

**Athens Bancshares Corporation & Subsidiary**  
**Unaudited Consolidated Statement of Changes in Shareholders' Equity**  
(Dollars in thousands, except share data)  
**For the Nine Months Ended September 30, 2018**

	Common stock, voting (shares)	Common stock, voting (amount)	Additional paid-in capital	Common stock acquired by benefit plans	Retained earnings	Accumulated other comprehensive loss	Total shareholders' equity
Balance December 31, 2017	1,806,084	\$ 18	\$ 18,800	\$ (1,037)	\$ 34,906	\$ (143)	\$ 52,544
Stock-based compensation expense	—	—	83	—	—	—	83
Exercise of common stock options, net of withholdings to satisfy employee tax obligations	25,663	—	295	—	—	—	295
Shares released by ESOP trust and termination of ESOP	(22,389)	—	2,610	1,037	—	—	3,647
Common and preferred stock dividends declared	—	—	—	—	(258)	—	(258)
Net income	—	—	—	—	625	—	625
Other comprehensive loss	—	—	—	—	—	(1,412)	(1,412)
Balance September 30, 2018	<u>1,809,358</u>	<u>\$ 18</u>	<u>\$ 21,788</u>	<u>\$ —</u>	<u>\$ 35,273</u>	<u>\$ (1,555)</u>	<u>\$ 55,524</u>

See accompanying notes to consolidated financial statements.

**Athens Bancshares Corporation & Subsidiary**  
**Unaudited Consolidated Statement of Cash Flows**  
(Dollars in thousands)  
**For the Nine Months Ended September 30, 2018**

Cash flows from operating activities:		
Net income	\$	625
Adjustments to reconcile net income to net cash used in operating activities:		
Provision for loan losses		146
Depreciation and amortization		591
Net amortization of premiums on investment securities		218
Mortgage banking income		(842)
Net gain on sale of other real estate owned		(74)
Stock-based compensation		83
Deferred income tax benefit		(630)
Origination of loans held for sale		(13,333)
Proceeds from loans held for sale		13,699
Net increase in accrued interest receivable and other assets		(7,721)
Net decrease in accrued interest payable and other liabilities		(1,941)
Net cash used in operating activities		<u>(9,179)</u>
Cash flows from investing activities:		
Activities in securities available-for-sale:		
Maturities, prepayments and calls		7,336
Purchase of restricted equity securities		1,260
Net increase in loans		(25,999)
Purchase of premises and equipment		(716)
Net cash used in investing activities		<u>(18,119)</u>
Cash flows from financing activities:		
Net increase in deposits		1,004
Payments on note payable to bank		(1,383)
Exercise of common stock options		295
Common and preferred stock dividends paid		(258)
Termination of ESOP		3,647
Net decrease in repurchase agreements		(463)
Net cash provided by financing activities		<u>2,842</u>
Net decrease in cash and cash equivalents		<u>(24,456)</u>
Cash and cash equivalents at beginning of period		<u>36,509</u>
Cash and cash equivalents at end of period	\$	<u><u>12,053</u></u>
Supplemental disclosures of cash paid:		
Interest paid	\$	1,445
Income taxes		1,645

See accompanying notes to consolidated financial statements.

**Athens Bancshares Corporation & Subsidiary**  
**Notes to Consolidated Financial Statements**

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

*Basis of Presentation*

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

The accompanying unaudited consolidated financial statements have been prepared in accordance with Generally Accepted Accounting Principles (“GAAP”) for interim financial information and in accordance with the instructions to Form 10-Q and Article 8 of Regulation S-X as promulgated by the SEC. Accordingly, they do not include all the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring accruals) considered necessary for a fair presentation of the financial condition and results of operations for the periods presented have been included. Operating results for the nine months ended September 30, 2018, are not necessarily indicative of the results that may be expected for the full year or in any other period.

*Use of Estimates*

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

*Subsequent Events*

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

**NOTE 2 – LOANS AND ALLOWANCE FOR LOAN LOSSES**

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

Commercial real estate	\$	117,744
Consumer real estate		138,255
Construction and land development		51,872
Commercial and industrial		23,885
Consumer and other		18,548
Total		350,304
Less net unearned income		(1,183)
Total loans		349,121
Allowance for loan losses		(4,039)
Total loans, net	\$	<u>345,082</u>

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

	<u>Commercial real estate</u>	<u>Consumer real estate</u>	<u>Construction and land development</u>	<u>Commercial and industrial</u>	<u>Consumer and other</u>	<u>Total</u>
Balance, beginning of period	\$ 1,333	\$ 1,011	\$ 206	\$ 474	\$ 937	\$ 3,961
Charged-off loans	—	—	—	—	(181)	(181)
Recoveries	20	17	1	—	75	113
Provision for loan losses	(3)	260	17	(76)	(52)	146
Balance, end of period	\$ 1,350	\$ 1,288	\$ 224	\$ 398	\$ 779	\$ 4,039

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

	<u>Commercial real estate</u>	<u>Consumer real estate</u>	<u>Construction and land development</u>	<u>Commercial and industrial</u>	<u>Consumer and other</u>	<u>Total</u>
<b>Allowance for Loan Losses:</b>						
Collectively evaluated for impairment	\$ 1,284	\$ 1,288	\$ 224	\$ 356	\$ 777	\$ 3,929
Individually evaluated for impairment	66	—	—	42	2	110
Balances, end of period	\$ 1,350	\$ 1,288	\$ 224	\$ 398	\$ 779	\$ 4,039
<b>Loans:</b>						
Collectively evaluated for impairment	\$ 117,562	\$ 136,983	\$ 51,850	\$ 22,370	\$ 18,480	\$ 347,245
Individually evaluated for impairment	182	1,272	22	1,515	68	3,059
Balances, end of period	\$ 117,744	\$ 138,255	\$ 51,872	\$ 23,885	\$ 18,548	\$ 350,304

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

	<u>Recorded investment</u>	<u>Unpaid principal balance</u>	<u>Related allowance</u>
<b>With no related allowance recorded:</b>			
Commercial real estate	\$ —	\$ —	\$ —
Consumer real estate	1,272	1,272	—
Construction and land development	22	22	—
Commercial and industrial	—	—	—
Consumer	—	—	—
Other	—	—	—
Subtotal	1,294	1,294	—
<b>With an allowance recorded:</b>			
Commercial real estate	182	182	66
Consumer real estate	—	—	—
Construction and land development	—	—	—
Commercial and industrial	1,515	1,515	42
Consumer	68	68	2
Other	—	—	—
Subtotal	1,765	1,765	110
Total	\$ 3,059	\$ 3,059	\$ 110



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

	Non-Accrual	Past Due Over 89 Days and Accruing	Troubled Debt Restructurings
Commercial real estate	\$ —	\$ —	\$ 182
Consumer real estate	987	—	783
Construction and land development	21	—	—
Commercial and industrial	—	—	1,510
Consumer and other	64	—	20
Total	<u>\$ 1,072</u>	<u>\$ —</u>	<u>\$ 2,495</u>

### NOTE 3 – STOCK OPTIONS

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 statement of income as follows for the nine months ended September 30, 2018 (dollars in thousands):

Stock-based compensation expense before income taxes	\$ 83
Less: deferred tax benefit	(22)
Reduction of net income	<u>\$ 61</u>

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

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)
Outstanding at beginning of period	217,024	\$ 14.12	
Granted	—	—	
Exercised	(25,663)	11.50	
Forfeited or expired	—	—	
Outstanding at end of period	<u>191,361</u>	<u>\$ 14.48</u>	<u>3.1</u>
Fully vested and expected to vest	<u>191,361</u>	<u>\$ 14.48</u>	<u>3.1</u>
Exercisable at end of period	<u>191,361</u>	<u>\$ 14.48</u>	<u>3.1</u>

Information related to stock options for the nine months ended September 30, 2018 follows:

Intrinsic value of options exercised	\$ 1,038,000
Cash received from option exercises	295,000
Tax benefit realized from option exercises	189,000
Weighted average fair value of options granted	—

**NOTE 4 – EARNINGS PER SHARE**

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

Basic net income per share calculation:	
Numerator – Net income	\$ 625
Denominator – Average common shares outstanding	1,725,105
Basic net income per share	<u>\$ 0.36</u>
Diluted net income per share calculation:	
Numerator – Net income	\$ 625
Denominator – Average common shares outstanding	1,725,105
Dilutive shares contingently issuable	77,490
Average diluted common shares outstanding	1,802,595
Diluted net income per share	<u>\$ 0.35</u>

**NOTE 5 – EMPLOYEE STOCK OWNERSHIP PLAN**

The Bank sponsored a leveraged ESOP that covered substantially all employees who met certain age and eligibility requirements. The ESOP purchased 222,180 shares with the proceeds of a 15 year loan from the Company which was payable in annual installments and bore interest at 3.25% per annum. ESOP shares are held by the plan trustee in a suspense account until allocated to participant accounts. Shares released from the suspense account are allocated to participants on the basis of their relative compensation in the year of allocation. Participants become vested in the allocated shares upon four years of employment with the Bank. Any forfeited shares are allocated to other participants in the same proportion as contributions. As ESOP shares are allocated to participants, the Bank recognizes compensation expense equal to the fair value of the earned ESOP shares. As of September 30, 2018 the Bank terminated the ESOP, allocated all unallocated shares to participants and paid of the loan to the Company. For the nine months ended September 30, 2018, the Bank recognized \$3.6 million in compensation expense related to terminating the ESOP and allocating the remaining shares to participants.

**NOTE 6 – SUBSEQUENT EVENT**

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

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

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

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

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

## **SCHEDULE II—UNAUDITED PRO FORMA COMBINED CONSOLIDATED FINANCIAL INFORMATION OF CAPSTAR FINANCIAL HOLDINGS, INC. AND ATHENS BANCSHARES CORPORATION**

The following unaudited pro forma combined consolidated financial information and accompanying notes showing the impact on the historical financial conditions and results of operations of CapStar and Athens have been prepared to illustrate the effects of the merger under the acquisition method of accounting. See “The Merger — Accounting Treatment.”

The unaudited pro forma combined consolidated income statement for the year ended December 31, 2018 is presented as if the merger had occurred on January 1, 2018. The historical consolidated financial information has been adjusted to reflect factually supportable items that are directly attributable to the merger and, with respect to the income statement only, expected to have a continuing impact on consolidated results of operations, as such, one-time merger costs are not included.

The unaudited pro forma combined consolidated financial statement is provided for informational purposes only. The unaudited pro forma combined consolidated financial statements is not necessarily, and should not be assumed to be, an indication of the results that would have been achieved had the merger been completed as of the dates indicated or that may be achieved in the future. The preparation of the unaudited pro forma combined consolidated financial statement and related adjustments required management to make certain assumptions and estimates. The unaudited pro forma combined consolidated financial statements should be read together with:

- the accompanying notes to the unaudited pro forma combined consolidated financial statement;
- CapStar’s audited consolidated financial statements and accompanying notes as of and for the twelve months ended December 31, 2018, included in CapStar’s Annual Report on Form 10-K for the year ended December 31, 2018;
- CapStar’s Quarterly Report on Form 10-Q for the three months ended September 30, 2018, which is incorporated by reference into this joint proxy statement/prospectus;
- Athens’ audited consolidated financial statements and accompanying notes as of and for the year ended December 31, 2017;
- Athens’ unaudited consolidated financial statements and accompanying notes as of and for the nine months ended September 30, 2018;
- other information pertaining to CapStar and Athens incorporated by reference into, or included in, this joint proxy statement/prospectus.

See “Selected Historical Consolidated Financial Data of CapStar,” “Selected Historical Consolidated Financial Data of Athens,” “Documents Incorporated by Reference” and “Index to Athens’s Consolidated Financial Statements.”

**Unaudited Pro Forma Combined Consolidated Statement of Income**  
**For the year ended December 31, 2018**  
(in thousands, except per share data)

	CapStar, as reported, For the Nine Months Ended September 30, 2018	Athens, as reported, for the Nine Months Ended September 30, 2018	CapStar, as reported, for the Three Months Ended December 31, 2018	Pro Forma Adjustments		Pro Forma Combined For the Year Ended December 31, 2018
Interest income:						
Loans, including fees	\$ 40,197	\$ 13,443	\$ 20,554	\$ 1,003	b,f	\$ 75,197
Securities:						
Taxable	2,775	772	1,411	—		4,958
Tax-exempt	784	593	416	—		1,793
Federal funds sold	56	135	8	—		199
Restricted equity securities	389	339	181	—		909
Interest-bearing deposits in financial institutions	679	183	330	—		1,192
Total interest income	<u>44,880</u>	<u>15,465</u>	<u>22,900</u>	<u>1,003</u>		<u>84,248</u>
Interest expense:						
Deposits	9,088	1,403	4,462	(178)	e	14,775
Federal funds purchased	3	—	—	—		3
Securities sold under agreements to repurchase	—	—	3	—		3
Federal Home Loan Bank advances	1,813	—	719	—		2,532
Note payable to bank	—	9	—	(9)	b	—
Total interest expense	<u>10,904</u>	<u>1,412</u>	<u>5,184</u>	<u>(187)</u>		<u>17,313</u>
Net interest income	33,976	14,053	17,716	1,190		66,935
Provision for loan losses	1,328	146	1,514	—		2,988
Net interest income after provision for loan losses	<u>32,648</u>	<u>13,907</u>	<u>16,202</u>	<u>1,190</u>		<u>63,947</u>
Noninterest income:						
Treasury management and other deposit service charges	1,357	2,184	793	—		4,334
Net gain (loss) on sale of securities	2	—	1	—		3
Tri-Net fees	1,227	—	276	—		1,503
Mortgage banking income	4,329	842	1,324	—		6,495
Other noninterest income	2,157	2,207	3,993	—		8,357
Total noninterest income	<u>9,072</u>	<u>5,233</u>	<u>6,387</u>	<u>—</u>		<u>20,692</u>
Noninterest expense:						
Salaries and employee benefits	19,111	7,065	9,475	—		35,651
Data processing and software	2,411	1,138	1,424	—		4,973
Professional fees	1,074	532	534	—		2,140
Occupancy	1,600	1,112	736	—		3,448
Equipment	1,661	568	810	—		3,039
Regulatory fees	664	269	364	—		1,297
Merger related expenses	875	4,731	8,929	(14,535)	a	—
Other operating	2,259	2,347	1,560	985	c,d	7,151
Total noninterest expense	<u>29,655</u>	<u>17,762</u>	<u>23,832</u>	<u>(13,550)</u>		<u>57,699</u>
Income before income taxes	12,065	1,378	(1,243)	14,740		26,940
Income tax expense (benefit)	1,702	753	(535)	3,853	g	5,773
Net income	<u>\$ 10,363</u>	<u>\$ 625</u>	<u>\$ (708)</u>	<u>\$ 10,887</u>		<u>\$ 21,167</u>
Per share information:						
Basic net income per share of common stock	<u>\$ 0.87</u>	<u>\$ 0.36</u>	<u>\$ (0.04)</u>	<u>\$ —</u>		<u>\$ 1.24</u>
Diluted net income per share of common stock	<u>\$ 0.79</u>	<u>\$ 0.35</u>	<u>\$ (0.04)</u>	<u>\$ —</u>		<u>\$ 1.14</u>
Weighted average shares outstanding:						
Basic	<u>11,851,476</u>	<u>1,725,105</u>	<u>17,509,525</u>	<u>3,456,811</u>		<u>17,033,392</u>
Diluted	<u>13,052,758</u>	<u>1,802,595</u>	<u>18,716,562</u>	<u>3,761,316</u>		<u>18,616,669</u>

See accompanying notes to Unaudited Pro Forma Combined Consolidated Financial Information

**NOTES TO UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL STATEMENT**  
**(all amounts are in thousands, except per share data, unless otherwise indicated)**

**Note 1—Basis of Pro Forma Presentation**

The unaudited pro forma combined income statement for the year ended December 31, 2018 is based on the historical financial statements of CapStar and Athens after giving effect to the completion of the mergers and the assumptions and adjustments described in the accompanying notes. Such financial statements do not reflect cost savings or operating synergies expected to result from the mergers, or the costs to achieve these cost savings or operating synergies, or any anticipated disposition of assets that may result from the integration of the operations of the three companies. Certain historical financial information has been reclassified to conform to the current presentation.

The transactions will be accounted for under the acquisition method of accounting in accordance with Accounting Standards Codification (“ASC”) Topic 805, Business Combinations (“ASC 805”). In business combination transactions in which the consideration given is not in the form of cash (that is, in the form of non-cash assets, liabilities incurred, or equity interests issued), measurement of the acquisition consideration is based on the fair value of the consideration given or the fair value of the asset (or net assets) acquired, whichever is more clearly evident and, thus, a more reliable measure.

Under ASC 805, all of the assets acquired and liabilities assumed in a business combination are recognized at their acquisition-date fair value, while transaction costs and restructuring costs associated with the business combination are expensed as incurred. The excess of the acquisition consideration over the fair value of assets acquired and liabilities assumed, if any, is allocated to goodwill. Changes in deferred tax asset valuation allowances and income tax uncertainties after the acquisition date generally affect income tax expense. Subsequent to the completion of the merger, CapStar and Athens will finalize an integration plan, which may affect how the assets acquired, including intangible assets, will be utilized by the combined company. For those assets in the combined company that will be phased out or will no longer be used, additional amortization, depreciation and possibly impairment charges will be recorded after management completes the integration plan.

The unaudited pro forma information is presented solely for informational purposes and is not necessarily indicative of the combined results of operations or financial position that might have been achieved for the periods or dates indicated, nor is it necessarily indicative of the future results of the combined company.

## Note 2—Acquisition Consideration

Under the terms of the Athens Merger Agreement, Athens shareholders received 2.864 shares of CapStar common stock for each share of Athens common stock.

As of October 1, 2018, the acquisition consideration was as follows.

(dollars are in thousands, except per share data)

Total number of common shares as provided by Athens management	1,809,358
Total number of Athens common stock to exchange	1,809,358
Per share exchange ratio	2.864
Number of shares of CapStar common stock as exchanged	5,181,916
Multiplied by CapStar common stock price per share on September 30, 2018	\$ 16.70
Estimated fair value of CapStar common stock issued ("Stock Consideration")	\$ 86,538
Total number of stock options outstanding as provided by Athens management to exchange	548,051
Intrinsic value per stock option outstanding	\$ 11.64
Estimated fair value of stock options rolled ("Rolled Stock Options Consideration")	\$ 6,380
Stock Consideration	\$ 86,538
Rolled Stock Options Consideration	\$ 6,380
Total Preliminary Estimated Acquisition Consideration	\$ 92,918

## Note 3—Preliminary Estimated Acquisition Consideration Allocation

Under the acquisition method of accounting, the total acquisition consideration is allocated to the acquired tangible and intangible assets and assumed liabilities of Athens based on their estimated fair values as of the closing of the merger. The excess of the acquisition consideration over the fair value of assets acquired and liabilities assumed, if any, is allocated to goodwill.

The allocation of the estimated acquisition consideration with regard to Athens is preliminary because the proposed merger has not yet been completed. The preliminary allocation is based on estimates, assumptions, valuations, and other studies which have not progressed to a stage where there is sufficient information to make a definitive allocation. Accordingly, the acquisition consideration allocation unaudited pro forma adjustments will remain preliminary until CapStar management determines the final acquisition consideration and the fair values of assets acquired and liabilities assumed. The final determination of the acquisition consideration allocation is anticipated to be completed as soon as practicable after the completion of the merger and will be based on the value of the CapStar common stock at the closing of the merger. The final amounts allocated to assets acquired and liabilities assumed could differ significantly from the amounts presented in the unaudited pro forma combined consolidated financial statement.

The total preliminary estimated acquisition consideration as shown in the table above is allocated to Athens’s tangible and intangible assets and liabilities as of September 30, 2018 based on their preliminary estimated fair values as follows.

Cash and cash equivalents	\$	12,053
Securities available-for-sale		67,426
Loans		344,833
Premises and equipment, net		9,208
Goodwill		31,291
Core deposit intangible		8,980
Other assets		30,510
Deposits		(404,520)
Other liabilities		(6,863)
Total acquisition consideration	\$	<u>92,918</u>

Approximately \$8,980 has been allocated to amortizable intangible assets acquired. The amortization related to the fair value of net amortizable intangible assets is reflected as a pro forma adjustment to the unaudited pro forma condensed combined financial statement.

*Identifiable intangible assets.* The fair values of intangible assets were determined based on the provisions of ASC 805, which defines fair value in accordance with ASC Topic 820, *Fair Value Measurements and Disclosures* (“ASC 820”). ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Intangible assets were identified that met either the separability criterion or the contractual-legal criterion described in ASC 805. The allocation to intangible assets is allocated to core deposit intangibles.

*Goodwill.* Goodwill represents the excess of the preliminary estimated acquisition consideration over the preliminary fair value of the underlying net tangible and intangible assets. Among the factors that contributed to a purchase price in excess of the fair value of the net tangible and intangible assets are the skill sets, operations, customer base and organizational cultures that can be leveraged to enable the combined company to build an enterprise greater than the sum of its parts. In accordance with ASC Topic 350, *Intangibles—Goodwill and Other*, goodwill will not be amortized, but instead will be tested for impairment at least annually and whenever events or circumstances have occurred that may indicate a possible impairment. In the event management determines that the value of goodwill has become impaired, the combined company will incur an accounting charge for the amount of the impairment during the period in which the determination is made.

#### **Note 4—Preliminary Unaudited Pro Forma and Acquisition Accounting Adjustments**

The unaudited pro forma financial information is not necessarily indicative of what the financial position actually would have been had the merger been completed at the date indicated. Such information includes adjustments which are preliminary and may be revised. Such revisions may result in material changes. The financial position shown herein is not necessarily indicative of what the past financial position of the combined companies would have been, nor necessarily indicative of the financial position of the post-merger periods. The unaudited pro forma financial information does not give consideration to the impact of possible cost savings, expense efficiencies, synergies, strategy modifications, asset dispositions or other actions that may result from the merger.

The following unaudited pro forma adjustments result from accounting for the merger, including the determination of fair value of the assets, liabilities, and commitments which CapStar, as the acquirer, will acquire from Athens. The descriptions related to these preliminary adjustments are as follows.



Income Statement – Pro Forma Adjustments

	<u>Debit</u>	<u>Credit</u>
a	Remove one-time merger related expenses	\$ 14,535
b	Elimination of intercompany income/expense	9
c	Remove amortization of existing CDI	273
d	Amortization of new CDI	1,258
e	Deposit premium amortization	178
f	Estimate of loan interest accretion	1,012
g	Income tax benefit of pro forma adjustments	3,853

- a) Remove one-time merger related expenses incurred to date.  
b) Elimination of intercompany income/expense related to Athens' deposits/loan held at CapStar.  
c) Remove amortization expense of Athens' existing core deposit intangible ("CDI") asset.  
d) The estimate of CDI related to CapStar's acquisition of Athens is expected to approximate \$8,980 and will be amortized over a ten year period on an accelerated basis which is expected to produce approximately \$1.7 million of amortization expense during the first twelve months of operations.  
e) The amortization related to a time deposit premium recorded in connection with estimating the fair value of Athens' time deposits.  
f) Represents the estimate of the first twelve months interest income accretion related to the preliminary estimate of the fair value adjustment of the loans acquired pursuant to the merger. The total amount to be accreted in interest income over the estimated lives of the related loans is approximately \$4.8 million.  
g) Adjustment to reflect the income tax provision of the Pro Forma Adjustments using 26.14% as the incremental effective tax rate.

**Note 5—Earnings per Common Share**

Unaudited pro forma earnings per common share for the year ended December 31, 2018 has been calculated using CapStar's historic weighted average common shares outstanding plus the common shares assumed to be issued to Athens' shareholders in the merger.

The following table sets forth the calculation of basic and diluted unaudited pro forma earnings per common share for the year ended December 31, 2018. In the table below, amounts are in thousands except for per share data.

	<u>Basic</u>	<u>Diluted</u>
Pro forma net income available to common shareholders	\$ 21,167	\$ 21,167
Weighted average common shares outstanding:		
CapStar	11,851,476	13,052,758
Common shares issued to Athens	5,181,916	5,563,911
Pro forma	17,033,392	18,616,669
Pro forma net income per common share	<u>\$ 1.24</u>	<u>\$ 1.14</u>

## **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, 2018, 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, 2018, 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, 2018.

#### **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.—Exhibits and Financial Statements" 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 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 2019 Annual Meeting of Shareholders which will be filed with the SEC within 120 days of December 31, 2018.

#### 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 2019 Annual Meeting of Shareholders which will be filed with the SEC within 120 days of December 31, 2018.

#### 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, 2018:

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	507,903	\$ 8.66	422,900
Equity compensation plans not approved by shareholders	—	—	—
Total	<u>507,903</u>	<u>\$ 8.66</u>	<u>422,900</u>

(1) Represents 507,903 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 2019 Annual Meeting of Shareholders which will be filed with the SEC within 120 days of December 31, 2018.

#### 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 2019 Annual Meeting of Shareholders which will be filed with the SEC within 120 days of December 31, 2018.

#### 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 2019 Annual Meeting of Shareholders which will be filed with the SEC within 120 days of December 31, 2018.

## PART IV

### 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  
Included herein at pages 59 through 125.
- (2) Financial Statement Schedules  
See Item 15(c) of this Report.
- (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.

Schedule I—Athens Bancshares Corporation & Subsidiary—Unaudited Financial Statements as of and for the Nine Months Ended September 30, 2018

Schedule II—Unaudited Pro Forma Combined Consolidated Financial Information of CapStar Financial Holdings, Inc. and Athens Bancshares Corporation

### 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>
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>Bylaws of CapStar Financial Holdings, Inc. (incorporated by reference herein to Exhibit 3.2 to the Company's Registration Statement on Form S-1 (File Number 333-213367) filed on August 29, 2016)</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>

- 10.1† [Seventh Amended and Restated Executive Employment Agreement, dated April 26, 2018, between CapStar Financial Holdings, Inc., CapStar Bank, and Claire W. Tucker \(incorporated by reference herein to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q filed on May 2, 2018\).](#)
- 10.2† [Amendment to the Seventh Amended and Restated Executive Employment Agreement between CapStar Financial Holdings, Inc. and Claire W. Tucker, dated as of December 28, 2018 \(incorporated by reference herein to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on January 4, 2019\).](#)
- 10.3† [Fourth Amended and Restated Executive Employment Agreement between CapStar Financial Holdings, Inc., CapStar Bank and Robert B. Anderson, dated as of December 28, 2018 \(incorporated by reference herein to Exhibit 10.2 to the Company's Current Report on Form 8-K filed on January 4, 2019\).](#)
- 10.4† [CapStar Financial Holdings, Inc. Restricted Stock Agreement between CapStar Financial Holdings, Inc. and Robert B. Anderson, dated as of December 28, 2018 \(incorporated by reference herein to Exhibit 10.3 to the Company's Current Report on Form 8-K filed on January 4, 2019\).](#)
- 10.5† [Promissory Note between CapStar Bank and Robert B. Anderson, dated December 28, 2018 \(incorporated by reference to Exhibit 10.4 to the Company's Current Report on Form 8-K filed on January 4, 2019\).](#)
- 10.6† [Fourth Amended and Restated Executive Employment Agreement, dated April 26, 2018, between CapStar Bank and Dandridge W. Hogan \(incorporated by reference herein to Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q filed on May 2, 2018\).](#)
- 10.7† [Second Amended and Restated Executive Employment Agreement between CapStar Bank and Christopher Tietz, dated as of December 28, 2018 \(incorporated by reference herein to Exhibit 10.5 to the Company's Current Report on Form 8-K filed on January 4, 2019\).](#)
- 10.8† [CapStar Financial Holdings, Inc. Restricted Stock Agreement between CapStar Financial Holdings, Inc. and Christopher Tietz, dated as of December 28, 2018 \(incorporated by reference herein to Exhibit 10.6 to the Company's Current Report on Form 8-K filed on January 4, 2019\).](#)
- 10.9† [Promissory Note between CapStar Bank and Christopher Tietz, dated December 28, 2018 \(incorporated by reference to Exhibit 10.7 to the Company's Current Report on Form 8-K filed on January 4, 2019\).](#)
- 10.10† [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† [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\).](#)
- 10.12† [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\).](#)
- 10.13† [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\).](#)
- 10.14† [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\).](#)

10.15†	<a href="#"><u>Form of Common Stock Purchase Warrant Agreement (incorporated by reference herein to Exhibit 10.10 to the Company's Registration Statement on Form S-1 (File Number 333-213367) filed on August 29, 2016)</u></a>
10.16†	<a href="#"><u>Form of Non-Voting Common Stock Warrant (incorporated by reference herein to Exhibit 10.11 to the Company's Registration Statement on Form S-1 (File Number 333-213367) filed on August 29, 2016)</u></a>
10.17†	<a href="#"><u>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)</u></a>
10.18†	<a href="#"><u>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)</u></a>
10.19†	<a href="#"><u>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)</u></a>
10.20†	<a href="#"><u>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)</u></a>
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 15, 2019

By: /s/ Claire W. Tucker  
 Claire W. Tucker  
 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/ Claire W. Tucker</u> Claire W. Tucker	Director, President and Chief Executive Officer (Principal Executive Officer)	March 15, 2019
<u>/s/ Robert B. Anderson</u> Robert B. Anderson	Chief Financial Officer and Chief Administrative Officer (Principal Financial Officer and Principal Accounting Officer)	March 15, 2019
<u>/s/ Dennis C. Bottorff</u> Dennis C. Bottorff	Chairman	March 15, 2019
<u>/s/ Jeffrey L. Cunningham</u> Jeffrey L. Cunningham	Director, EVP of Strategic Mergers & Acquisitions	March 15, 2019
<u>/s/ L. Earl Bentz</u> L. Earl Bentz	Director	March 15, 2019
<u>/s/ Thomas R. Flynn</u> Thomas R. Flynn	Director	March 15, 2019
<u>/s/ Julie D. Frist</u> Julie D. Frist	Vice Chair	March 15, 2019
<u>/s/ Louis A. Green III</u> Louis A. Green III	Director	March 15, 2019
<u>/s/ Myra NanDora Jenne</u> Myra NanDora Jenne	Director	March 15, 2019
<u>/s/ Dale W. Polley</u> Dale W. Polley	Vice Chair	March 15, 2019
<u>/s/ Stephen B. Smith</u> Stephen B. Smith	Director	March 15, 2019
<u>/s/ Richard E. Thornburgh</u> Richard E. Thornburgh	Director	March 15, 2019
<u>/s/ James S. Turner, Jr.</u> James S. Turner, Jr.	Director	March 15, 2019
<u>/s/ Toby S. Wilt</u> Toby S. Wilt	Director	March 15, 2019



**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 15, 2019, 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, 2018.

/s/ Elliott Davis, LLC

Franklin, Tennessee  
March 15, 2019

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

I, Claire W. Tucker, certify that:

1. I have reviewed this 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 15, 2019

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

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

I, Robert B. Anderson, certify that:

1. I have reviewed this 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 15, 2019

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, 2018, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Claire W. Tucker, President and Chief Executive Officer of the Company, certify in my capacity as an officer of the Company, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

1. The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities 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 15, 2019

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

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

In connection with the Annual Report on Form 10-K of CapStar Financial Holdings, Inc. (the "Company") for the year ended December 31, 2018, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Robert B. Anderson, Chief Financial Officer and Chief Administrative Officer of the Company, certify in my capacity as an officer of the Company, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

1. The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities 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 15, 2019

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