CHOICEONE FINANCIAL SERVICES INC
Form 10-Q
May 13, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended March 31, 2016

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: **000-19202**

ChoiceOne Financial Services, Inc.
(Exact Name of Registrant as Specified in its Charter)

Michigan (State or Other Jurisdiction of Incorporation or Organization)	**38-2659066** (I.R.S. Employer Identification No.)
109 East Division **Sparta, Michigan** (Address of Principal Executive Offices)	**49345** (Zip Code)

(616) 887-7366
(Registrant's Telephone Number, including Area Code)

Indicate by checkmark 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 and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

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

As of April 30, 2016, the Registrant had outstanding 3,301,005 shares of common stock.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

ChoiceOne Financial Services, Inc.
CONSOLIDATED BALANCE SHEETS (Unaudited)

(Dollars in thousands)	March 31, 2016 (Unaudited)	December 31, 2015 (Audited)
Assets		
Cash and due from banks	$ 12,572	$ 11,187
Securities available for sale (Note 2)	171,238	160,136
Federal Home Loan Bank stock	1,614	1,614
Federal Reserve Bank stock	1,573	1,573
Loans held for sale	1,508	4,957
Loans (Note 3)	351,344	349,304
Allowance for loan losses (Note 3)	(4,125)	(4,194)
Loans, net	347,219	345,110
Premises and equipment, net	12,009	11,847
Other real estate owned, net	—	31
Cash value of life insurance policies	12,348	12,261
Intangible assets, net	241	379
Goodwill	13,728	13,728
Other assets	4,808	4,923
Total assets	$ 578,858	$ 567,746
Liabilities		
Deposits – noninterest-bearing	$ 121,513	$ 122,937
Deposits – interest-bearing	358,338	351,759
Total deposits	479,851	474,696
Repurchase agreements	8,355	9,460
Federal funds purchased	4,100	—
Advances from Federal Home Loan Bank	12,325	11,332
Other liabilities	2,801	2,416
Total liabilities	507,432	497,904
Shareholders' Equity		
Common stock and paid in capital, no par value;		

shares authorized: 7,000,000; shares outstanding:		
3,297,516 at March 31, 2016 and 3,295,228 at December 31, 2015	46,709	46,501
Retained earnings	22,851	22,138
Accumulated other comprehensive income, net	1,866	1,203
Total shareholders' equity	71,426	69,842
Total liabilities and shareholders' equity	$ 578,858	$ 567,746

See accompanying notes to interim consolidated financial statements.

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ChoiceOne Financial Services, Inc.
CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

(Dollars in thousands, except per share data)	Three Months Ended March 31, 2016	2015
Interest income		
Loans, including fees	$3,996	$3,942
Securities:		
Taxable	553	452
Tax exempt	366	349
Other	6	3
Total interest income	4,921	4,746
Interest expense		
Deposits	209	225
Advances from Federal Home Loan Bank	30	19
Other	2	12
Total interest expense	241	256
Net interest income	4,680	4,490
Provision for loan losses	—	100
Net interest income after provision for loan losses	4,680	4,390
Noninterest income		
Customer service charges	960	983
Insurance and investment commissions	223	341
Gains on sales of loans	419	503
Gains on sales of securities	70	8
Losses on sales and write-downs of other assets	(23)	(21)
Earnings on life insurance policies	88	388
Other	106	92
Total noninterest income	1,843	2,294
Noninterest expense		
Salaries and benefits	2,411	2,299
Occupancy and equipment	641	596
Data processing	559	553
Professional fees	236	277
Supplies and postage	125	105
Advertising and promotional	43	67
Intangible amortization	112	112
Loan and collection expense	22	44
FDIC insurance	67	78
Other	582	429
Total noninterest expense	4,797	4,560

Income before income tax	1,726	2,124
Income tax expense	452	482
Net income	$1,274	$1,642
Basic earnings per share (Note 4)	$0.39	$0.50
Diluted earnings per share (Note 4)	$0.39	$0.50
Dividends declared per share	$0.17	$0.15

See accompanying notes to interim consolidated financial statements.

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ChoiceOne Financial Services, Inc.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

(Dollars in thousands)	Three Months Ended March 31,	
	2016	2015
Net income	$1,274	$1,642
Other comprehensive income:		
Unrealized holding gains on available for sale securities	1,074	1,141
Less: Reclassification adjustment for gain recognized in net income	(70)	(8)
Net unrealized gain	1,004	1,133
Less tax effect	(341)	(385)
Other comprehensive income, net of tax	663	748
Comprehensive income	$1,937	$2,390

See accompanying notes to interim consolidated financial statements

ChoiceOne Financial Services, Inc.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)

(Dollars in thousands)	Number of Shares	Common Stock and Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income, Net	Total
Balance, January 1, 2015	3,295,831	$46,552	$18,565	$ 1,073	$66,190
Net income			1,642		1,642
Other comprehensive income				748	748
Shares issued	2,315	35			35
Change in ESOP repurchase obligation		(4)			(4)
Shares repurchased	(15,000)	(343)			(343)
Effect of employee stock purchases		3			3
Stock-based compensation		12			12
Cash dividends declared ($0.15 per share)			(492)		(492)
Balance, March 31, 2015	3,283,146	$46,255	$19,715	$ 1,821	$67,791
Balance, January 1, 2016	3,295,228	$46,501	$22,138	$ 1,203	$69,842
Net income			1,274		1,274
Other comprehensive income				663	663
Shares issued	2,288	34			34
Change in ESOP repurchase obligation		127			127
Shares repurchased	—	—			—
Effect of employee stock purchases		8			8
Stock-based compensation		39			39
Cash dividends declared ($0.17 per share)			(561)		(561)
Balance, March 31, 2016	3,297,516	$46,709	$22,851	$ 1,866	$71,426

See accompanying notes to interim consolidated financial statements.

ChoiceOne Financial Services, Inc.
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(Dollars in thousands)	Three Months Ended March 31, 2016	2015
Cash flows from operating activities:		
Net income	$1,274	$1,642
Adjustments to reconcile net income to net cash from operating activities:		
Provision for loan losses	—	100
Depreciation	258	244
Amortization	393	385
Compensation expense on stock purchases and restricted stock units	47	15
Gains on sales of securities	(70)	(8)
Gains on sales of loans	(419)	(503)
Loans originated for sale	(9,128)	(6,772)
Proceeds from loan sales	12,934	7,364
Earnings on bank-owned life insurance	(88)	(387)
Proceeds on bank-owned life insurance	—	461
(Gains)/losses on sales of other real estate owned	4	(2)
Write-downs of other real estate owned	—	23
Proceeds from sales of other real estate owned	28	58
Deferred federal income tax benefit	47	(175)
Net changes in other assets	(109)	(408)
Net changes in other liabilities	121	298
Net cash from operating activities	5,292	2,335
Cash flows from investing activities:		
Securities available for sale:		
Sales	2,217	1,123
Maturities, prepayments and calls	5,602	1,157
Purchases	(18,060)	(9,441)
Loan originations and payments, net	(2,109)	7,690
Additions to premises and equipment	(173)	(147)
Net cash from investing activities	(12,523)	382
Cash flows from financing activities:		
Net change in deposits	5,155	(5,746)
Net change in repurchase agreements	(1,105)	(5,590)
Net change in federal funds purchased	4,100	—
Proceeds from Federal Home Loan Bank advances	92,000	38,550
Payments on Federal Home Loan Bank advances	(91,007)	(36,033)
Issuance of common stock	34	35
Repurchase of common stock	—	(343)

Cash dividends	(561)	(492)
Net cash from financing activities	8,616	(9,619)
Net change in cash and cash equivalents	1,385	(6,902)
Beginning cash and cash equivalents	11,187	16,650
Ending cash and cash equivalents	$12,572	$9,748
Supplemental disclosures of cash flow information:		
Cash paid for interest	$240	$257
Cash paid for taxes	$—	$320

See accompanying notes to interim consolidated financial statements.

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ChoiceOne Financial Services, Inc.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The consolidated financial statements include ChoiceOne Financial Services, Inc. ("ChoiceOne") and its wholly-owned subsidiary, ChoiceOne Bank (the "Bank"), and the Bank's wholly-owned subsidiary, ChoiceOne Insurance Agencies, Inc. Intercompany transactions and balances have been eliminated in consolidation.

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information, prevailing practices within the banking industry and the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

The accompanying consolidated financial statements reflect all adjustments ordinary in nature which are, in the opinion of management, necessary for a fair presentation of the Consolidated Balance Sheets as of March 31, 2016 and December 31, 2015, the Consolidated Statements of Income for the three-month periods ended March 31, 2016 and March 31, 2015, the Consolidated Statements of Comprehensive Income for the three-month periods ended March 31, 2016 and March 31, 2015, the Consolidated Statements of Changes in Shareholders' Equity for the three-month periods ended March 31, 2016 and March 31, 2015, and the Consolidated Statements of Cash Flows for the three-month periods ended March 31, 2016 and March 31, 2015. Operating results for the three months ended March 31, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016.

The accompanying consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in ChoiceOne's Annual Report on Form 10-K for the year ended December 31, 2015.

Allowance for Loan Losses

The allowance for loan losses is maintained at a level believed adequate by management to absorb probable incurred losses inherent in the consolidated loan portfolio. Management's evaluation of the adequacy of the allowance is an estimate based on reviews of individual loans, assessments of the impact of current economic conditions on the portfolio and historical loss experience of seasoned loan portfolios. See Note 3 to the interim consolidated financial statements for additional information.

Management believes the accounting estimate related to the allowance for loan losses is a "critical accounting estimate" because (1) the estimate is highly susceptible to change from period to period because of assumptions concerning the changes in the types and volumes of the portfolios and economic conditions and (2) the impact of recognizing an impairment or loan loss could have a material effect on ChoiceOne's assets reported on the balance sheets as well as its net income.

Stock Transactions

A total of 784 shares of common stock were issued to ChoiceOne's Board of Directors for a cash price of $19,000 under the terms of the Directors' Stock Purchase Plan in the first quarter of 2016. A total of 669 shares were issued upon the exercise of stock options in the first quarter of 2016. A total of 64 shares were issued upon vesting of Restricted Stock Units in the first quarter of 2016.

Stock-Based Compensation

Effective July 1, 2013, ChoiceOne began granting Restricted Stock Units to a select group of employees under the Stock Incentive Plan of 2012. All of the Restricted Stock Units are initially unvested and vest in three annual installments on each of the next three anniversaries of the grant date. Certain additional vesting provisions apply. Each unit, once vested, is settled by delivery of one share of ChoiceOne common stock.

Reclassifications

Certain amounts presented in prior periods have been reclassified to conform to the current presentation.

NOTE 2 - SECURITIES

The fair value of securities available for sale and the related gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) were as follows:

	March 31, 2016			
(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government and federal agency	$61,684	$262	$(34)	$61,912
U.S. Treasury	6,126	63	—	6,189
State and municipal	82,757	2,244	(55)	84,946
Mortgage-backed	6,598	42	(9)	6,631
Corporate	7,907	45	(4)	7,948
Foreign debt	1,000	—	(1)	999
Equity securities	2,280	87	—	2,367
Asset-backed securities	250	—	(4)	246
Total	$168,602	$2,743	$(107)	$171,238

	December 31, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government and federal agency	$57,406	$30	$(229)	$57,207
U.S. Treasury	6,133	—	(33)	6,100
State and municipal	76,005	1,858	(109)	77,754
Mortgage-backed	6,989	26	(45)	6,970
Corporate	8,418	8	(39)	8,387
Foreign debt	1,000	—	(5)	995
Equity securities	2,279	174	—	2,453
Asset-backed securities	274	—	(4)	270
Total	$158,504	$2,096	$(464)	$160,136

ChoiceOne reviews its securities portfolio on a quarterly basis to determine whether unrealized losses are considered to be temporary or other-than-temporary. No other-than-temporary impairment charges were recorded in the first quarter of 2016. ChoiceOne believed that unrealized losses on securities were temporary in nature and were due to changes in interest rates and reduced market liquidity and not as a result of credit quality issues.

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES

Activity in the allowance for loan losses and balances in the loan portfolio were as follows:

(Dollars in thousands)	Agricultural	Commercial and Industrial	Consumer	Commercial Real Estate	Construction Real Estate	Residential Real Estate	Unallocated	Total
Allowance for Loan Losses								
Three Months Ended March 31, 2016								
Beginning balance	$ 420	$ 586	$ 297	$ 1,030	$ 46	$ 1,388	$ 427	$ 4,194
Charge-offs	—	(33)	(39)	—	—	(69)	—	(141)
Recoveries	—	15	42	8	—	7	—	72
Provision	(38)	123	(28)	100	(3)	24	(178)	—
Ending balance	$ 382	$ 691	$ 272	$ 1,138	$ 43	$ 1,350	$ 249	$ 4,125
Individually evaluated for impairment	$ 2	$ 9	$ 2	$ 219	$ —	$ 343	$ —	$ 575
Collectively evaluated for impairment	$ 380	$ 682	$ 270	$ 919	$ 43	$ 1,007	$ 249	$ 3,550
December 31, 2015								
Individually evaluated for impairment	$ 3	$ 15	$ 1	$ 191	$ —	$ 296	$ —	$ 506
Collectively evaluated for impairment	$ 417	$ 571	$ 296	$ 839	$ 46	$ 1,092	$ 427	$ 3,688
Three Months Ended March 31, 2015								
Beginning balance	$ 186	$ 527	$ 184	$ 1,641	$ 9	$ 1,193	$ 433	$ 4,173
Charge-offs	—	—	(51)	—	—	(1)	—	(52)
Recoveries	—	28	36	6	—	30	—	100
Provision	13	58	25	(149)	30	261	(138)	100
Ending balance	$ 199	$ 613	$ 194	$ 1,498	$ 39	$ 1,483	$ 295	$ 4,321
Individually evaluated for impairment	$ 1	$ —	$ 2	$ 414	$ —	$ 384	$ —	$ 801
Collectively evaluated for impairment	$ 198	$ 613	$ 192	$ 1,084	$ 39	$ 1,099	$ 295	$ 3,520
Loans								
March 31, 2016								
Individually evaluated for impairment	$ 175	$ 310	$ 23	$ 3,083	$ —	$ 2,660		$ 6,251
	35,910	98,308	20,309	95,919	4,981	89,666		345,093

Collectively evaluated for impairment								
Ending balance	$ 36,085	$ 98,618	$ 20,332	$ 99,002	$ 4,981	$ 92,326		$ 351,344

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The process to monitor the credit quality of ChoiceOne’s loan portfolio includes tracking (1) the risk ratings of business loans, (2) the level of classified business loans, and (3) delinquent and nonperforming consumer loans. Business loans are risk rated on a scale of 1 to 8. A description of the characteristics of the ratings follows:

Risk ratings 1 and 2: These loans are considered pass credits. They exhibit good to exceptional credit risk and demonstrate the ability to repay the loan from normal business operations.

Risk rating 3: These loans are considered pass credits. They exhibit acceptable credit risk and demonstrate the ability to repay the loan from normal business operations.

Risk rating 4: These loans are considered pass credits. However, they have potential developing weaknesses that, if not corrected, may cause deterioration in the ability of the borrower to repay the loan. While a loss is possible for a loan with this rating, it is not anticipated.

Risk rating 5: These loans are considered special mention credits. Loans in this risk rating are considered to be inadequately protected by the net worth and debt service coverage of the borrower or of any pledged collateral. These loans have well defined weaknesses that may jeopardize the borrower’s ability to repay the loan. If the weaknesses are not corrected, loss of principal and interest could be probable.

Risk rating 6: These loans are considered substandard credits. These loans have well defined weaknesses, the severity of which makes collection of principal and interest in full questionable. Loans in this category may be placed on nonaccrual status.

Risk rating 7: These loans are considered doubtful credits. Some loss of principal and interest has been determined to be probable. The estimate of the amount of loss could be affected by factors such as the borrower’s ability to provide additional capital or collateral. Loans in this category are on nonaccrual status.

Risk rating 8: These loans are considered loss credits. They are considered uncollectible and will be charged off against the allowance for loan losses.

Information regarding the Bank's credit exposure is as follows:

Corporate Credit Exposure - Credit Risk Profile By Creditworthiness Category

(Dollars in thousands)	Agricultural March 31, 2016	December 31, 2015	Commercial and Industrial March 31, 2016	December 31, 2015	Commercial Real Estate March 31, 2016	December 31, 2015
Risk ratings 1 and 2	$7,021	$10,416	$10,941	$10,480	$5,918	$3,875
Risk rating 3	21,739	25,189	68,582	66,921	54,846	57,540
Risk rating 4	5,717	3,086	18,092	16,169	31,940	29,826
Risk rating 5	1,560	1,491	886	574	3,778	3,776
Risk rating 6	48	50	117	129	2,521	2,719
Risk rating 7	—	—	—	74	—	—
	$36,085	$40,232	$98,618	$94,347	$99,002	$97,736

Corporate Credit Exposure - Credit Risk Profile Based On Payment Activity

	Consumer March 31, 2016	December 31, 2015	Construction Real Estate March 31, 2016	December 31, 2015	Residential Real Estate March 31, 2016	December 31, 2015
Performing	$20,332	$20,090	$4,981	$5,390	$91,842	$90,796
Nonperforming	—	—	—	—	—	282
Nonaccrual	—	—	—	—	484	431
	$20,332	$20,090	$4,981	$5,390	$92,326	$91,509

The following schedule provides information on loans that were considered TDRs that were modified during the three months ended March 31, 2016 and March 31, 2015:

(Dollars in thousands)	March 31, 2016 Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	March 31, 2015 Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial real estate	1	$128	$128	3	$669	$669
Residential real estate	1	30	30	1	111	111
	2	$158	$158	4	$780	$780

The pre-modification and post-modification outstanding recorded investment represents amounts as of the date of loan modification. If a difference exists between the pre-modification and post-modification outstanding recorded investment, it represents impairment recognized through the provision for loan losses computed based on a loan's post-modification present value of expected future cash flows discounted at the loan's original effective interest rate. If no difference exists, a loss is not expected to be incurred based on an assessment of the borrower's expected cash flows.

The following schedule provides information on TDRs as of March 31, 2016 and 2015 where the borrower was past due with respect to principal and/or interest for 30 days or more during the three-month periods ended March 31, 2016 and March 31, 2015 that had been modified during the year prior to the default:

	Three Months Ended March 31, 2016		Three Months Ended March 31, 2015	
(Dollars in thousands)	Number of Loans	Recorded Investment	Number of Loans	Recorded Investment
Agricultural	1	$ 128	—	$ —
Commercial real estate	—	0		