

# 2021 Annual Report

SOUTHERN MICHIGAN  
BANCORP, INC.



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# Message to our Shareholders

**A**s the global pandemic continued to bring hardship to families and businesses throughout 2021, we have been humbled by the dedication of front-line health care workers and all those who persevered to serve others. We are hopeful that the COVID-19 pandemic continues to trend toward an endemic phase, and we can begin enjoying life as we once did.

Southern Michigan Bancorp, Inc. achieved both balance sheet and income milestones for year end 2021. The bank attained record earnings of \$11,757,000, an increase of \$4,371,000, or 59.2 percent, over 2020 results of \$7,386,000. Earnings per share were \$2.59 for 2021, compared to \$1.61 for 2020 after adjusting for the 100 percent stock dividend issued in May 2021. Fourth quarter net income was \$2,522,000, or \$0.56 per

share, an increase of \$498,000, or 24.6 percent, compared to \$2,024,000, or \$0.44 per share for the fourth quarter of 2020. Net income for ten of the twelve months during 2021 were record-setting months.

Southern ended 2021 with record year-end total assets of \$1.161 billion, which is \$163.6 million higher than \$997.6 million on December 31, 2020. Loan totals also reached a new historic high, increasing to \$741.4 million, or 16.6 percent, as of December 31, 2021, as compared to \$635.9 million at year end 2020. Loan growth exceeded \$150 million excluding the impact of Paycheck Protection Program (PPP) loans. Deposits finished the year strong as well, at a year-end record high of \$974.4 million. This was an increase of \$136.1 million, or 16.2 percent, over December 31, 2020 levels of \$838.3 million.



**"The bank attained record earnings of \$11,757,000, an increase of \$4,371,000, or 59.2 percent, over 2020 results of \$7,386,000... Southern ended 2021 with record year-end total assets of \$1.161 billion, which is \$163.6 million higher than \$997.6 million on December 31, 2020."**

Southern's return on average assets and return on average equity for 2021 was 1.06 percent and 12.32 percent, respectively. Our return on average tangible equity, which is total shareholders' equity, less goodwill and other intangibles, was 14.41 percent. The tax equivalent net interest margins for 2021 and 2020 were 3.27 percent and 3.24 percent, respectively.

Total PPP fee income was \$3.6 million during 2021 compared to \$1.3 million in 2020. In addition, total non-interest income was significant at over \$9 million including Trust income of \$2,267,000, an increase of \$219,000 over 2020 results of \$2,048,000, and mortgage lending activities generated \$2,293,000 in gains on the sale of mortgage loans originated and sold in the secondary market.

Our asset quality remained strong in 2021. The bank realized net loan loss recoveries of \$31,000 for the year. Delinquent and non-accrual loans at December 31, 2021 totaled \$1,485,000, or 0.20 percent of gross loans, down significantly from \$4,588,000, or 0.72 percent, at December 31, 2020. Non-performing assets totaled \$1,521,000 at year end, or 0.13 percent of total assets, compared to \$4,959,000 at December 31, 2020, or 0.50 percent of total assets. Southern's provision expense for loan losses totaled \$1,500,000 in 2021 compared to \$2,600,000 in 2020. The provision expense in 2021 was a result of loan growth, while the 2020 provision expense was due to the economic uncertainty associated with COVID-19.

The allowance for loan losses at December 31, 2021 was \$9.32 million, or 1.26 percent of loans. Excluding SBA guaranteed PPP loans from the calculation, the allowance was 1.28 percent of gross loans.

The board of directors approved a 100 percent stock dividend in April 2021 as a result of the bank's strong financial condition and optimistic outlook for the ongoing operation of the company. In addition, the board also approved an increase in the quarterly cash dividend from \$0.23 per share to \$0.24 beginning with the April 2021 dividend payment. The new annualized rate of \$0.48 per share after adjusting for the 100 percent stock dividend represented a dividend yield of 2.4 percent based on the market price of \$20.20 per share at year end.

In addition, in April 2021 Southern completed a private placement of \$30 million in subordinated notes due April 16, 2031. The notes qualify as Tier 2 capital and the tax-deductible nature of the instrument, combined with a low-interest rate, makes the overall cost of capital quite attractive. The proceeds allowed us to retire existing debt and provided additional capital for continued growth. Regardless of the rate environment, we remain well positioned to benefit and take advantage of both our strong liquidity and capital positions.

As we have in previous years, we are proud to highlight in our 2021 Annual Report two significant clients of the bank. Gull Lake Marine was established in 1911 and is owned by Donald Parfet. They feature some of the most widely recognized names in boating and have locations in Richland, the Bay of Gull Lake and Grand Rapids.

Value Max Products is owned by Travis Hampton and specializes in packaging, marketing, and distributing high quality products to some of the largest retailers in the country. These businesses, while uniquely different, have attained their success by understanding the importance of developing and maintaining personal relationships, the hallmark of Southern's own guiding principle.

The employees and officers at Southern remain committed to our customers, businesses, shareholders, and communities that we serve. On behalf of Southern's directors, management team and staff, thank you for your continued support.

Sincerely,



**John H. Castle**  
Chairman and Chief Executive Officer



# Gull Lake Marine

Gull Lake in Richland

Serving Southwest Michigan continuously since 1911, Gull Lake Marine is one of the oldest and most well-respected marinas in the area. For the past fifty plus years the operation has been owned by individuals in the Boudeman and Parfet families; most recently Donald Parfet, who leads the company's ownership along with daughters Sydney Parfet and Rachel Worgess, who serve as directors and officers.

With locations in Richland, Bayside and Grand Rapids, Gull Lake Marine features some of the biggest names in boating and offers a full suite of services and merchandise.

The Richland location, located on M-89 Highway, houses the Richland sales team, service team, parts department and corporate offices. Richland offers premium brands; Boston Whaler, Crest, Inmar, JC Tri-Toon, Chaparral, Robalo,

Malibu, Axis and Harris, as well as quality pre-owned inventory. This location is home to multiple buildings where they store over 600 boats annually. Richland also features a state-of-the-art 35,000 square-foot building located one mile away, known as the Richland Showroom, where their extensive inventory is available for viewing all winter long.

The Bayside location on the South Bay of Gull Lake features a pro shop and serves as one of the largest kayak outfitters in Michigan, carrying all the latest products from Hobie and Jackson kayaks, paddleboards, and stand-up paddleboards. This location also offers a full-service fuel dock and pontoon boat rentals. In addition, Bayside maintains over eighty wet slips on Gull Lake.



Gull Lake  
Marine





Gull Lake Marine  
Richland Facility



Gull Lake Marine  
Bayside Facility

In 2015, Gull Lake Marine opened their Grand Rapids location. Conveniently located off I-96 between Grand Rapids and Grand Haven, this facility houses an indoor showroom with a sales team, service team, parts department and pro shop. This location is also the home of two storage buildings as well as multiple off-site options housing over 250 boats annually, allowing the ability to take care of customers' year-round boating needs.

In 2018, the owners brought on Barry Broekhuizen to serve as General Manager. "At the time, I had never owned a boat," said Broekhuizen. "Don insisted that was okay as they had boaters working for them already. Now, I can officially say I'm a boater."

Broekhuizen has helped grow the company and continues to explore new opportunities to expand the business. "We're more than just selling boats to people," said Broekhuizen. "We strive to establish a positive relationship so we can take care of our customers for a lifetime."

While they provide all the traditional services one would expect from a marina, Gull Lake Marine also offers a unique alternative to owning a boat via a membership-based program. New in 2022, Bayside is home to Carefree Boat Club of Gull Lake, an exclusive membership option for seasoned or new boaters to enjoy lake life. Carefree Boat Club members can choose from a variety of boats and reserve them up to six months in advance. This new approach to boating gets customers out on the water without the hassle of ongoing maintenance, purchasing a boat, lift, boat detailing, winterizing, and all at an affordable price. "We're positioning ourselves to be a company that moves forward in an everchanging environment," said Broekhuizen. "Whether you want to go fishing on lake Michigan or skiing on Gull Lake, the Carefree Boat Club gives you an option to choose the best boat for every occasion."





**"When we were in the middle of May 2020, scrambling to get boats in the water, they were flexible. There is an ease of working with Tom and the Southern team and they always get things done."**

Barry Broekhuizen



Gull Lake Marine  
Grand Rapids  
Facility

Shortly after his arrival, Broekhuizen was tasked with finding new banking options for the marina, and he knew just who to call. Tom Swoish, Southern Michigan Bank & Trust Regional Vice President/Commercial Loan Manager, was a lender for his previous employer. "Tom has a very practical approach," said Broekhuizen. "He learns the industry, allowing for deeper understanding of our financing needs. When we were in the middle of May 2020, scrambling to get boats in the water, he was flexible. There is an ease of working with Tom and the Southern team and they always get things done."

Tom Swoish said, "It is a pleasure to work with Barry again in his new role with Gull Lake Marine. When he wanted to establish a relationship with a new lending and deposit partner, we knew we could offer the depth of banking services they needed and get them on board quickly."

From Cash Management, Remote Deposit Capture, ACH Services and ACH Debit Block fraud protection to Business Loans, Courier Services and Gift Cards, Southern has been pleased to provide banking services that are safe and convenient for Gull Lake Marine. Looking toward the future, they have their eye on continued growth, and Southern plans to be there every step of the way.



2022 Boston  
Whaler 280  
Outrage on  
display in Grand  
Rapids



# Value Max Products, LLC

Bela Pure  
Natural Soap

Value Max Products, LLC (VMP) is an international business headquartered in Coldwater, Michigan. Travis Hampton could have based his company anywhere, but he chose the area where he grew up, and currently resides with his wife, Alysia and two children. Travis has always appreciated the personal and business benefits that southwest Michigan has to offer. Looking back, Travis points to his father, Terry Hampton, as the biggest influence in his career as an entrepreneur. Terry founded Hampton Games, a successful business which continues to this day designing and building games for the worldwide amusement industry. Travis and his siblings helped pay their way through college by working at local fairs and other special events selling lemonade from concession trailers their father built and their mother managed.

Shortly after earning his bachelor's degree from Western Michigan University, Travis started Hampton Homes, a real estate business offering consumers a one stop shop for building, and a variety of other real estate needs. Hampton Homes is also a very successful business that is now managed by his brother and partner in the company, Troy Hampton, enabling Travis the time to focus on Value Max Products.

After researching the wholesale/distribution industry, Travis was convinced there was a strong business opportunity to compete in this arena, without asking customers to compromise on quality. Travis says, "the initial vision of VMP was to introduce products to retailers and distributors that provided the best value available in the market in all the product categories we entered. We wanted the reputation with our customers that if VMP was offering it, they could compete and provide their customers with the best value."



*Bela*  
AFFORDABLE LUXURY

WAVERTREE & LONDON



Bela Bath & Beauty Products  
Trade Show Display



VMP Team, pictured from left to right: Sterling Sobeske, Sales Manager; Travis Hampton, CEO; and Brooke Foster, Office Manager

During the initial years, Value Max Products gained traction selling and distributing other companies' brands/products and sourcing products from outside manufacturers. As time went on, they saw the need to create their own brands of products so they could control the quality and the direction of the brands. "Instead of just sourcing products from manufacturers, we started partnering and investing in manufacturers with clear competitive advantages in our product categories," Travis added. "Some of our partners are located in the US and others around the world. We work together to develop new products and create packaging and displays that help our customers increase sales and meet their strategic goals."

Currently, Value Max Products has two divisions, or major product categories. The first focuses on high impulse, general merchandise items that might be seen at the checkout counter or endcap in high traffic locations. The other side features health and beauty, and natural skin care products such as natural bar soap, lip balm, bath salts, and many others. Their products can be found in some of the largest retail

companies, such as Costco, Walmart, Spartan Nash, Food Lion, Meijer, Amazon, and Albertsons.

A growing segment of the business involves the manufacturing of products for retailers in their private label brands. Value Max Products also has licensing agreements with companies such as Nickelodeon, allowing them to brand their products with familiar characters for children, like Paw Patrol and Sponge Bob Square Pants.

As he looks toward the future of the company, Travis says, "Our product development team is continuously planning what is next for our product lines. We want to strategically continue to grow the volume of business with our retail and distribution partners, while simultaneously putting more of a focus on growing the direct-to-consumer part of our business. We have a great team, many that have been with the company since the early years. When you have a great support system in place like we do at VMP it allows you to move forward in new directions with confidence."



**"Southern's individualized approach to each business they work with has been important to us. Their team gets to know you, your family, and the unique needs of your business, and works hard to find a way to help you."**

Travis Hampton

Practically a lifelong customer of Southern Michigan Bank & Trust, Travis opened his first savings account in the second grade. When, as a college freshman, he wanted to purchase some rental properties, he financed those through Southern. Now, conducting international transactions and dealing in multiple currencies, Travis must work with some larger institutions as well. He describes the experience as very transactional, adding, "All financial institutions' primary focus should be increasing shareholder value, but Southern does that in a way where you don't feel like that is the only focus."

"Southern's individualized approach to each business they work with has been important to us. Their team gets to know you, your family, and the unique needs of your business, and works hard to find a way to help you. It is always, 'what do you need' or 'what problem are you trying to solve' and then prompt approvals or implementation."

Among the many services Travis and his company utilize, such as Cash Management, Business Bill Pay, Remote Deposit Capture and Remote Deposit Anywhere, he is particularly happy with the Fraud Protection features. "We send and receive a lot of international wires, which makes us a target for phishing schemes and fraud. Southern's online dual control wire transfer process has helped us to implement the proper internal controls to prevent a breach or fraud."

Southern Michigan Bank & Trust Vice President/Commercial Loan Officer Jim Sobeske says, "Travis started Value Max Products from scratch and developed it into an impressive company. His dad encouraged his children to make their own mark in the world, and they followed his lead. We are fortunate to have this caliber of business in our community."

"Something most people don't know about Travis and his company is how generously he supports our community behind the scenes," Sobeske continued. "One example is when COVID struck, and masks, hand sanitizer and disinfectant wipes were in short supply. VMP created their own brand of personal protection equipment and donated over one million units to schools, local non-profits, food banks, and Goodwill retail locations throughout the United States. It is a privilege to work with such a remarkable business leader and quality person."



Nature's Bees  
Lip Balm



Paw Patrol Bath  
Bombs Display

# Financial Summary

For the Year	2021	2020
Net interest income	\$33,319,000	\$26,677,000
Provision for loan losses	1,500,000	2,600,000
Non-interest income	9,009,000	8,378,000
Non-interest expense	26,708,000	23,666,000
Net income	11,757,000	7,386,000

## Per Share\*

Basic earnings	\$2.59	\$1.61
Diluted earnings	2.58	1.61
Cash dividends declared	0.48	0.46

## At Year End

Assets	\$1,161,154,000	\$997,574,000
Gross loans	741,408,000	635,870,000
Allowance for loan loss	9,320,000	7,789,000
Deposits	974,352,000	838,298,000
Shareholders' equity	97,749,000	92,977,000

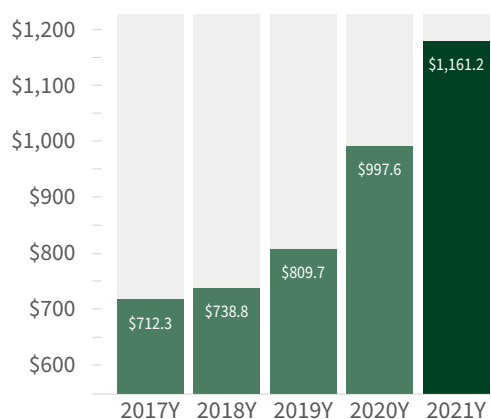
## Ratios

Return on average assets	1.06%	0.82%
Return on average equity	12.32%	8.36%
Total risk-based capital ratio	14.57%	12.68%
ALLL as percentage of loans	1.26%	1.22%

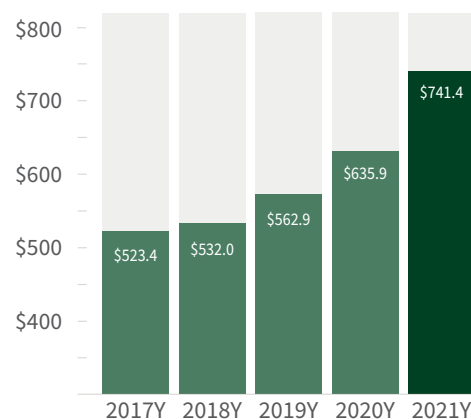
\*Per Share Data is Adjusted for the 100% Stock Dividend Paid on 5/14/2021

**Total Assets | \$1,161.2**

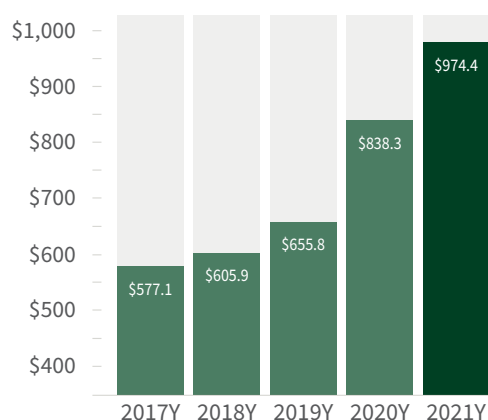
Note Data in \$ millions

**Total Loans | \$741.4**

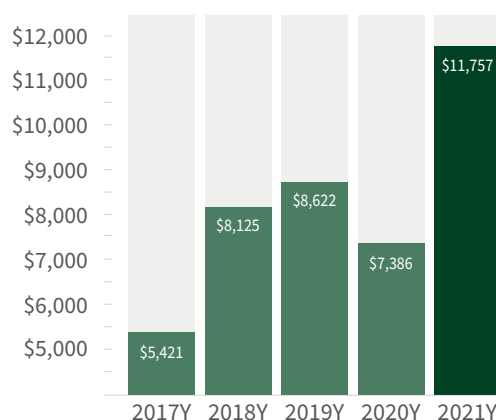
Note Data in \$ millions

**Total Deposits | \$974.4**

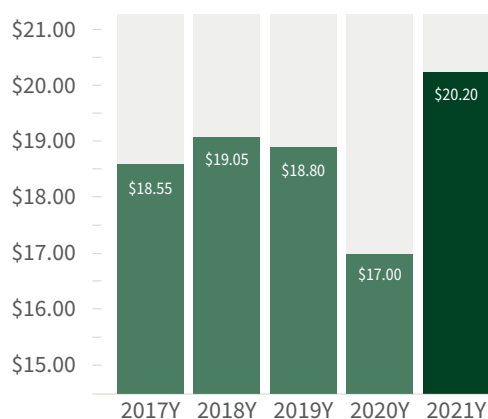
Note Data in \$ millions

**Net Income | \$11,757**

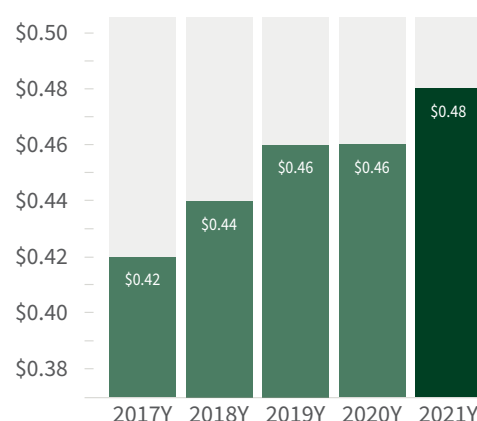
Note Data in \$ thousands

**Stock Price\* | \$20.20**

End of the Year Stock Prices

**Common Equity Dividend\* | \$0.48**

Common Equity Dividends Declared



\*Stock Price and Dividend Data is Adjusted for the 100% Stock Dividend Paid on 5/14/2021

# Our Company Footprint

Southern Michigan Bancorp, Inc. is a bank holding company. The Company's wholly-owned subsidiary, Southern Michigan Bank and Trust (SMBT) offers individuals, businesses, institutions and governmental agencies a full range of commercial banking services primarily in the southern Michigan communities in which they are located and in areas immediately surrounding these communities.

## 212

individuals working for SMBT in the state of Michigan and beyond. The introduction of a remote/hybrid work schedule has enabled us to extend our workforce for numerous positions, while adding an additional level of flexibility to the employee experience.

## 13

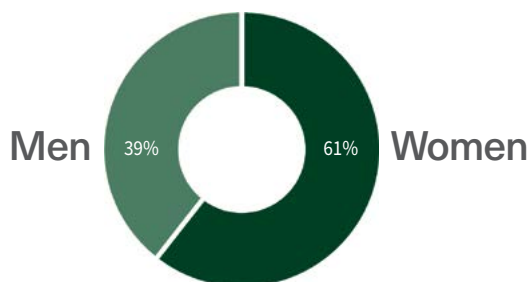
branches and offices strategically located throughout Southern's service area. We proudly reside in the cities of: Battle Creek, Centreville, Coldwater, Constantine, Hillsdale, Marshall, Mendon, Portage, Tekonsha, Three Rivers and Union City.

## 5

counties with brick-and-mortar buildings: Branch County, Calhoun County, Hillsdale County, Kalamazoo County and St. Joseph County. Southern's reach extends even further, as we continue to invest in branchless banking technology.

## Bank Officer Demographics

Southern has 26 Men and 40 Women serving as Officers



## Community Involvement

Giving back to the communities in which we serve

**\$100k+** Corporate Donations Given

**80+** Volunteer Boards/Committees Served On

**200+** Hours of Financial Literacy Programs Administered



# Executive Officers & Board of Directors

## SMB AND SMBT Executive Officers

**John H. Castle**  
Chairman /  
Chief Executive Officer

**Kurt G. Miller**  
President

**Nicholas M. Grabowski**  
Executive Vice President /  
Head of Lending

**Eric M. Anglin**  
Executive Vice President /  
Chief Strategy Officer /  
Head of Business Development

**Danice L. Chartrand**  
Senior Vice President /  
Chief Financial Officer

## SMB AND SMBT Board of Directors

**Melissa J. Bauer**  
B&M Crop Consulting

**John H. Castle**  
Chairman /  
Chief Executive Officer  
SMB, Inc. and SMBT

**Charles James Scott Clark**  
Clark Logic

**Patrick H. Flannery**  
Hillsdale College

**Stacey Hamlin**  
Jeffrey N. Hamlin DMD, PC

**Nolan E. (Rick) Hooker**  
Best American Car Washes

**Brian P. McConnell**  
Burr Oak Tool, Inc.

**Kurt G. Miller**  
President  
SMB, Inc. and SMBT

## Directors Emeritus

Dean Calhoun

John S. Carton

H. Kenneth Cole

James T. Grohalski

Gregory J. Hull

Thomas E. Kolassa

Thomas D. Meyer

Jane L. Randall

# SMBT Officers

## Commercial Loans

### Aaron Lewis

First Vice President /  
Chief Credit Officer

### Sarah Headley

First Vice President /  
Commercial Loan Manager

### Douglas W. Kiessling

Regional Vice President /  
Commercial Loan Manager

### Tom Swoish

Regional Vice President /  
Commercial Loan Manager

### Gabriel Alvez

Vice President /  
Commercial Loan Officer

### Deb Davis

Vice President /  
Commercial Loan Officer

### Corey Donner

Vice President /  
Commercial Loan Officer

### Rachel Doty

Vice President /  
Commercial Loan Officer

### Adam Losinski

Vice President /  
Commercial Loan Officer

### Greg Miller

Vice President /  
Commercial Loan Officer

### Jim Sobeske

Vice President /  
Commercial Loan Officer

### Samantha Gripman

Credit Manager

## Portage Trade Centre

### M. Travis Grimwood

Kalamazoo Regional  
President

### Justin Horn

Vice President /  
Commercial Loan Officer

### Trent Pierre

Vice President /  
Commercial Loan Officer

### Tom Schlueter

Vice President /  
Market Development

### Joseph Spoerl

Vice President /  
Wealth Management Officer

## Retail

### Derek Naylor

First Vice President /  
Head of Retail /  
Chief Deposit Officer

## Retail Loans

### DeAnne Hawley

Vice President /  
Retail Loan Sales Manager

### Connie Caudill

Vice President /  
Collections Manager

### Jodie Johnson

Vice President /  
Mortgage Loan Officer

### Shari Kline

Vice President /  
Mortgage Loan Officer

### Diane Krimmel

Assistant Vice President /  
Consumer Loan Specialist

### Stephanie Minniear

Assistant Vice President /  
Mortgage Loan Officer

### Kristen Niedzwiecki

Assistant Vice President /  
Mortgage Loan Officer

### LeAndra Otis

Mortgage Loan Officer

## Retail Loan Operations

### Tina Mack

Vice President / Retail Loan  
Operations Manager

### Phyllis Wingate

Vice President /  
Retail Lending Functions  
and Systems

## Retail Banking

### Lori Neill

Vice President / Retail Banking  
Operations Manager

### Tina Cronkhite

Vice President /  
Regional Business Development  
Manager

### BATTLE CREEK BRANCH

#### Lisa Walker

Vice President /  
Branch Manager

### CENTREVILLE BRANCH

#### Jenny Haydon

Branch Manager

### COLDWATER MAIN & EAST CHICAGO BRANCHES

#### Felicia Landis

Branch Manager

**"We have momentum. We reached one billion dollars in assets and remain one of the top community banks in Michigan, and this is accomplished because of our staff. We have the products, we have the service, but the energy from our employees has made Southern what it is today."**

John H. Castle

CONSTANTINE BRANCH  
**Veronica Wolcott**  
Branch Manager

HILLSDALE BRANCH  
**Jennifer Crist**  
Assistant Vice President /  
Branch Manager

MARSHALL BRANCH  
**Kara Mead**  
Vice President /  
Commercial Loan Officer /  
Branch Manager

MENDON BRANCH  
**Doreen Tobin**  
Assistant Vice President /  
Branch Manager

PORTAGE BRANCH  
**Cammy Fleckenstein**  
Branch Manager

TEKONSHA BRANCH  
**Dawn Copas**  
Branch Manager

THREE RIVERS BRANCH  
**Kelsey McClish**  
Branch Manager

UNION CITY BRANCH  
**Elizabeth DiDonato**  
Branch Manager

## Business Solutions

**Laurel Walkup**  
Vice President /  
Business Solutions Manager

**Deanna Manville**  
Assistant Vice President /  
Business Solutions Officer

**Karen Fleisher**  
Business Solutions Officer

## Municipal Banking

**Aimee Kornowicz**  
Municipal Banking Officer

## Finance

**Kim Hudelson**  
Vice President /  
Controller

## Human Resources

**Angela NaDell**  
First Vice President /  
Chief People Officer

## Information Technology

**Greg Sopcak**  
First Vice President /  
Head of Information  
Technology

**Joseph Duke**  
Assistant Vice President /  
Network Administrator

## Marketing

**Quinn White**  
Vice President /  
Head of Marketing

## Operations

**Angie Smith**  
First Vice President /  
Head of Operations

**Maggie Usher**  
Vice President / Treasury and eService  
Operations Manager

**Becky Omo**  
Assistant Vice President /  
Deposit Operations Manager

**Lani Smith**  
Assistant Vice President /  
Operations Support Manager

**Vikki Kline**  
Core System Administrator

## Risk Management

**Scott McQueen**  
Vice President /  
Risk Management Officer

**Jennifer Pope**  
Information Security Officer

## Wealth Management

**Matt Moses**  
Senior Vice President /  
Head of Wealth Management

**Melissa Natzke-Barlow**  
Vice President /  
Senior Investment Officer

**Sherrie Cochran**  
Vice President /  
Wealth Management Officer

**Buzz Leach**  
Vice President /  
Wealth Management Officer

**Michael Depew**  
Wealth Management  
Operations Manager

# Shareholder Information

## Annual Meeting

The annual meeting of shareholders for Southern Michigan Bancorp, Inc. will be held virtually on Thursday, May 12, 2022 at 4:00 p.m. local time, at the following URL:  
[www.virtualshareholdermeeting.com/SOMC2022](http://www.virtualshareholdermeeting.com/SOMC2022)

Scan the QR code to access the URL with your phone:



## Market Information

Inquiries regarding stock certificate administration, address changes, transfers, and other related services should be directed to:

American Stock Transfer and Trust Company, LLC

Website: [www.astfinancial.com](http://www.astfinancial.com)

Phone: (718) 921-8124

Toll Free: (800) 937-5449

Email: [info@amstock.com](mailto:info@amstock.com)

Address: 6201 15th Avenue  
Brooklyn, NY 11219

## Market Makers

D.A. Davidson & Co.  
Dublin, Ohio  
(800) 394-9230

Boenning & Scattergood  
Powell, Ohio  
(866) 326-8113

# SOUTHERN MICHIGAN BANCORP, INC.

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## Forward-looking Statements

This Southern Michigan Bancorp, Inc. Annual Report contains forward-looking statements that are based on management's beliefs, assumptions, current expectations, estimates and projections about the financial services industry, the economy, and Southern Michigan Bancorp, Inc. Forward-looking statements are identifiable by words or phrases such as "anticipates," "believes," "expects," "forecasts," "intends," "is likely," "may," "plans," or "projects," and variations of such words and similar expressions. Management's determination of the provision and allowance for loan losses, the appropriate carrying value of intangible assets (including goodwill and mortgage servicing rights), deferred tax assets and other real estate owned, and the fair value of investment securities (including whether any impairment on any investment security is temporary or other-than-temporary and the amount of any impairment), involves judgments that are inherently forward-looking. All statements with references to future time periods are forward-looking. All of the information concerning interest rate sensitivity is forward-looking. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions ("risk factors") that are difficult to predict with regard to timing, extent, likelihood and degree of occurrence. Therefore, actual results and outcomes may materially differ from what may be expressed or forecasted in such forward-looking statements.

Risk factors may emerge and could cause a difference between an ultimate actual outcome and a preceding forward-looking statement. Southern Michigan Bancorp, Inc. undertakes no obligation to update, clarify or revise forward-looking statements whether as a result of new information, future events, or otherwise.



## Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion provides a review of the consolidated financial condition and results of operations of Southern Michigan Bancorp, Inc. (Southern) and its subsidiaries for the periods indicated. This discussion should be read in conjunction with the consolidated financial statements and related notes to the consolidated financial statements.

### Overview

Southern is a Michigan corporation and registered financial holding company. Southern wholly owns Southern Michigan Bank & Trust (the Bank), Southern Michigan Bancorp Capital Trust I (a Delaware statutory trust), SMB Risk Management, Inc. (a Nevada captive insurance company), and 27 Marshall Street, LLC. The Bank wholly owns SMB Financial Services, Inc., a Michigan corporation.

Our business, which we conduct primarily through the Bank, is concentrated in a single industry segment – commercial banking. We offer a variety of deposit, payment, credit, and other financial services to all types of customers. These services include time, savings, and demand deposits; safe deposit box services; and automated teller machine services. Loans, including both commercial and consumer, are extended primarily on a secured basis to corporations, partnerships, and individuals. Commercial lending covers such categories as business, industrial, agricultural, construction, inventory, and real estate. Consumer lending covers direct and indirect loans to purchasers of residential real property and consumer goods. We offer trust and investment services, which include investment management, trustee services, IRA rollovers and retirement plans, institutional and personal custody, estate settlement, wealth management, estate planning assistance, wealth transfer planning assistance, charitable gift planning assistance, and cash management custody. We operate thirteen banking offices located in Battle Creek, Centreville, Coldwater, Constantine, Hillsdale, Marshall, Mendon, Portage, Tekonsha, Three Rivers, and Union City, Michigan.

At December 31, 2021, on a consolidated basis, we had assets of \$1.161 billion, deposits of \$974 million, a loan portfolio of \$741 million, trust assets under management totaling \$342 million, and shareholders' equity of \$98 million.

### Results of Operations

Southern's net income for 2021 was \$11,757,000, compared to \$7,386,000 in 2020, an increase of \$4,371,000, or 59.18%. Net interest income increased \$6,642,000. Provision for loan losses of \$1,500,000 was expensed in 2021, down from \$2,600,000 in 2020. Non-interest income increased 7.53%, or \$631,000, to \$9,009,000 in 2021. Non-interest expense increased 12.85%, or \$3,042,000, to \$26,708,000 in 2021. The following is a summary of percentage changes from the prior year for various financial statement elements:

	Percent Change from Prior Year			Percent Change from Prior Year	
	<u>2021</u>	<u>2020</u>		<u>2021</u>	<u>2020</u>
Net interest income	24.90%	2.11%	Total assets	16.40%	23.20%
Provision for loan losses	-42.31%	1,055.56%	Securities available-for-sale	17.98%	68.82%
Non-interest income	7.53%	9.44%	Gross loans (1)	16.47%	13.04%
Non-interest expense	12.85%	1.80%	Allowance for loan losses	19.66%	50.25%
Federal income tax	68.42%	-16.83%	Deposits	16.23%	27.84%
Net income	59.18%	-14.34%	Shareholders' equity	5.13%	11.56%

(1) Includes loans held for sale

Results of operations can be measured by various ratio analyses. Two widely recognized performance indicators are return on average equity and return on average assets. Southern's return on average equity was 12.32% in 2021, 8.36% in 2020, and 10.74% in 2019. The return on average assets was 1.06% in 2021, 0.82% in 2020, and 1.09% in 2019.

### *Net Interest Income*

Interest income is the total amount earned on funds invested in loans, investment securities, interest bearing correspondent bank balances, and federal funds sold. Interest expense is the amount of interest paid on interest bearing checking and savings accounts, time deposits, short-term advances, subordinated debentures, and other long-term borrowings. Net interest income, on a fully taxable equivalent (FTE) basis, is the difference between interest income and interest expense, adjusted for the tax benefit received on tax-exempt loan and investment securities. Net interest margin is calculated by dividing net interest income (FTE) by average interest earning assets. Net interest spread is the difference between the average yield on interest earning assets and the average cost of interest bearing liabilities. Because non-interest bearing sources of funds also support earning assets, the net interest margin exceeds the net interest spread.

The presentation of net interest income on an FTE basis is not in accordance with Generally Accepted Accounting Principles (GAAP), but is customary in the banking industry. This non-GAAP measure ensures comparability of net interest income arising from both taxable and tax-exempt loans and investment securities. The adjustments to determine tax equivalent net interest income are itemized in Table 1 on the following page.

Net interest income is the most important source of Southern's earnings. Changes in Southern's net interest income are influenced by a number of factors, including changes in the level of interest earning assets, changes in the mix of interest earning assets and interest bearing liabilities, the level and direction of market interest rates, and the steepness of the yield curve.

For 2021, Southern's net interest margin (FTE) was 3.27%, compared to 3.24% for 2020. Southern's interest rate spread was 3.14%, compared to 3.04% in 2020. The increase in the interest spread was due to funding costs declining more than asset yields in terms of basis points. Declines in interest expense totaled \$1,303,000, or 25.9% when comparing 2021 to 2020. Due to the significant increase in earning asset volume and an increase in loan fees, interest income increased \$5,435,000, or 17.0%, in 2021 compared to 2020 on a tax-equivalent adjusted basis. Combined, the growth in interest income coupled with the decline in interest expense resulted in a positive net effect to net interest income (FTE) of \$6,738,000. Interest income included Paycheck Protection Program fees of \$3,645,000 and \$1,294,000 in 2021 and 2020, respectively.

For 2020, Southern's net interest margin (FTE) was 3.24%, compared to 3.66% for 2019. Southern's interest rate spread was 3.04%, compared to 3.42% in 2019. The decline in the interest spread was due to asset yields decreasing at a faster rate than funding costs in terms of basis point cost. Declines in interest expense totaled \$1,257,000, or 20.0% when comparing 2020 to 2019. The decline in interest income in 2020 compared to 2019 totaled \$733,000, or 2.2% on a tax-equivalent adjusted basis. However, earning asset growth outpaced growth in interest bearing liabilities which resulted in a positive net effect to net interest income (FTE) of \$524,000.

The following table presents a summary of net interest income (FTE) for 2021, 2020, and 2019.

**Table 1: Average Balances and Tax Equivalent Interest Rates**

(Dollars in Thousands)	2021			2020			2019		
	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate
<b>ASSETS</b>									
Interest earning assets:									
Loans(1)(2)(3)	\$ 690,064	\$ 32,613	4.73%	\$ 610,113	\$ 28,397	4.65%	\$ 543,718	\$ 28,289	5.20%
Taxable investment securities(4)	185,135	3,330	1.80	124,989	2,482	1.99	84,795	2,185	2.58
Tax-exempt investment securities(1)	60,585	1,353	2.23	28,811	816	2.83	25,489	786	3.08
Federal funds sold and other(5)	93,927	148	0.16	67,736	314	0.46	68,737	1,482	2.16
Total interest earning assets	1,029,711	37,444	3.64	831,649	32,009	3.85	722,739	32,742	4.53
Non-interest earning assets:									
Cash and due from banks	17,737			16,751			13,567		
Other assets(6)	67,542			59,903			56,644		
Less allowance for loan losses	(8,190)			(6,445)			(5,157)		
Total assets	<u>\$ 1,106,800</u>			<u>\$ 901,858</u>			<u>\$ 787,793</u>		
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>									
Interest bearing liabilities:									
Demand deposits	\$ 464,486	\$ 1,159	0.25%	\$ 341,045	\$ 1,529	0.45%	\$ 289,973	\$ 2,207	0.76%
Savings deposits	105,369	38	0.04	83,565	44	0.05	81,810	116	0.14
Time deposits	113,803	1,070	0.94	145,763	2,452	1.68	140,032	2,805	2.00
Securities sold under agreements to repurchase and overnight borrowings	15,526	29	0.19	15,695	32	0.20	13,563	37	0.27
Other borrowings	22,064	438	1.99	31,894	791	2.48	34,279	862	2.52
Subordinated debentures	26,070	994	3.81	5,155	184	3.57	5,155	262	5.08
Total interest bearing liabilities(7)	747,318	3,728	0.50	623,117	5,032	0.81	564,812	6,289	1.11
Non-interest bearing liabilities:									
Demand deposits	252,576			178,866			136,429		
Other	11,468			11,522			6,236		
Shareholders' equity	95,438			88,353			80,316		
Total liabilities and shareholders' equity	<u>\$ 1,106,800</u>			<u>\$ 901,858</u>			<u>\$ 787,793</u>		
Net interest income		<u>\$ 33,716</u>			<u>\$ 26,977</u>			<u>\$ 26,453</u>	
Interest rate spread			<u>3.14%</u>			<u>3.04%</u>			<u>3.42%</u>
Net margin on interest earning assets			<u>3.27%</u>			<u>3.24%</u>			<u>3.66%</u>

- (1) Includes tax equivalent adjustment of interest (assuming a 21% tax rate in 2021, 2020, and 2019) for securities and loans of \$284,000 and \$20,000, respectively, for 2021; \$171,000 and \$20,000, respectively, for 2020; and \$165,000 and \$24,000, respectively, for 2019.
- (2) Average balance includes average non-accrual loan balances of \$1,909,000 in 2021, \$3,868,000 in 2020, and \$4,348,000 in 2019.
- (3) Interest income includes loan fees of \$4,495,000 in 2021, \$2,014,000 in 2020, and \$459,000 in 2019.
- (4) Average balance includes average unrealized gain of \$2,869,000 in 2021, \$2,598,000 in 2020, and \$58,000 in 2019.
- (5) Includes average federal reserve deposit account balances of \$88,939,000 in 2021, \$63,198,000 in 2020, and \$64,365,000 in 2019.
- (6) Includes \$13,660,000 in 2021, \$13,696,000 in 2020, and \$13,732,000 in 2019 relating to goodwill and other intangible assets.

- (7) Interest expense on deferred compensation balances totaling \$93,000, \$109,000, and \$138,000 for 2021, 2020, and 2019, respectively, is excluded from interest expense.

The next table sets forth, for the periods indicated, a summary of changes in interest income and interest expense. The changes are based upon a tax equivalent basis resulting from changes in volume and changes in rates:

- Volume Variance – change in volume multiplied by the previous year’s rate.
- Rate Variance – change in rate multiplied by the previous year’s volume.
- Rate/Volume Variance – change in volume multiplied by the change in rate. This variance was allocated to volume variance and rate variance in proportion to the relationship of the absolute dollar amount of the change in each.

**Table 2: Changes in Tax Equivalent Net Interest Income**

(Dollars in Thousands)

	2021 Compared to 2020			2020 Compared to 2019		
	Increase (Decrease) Due To:			Increase (Decrease) Due To:		
	Rate	Volume	Net	Rate	Volume	Net
Interest income on:						
Loans	\$ 443	\$ 3,773	\$ 4,216	\$ (3,151)	\$ 3,259	\$ 108
Taxable investment securities	(252)	1,100	848	(579)	876	297
Tax-exempt investment securities	(203)	740	537	(67)	97	30
Federal funds sold and other	(258)	92	(166)	(1,147)	(21)	(1,168)
Total interest earning assets	<u>\$ (270)</u>	<u>\$ 5,705</u>	<u>\$ 5,435</u>	<u>\$ (4,944)</u>	<u>\$ 4,211</u>	<u>\$ (733)</u>
Interest expense on:						
Demand deposits	\$ (813)	\$ 443	\$ (370)	\$ (1,019)	\$ 341	\$ (678)
Savings deposits	(16)	10	(6)	(74)	2	(72)
Time deposits	(922)	(459)	(1,381)	(464)	111	(353)
Securities sold under agreements to repurchase and overnight borrowings	(3)	-	(3)	(10)	5	(5)
Other borrowings	(139)	(214)	(353)	(12)	(59)	(71)
Subordinated debentures	13	797	810	(78)	-	(78)
Total interest bearing liabilities	<u>\$ (1,880)</u>	<u>\$ 577</u>	<u>\$ (1,303)</u>	<u>\$ (1,657)</u>	<u>\$ 400</u>	<u>\$ (1,257)</u>
Net interest income	<u>\$ 1,610</u>	<u>\$ 5,128</u>	<u>\$ 6,738</u>	<u>\$ (3,287)</u>	<u>\$ 3,811</u>	<u>\$ 524</u>

#### *Provision for Loan Losses*

The provision for loan losses is based on an analysis of the required additions to the allowance for loan losses. The provision is charged to income to bring the allowance for loan losses to a level believed adequate by management to absorb probable incurred losses in the loan portfolio. Some factors considered by management in determining the level at which the allowance is maintained include the following: specific credit reviews; historical loan loss experiences; current economic conditions and trends; results of examinations by regulatory agencies; and the volume, growth, and composition of the loan portfolio. The provision is adjusted quarterly to reflect changes in the factors above, as well as actual charge-off experience and any known losses. For further information, see “Allowance for Loan Losses” below.

The provision for loan losses was \$1,500,000 in 2021, compared to \$2,600,000 in 2020, and \$225,000 in 2019. The provision taken in 2021 was to support loan portfolio growth. The 2020 provision was driven by an increase in qualitative factors associated with the Allowance for Loan and Lease methodology. The 2020 increases were primarily related to economic uncertainty caused by the Covid-19 pandemic. The 2019 provision was due to growth in the loan portfolio.

Net loan recoveries totaled \$31,000 in 2021, compared to net recoveries of \$5,000 in 2020, and net charge-offs of \$158,000 in 2019.

#### *Non-Interest Income*

Total non-interest income increased \$631,000, or 7.5%, when comparing 2021 to 2020. The increase is attributed to a \$312,000, or 81.5% increase in earnings on life insurance assets; a \$280,000, or 18.2%, increase in ATM and debit card fee income; and a \$219,000, or 10.7%, increase in trust fees. The increases offset modest declines in service charges on deposit accounts of \$87,000, or -6.3%, and gains on loans sold to the secondary market of \$96,000, or -4.0%.

Total non-interest income increased \$723,000, or 9.4%, when comparing 2020 to 2019. The increase is primarily attributed to a \$1,706,000, or 249.8%, increase in net gains on loan sales and a \$83,000, or 5.7%, increase in ATM and debit card fee income. Those improvements offset declines in service charges on deposit accounts of \$630,000, or 31.5%; gains on the sale of investments of \$366,000, or 100.0%; earnings on life insurance assets of \$60,000, or 13.5%; and trust fees of \$37,000, or 1.8%.

To reduce the risk associated with changing interest rates, Southern regularly sells fixed-rate real estate mortgage loans to the secondary market. Southern recognizes a gain at the time of the sale to the extent proceeds exceed the basis of the loan, excluding any value assigned to capitalized servicing rights. Southern originated real estate mortgage loans for sale in the secondary market of \$51,055,000 in 2021, compared to \$63,080,000 in 2020, and \$23,788,000 in 2019. Net gains on loan sales decreased \$96,000 when comparing 2021 to 2020 and increased \$1,706,000 when comparing 2020 to 2019.

Service charges on deposit accounts declined in 2021 compared to 2020 due to the ongoing impacts of the Covid-19 pandemic. The decline in 2020 compared to 2019 was also due to the impacts of the Covid-19 pandemic. Customers received stimulus monies, increased unemployment dollars, and had fewer opportunities to spend money in both 2020 and 2021.

The increase in gain on life insurance assets was due to additional policy purchases made in 2021 as well as death benefits received in excess of recorded cash values totaling \$231,000. The decline in earnings on life insurance in 2020 was primarily due to life insurance policies paying out death benefits in excess of recorded cash values in 2019, which totaled approximately \$55,000.

Securities gains of \$5,000 were booked in 2021 due to an investment being called that resulted in the modest gain. No securities losses or gains were recognized in 2020. Net securities gains of \$366,000 were recognized in 2019. The gains in 2019 were recognized due to portfolio restructures done to move into more desirable investment sectors.

#### *Non-Interest Expense*

Non-interest expense increased \$3,042,000, or 12.9%, when comparing 2021 to 2020. Salary and employee benefit costs increased \$1,912,000, or 13.1%, in 2021. Salaries increased as the volume of full-time equivalent employees grew across departments to ensure staffing levels were in place to support growth. In addition, health insurance costs increased 28.1%. Additional expense increases included professional and outside services (\$282,000), advertising and marketing (\$179,000), FDIC deposit assessments (\$133,000), software maintenance (\$125,000), ATM expenses (\$92,000), and occupancy (\$46,000). Telecommunication expense decreased \$95,000, or 21.1%.

Non-interest expense increased \$419,000, or 1.8%, when comparing 2020 to 2019. Salary and employee benefit costs increased \$793,000, or 6.6%, in 2020. In addition, modest expense increases included occupancy (\$135,000), FDIC assessments (\$63,000) and ATM expense (\$8,000). Due to the implications of the Covid-19 pandemic, advertising



and marketing expenses declined \$230,000, or 51.3%. Other more modest expense declines were noted in the following areas: professional and outside services (\$85,000); printing, postage, and supplies (\$42,000); equipment (\$25,000); and software maintenance (\$13,000).

Other non-interest expense increased \$503,000, or 30.8%, when comparing 2021 to 2020. The most significant increases occurred in FDIC deposit assessments (\$133,000), insurance expenses (\$100,000), Michigan business taxes (\$90,000), loan related expenses (\$53,000), freight/courier expenses (\$26,000), and travel expenses (\$23,000). Increased FDIC assessments occurred as the small bank assessment credit awarded in 2018 was fully utilized in 2020. Increased insurance expenses are related to the market increase in commercial insurance coverage and the Michigan business tax increase is the result of the state of Michigan changing the formula for calculating state taxes.

Other non-interest expense decreased \$169,000, or 10.3%, when comparing 2020 to 2019. Gains on the sale of other real estate owned and fixed assets in 2020 were \$82,000 above the losses recorded in 2019. Additional declines were realized in Michigan Use Tax (\$66,000), entertainment and business meals (\$62,000), and travel (\$56,000). Notable increases included FDIC Assessments (\$63,000), total loan related expenses (\$42,000), and correspondent banking charges (\$35,000).

### *Income Taxes*

Income tax provision was \$2,363,000 in 2021, \$1,403,000 in 2020, and \$1,687,000 in 2019. Tax-exempt income continues to have an impact on Southern's income tax provision. The benefit offsetting lower coupon rates on certain municipal instruments is the non-taxable feature of the income earned on such instruments. This resulted in a lower effective tax rate and reduced the federal income tax provision by \$234,000 in 2021, \$144,000 in 2020, and \$140,000 in 2019. Furthermore, tax-exempt income from the captive insurance company reduced the federal income tax provision by \$174,000 in 2021, \$160,000 in 2020, and \$164,000 in 2019. Finally, tax-exempt income from earnings on life insurance assets resulted in a lower effective tax rate and reduced the federal income tax provision by \$146,000 in 2021, \$81,000 in 2020, and \$93,000 in 2019. Additional income tax information is reported in Note K of the consolidated financial statements.

### *Financial Condition*

Total assets were \$1,161,154,000 as of December 31, 2021, an increase of \$163,580,000, or 16.4%, compared to December 31, 2020. Gross loans increased \$105,538,000, or 16.5%, in 2021 with the growth occurring primarily in commercial real estate loans. The securities portfolio increased \$37,466,000, or 18.0%, in 2021 with increases primarily in mortgage backed and state and political subdivision securities. Deposit volumes increased \$136,054,000, or 16.2%, during 2021. The growth occurred in non-interest bearing checking deposits, interest bearing checking deposits, and savings deposits, while money market accounts and time deposits declined. Other borrowings decreased \$6,500,000, or 24.5%, in 2021 due to the pay off of the term loan with United Bankers' Bank. Subordinated debt increased \$29,359,000, or 569.5%, due to the holding company issuing \$30,000,000 of new debt in 2021. More information on the subordinated debt issuance can be found in Note J.

### *Cash and Cash Equivalents*

Cash and cash equivalents at December 31, 2021, increased \$19,779,000, or 19.9%, compared to balances at December 31, 2020. This increase was realized due to deposit growth and sub-debt issuance outpacing loan growth and investment purchases.

### *Federal Funds Sold*

Federal funds sold totaled \$271,000 at December 31, 2021, compared to \$231,000 at December 31, 2020. The Bank sells excess overnight funds to its primary correspondent in lieu of maintaining the balances in interest bearing deposit accounts when there is a higher interest rate being paid by correspondents. The Bank continues to hold excess funds in interest bearing deposit accounts due to the rate being paid.

### *Securities Available-for-Sale*

The available-for-sale securities portfolio increased \$37,466,000, or 18.0%, from December 31, 2020, to December 31, 2021. The portfolio is monitored and securities are purchased as deemed prudent by the Asset Liability Management Committee (ALCO).

The available-for-sale securities portfolio had an unrealized gain of \$1,083,000 at December 31, 2021, and an unrealized gain of \$5,522,000 at December 31, 2020. At December 31, 2021, Southern had no investment in securities of issuers outside of the United States.

### *Loans*

Substantially all loans are granted to customers located in Southern's service area, which is primarily southwest Michigan. Gross loans increased \$105,538,000, or 16.6%, in 2021. Gross loans increased \$73,006,000, or 13.0%, in 2020. The increase in 2021 is attributed to increased loan demand, primarily from customer relationships in the Portage region. The loan increase in 2020 can be attributed the Bank's participation in the SBA's PPP loan program. At December 31, 2021, \$13,060,000 of PPP loans remained on the balance sheet compared to \$60,004,000 at December 31, 2020.

Loan commitments consisting of unused credit card and home equity lines, available amounts on revolving lines of credit, and other approved loans that have not been funded were \$176,990,000 and \$195,060,000 at December 31, 2021, and 2020, respectively. The 2021 commitments consist of \$82,917,000 in fixed-rate commitments and \$94,073,000 in variable rate commitments.

### *Nonperforming Assets*

Nonperforming assets include non-accrual loans, loans modified under troubled debt restructurings, accruing loans past due 90 days or more, and other real estate owned, which includes real estate acquired through foreclosures and deeds in lieu of foreclosure.

A loan generally is classified as non-accrual when full collectability of principal or interest is doubtful, or a loan becomes 90 days past due as to principal or interest, unless management determines that the estimated net realizable value of the collateral is sufficient to cover the principal balance and accrued interest. When interest accruals are discontinued, unpaid interest is reversed. Nonperforming loans are returned to performing status when the loan is brought current and has performed in accordance with contract terms for a period of time.

In the course of working with borrowers, Southern may choose to restructure the contractual terms of certain loans. In certain circumstances, Southern attempts to work out an alternative payment schedule with the borrower in order to optimize collectability of the loan. Any loans that are modified are reviewed by Southern to identify if a troubled debt restructuring (TDR) has occurred, which is when, for economic or legal reasons related to a borrower's financial difficulties, Southern grants a concession to the borrower that it would not otherwise consider. Terms may be modified to fit the ability of the borrower to repay in line with their current financial status, and the restructuring of the loan may include the transfer of assets from the borrower to satisfy the debt, a modification of loan terms, or a combination of the two.

During 2021, Southern entered into loan modifications totaling \$13,613,000 in accordance with interagency guidance in response to the Covid-19 pandemic. At the end of the year, all of those loans had returned to normal payment status. Additional information regarding these restructures is included in Note D of the consolidated financial statements.

The following table sets forth the aggregate amount of nonperforming assets in each of the following categories:

	<b>December 31,</b>		
	<b>2021</b>	<b>2020</b>	<b>2019</b>
	(Dollars in thousands)		
Non-accrual loans:			
Commercial, commercial real estate, and agriculture	\$ 1,079	\$ 4,134	\$ 3,276
Real estate mortgage	244	355	762
Consumer	-	-	-
	<u>1,323</u>	<u>4,489</u>	<u>4,038</u>
Loans contractually past due 90 days or more and still on accrual:			
Commercial, commercial real estate, and agriculture	-	-	79
Real estate mortgage	-	-	-
Consumer	-	-	-
	<u>-</u>	<u>-</u>	<u>79</u>
Accruing loans modified under troubled debt restructurings:			
Commercial, commercial real estate, and agriculture	131	233	211
Real estate mortgage	67	237	684
Consumer	-	-	-
	<u>198</u>	<u>470</u>	<u>895</u>
Total nonperforming loans	1,521	4,959	5,012
Other real estate owned	-	-	83
	<u>-</u>	<u>-</u>	<u>83</u>
Total nonperforming assets	<u>\$ 1,521</u>	<u>\$ 4,959</u>	<u>\$ 5,095</u>
Nonperforming loans to year-end loans	<u>0.21%</u>	<u>0.78%</u>	<u>0.89%</u>
Nonperforming assets to total assets	<u>0.13%</u>	<u>0.50%</u>	<u>0.63%</u>

The balance of non-accrual restructured loans, which is included in non-accrual loans, was \$83,000 at December 31, 2021, \$2,938,000 at December 31, 2020, and \$3,390,000 at December 31, 2019.

Nonperforming loans are subject to continuous monitoring by management and estimated losses are specifically allocated in the allowance for loan losses, where appropriate. Nonperforming loans decreased from December 31, 2020, to December 31, 2021. At December 31, 2021, 2020, and 2019, Southern had loans of \$2,154,000; \$5,450,000; and \$5,480,000, respectively, which were considered impaired.

Southern held no other real estate owned assets at December 31, 2021 or December 31, 2020. During 2021 no loans were transferred to other real estate owned. In 2020, loans of \$57,000 were transferred to other real estate owned.

In management's evaluation of the loan portfolio risks, any significant future increases in nonperforming loans are dependent largely on the economic environment. In a deteriorating or uncertain economy, management applies assumptions that are more conservative when assessing the future prospects of borrowers and when estimating collateral values. This may result in a higher number of loans being classified as nonperforming.

#### *Allowance for Loan Losses*

The allowance for loan losses is based on quarterly assessments of the probable estimated incurred losses inherent in the loan portfolio. The allowance is maintained at a level which, in management's judgment, is believed adequate to absorb probable incurred loan losses in the loan portfolio. While management uses the information available to make these estimates, future adjustments to the allowance may be necessary due to economic, operating, or regulatory conditions beyond Southern's control.



The allowance is based on two accounting standards: Accounting Standards Codification (ASC) 450-10, *Accounting for Contingencies*, and ASC 310-10, *Accounting by Creditors for Impairment of a Loan*. The methodology used relies on several key features, including historical loss experience, specific allowances for identified problem loans, and a number of other factors recommended in regulatory guidance.

The historical loss component of the allowance is based on considering the historical loss experience for each loan category. The component may be adjusted for significant factors that, in management's judgment, will affect the collectability of the portfolio. The resulting loss estimate could materially differ from the losses actually incurred in the future.

Specific allowances are established in cases where management has identified significant conditions or circumstances related to a specific loan credit. As of December 31, 2021, specific reserves totaled \$400,000, compared to \$524,000 at December 31, 2020, a decrease of \$124,000.

The final components of the allowance are based on management's evaluation of conditions that are not directly measured in the historical loss component or specific allowances. The evaluation of the inherent incurred loss with respect to these conditions is subject to a higher degree of uncertainty. The conditions evaluated in connection with these components of the allowance include the following: current economic conditions; delinquency and charge-off trends; loan volume; portfolio mix; concentrations of credit; lending policies and procedures; changes in the loan review function; changes in underlying collateral; and lending personnel.

The allowance for loan losses was \$9,320,000, or 1.26% of total loans, at December 31, 2021, compared to \$7,789,000, or 1.22% of total loans, at December 31, 2020.

The allowance for loan losses at December 31, 2021, consisted of \$463,000 from the historical loss experience component and specifically allocated reserves, leaving \$8,857,000 from the other factors. This compares to \$658,000 from the historical loss experience component and specifically allocated reserves, and \$7,131,000 from the other factors at December 31, 2020. The increase in the other factors component of the allowance for loan losses at December 31, 2021, as compared to December 31, 2020, is largely attributable to loan growth. This is because only modest adjustments were made to factors not directly related to historical losses or specific allowances.

At December 31, 2021, management was not aware of any problem loan that would have a material effect on loan delinquency or loan charge-offs. Loans are subject to continual review and are given management's attention whenever a problem situation appears to be developing.

### *Deposits*

Deposits have traditionally represented Southern's principal funding source. Total deposits increased 16.2%, or \$136,054,000, in 2021 compared to 2020, and increased 27.8%, or \$182,536,000, in 2020 compared to 2019. The majority of deposits are derived from core client sources, relating to long-term relationships with local individuals, businesses, and public clients. A modest amount of brokered deposits, \$3,057,000 at December 31, 2021, is maintained. Attracting and keeping traditional deposit relationships will continue to be a focus of Southern.

### *Other Borrowings*

Southern borrowed \$10,000,000 in May 2017 from United Bankers' Bank to fund a stock repurchase and provide a capital infusion into the Bank. The note was paid off in April 2021 with funds received from the subordinated debt issued in 2022.

As another funding source, Southern obtains advances from the Federal Home Loan Bank (FHLB). The advances are secured by a blanket collateral agreement with the FHLB, giving them an unperfected security interest in select 1-4 family mortgage and commercial real estate loans. FHLB advances are used as an alternative funding source to paying a premium for long-term deposits. At December 31, 2021, Southern had \$20,000,000 in FHLB advances with interest rates between 1.73% and 1.96%, with a weighted average rate of 1.85%.

### *Subordinated Debentures*

On April 16, 2021, the Company completed a private placement of \$30 million in aggregate principal amount of 3.75% Fixed-to-Floating Rate Subordinated Notes due April 16, 2031 (the "Notes"). The Notes will initially bear interest at a fixed rate of 3.75% through April 16, 2026, after which time, until maturity, the interest rate will reset quarterly to an annual floating rate equal to the then-current 3-month SOFR, plus 302 basis points. The Notes are redeemable by the Company at its option, in whole or in part, on or after April 16, 2026. The Notes are not subject to redemption at the option of the holders.

In March 2004, Southern Michigan Bancorp Capital Trust I, a trust formed by Southern, closed a pooled private offering of 5,000 trust preferred securities with a liquidation amount of \$1,000 per security. Southern issued \$5,155,000 of subordinated debentures to the trust in exchange for ownership of all common securities of the trust and the proceeds of the preferred securities sold by the trust. Southern is not considered the primary beneficiary of this trust, therefore the trust is not consolidated in Southern's financial statements. Rather, the subordinated debentures are shown as a liability. Southern may redeem the subordinated debentures, subject to the receipt by Southern of the proper approval of the Federal Reserve, if such approval is required under applicable capital guidelines or policies of the Federal Reserve. The subordinated debentures may be redeemed on January 7, April 7, July 7, and October 7 of each year and may occur either in whole or in integrals of \$1,000 at 100% of the principal amount, plus accrued and unpaid interest. The subordinated debentures mature on April 6, 2034. The subordinated debentures are also redeemable in whole, but not in part, from time to time upon the occurrence of specific events defined within the trust indenture. Southern has the option to defer interest payments on the subordinated debentures from time to time for a period, not to exceed 20 consecutive quarterly periods. Southern's investment in the common stock of the trust is \$155,000 and is included in other assets.

The \$5,000,000 in trust preferred securities is included in Tier I capital (with certain limitations applicable) under current regulatory guidelines and interpretations. The trust preferred securities and subordinated debentures have a variable rate of interest equal to the three-month London Interbank Offered Rate (LIBOR), plus 2.75%. The rate at December 31, 2021, was 2.87%.

### *Capital Resources*

Southern obtains funds for operating expenses and dividends to shareholders through dividends from the Bank. In general, the Bank pays only those amounts required to meet the liquidity requirements of Southern, while maintaining appropriate capital levels at the Bank. Capital is maintained at the Bank to support its current operations and projected future growth. See additional discussion under the section titled "Liquidity" below.

Shareholders' equity increased \$4,772,000, or 5.1%, from December 31, 2020 to December 31, 2021, and increased \$9,632,000, or 11.6%, from December 31, 2019 to December 31, 2020. The increase in 2021 was attributed to positive changes in retained earnings (net income less dividends). That change was offset by the decline in other comprehensive income of \$3,506,000 which reflects the net decrease in unrealized gains on available for sale securities, net of tax. The increase in 2020 was attributed to positive changes in retained earnings (net income less dividends) and other comprehensive income (\$4,414,000) representing the net increase in unrealized gains on available for sale securities, net of tax.

The Federal Reserve Board uses capital adequacy guidelines in its examination and regulation of bank holding companies. If capital falls below minimum guidelines, a bank holding company may, among other items, be denied approval to acquire or establish additional banks or non-bank businesses.

The FDIC Improvement Act of 1991 established a system of prompt corrective action to resolve the problems of undercapitalized banks. Under this system, federal banking regulators have established five capital categories in which all institutions are placed: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The FDIC has also specified by regulation the relevant capital levels for each of the categories.

The FDIC is required to take specified mandatory supervisory actions and is authorized to take other discretionary actions with respect to banks in the three undercapitalized categories. The severity of the action depends upon the capital category in which a bank is placed. Subject to a narrow exception, the FDIC must generally appoint a receiver or conservator for a bank that is critically undercapitalized. A bank in any of the under-capitalized categories is required to submit an acceptable capital restoration plan to its appropriate federal banking agency. An undercapitalized bank is also generally prohibited from paying any dividends, 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 FDIC approval.

Failure to meet capital guidelines could subject a bank to a variety of enforcement remedies, including issuance of a capital directive, the termination of deposit insurance by the FDIC, a prohibition on accepting brokered deposits, and other restrictions on its business. In addition, such a bank would generally not receive regulatory approval of any application that requires the consideration of capital adequacy, such as a branch or merger application, unless the bank could demonstrate a reasonable plan to meet the capital requirement within a reasonable time period.

With the implementation of BASEL III in 2015, regulatory agencies granted banks a one-time election to determine whether the capital component created by the net unrealized gain or loss on available-for-sale securities is included in Tier 1 capital. Southern elected not to include the net unrealized gain or loss on available-for-sale investments in Tier 1 capital. Therefore, the net unrealized gain or loss is not included in the capital ratios listed in Note U to the consolidated financial statements.

As of December 31, 2021, the capital ratios of the Bank exceeded the minimum thresholds to be categorized as “well-capitalized” under applicable regulations. Note U of our consolidated financial statements provides additional information regarding our capital ratios.

### ***Liquidity***

Liquidity management involves the ability to meet the cash flow requirements of customers who may be either depositors wanting to withdraw funds or borrowers needing assurance that sufficient funds will be available to meet their credit needs. Southern maintains certain levels of liquid assets (the most liquid of which are cash and cash equivalents, federal funds sold, and investment securities) in order to meet these demands. Cash and equivalents, maturing loans, and investment securities are the principal sources of asset liquidity. Liquidity is monitored and closely managed by the ALCO, whose members are comprised of senior management.

Southern maintains correspondent accounts with regional and national banks for various purposes. Historically, cash sufficient to meet the operating needs of the Bank’s branches is maintained at its lowest practical level.

From time to time, Southern is a participant in the federal funds market. Federal funds are generally borrowed or sold for one-day periods. The average balance of federal funds sold was \$257,000 in 2021 and \$271,000 in 2020. During 2021 and 2020, Southern averaged \$88,939,000 and \$63,198,000, respectively, on deposit at the Federal Reserve.

In the past, Southern has used overnight federal funds lines of credit with correspondent banks as a short-term source of liquidity. As of December 31, 2021, Southern had \$56 million in line-of-credit availability with three correspondent banks, including \$53 million in overnight federal funds lines. The remaining \$3 million is available through the Federal Reserve’s “Discount Window” based on the current collateral pledged. Southern also has the ability to borrow \$73 million from the Federal Home Loan Bank based on collateral pledged. Southern has \$179 million of securities which could be pledged to secure additional borrowing capacity.

Southern’s principal source of funds to pay cash dividends comes from dividends paid by the Bank from its earnings. Dividend amounts are restricted under current banking laws and regulations. Capital guidelines adopted by federal and state regulatory agencies, as well as restrictions imposed by law, limit the amount of cash dividends the Bank can pay to Southern. At December 31, 2021, using the most restrictive of these conditions, the aggregate cash dividends the Bank could pay Southern without prior regulatory approval was \$28.8 million.



### ***Impact of Inflation and Changing Prices***

The majority of assets and liabilities of a financial institution are monetary in nature and differ greatly from most commercial and industrial companies that have significant investments in fixed assets or inventories. However, inflation does have an important impact on the growth of total assets in the banking industry and the resulting need to increase equity capital at higher-than-normal rates in order to maintain an appropriate equity-to-assets ratio. Other expenses are also significantly affected by inflation, tending to rise during periods of general inflation.

### ***Commitments and Off-Balance Sheet Risk***

Southern maintains off-balance sheet financial instruments in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, letters of credit, and standby letters of credit. Loan commitments to extend credit are agreements to lend to customers at any time, as the customers' needs vary, as long as there is no violation of any condition established in the contract. Letters of credit are used to facilitate customers' trade transactions. Under standby letters of credit agreements, Southern agrees to honor certain commitments in the event that its customers are unable to do so. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. At December 31, 2021, Southern had loan commitments of \$176,990,000; \$13,197,000 in standby letters of credit; and no commitments under commercial letters of credit outstanding.

These arrangements have credit risk similar to that involved in extending loans to customers and are subject to Southern's normal credit policies. Collateral generally consists of receivables, inventory, and equipment and is obtained based on management's credit assessment of the customer. These financial instruments are recorded when they are funded.

### ***Interest Rate Sensitivity***

Net interest income is the largest component of Southern's earnings. Net interest income is the difference between the yield on interest earning assets and the cost of interest bearing liabilities. Management of interest rate sensitivity seeks to avoid fluctuating net interest margins and enhance consistent growth of net interest income through periods of changing interest rates.

Interest rate risk arises when the maturity or repricing characteristics of assets differ significantly from the maturity or repricing characteristics of liabilities. Accepting this risk can be an important source of profitability and shareholder value. However, excessive levels of interest rate risk could pose a significant threat to Southern's earnings and capital base. Accordingly, effective risk management that maintains interest rate risk at prudent levels is essential to Southern's safety and soundness.

A number of tools are used to monitor and manage interest rate risk, including income simulation and market value of equity analyses. The income simulation model is used to estimate the effect that specific interest rate changes would have on net interest income. The changes include ramped and shocked increases of 1%, 2%, 3%, and 4% to interest rates on both a static and dynamic balance sheet over 12 and 24 month timeframes. A 1% and 2% declining scenario was also modeled at December 31, 2021. Assumptions in the simulation are based on management's estimates and are inherently uncertain. As a result, the models cannot predict precisely the impact of higher or lower interest rates on net interest income.

The simulation's effect on net interest income is shown in the table below:

<b>Ramp Change/ Dynamic</b>	<b>12 Month % Change</b>	<b>24 Month % Change</b>	<b>Ramp Change/ Static</b>	<b>12 Month % Change</b>	<b>24 Month % Change</b>
+400	4.74%	8.51%	+400	5.38%	9.56%
+300	3.45%	6.39%	+300	3.91%	7.15%
+200	2.24%	4.23%	+200	2.52%	4.69%
+100	1.12%	2.11%	+100	1.24%	2.31%
-100	-0.41%	-1.41%	-100	-0.22%	-0.96%
-200	-1.58%	-3.15%	-200	-1.19%	-2.32%
-300	NA	NA	-300	NA	NA
-400	NA	NA	-400	NA	NA
<b>Shock Change/ Dynamic</b>	<b>12 Month % Change</b>	<b>24 Month % Change</b>	<b>Shock Change/ Static</b>	<b>12 Month % Change</b>	<b>24 Month % Change</b>
+400	10.90%	13.32%	+400	10.81%	12.88%
+300	8.08%	9.98%	+300	7.99%	9.64%
+200	5.14%	6.54%	+200	5.05%	6.26%
+100	2.29%	3.14%	+100	2.21%	2.96%
-100	-1.69%	-2.67%	-100	-1.26%	-1.89%
-200	-3.09%	-4.39%	-200	-2.48%	-3.36%
-300	NA	NA	-300	NA	NA
-400	NA	NA	-400	NA	NA

The market value of equity analysis estimates the change in the market value of equity using interest rate change scenarios from +4% to -4% in 1% increments. Only a 100 bp decline was modeled at December 31, 2021. The following table illustrates the percent change in equity based on changes in market interest rates:

	<b><u>Change in market value of equity</u></b>
4% increase in market rates	9.69%
3% increase in market rates	7.97%
2% increase in market rates	5.67%
1% increase in market rates	3.03%
No change	0.00%
1% decrease in market rates	-5.51%
2% decrease in market rates	NA
3% decrease in market rates	NA
4% decrease in market rates	NA

Management continues to monitor the ratios and report the results to the Board of Directors on a quarterly basis.

### ***Critical Accounting Policies***

The discussion and analysis of the financial condition and results of operations are based upon Southern's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these consolidated financial statements requires Southern to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of our consolidated financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and potentially could result in materially different results under different assumptions and conditions. A summary of significant accounting policies of Southern are detailed in Note A to the consolidated financial statements.

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

The allowance for loan losses is maintained at a level management believes is adequate to absorb probable, incurred credit losses inherent in Southern's loan portfolio. Accounting for loan classification, accrual status, and determination of the allowance for loan losses is based on regulatory guidance. This guidance includes, but is not limited to, generally accepted accounting principles, the uniform retail credit classification and account management policy issued by the Federal Financial Institutions Examination Council, and the joint policy statement on the allowance for loan loss methodologies also issued by the Federal Financial Institutions Examination Council. Using this guidance, management estimates the allowance balance based on past loan loss experience, nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, information in regulatory examination reports, and other factors. Many of the factors listed are inherently subjective and require the use of significant management estimates.

#### ***Fair Value Measurements***

Southern uses fair value measurements to record certain financial instruments and to determine fair value disclosures. Available-for-sale securities are financial instruments recorded at fair value on a recurring basis. Additionally, Southern may be required to record at fair value other financial assets on a nonrecurring basis. These nonrecurring fair value adjustments typically involve write-downs of, or specific reserves against, individual assets. ASC 820-10-55 establishes a three-level hierarchy for disclosure of assets and liabilities recorded at fair value. The classification of assets and liabilities within the hierarchy is based on whether the inputs to the valuation methodology used in the measurement are observable or unobservable. Observable inputs reflect market driven or market-based information obtained from independent sources, while unobservable inputs reflect management's estimates about market data.

The degree of management's judgment involved in determining the fair value of a financial instrument is dependent upon the availability of quoted market prices or observable market data. For financial instruments that trade actively and have quoted market prices or observable market data, there is minimal subjectivity involved in measuring fair value. When observable market prices and data are not fully available, management's judgment is necessary to estimate fair value. In addition, changes in the market conditions may reduce the availability of quoted prices or observable data. When market data is not available, management uses valuation techniques that require more judgment to estimate the appropriate fair value measurement. Fair value is discussed further in Note A under the heading "Fair Values of Financial Instruments" and in Note T, "Fair Value Measurements", of the notes to the consolidated financial statements.

#### ***Mortgage Servicing Rights***

Mortgage servicing rights represent the allocated value of servicing loans that are sold with servicing retained by Southern. Servicing rights are expensed in proportion to, and over the period of, estimated net servicing revenues. Management's accounting treatment of loan servicing rights is estimated utilizing a discounted cash flow model to determine the value of its servicing rights. The valuation model utilizes mortgage prepayment speeds, the remaining life of the mortgage pool, delinquency rates, our cost to service loans, and other factors to determine the cash flow that we will receive from servicing each grouping of loans. These cash flows are then discounted based on current interest rate assumptions to arrive at the fair value for the right to service those loans.

*Acquisition Intangibles*

Generally accepted accounting principles require a determination of the fair value of all of the assets and liabilities of an acquired entity, and a recording of their fair value on the date of acquisition. A variety of means are employed in determination of fair value, including the use of discounted cash flow analyses, market comparisons, and projected future revenue streams. Once valuations have been adjusted, the net difference between the price paid for the acquired company and the value of its balance sheet is recorded as goodwill. Goodwill is subject to an impairment analysis, performed at least annually. Southern has elected to perform its annual goodwill impairment test as of November 30 each year. No material issues were noted during December 2021 that would have impacted the analysis within the goodwill impairment test.



**MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING**

Management of Southern has prepared and is responsible for the accompanying consolidated financial statements and for their integrity and objectivity. In the opinion of management, the financial statements, which necessarily include amounts based on management's estimates and judgments, have been prepared in conformity with accounting principles generally accepted in the United States of America, on a consistent basis. Management also prepared the other information in the Annual Report and is responsible for its accuracy and consistency with the financial statements.

Southern maintains a system of internal accounting controls designed to provide reasonable assurance that assets are safeguarded and that transactions are executed in accordance with Southern's authorizations and policies. Further, such a system provides reasonable assurances as to the integrity and reliability of the financial statements which fairly present financial position and results of operations in conformity with accounting principles generally accepted in the United States of America. Internal accounting controls are augmented by written policies covering standards of personal and business conduct and an organizational structure providing for division of responsibility and authority.

Management monitors the effectiveness of and compliance with established control systems through a continuous program of internal audit and credit examinations and recommends possible improvements thereto. Management believes that, as of December 31, 2021, Southern's system of internal controls has prevented or detected on a timely basis any occurrences that could be material to the financial statements and that timely corrective actions have been initiated when appropriate.

The Board of Directors exercises its responsibility for the financial statements and related information through the Audit Committee, which is composed entirely of outside directors. The Audit Committee meets regularly with management and CliftonLarsonAllen LLP. CliftonLarsonAllen LLP has direct and confidential access to the Audit Committee to discuss the results of their audit.

The 2021 consolidated financial statements have been audited by the independent accounting firm of CliftonLarsonAllen LLP, which was given unrestricted access to all financial records and related data, including minutes of all meetings of shareholders, the Board of Directors, and committees of the Board. Management believes that all representations made to the independent auditors during their audit were valid and appropriate. CliftonLarsonAllen LLP's Auditor's Report is presented on the following page.



John H. Castle  
Chairman and Chief Executive Officer



Danice L. Chartrand  
Chief Financial Officer

February 11, 2022



CliftonLarsonAllen LLP  
CLAconnect.com

**SOUTHERN MICHIGAN BANCORP, INC.  
INDEPENDENT AUDITORS' REPORT**

Shareholders and Board of Directors  
Southern Michigan Bancorp, Inc.  
Coldwater, Michigan

**Report on the Audit of the Consolidated Financial Statements**

***Opinion***

We have audited the accompanying consolidated financial statements of Southern Michigan Bancorp, Inc. and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 2021 and 2020, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2021, and the related notes to the consolidated financial statements.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Southern Michigan Bancorp, Inc and its subsidiaries as of December 31, 2021 and 2020, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2021 in accordance with accounting principles generally accepted in the United States of America.

***Basis for Opinion***

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditors' Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are required to be independent of Southern Michigan Bancorp, Inc. and its subsidiaries and to meet our other ethical responsibilities in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

***Responsibilities of Management for the Consolidated Financial Statements***

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about Southern Michigan Bancorp, Inc. and its subsidiaries' ability to continue as a going concern for one year after the date the consolidated financial statements are available to be issued.

***Auditors' Responsibilities for the Audit of the Consolidated Financial Statements***

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from

error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the consolidated financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Southern Michigan Bancorp, Inc. and its subsidiaries' internal control. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the consolidated financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about Southern Michigan Bancorp, Inc. and its subsidiaries' ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control related matters that we identified during the audit.

#### **Other Information Included in the Company's Annual Report**

Management is responsible for the other information included in the Company's Annual Report. The other information comprises the message to shareholders, client profiles, financial summary, SMB&T officers & board of directors, shareholder information, management's discussion and analysis, selected financial data, and common stock market prices and dividends but it does not include the consolidated financial statements and our auditor's report thereon. Our opinion on the consolidated financial statements does not cover the other information, and we do not express an opinion or any form of assurance on it.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information and consider whether a material inconsistency exists between the other information and the consolidated financial statements, or the other information otherwise appears to be materially misstated. If, based on the work performed, we conclude that an uncorrected material misstatement of the other information exists, we are required to describe it in our report.



**CliftonLarsonAllen LLP**

Toledo, Ohio  
March 7, 2022

**SOUTHERN MICHIGAN BANCORP, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(In thousands, except share data)

	<b>December 31,</b>	
	<b>2021</b>	<b>2020</b>
<b>ASSETS</b>		
Cash	\$ 6,299	\$ 7,062
Due from banks	113,090	92,548
Cash and cash equivalents	119,389	99,610
Federal funds sold	271	231
Securities available-for-sale	245,846	208,380
Loans held for sale	1,146	1,691
Loans, net of allowance for loan losses of \$9,320 – 2021 (\$7,789 – 2020)	732,088	628,081
Premises and equipment, net	13,115	13,698
Accrued interest receivable	4,193	4,749
Cash surrender value of life insurance	18,671	16,016
Goodwill	13,422	13,422
Other intangible assets, net	219	255
Other assets	12,794	11,441
<b>Total Assets</b>	<b>\$ 1,161,154</b>	<b>\$ 997,574</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Liabilities:		
Deposits		
Non-interest bearing	\$ 262,980	\$ 220,786
Interest bearing	711,372	617,512
Total deposits	974,352	838,298
Securities sold under agreements to repurchase and overnight borrowings	20,609	20,083
Accrued expenses and other liabilities	13,930	14,561
Other borrowings	20,000	26,500
Subordinated debentures	34,514	5,155
<b>Total Liabilities</b>	<b>1,063,405</b>	<b>904,597</b>
Shareholders' Equity:		
Preferred stock, 100,000 shares authorized; none issued or outstanding	-	-
Common stock, \$2.50 par value:		
Authorized – 10,000,000 shares		
Issued and outstanding – 4,516,377 shares in 2021 (2,301,269 shares in 2020)	11,287	5,748
Additional paid-in capital	14,235	15,416
Retained earnings	71,581	67,741
Accumulated other comprehensive income, net	856	4,362
Unearned Employee Stock Ownership Plan (ESOP) shares	(210)	(290)
<b>Total Shareholders' Equity</b>	<b>97,749</b>	<b>92,977</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 1,161,154</b>	<b>\$ 997,574</b>

The accompanying notes are an integral part of the consolidated financial statements.



**SOUTHERN MICHIGAN BANCORP, INC.**  
**CONSOLIDATED STATEMENTS OF INCOME**

(In thousands, except per share data)

	<b>Year Ended December 31,</b>		
	<b>2021</b>	<b>2020</b>	<b>2019</b>
Interest income:			
Loans, including fees	\$ 32,593	\$ 28,377	\$ 28,265
Securities:			
Taxable	3,330	2,482	2,185
Tax-exempt	1,069	645	621
Other	148	314	1,482
Total interest income	<u>37,140</u>	<u>31,818</u>	<u>32,553</u>
Interest expense:			
Deposits	2,268	4,025	5,128
Other	1,553	1,116	1,299
Total interest expense	<u>3,821</u>	<u>5,141</u>	<u>6,427</u>
<b>Net Interest Income</b>	<u>33,319</u>	<u>26,677</u>	<u>26,126</u>
Provision for loan losses	<u>1,500</u>	<u>2,600</u>	<u>225</u>
<b>Net Interest Income After Provision for Loan Losses</b>	<u>31,819</u>	<u>24,077</u>	<u>25,901</u>
Non-interest income:			
Service charges on deposit accounts	1,286	1,373	2,003
Trust fees	2,267	2,048	2,085
Net securities gains	5	-	366
Net gains on loan sales	2,293	2,389	683
Earnings on life insurance assets	695	383	443
ATM and debit card fees	1,823	1,543	1,460
Other	640	642	615
Total non-interest income	<u>9,009</u>	<u>8,378</u>	<u>7,655</u>
Non-interest expense:			
Salaries and employee benefits	16,492	14,580	13,828
Occupancy, net	1,565	1,519	1,384
Equipment	1,174	1,180	1,205
Printing, postage, and supplies	390	386	428
Telecommunication	356	451	426
Professional and outside services	1,814	1,532	1,617
Software maintenance	1,677	1,552	1,565
Amortization of other intangibles	36	36	36
ATM expenses	670	578	570
Advertising and marketing	397	218	448
Other	2,137	1,634	1,740
Total non-interest expense	<u>26,708</u>	<u>23,666</u>	<u>23,247</u>
Income before income taxes	<u>14,120</u>	<u>8,789</u>	<u>10,309</u>
Income tax provision	<u>2,363</u>	<u>1,403</u>	<u>1,687</u>
<b>Net Income</b>	<u>\$ 11,757</u>	<u>\$ 7,386</u>	<u>\$ 8,622</u>
<b>Basic Earnings Per Common Share</b>	<u>\$ 2.59</u>	<u>\$ 1.61</u>	<u>\$ 1.87</u>
<b>Diluted Earnings Per Common Share</b>	<u>\$ 2.58</u>	<u>\$ 1.61</u>	<u>\$ 1.87</u>

The accompanying notes are an integral part of the consolidated financial statements.

**SOUTHERN MICHIGAN BANCORP, INC.**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(In thousands)

	Year Ended December 31,		
	2021	2020	2019
<b>Net Income</b>	<u>\$ 11,757</u>	<u>\$ 7,386</u>	<u>\$ 8,622</u>
<b>Other Comprehensive Income (Loss):</b>			
Unrealized gain (loss) on available-for-sale securities	(4,434)	5,588	1,947
Reclassification adjustments for net realized securities gains included in net income	<u>(5)</u>	<u>-</u>	<u>(366)</u>
	(4,439)	5,588	1,581
Income tax effect	<u>933</u>	<u>(1,174)</u>	<u>(332)</u>
Other comprehensive income (loss)	<u>(3,506)</u>	<u>4,414</u>	<u>1,249</u>
<b>Total Comprehensive Income</b>	<u>\$ 8,251</u>	<u>\$ 11,800</u>	<u>\$ 9,871</u>

The accompanying notes are an integral part of the consolidated financial statements.

**SOUTHERN MICHIGAN BANCORP, INC.**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**  
(In thousands, except number of shares and per share data)

Years Ended December 31, 2021, 2020, and 2019:

	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net	Unearned ESOP Shares	Total
<b>Balance at January 1, 2019</b>	\$ 5,783	\$ 15,246	\$ 55,972	\$ (1,301)	\$ (173)	\$75,527
Net income for 2019			8,622			8,622
Other comprehensive loss				1,249		1,249
Cash dividends declared – \$.46 per share			(2,110)			(2,110)
Issuance of restricted stock (14,100 shares of common stock at \$19.00 per share)	35	(35)				-
Vesting of restricted stock		745				745
Restricted stock forfeiture	(1)	1				-
Stock options exercised (150 shares)		3				3
Repurchase of common stock (14,497 shares)	(36)	(526)				(562)
Net increase in ESOP obligation					(216)	(216)
Stock option expense		87				87
<b>Balance at December 31, 2019</b>	5,781	15,521	62,484	(52)	(389)	83,345
Net income for 2020			7,386			7,386
Other comprehensive income				4,414		4,414
Cash dividends declared – \$.46 per share			(2,129)			(2,129)
Issuance of restricted stock (14,200 shares of common stock at \$18.80 per share)	36	(36)				-
Vesting of restricted stock		776				776
Stock options exercised (250 shares)	1	2				3
Repurchase of common stock (28,059 shares)	(70)	(938)				(1,008)
Net decrease in ESOP obligation					99	99
Stock option expense		91				91
<b>Balance at December 31, 2020</b>	5,748	15,416	67,741	4,362	(290)	92,977
Net income for 2021			11,757			11,757
Other comprehensive loss				(3,506)		(3,506)
Cash dividends declared – \$.48 per share			(2,186)			(2,186)
Stock dividend declared	5,731		(5,731)			-
Issuance of restricted stock (23,650 shares of common stock at \$17.05 per share)	59	(59)				-
Vesting of restricted stock		957				957
Restricted stock forfeiture	(5)	5				-
Stock options exercised (3,450 shares)	9	35				44
Repurchase of common stock (101,876 shares)	(255)	(2,180)				(2,435)
Net decrease in ESOP obligation					80	80
Stock option expense		61				61
<b>Balance at December 31, 2021</b>	<u>\$ 11,287</u>	<u>\$ 14,235</u>	<u>\$ 71,581</u>	<u>\$ 856</u>	<u>\$ (210)</u>	<u>\$97,749</u>

The accompanying notes are an integral part of the consolidated financial statements.

**SOUTHERN MICHIGAN BANCORP, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands)

	<b>Year ended December 31,</b>		
	<b>2021</b>	<b>2020</b>	<b>2019</b>
<b>Operating Activities</b>			
Net income	\$ 11,757	\$ 7,386	\$ 8,622
Adjustments to reconcile net income to net cash from operating activities:			
Provision for loan losses	1,500	2,600	225
Depreciation of premises and equipment	1,353	1,431	1,369
Deferred income taxes	(354)	(1,292)	(95)
Amortization of other intangible assets	36	36	36
Amortization of subordinated debt issuance costs	52	-	-
Net amortization of available-for-sale securities	1,392	637	482
Stock option and restricted stock grant compensation expense	1,018	867	832
Net gains on security calls and sales	(5)	-	(366)
Loans originated for sale	(51,055)	(63,080)	(23,788)
Proceeds on loans sold	53,893	64,418	23,300
Net gains on loan sales	(2,293)	(2,389)	(683)
Gain from life insurance	(231)	-	(55)
Net (gain) loss from sale or write down of other real estate owned	(7)	(19)	10
Net (gain) loss on disposal of premises and equipment	(6)	(21)	31
Net change in ESOP obligation	80	99	166
Net change in:			
Accrued interest receivable	556	(1,369)	(86)
Cash surrender value	(464)	(383)	(388)
Other assets	(841)	968	100
Accrued expenses and other liabilities	133	1,367	422
Net cash from operating activities	<u>16,514</u>	<u>11,256</u>	<u>10,134</u>
<b>Investing Activities</b>			
Activity in available-for-sale securities:			
Proceeds on securities sold	-	-	79,990
Proceeds from maturities and calls	24,733	21,208	14,918
Purchases	(68,025)	(101,202)	(115,439)
Net change in federal funds sold	(40)	34	800
Loan originations and payments, net	(105,507)	(73,058)	(31,108)
Proceeds from sale of other real estate owned	7	160	128
Purchase of life insurance	(3,000)	-	-
Proceeds from life insurance	1,040	-	495
Proceeds from sale of equipment	11	40	51
Additions to premises and equipment	(775)	(633)	(1,887)
Net cash from investing activities	<u>(151,556)</u>	<u>(153,451)</u>	<u>(52,052)</u>
<b>Financing Activities</b>			
Net change in deposits	136,054	182,536	49,869
Net change in securities sold under agreements to repurchase and overnight borrowings	526	4,682	59
Proceeds from other borrowings	-	-	10,000
Proceeds from subordinated debt, net of issuance costs	29,307	-	-
Repayments of other borrowings	(6,500)	(11,000)	(1,000)
Stock options exercised	44	3	3
Purchase of ESOP shares	-	-	(382)
Cash dividends paid	(2,175)	(2,131)	(2,087)
Repurchase of common stock	(2,435)	(1,008)	(562)
Net cash from financing activities	<u>154,821</u>	<u>173,082</u>	<u>55,900</u>
<b>Net Change in Cash and Cash Equivalents</b>	<u>19,779</u>	<u>30,887</u>	<u>13,982</u>
Beginning cash and cash equivalents	<u>99,610</u>	<u>68,723</u>	<u>54,741</u>
<b>Ending Cash and Cash Equivalents</b>	<u>\$ 119,389</u>	<u>\$ 99,610</u>	<u>\$ 68,723</u>

The accompanying notes are an integral part of the consolidated financial statements.



## SOUTHERN MICHIGAN BANCORP, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE A – NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES

**Nature of Operations and Industry Segments:** Southern Michigan Bancorp, Inc. (the Company) is a Michigan corporation and registered financial holding company. The Company's principal activity is the ownership and management of its wholly-owned subsidiary bank, Southern Michigan Bank & Trust (the Bank). The Bank offers individuals, businesses, institutions, and government agencies a full range of commercial banking services. The customer base is located primarily in the southwest Michigan communities in which the Bank has branches, and in areas immediately surrounding these communities. The Bank makes commercial and consumer loans to customers. The majority of loans are secured by business assets, commercial and residential real estate, and consumer assets. There are no foreign loans.

**Principles of Consolidation:** The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries: SMB Risk Management, Inc.; 27 Marshall Street, LLC; and the Bank. On November 18, 2015, 27 Marshall Street, LLC was formed as a wholly-owned subsidiary of the Company to own a parcel of real estate. On May 31, 2016, SMB Risk Management, Inc., a captive insurance company incorporated in Nevada, was formed as a wholly-owned subsidiary of the Company. During 2004, the Company formed a special purpose trust, Southern Michigan Bancorp Capital Trust I, for the sole purpose of issuing trust preferred securities. Under generally accepted accounting principles, the trust is not consolidated into the financial statements of the Company. All inter-company transactions and balances are eliminated in consolidation.

**Use of Estimates:** The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosure of contingent liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Estimates that are more susceptible to change in the near term include the allowance for loan losses and fair values of securities.

**Securities:** Management determines the appropriate classification of securities at the time of purchase. If management has the intent and the Company has the ability at the time of purchase to hold securities until maturity, they are classified as held-to-maturity and carried at amortized historical cost. Securities to be held for an undeterminable period of time and not intended to be held until maturity are classified as available-for-sale and carried at fair value, with unrealized gains and losses reported in other comprehensive income or loss, net of tax. Securities classified as available-for-sale include securities that management intends to use as part of its asset/liability management strategy and that may be sold in response to changes in interest rates, prepayment risk, and other factors. There were no held-to-maturity securities as of December 31, 2021, or 2020.

Premiums and discounts on securities are recognized in interest income using the level yield method over the estimated life of the security. Premiums are amortized to the earliest call date. Gains and losses on the sale of available-for-sale securities are determined using the specific identification method. Securities are written down to fair value and reflected as a loss when a decline in fair value is not temporary. In estimating other than temporary losses, management considers: (1) the length of time and extent that fair value has been less than cost; (2) the financial condition and near term prospects of the issuer; and (3) the fact that the Company has the intention and the ability to hold the security to maturity.

**Loans Held for Sale:** Loans held for sale are reported at the lower of cost or market value in the aggregate. Net unrealized losses are recorded in a valuation allowance by charges to income.

**Loans:** Loans are reported at the principal balance outstanding, net of unearned interest, deferred loan fees and costs, and an allowance for loan losses. Interest income is reported on the interest method and includes amortization of net deferred loan fees and costs over the loan term.

Interest income is not reported when full loan repayment is in doubt, typically when payments are past due over 90 days, unless the loan is both well secured and in the process of collection. Past due status is based on the contractual terms of the loan. All interest accrued, but not received, for these loans is reversed against interest income. Payments received on such loans are reported as principal reductions until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest contractually due are brought current and future payments are reasonably assured.

## SOUTHERN MICHIGAN BANCORP, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

#### NOTE A – NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**Allowance for Loan Losses:** The allowance for loan losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan losses and decreased by charge-offs, net of recoveries. Estimating the risk of loss and the amount of loss on any loan is necessarily subjective. Management estimates the allowance balance based on past loan loss experience, nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, information in regulatory examination reports, and other factors. 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. The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired.

Loans are considered impaired when full contractual payments under the loan terms are not expected. Impairment is measured in total for smaller-balance loans of similar nature, such as residential mortgage and consumer loans, and on an individual loan basis for other loans. If a loan is determined to be impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's effective interest rate, or at the fair value of collateral, if repayment is collateral dependent. Loans are evaluated as potentially impaired when payments are delayed, typically 90 days or more, or when management judges it to be probable that all principal and interest amounts will not be collected according to the original terms of the loan.

Consumer loans are typically charged off no later than when they become 120 days past due. Real estate mortgage loans in the process of collection are charged off on or before they become 365 days past due. Commercial loans are charged off promptly upon the determination that all or a portion of any loan balance is uncollectible. In all cases, loans are placed on nonaccrual status or charged off at an earlier date if collection of principal or interest is considered doubtful.

Under certain circumstances, the Bank may provide borrowers relief through loan restructurings. A restructuring of debt constitutes a troubled debt restructuring (TDR) if the Bank, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. Concessions may include reduction of interest rates, extension of maturity dates, forgiveness of principal or interest due, or acceptance of other assets in full or partial satisfaction of the debt. TDR loans typically present an elevated level of credit risk, as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and measured for impairment, as previously described. TDR loans that have performed as agreed under the restructured terms for a period of 12 months or longer may cease to be reported as TDR loans. However, such loans continue to be individually evaluated for impairment.

**Premises and Equipment:** Premises and equipment are stated at cost, less accumulated depreciation. Depreciation is computed principally, using straight-line or accelerated methods over their estimated useful lives. The estimated useful lives are 10 to 40 years for buildings and improvements, and 3 to 10 years for furniture and equipment. These assets are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. Maintenance, repairs, and minor alterations are charged to current operations as expenditures occur. Major improvements are capitalized. Land is carried at cost.

**Mortgage Servicing Rights:** Mortgage servicing rights, included in other assets, represent the allocated fair value of mortgage servicing rights retained on loans sold. Mortgage servicing rights are amortized to expense in proportion to, and over the period of, estimated net servicing revenues.

Impairment is evaluated based on the fair value of the rights, using groupings of the underlying loans as to interest rates and then, secondarily, as to geographic and prepayment characteristics. Any impairment of a grouping is reported as a valuation allowance.

## SOUTHERN MICHIGAN BANCORP, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

#### NOTE A – NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**Transfers of Financial Assets:** Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Bank; (2) 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 (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

The transfer of a participating interest in a financial asset must have all of the following characteristics: (1) from the date of transfer, it must represent a proportionate ownership interest in the financial asset; (2) from the date of transfer, all cash flows received, except cash flows allocated as compensation for servicing or other services performed, must be divided proportionately among participating interest holders in the amount equal to their share of ownership; (3) the rights of each participating interest holder must have the same priority; and (4) no party has the right to pledge or change the entire financial asset unless all participating interest holders agree to do so.

**Cash Surrender Value of Life Insurance:** The Bank has purchased life insurance policies on certain directors, key executives, and other members of management. Bank-owned life insurance is recorded at its net cash surrender value, or the amount that can be realized.

**Goodwill and Other Intangible Assets:** Goodwill resulting from acquisitions is not amortized, but is tested for impairment annually. As part of its testing, the Company first assesses the qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If the Company determines the fair value of a reporting unit is less than its carrying amount using these qualitative factors, the Company compares the fair value of the goodwill with its carrying amount, and then measures impairment loss by comparing the implied fair value of goodwill with the carrying amount of that goodwill.

Significant judgment is applied when goodwill is assessed for impairment. If qualitative factors indicate the potential for impairment, then further analysis includes developing cash flow projections, selecting appropriate discount rates, identifying relevant market comparisons, incorporating general economic and market conditions, and selecting an appropriate control premium. At December 31, 2021, the Company believes the Bank does not have any indicators of potential impairment.

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 Company's balance sheet. Other intangible assets consist of acquired customer relationships which are amortized on an accelerated method over their estimated useful lives of 10 years.

**Other Real Estate Owned:** Other real estate owned is comprised of properties acquired through a foreclosure proceeding or acceptance of a deed in lieu of foreclosure. These properties are initially recorded at fair value, less estimated cost to sell at the date of foreclosure, establishing a new cost basis. After foreclosure, valuations are periodically performed by management; other real estate owned is carried at the lower of the carrying amount or fair value, less the estimated cost to sell. Expenses, gains and losses on disposition, and reductions in carrying value are reported as non-interest expense. There was no Other Real Estate Owned as of December 31, 2021 or 2020.

At December 31, 2021 and 2020, there were no formal foreclosure proceedings in process for consumer mortgage loans secured by residential properties.

**Stock-Based Compensation:** The Company follows the requirements of "share-based payment transactions" using the modified prospective transition method. Under this method, the Company recognizes compensation cost for stock-based compensation for all new or modified grants.

See Note M regarding the various assumptions used in computing the compensation expense.

## SOUTHERN MICHIGAN BANCORP, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

#### NOTE A – NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**Advertising Costs:** Advertising costs are expensed as incurred.

**Income Taxes:** The income tax provision is the total of the current year's 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. Benefits from tax positions taken, or expected to be taken, in a tax return are not recognized if the likelihood that the tax positions would be sustained upon examination by a taxing authority is considered to be 50% or less. Any interest and penalties resulting from the filing of the income tax returns are included in the provision for income taxes.

**Cash Flow Definition:** For purposes of the consolidated statements of cash flows, the Company considers cash and due from banks as cash and cash equivalents. The Company reports net cash flows for customer loan transactions, deposit transactions, and short-term borrowings with a maturity of 90 days or less.

**Earnings and Dividends Per Common Share:** Basic earnings per common share is based on net income divided by the weighted average number of common shares outstanding during the period. Employee Stock Ownership Plan shares are considered outstanding for this calculation, unless unearned. Diluted earnings per common share reflects the dilutive effect of any additional, potential common shares issuable under stock options. Earnings and dividends per share are restated for all stock splits and stock dividends through the date of issuance of the financial statements.

**Comprehensive Income:** Comprehensive income consists of net income and other comprehensive income or loss. Other comprehensive income or loss includes the net change in unrealized gains and losses on securities available-for-sale.

**Employee Stock Ownership Plan (ESOP):** Compensation expense is based on the market price of shares as they are committed to be released to participants' accounts. Dividends on allocated ESOP shares reduce retained earnings; dividends on unearned ESOP shares reduce debt and accrued interest.

**Fair Values of Financial Instruments:** Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note S. 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 market conditions could significantly affect such estimates.

**Concentrations of Credit Risk:** The Company grants commercial, real estate, and installment loans to customers mainly in southwest Michigan. Commercial loans include loans collateralized by commercial real estate, business assets, and agricultural loans collateralized by crops and farm equipment. Commercial loans make up approximately 83% of the loan portfolio at December 31, 2021, and 86% at December 31, 2020; repayment is expected with cash flow from operations of businesses. Residential mortgage loans make up approximately 16% of the loan portfolio at December 31, 2021, and 13% at December 31, 2020, and are collateralized by mortgages on residential real estate. Consumer loans make up 1% of the loan portfolio at December 31, 2021, and 2020, and are primarily collateralized by consumer assets.

**Operating Segments:** While the chief decision makers monitor the revenue streams of the various products and services, operations are managed and financial performance is evaluated on a Company-wide basis. Operating segments are aggregated into one, as operating results for all segments are similar. Accordingly, all of the financial service operations are considered by management to be aggregated in one reportable operating segment: commercial banking.



## SOUTHERN MICHIGAN BANCORP, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

#### NOTE A – NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**Restrictions on Cash:** The Bank is a party to an offsetting interest rate swap with a notional amount totaling \$10,564,000 as of December 31, 2021, and \$10,856,000 as of December 31, 2020. This swap between the Bank, commercial borrower, and financial intermediary (counterparty) provides for the Bank to receive interest on the underlying commercial loan at a variable rate of interest and for the commercial borrower to receive a fixed rate of interest during the term of the loan. The Bank is required to post collateral with the counterparty to cover any financial exposure of the commercial borrower to the counterparty if the commercial borrower terminates the swap before the stated maturity of the underlying loan. Conversely, the counterparty is required to post collateral with the Bank to cover any financial exposure of the counterparty if the borrower terminates the swap before the stated maturity of the loan. The Bank has posted cash as collateral for the financial exposure of the commercial borrower in the amount of \$1,810,000 as of December 31, 2021, and 2020. See Note Y for further information.

**Financial Instruments with Off-Balance-Sheet Risk:** Financial instruments include off-balance-sheet credit instruments, such as commitments to make loans and standby letters of credit issued to meet customer needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded. Commitments may include interest rates determined prior to funding the loan (rate lock commitments). Rate lock commitments on loans intended to be sold are considered derivatives. Such commitments were not material at December 31, 2021, and 2020.

**Cash Balances:** The Company maintains deposits with other correspondent banks. These deposits may exceed FDIC insured limits.

**Loss Contingencies:** Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there are any such matters outstanding as of December 31, 2021, that will have a material future adverse effect on the consolidated financial statements.

**Stock Dividends:** The Company issued 2,292,376 common shares in connection with a 100% stock dividend effected in May 2021. All prior year per share information has been restated to reflect this dividend.

**Subsequent Events:** Management evaluated subsequent events through March 7, 2022, the date the consolidated financial statements were available to be issued. Events or transactions occurring after December 31, 2021, but prior to when the consolidated financial statements were available to be issued, that provided additional evidence about conditions that existed at December 31, 2021, have been recognized in the consolidated financial statements for the year ended December 31, 2021. Events or transactions that provided evidence about conditions that did not exist at December 31, 2021, but arose before the consolidated financial statements were available to be issued, have not been recognized in the consolidated financial statements for the year ended December 31, 2021.

**New Accounting Standard:** In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments – Credit Losses (Topic 326)*. This update, effective for the Company beginning January 1, 2023, will change the accounting for credit losses on loans and debt securities. For loans, the proposal will require an expected credit loss model rather than the current incurred loss model to determine the allowance for credit losses. The expected credit loss model would estimate losses for the estimated life of the financial asset. In addition, the guidance will modify the other-than-temporary impairment model for available-for-sale debt securities to require an allowance for credit impairment instead of a direct write-down, which will allow for reversal of credit impairments in future periods. The Company has identified a software solution that will assist in estimating the allowance for loan loss under ASU 2016-13. Loan level data has been identified and data collection efforts are in process. The adoption of ASU 2016-13 may result in a material increase to the allowance for loan losses balance. A one-time, cumulative effect adjustment to the allowance for loan losses will be recognized as of January 1, 2023. The Company is evaluating, but has not fully determined, the impact the adoption of ASU 2016-13 will have on the consolidated financial statements.

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE B – BASIC AND DILUTED EARNINGS PER COMMON SHARE**

A reconciliation of the numerators and denominators of basic and diluted earnings per common share for the years ended December 31, 2021, 2020, and 2019 is presented below:

	<u>2021</u>	<u>2020</u>	<u>2019</u>
<b>Basic Earnings Per Common Share</b>			
Net income (in thousands)	<u>\$ 11,757</u>	<u>\$ 7,386</u>	<u>\$ 8,622</u>
Weighted average common shares outstanding	4,558,352	4,623,698	4,633,328
Less: Weighted average unallocated ESOP shares	<u>(13,538)</u>	<u>(19,736)</u>	<u>(26,778)</u>
Weighted average common shares outstanding for basic earnings per common share	<u>4,544,814</u>	<u>4,603,962</u>	<u>4,606,550</u>
<b>Basic Earnings Per Common Share</b>	<u>\$ 2.59</u>	<u>\$ 1.61</u>	<u>\$ 1.87</u>
<b>Diluted Earnings Per Common Share</b>			
Net income (in thousands)	<u>\$ 11,757</u>	<u>\$ 7,386</u>	<u>\$ 8,622</u>
Weighted average common shares outstanding for basic earnings per common share	4,544,814	4,603,962	4,606,550
Add: Dilutive effects of assumed exercises of stock options	<u>6,322</u>	<u>1,462</u>	<u>4,618</u>
Average shares and dilutive potential of common shares outstanding	<u>4,551,136</u>	<u>4,605,424</u>	<u>4,611,168</u>
<b>Diluted Earnings Per Common Share</b>	<u>\$ 2.58</u>	<u>\$ 1.61</u>	<u>\$ 1.87</u>

In 2021, 2020, and 2019, stock options totaling 1,000, 86,700, and 28,946, respectively, were not considered in computing diluted earnings per share because they were anti-dilutive.

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE C – SECURITIES**

Year-end investment securities were as follows (in thousands):

	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
<b>Available-for-sale, December 31, 2021</b>				
State and political subdivisions	\$ 161,101	\$ 4,074	\$ (2,546)	\$ 162,629
Mortgage-backed securities	59,839	198	(654)	59,383
Asset-backed securities	21,773	85	(57)	21,801
Corporate securities	2,050	-	(17)	2,033
<b>Total</b>	<b>\$ 244,763</b>	<b>\$ 4,357</b>	<b>\$ (3,274)</b>	<b>\$ 245,846</b>

	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
<b>Available-for-sale, December 31, 2020</b>				
State and political subdivisions	\$ 126,828	\$ 5,777	\$ (144)	\$ 132,461
Mortgage-backed securities	49,331	165	(130)	49,366
Asset-backed securities	26,699	86	(232)	26,553
<b>Total</b>	<b>\$ 202,858</b>	<b>\$ 6,028</b>	<b>\$ (506)</b>	<b>\$ 208,380</b>

Securities with unrealized losses at December 31, 2021, and 2020, that have not been recognized in income are as follows (in thousands):

	<b>Continued Unrealized Loss for Less than 12 Months</b>		<b>Continued Unrealized Loss for 12 Months or More</b>		<b>Total</b>	
<b>Description of Securities</b>	<b>Fair Value</b>	<b>Unrealized Loss</b>	<b>Fair Value</b>	<b>Unrealized Loss</b>	<b>Fair Value</b>	<b>Unrealized Loss</b>
2021						
State and political subdivisions	\$ 52,584	\$ (1,664)	\$ 17,994	\$ (882)	\$ 70,578	\$ (2,546)
Mortgage-backed securities	4,770	(13)	18,208	(641)	22,978	(654)
Asset-backed securities	8,582	(33)	5,510	(24)	14,092	(57)
Corporate securities	2,033	(17)	-	-	2,033	(17)
<b>Total temporarily impaired</b>	<b>\$ 67,969</b>	<b>\$ (1,727)</b>	<b>\$ 41,712</b>	<b>\$ (1,547)</b>	<b>\$ 109,681</b>	<b>\$ (3,274)</b>

	<b>Continued Unrealized Loss for Less than 12 Months</b>		<b>Continued Unrealized Loss for 12 Months or More</b>		<b>Total</b>	
<b>Description of Securities</b>	<b>Fair Value</b>	<b>Unrealized Loss</b>	<b>Fair Value</b>	<b>Unrealized Loss</b>	<b>Fair Value</b>	<b>Unrealized Loss</b>
2020						
State and political subdivisions	\$ 15,520	\$ (144)	\$ -	\$ -	\$ 15,520	\$ (144)
Mortgage-backed securities	21,397	(129)	4,706	(1)	26,103	(130)
Asset-backed securities	-	-	15,290	(232)	15,290	(232)
<b>Total temporarily impaired</b>	<b>\$ 36,917</b>	<b>\$ (273)</b>	<b>\$ 19,996</b>	<b>\$ (233)</b>	<b>\$ 56,913</b>	<b>\$ (506)</b>

Unrealized losses have not been recognized through the income statement, as management believes the issuers are of sound credit quality, management has no intent to sell the securities, the Company has the ability to hold the securities to maturity, and the decline in fair value is largely due to changes in market interest rates. The fair value is expected to recover as the bonds approach their maturity date.

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE C – SECURITIES (CONTINUED)**

The proceeds from sale/call of securities and the associated gains are listed below (in thousands):

	<b>2021</b>	<b>2020</b>	<b>2019</b>
Proceeds	\$ 1,274	\$ -	\$ 79,990
Net gains	5	-	366

The tax provision related to net realized gains was \$1,000 for 2021 and \$77,000 for 2019, respectively.

The amortized cost and fair value of the investment securities portfolio are shown by contractual maturity. Contractual maturities of debt securities at year-end 2021 were as follows (in thousands):

	<b>Amortized Cost</b>	<b>Fair Value</b>
Due in one year or less	\$ 6,124	\$ 6,135
Due from one to five years	30,235	30,497
Due from five to ten years	47,960	48,685
Due after ten years	160,444	160,529
<b>Total</b>	<b>\$ 244,763</b>	<b>\$ 245,846</b>

Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Securities with a carrying value of \$34,497,000 and \$37,840,000, respectively, were pledged as collateral for repurchase accounts and for other purposes at December 31, 2021, and 2020.

At December 31, 2021, and 2020, the fair value of securities issued by the state of Michigan and all its political subdivisions totaled \$58,572,000 and \$42,334,000, respectively. No other securities of any single issuer were greater than 10% of shareholders' equity.

Investments in the Federal Home Loan Bank of Indianapolis stock totaled \$2,025,000 at December 31, 2021, and 2020, and are included in other assets because such investments are considered restricted. Such investments are recorded at cost and evaluated for impairment. Cash dividends received are recorded in taxable securities interest income.

The Company had no investment in securities of issuers outside of the United States as of December 31, 2021, or 2020.

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

Loans at year-end were as follows (in thousands):

	<b>2021</b>
Commercial real estate	\$ 448,380
Commercial	106,908
Agriculture	63,414
Real estate mortgage	119,991
Consumer	2,715
	<u>741,408</u>
Less allowance for loan losses	(9,320)
<b>Loans, net</b>	<b>\$ 732,088</b>
	<b>2020</b>
Commercial real estate	\$ 337,839
Commercial	150,369
Agriculture	59,567
Real estate mortgage	85,011
Consumer	3,084
	<u>635,870</u>
Less allowance for loan losses	(7,789)
<b>Loans, net</b>	<b>\$ 628,081</b>

**SOUTHERN MICHIGAN BANCORP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)****Credit Risk Elements – Commercial Real Estate, Commercial, and Agriculture:**

Loans to commercial real estate, commercial, and agricultural borrowers are underwritten based on the Bank's examination of current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. This underwriting includes the evaluation of cash flows of the borrower, the underlying collateral when applicable, and the borrower's ability to manage its business activities. The cash flows of borrowers and the collateral securing these loans may fluctuate in value after the initial evaluation.

Commercial real estate loans are also subject to underwriting standards unique to real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Loan-to-value is generally 75% of the lower of the cost or appraised value of the assets. Appraisals on properties securing these loans are generally performed by fee appraisers approved by the Commercial Loan Committee. Because payments on commercial real estate loans are often dependent on the successful operation or management of the properties, repayment of such loans may be subject to adverse conditions in the real estate market or the economy. Management monitors and evaluates commercial real estate loans based on collateral and risk rating criteria. The Bank typically requires personal guarantees on these loans. The Bank's commercial real estate loans are secured largely by properties located in its primary market area.

Commercial operating loans are underwritten with an emphasis on cash flow analysis and are generally secured by a first priority lien on the general assets of the business. Loan-to-value limits vary and are dependent upon the nature and type of the underlying collateral, as well as the financial strength of the borrower. Commercial loans are generally guaranteed by the principal(s). The Bank's commercial lending is principally done in its primary market area.

Agricultural loans are primarily made for real estate or operating purposes. Agricultural real estate loans are evaluated based upon cash flow first, and then as loans secured by real estate. Loan-to-value is generally 75% of the lower of the cost or appraised value of the assets. Appraisals on properties securing these loans are generally performed by fee appraisers. Agricultural operating loans are underwritten with reliance upon current and projected cash flows. Security for the operating loans is generally provided through first priority liens on agricultural assets. Guaranty of the principal(s) is required for most agricultural borrowers. The Bank's agricultural lending is done primarily in its operating area.

Construction loans are underwritten utilizing independent appraisals, sensitivity analysis of absorption, vacancy and lease rates, and financial analysis of the developers and property owners. Construction loans are generally based upon estimates of costs and value associated with completion of the project. Construction loans often involve the disbursement of funds with repayment substantially dependent on the success of the ultimate project. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, general economic conditions, and the availability of long-term financing. The Bank typically requires personal guarantees on these loans. The Bank's construction loans are secured predominantly by properties located in its primary market area.

**The Coronavirus Aid, Relief, and Economic Security Act (CARES Act):**

The CARES Act was signed into law on March 27, 2020, providing economic relief to businesses and individuals. Pursuant to the CARES Act, the Bank originated \$78,828,000 of Paycheck Protection Program (PPP) loans during the year ended December 31, 2020. During the year ended December 31, 2021, Second Draw PPP loans were originated by the bank totaling \$44,286,000 under the Economic Aid Hard-Hit Small Businesses, Non-Profits, and Venues Act (Economic Aid Act). Outstanding borrowings are guaranteed by the U.S. Small Business Administration (SBA) and are subject to partial or full forgiveness by the SBA, based on the Bank's borrowers meeting certain requirements, as stipulated in the PPP loan agreement.

The PPP loans originated in 2020 have terms of 24 or 60 months, bear interest at the rate of 1.0% and are payable in monthly installments with the initial installment deferred six months from the date of origination. Payments were later deferred for 10 months by the SBA. Through December 31, 2021, all but one loan totaling \$8,000 had been forgiven by the SBA.



## **SOUTHERN MICHIGAN BANCORP, INC.**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

#### **NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)**

The Second Draw PPP loans originated in 2021 have terms of 60 months, bear interest at the rate of 1.0%, and are payable in monthly installments with the initial installment deferred six months from the date of origination. As of December 31, 2021, all but \$13,052,000 of the Second Draw PPP loans had been forgiven.

The Bank received specified fees during 2020 based on the amount of each PPP loan originated, as follows: \$350,000 or less, 5%; over \$350,000 to \$1,000,000, 3%; or over \$1,000,000, 1%. The Bank received the following specified fees for Second Draw PPP loans originated during 2021 based on the amount of each PPP loan: 50% or \$2,500, whichever is less, for loans of not more than \$50,000; 5% for loans of more than \$50,000 and not more than \$350,000; 3% for loans of more than \$350,000 and less than \$2,000,000; and 1% for loans of at least \$2,000,000. Such fees, net of estimated origination costs have been deferred and are being amortized to interest income over the term of the loans. Amortization of deferred PPP loan fees amounted to \$3,645,000 in 2021 and \$1,294,000 in 2020. Deferred fees on PPP loans amounted to \$475,000 as of December 31, 2021 and \$1,541,000 as of December 31, 2020.

Also pursuant to the Interagency Guidance, the Bank entered into loan modification agreements with certain customers. The modification agreements provided for a 1 to 6 month payment deferral and extension of the final maturity date. Certain loans were extended for a second 3 month period. During the year ended December 31, 2020, the Bank entered into 258 modifications with outstanding borrowings for the modified loans aggregating \$102,701,000. As of December 31, 2020, the modification periods for all of the loans modified in 2020 had ended and the loans are paying as agreed.

During the year ended December 31, 2021, the bank entered into seven modifications with outstanding borrowings for the modified loans aggregating \$13,613,000. As of December 31, 2021, the modification periods for all of the loans modified in 2021 had ended and the loans are paying as agreed.

#### **Credit Risk Elements – Real Estate Mortgage and Consumer:**

The Bank originates 1-4 family real estate and consumer loans utilizing credit reports to supplement the underwriting process. The Bank's manual underwriting standards for 1-4 family loans are generally in accordance with Federal Home Loan Mortgage Corporation and loan policy manual underwriting guidelines. Properties securing 1-4 family real estate loans are appraised by fee appraisers, which are independent of the loan origination function and have been approved by management. The loan-to-value ratios normally do not exceed 80% without credit enhancements, such as mortgage insurance. The Bank will lend up to 100% of the lesser of the appraised value or purchase price for conventional 1-4 family real estate loans, provided private mortgage insurance is obtained. The underwriting standards for consumer loans include a determination of the applicant's payment history on other debts and an assessment of their ability to meet existing obligations and payments on the proposed loan. To monitor and manage loan risk, policies and procedures are developed and modified, as needed, by management. This activity, coupled with smaller loan amounts that are spread across many individual borrowers, minimizes risk. Additionally, market conditions are reviewed by management on a regular basis. The Bank's 1-4 family real estate loans are secured predominantly by properties located in its primary market area.

The Bank's internal credit analysis staff reviews and validates credit risk on a periodic basis. In addition, an independent loan review is performed annually. Credit analysts' results are presented to management. The independent loan review is presented to management and the Audit Committee. The credit analysts' results and loan review processes complement and reinforce the risk identification and assessment decisions made by lenders and credit personnel, as well as the Bank's policies and procedures.

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)**

At December 31, 2021, 2020, and 2019, certain directors and executive officers of the Company, including their associates and companies in which they are principal owners, were indebted to the Bank. The table below summarizes the aggregate loan activity (in thousands) exceeding \$60,000 for these individuals and their associates. All of these loans were made in the ordinary course of business, were made on substantially the same terms (including interest rates and collateral) as those prevailing at the time for comparable loans with persons not related to the Company, and did not involve more than the normal risk of collectability or present other unfavorable features. None of these loans were in default at December 31, 2021. Other changes include adjustments for loans applicable to one reporting period that are excludable from the other reporting period, including changes in the directorate.

	<u>2021</u>	<u>2020</u>	<u>2019</u>
Balance at January 1	\$ 22,529	\$ 22,637	\$ 16,922
New loans, including renewals	12,474	7,912	19,510
Repayments	(8,458)	(7,963)	(13,532)
Other changes	(4,856)	(57)	(263)
<b>Balance at December 31</b>	<u>\$ 21,689</u>	<u>\$ 22,529</u>	<u>\$ 22,637</u>

The unpaid principal balance of mortgage loans serviced for others, which are not included on the consolidated balance sheet, was \$189,761,000 and \$193,825,000 at December 31, 2021, and 2020, respectively.

Activity for capitalized mortgage servicing rights, included in other assets, was as follows (in thousands):

	<u>2021</u>	<u>2020</u>	<u>2019</u>
Balance at January 1	\$ 1,377	\$ 1,199	\$ 1,274
Additions	584	531	236
Amortized to expense	(427)	(353)	(311)
<b>Balance at December 31</b>	<u>\$ 1,534</u>	<u>\$ 1,377</u>	<u>\$ 1,199</u>

No valuation allowance for capitalized mortgage servicing rights was considered necessary at December 31, 2021, or 2020, because the estimated fair value of such rights exceeded the carrying value.

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)**

The following is an analysis of the allowance for loan loss activity, listed by portfolio segment. Information is based on impairment method as of, and for the years ended, December 31, 2021, 2020, and 2019 (in thousands):

	Commercial Real Estate	Commercial	Agriculture	Real Estate Mortgage	Consumer	Total
<b>December 31, 2021</b>						
Balance at January 1	\$ 5,220	\$ 943	\$ 739	\$ 778	\$ 109	\$ 7,789
Provision (credit) for loan losses	1,101	328	(41)	153	(41)	1,500
Loans charged off	-	-	-	-	(102)	(102)
Recoveries	-	-	-	40	93	133
Balance at December 31	<u>\$ 6,321</u>	<u>\$ 1,271</u>	<u>\$ 698</u>	<u>\$ 971</u>	<u>\$ 59</u>	<u>\$ 9,320</u>
Ending balance individually evaluated for impairment	\$ 59	\$ 309	\$ -	\$ 32	\$ -	\$ 400
Ending balance collectively evaluated for impairment	<u>6,262</u>	<u>962</u>	<u>698</u>	<u>939</u>	<u>59</u>	<u>8,920</u>
Total	<u>\$ 6,321</u>	<u>\$ 1,271</u>	<u>\$ 698</u>	<u>\$ 971</u>	<u>\$ 59</u>	<u>\$ 9,320</u>
<b>December 31, 2020</b>						
Balance at January 1	\$ 3,414	\$ 709	\$ 560	\$ 439	\$ 62	\$ 5,184
Provision for loan losses	1,804	234	172	326	64	2,600
Loans charged off	-	-	-	(26)	(107)	(133)
Recoveries	2	-	7	39	90	138
Balance at December 31	<u>\$ 5,220</u>	<u>\$ 943</u>	<u>\$ 739</u>	<u>\$ 778</u>	<u>\$ 109</u>	<u>\$ 7,789</u>
Ending balance individually evaluated for impairment	\$ 518	\$ -	\$ -	\$ 6	\$ -	\$ 524
Ending balance collectively evaluated for impairment	<u>4,702</u>	<u>943</u>	<u>739</u>	<u>772</u>	<u>109</u>	<u>7,265</u>
Total	<u>\$ 5,220</u>	<u>\$ 943</u>	<u>\$ 739</u>	<u>\$ 778</u>	<u>\$ 109</u>	<u>\$ 7,789</u>
<b>December 31, 2019</b>						
Balance at January 1	\$ 3,236	\$ 742	\$ 618	\$ 424	\$ 97	\$ 5,117
Provision (credit) for loan losses	173	(37)	23	45	21	225
Loans charged off	-	-	(81)	(45)	(148)	(274)
Recoveries	5	4	-	15	92	116
Balance at December 31	<u>\$ 3,414</u>	<u>\$ 709</u>	<u>\$ 560</u>	<u>\$ 439</u>	<u>\$ 62</u>	<u>\$ 5,184</u>
Ending balance individually evaluated for impairment	\$ 483	\$ -	\$ -	\$ 25	\$ -	\$ 508
Ending balance collectively evaluated for impairment	<u>2,931</u>	<u>709</u>	<u>560</u>	<u>414</u>	<u>62</u>	<u>4,676</u>
Total	<u>\$ 3,414</u>	<u>\$ 709</u>	<u>\$ 560</u>	<u>\$ 439</u>	<u>\$ 62</u>	<u>\$ 5,184</u>

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)**

In 2021, 2020, and 2019, consumer loans also included demand deposit loan account charge-offs and recoveries. These amounted to \$102,000 and \$86,000, respectively, for the year ended December 31, 2021; \$93,000 and \$86,000, respectively, for the year ended December 31, 2020; and \$137,000 and \$86,000, respectively, for the year ended December 31, 2019.

The following is a summary of the recorded investment in loans, by portfolio segment, and based on impairment method, as of December 31, 2021, and 2020 (in thousands):

	Commercial Real Estate	Commercial	Agriculture	Real Estate Mortgage	Consumer	Total
<b>December 31, 2021:</b>						
Ending balance individually evaluated for impairment	\$ 842	\$ 309	\$ 131	\$ 872	\$ -	\$ 2,154
Ending balance collectively evaluated for impairment	447,538	106,599	63,283	119,119	2,715	739,254
Ending balance	<u>\$ 448,380</u>	<u>\$ 106,908</u>	<u>\$ 63,414</u>	<u>\$ 119,991</u>	<u>\$ 2,715</u>	<u>\$ 741,408</u>

	Commercial Real Estate	Commercial	Agriculture	Real Estate Mortgage	Consumer	Total
<b>December 31, 2020:</b>						
Ending balance individually evaluated for impairment	\$ 4,134	\$ 75	\$ 159	\$ 1,082	\$ -	\$ 5,450
Ending balance collectively evaluated for impairment	333,705	150,294	59,408	83,929	3,084	630,420
Ending balance	<u>\$ 337,839</u>	<u>\$ 150,369</u>	<u>\$ 59,567</u>	<u>\$ 85,011</u>	<u>\$ 3,084</u>	<u>\$ 635,870</u>

The following tables present loans individually evaluated for impairment by class of loans, as of December 31, 2021, and 2020 (in thousands):

	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
<b>December 31, 2021</b>			
With no related allowance recorded:			
Commercial Real Estate	\$ 606	\$ 606	\$ -
Commercial	-	-	-
Agriculture	131	131	-
Real Estate Mortgage	247	247	-
Consumer	-	-	-
With an allowance recorded:			
Commercial Real Estate	236	236	59
Commercial	309	309	309
Agriculture	-	-	-
Real Estate Mortgage	625	625	32
Consumer	-	-	-
Total	<u>\$ 2,154</u>	<u>\$ 2,154</u>	<u>\$ 400</u>

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)**

<b>December 31, 2020</b>	<b>Unpaid Principal Balance</b>	<b>Recorded Investment</b>	<b>Allowance for Loan Losses Allocated</b>
With no related allowance recorded:			
Commercial Real Estate	\$ -	\$ -	\$ -
Commercial	75	75	-
Agriculture	159	159	-
Real Estate Mortgage	872	872	-
Consumer	-	-	-
With an allowance recorded:			
Commercial Real Estate	4,134	4,134	518
Commercial	-	-	-
Agriculture	-	-	-
Real Estate Mortgage	210	210	6
Consumer	-	-	-
<b>Total</b>	<b>\$ 5,450</b>	<b>\$ 5,450</b>	<b>\$ 524</b>

Information regarding impaired loans at December 31 follows (in thousands):

	<b>2021</b>	<b>2020</b>	<b>2019</b>
Average balance of impaired loans during the year	\$ 3,802	\$ 5,465	\$ 5,790
Cash basis interest income recognized during the year	\$ 120	\$ 252	\$ 389
Interest income recognized during the year	\$ 108	\$ 344	\$ 378

The Company's loan portfolio also includes certain loans that have been modified in a TDR where economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. These concessions typically result from the Company's loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance, or other actions.

When the Company modifies a loan, management evaluates any possible concession based on the present value of expected future cash flows (discounted at the contractual interest rate of the original loan agreement), except when the sole source of repayment for the loan is the liquidation of collateral. In these cases, management uses the current fair value of the collateral, less selling costs. If management determines that the value of the modified loan is less than the recorded investment in the loan (net of previous charge-offs and deferred loan fees or costs), impairment is recognized through an allowance estimate or a charge-off to the allowance.



**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)**

The following table summarizes the number and volume of TDRs the Company has recorded in its loan portfolio, as of December 31, 2021, and 2020. It also shows the number of TDR loans added each year and the amount of specific reserves in the allowance for loan losses relating to TDRs (dollars in thousands):

	<u>Total</u>			<u>Added During the Year</u>		
	<u>Number of Loans</u>	<u>Amount</u>	<u>Specific Reserves Allocated</u>	<u>Number of Loans</u>	<u>Amount</u>	<u>Specific Reserves Allocated</u>
<b>December 31, 2021</b>						
Commercial Real Estate	-	\$ -	\$ -	-	\$ -	\$ -
Commercial	-	-	-	-	-	-
Agriculture	1	131	-	-	-	-
Real Estate Mortgage	2	150	3	-	-	-
Consumer	-	-	-	-	-	-
<b>Total</b>	<b>3</b>	<b>\$ 281</b>	<b>\$ 3</b>	<b>-</b>	<b>\$ -</b>	<b>\$ -</b>
<b>December 31, 2020</b>						
Commercial Real Estate	2	\$ 2,922	\$ 55	-	\$ -	\$ -
Commercial	-	-	-	-	-	-
Agriculture	1	159	-	-	-	-
Real Estate Mortgage	4	327	5	-	-	-
Consumer	-	-	-	-	-	-
<b>Total</b>	<b>7</b>	<b>\$ 3,408</b>	<b>\$ 60</b>	<b>-</b>	<b>\$ -</b>	<b>\$ -</b>

The modification of loan terms that resulted in a TDR included one or more of the following: a reduction of the stated interest rate of the loan, an extension of the maturity date, and/or an extension of the amortization period. The post-modified loan balance for TDRs was essentially the same as the pre-modified balance.

The following table presents the aging of the recorded investment in past due and nonaccrual loans, as of December 31, 2021, and 2020. It is shown by class of loans (in thousands):

<b>December 31, 2021</b>	<u>Loans Past Due Accruing Interest</u>				<u>Loans on Non- Accrual</u>	<u>Loans Not Past Due or Non- Accrual</u>	<u>Total</u>
	<u>30-59 Days</u>	<u>60-89 Days</u>	<u>Over 90 Days</u>	<u>Total</u>			
Commercial Real Estate	\$ -	\$ -	\$ -	\$ -	770	\$ 447,610	\$ 448,380
Commercial	-	-	-	-	309	106,599	106,908
Agriculture	-	-	-	-	-	63,414	63,414
Real Estate Mortgage	162	-	-	162	244	119,585	119,991
Consumer	-	-	-	-	-	2,715	2,715
<b>Total</b>	<b>\$ 162</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ 162</b>	<b>\$ 1,323</b>	<b>\$ 739,923</b>	<b>\$ 741,408</b>

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)**

**December 31, 2020**

	<u>Loans Past Due Accruing Interest</u>					<u>Loans Not Past Due or Non- Accrual</u>	
	<u>30-59 Days</u>	<u>60-89 Days</u>	<u>Over 90 Days</u>	<u>Total</u>	<u>Loans on Non- Accrual</u>		<u>Total</u>
Commercial Real Estate	\$ -	\$ -	\$ -	\$ -	\$ 4,059	\$ 333,780	\$ 337,839
Commercial	20	-	-	20	75	150,274	150,369
Agriculture	-	-	-	-	-	59,567	59,567
Real Estate Mortgage	65	-	-	65	355	84,591	85,011
Consumer	14	-	-	14	-	3,070	3,084
Total	<u>\$ 99</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 99</u>	<u>\$ 4,489</u>	<u>\$ 631,282</u>	<u>\$ 635,870</u>

**Credit Quality Indicators:**

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 loans individually by classifying them based upon each loan's credit risk. This analysis includes all loans originated by the commercial loan department and is performed at least annually. A small number of loans listed as commercial loans in the Call Report but originated by the retail loan department as well as a portion of the remaining PPP loans were not assigned a loan grade. The Company uses the following definitions for risk ratings:

**Pass:** Loans classified as pass have no existing or known potential weaknesses deserving of management's close attention.

**Special Mention:** Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the Company's credit position at some future date.

**Substandard:** Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified 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 the deficiencies are not corrected.

**Doubtful:** Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make the full collection or liquidation highly questionable and improbable, based on the currently existing facts, conditions, and values.

As of December 31, 2021, and 2020, based on the most recent analysis performed, the risk category of loans by class of loans was as follows (in thousands):

<b>December 31, 2021</b>	<u>Pass</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Not Risk Rated</u>	<u>Total</u>
Commercial Real Estate	\$ 444,374	\$ 1,057	\$ 808	\$ -	\$ 2,141	\$ 448,380
Commercial	98,222	408	309	-	7,969	106,908
Agriculture	57,666	5,314	157	-	277	63,414
Real Estate Mortgage	68,000	712	67	-	51,212	119,991
Consumer	-	-	-	-	2,715	2,715
Total	<u>\$ 668,262</u>	<u>\$ 7,491</u>	<u>\$ 1,341</u>	<u>\$ -</u>	<u>\$ 64,314</u>	<u>\$ 741,408</u>

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)**

<b>December 31, 2020</b>	<b><u>Pass</u></b>	<b><u>Special Mention</u></b>	<b><u>Substandard</u></b>	<b><u>Doubtful</u></b>	<b><u>Not Risk Rated</u></b>	<b><u>Total</u></b>
Commercial Real Estate	\$ 321,508	\$ 12,197	\$ 4,134	\$ -	\$ -	\$ 337,839
Commercial	138,517	11,777	75	-	-	150,369
Agriculture	50,153	9,227	187	-	-	59,567
Real Estate Mortgage	29,393	457	77	-	55,084	85,011
Consumer	-	-	-	-	3,084	3,084
<b>Total</b>	<b><u>\$ 539,571</u></b>	<b><u>\$ 33,658</u></b>	<b><u>\$ 4,473</u></b>	<b><u>\$ -</u></b>	<b><u>\$ 58,168</u></b>	<b><u>\$ 635,870</u></b>

**NOTE E – PREMISES AND EQUIPMENT, NET**

Premises and equipment, net at December 31, consisted of (in thousands):

	<b><u>2021</u></b>	<b><u>2020</u></b>
Land	\$ 2,174	\$ 2,166
Buildings and improvements	20,009	19,754
Furniture and equipment	8,521	8,130
	<u>30,704</u>	<u>30,050</u>
Less accumulated depreciation	<u>(17,589)</u>	<u>(16,352)</u>
<b>Totals</b>	<b><u>\$ 13,115</u></b>	<b><u>\$ 13,698</u></b>

**NOTE F – OTHER INTANGIBLE ASSETS**

Acquired intangible assets as of December 31 were as follows (in thousands):

	<b><u>2021</u></b>		<b><u>2020</u></b>	
	<b><u>Gross Carrying Amount</u></b>	<b><u>Accumulated Amortization</u></b>	<b><u>Gross Carrying Amount</u></b>	<b><u>Accumulated Amortization</u></b>
Other acquired relationship intangibles	\$ 360	\$ 141	\$ 360	\$ 105

Amortization expense for each of the years ended December 31, 2021, 2020, and 2019, was \$36,000.

Amortization expense for each of the next five years is \$36,000 per year.

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE G – DEPOSITS**

The carrying amount of domestic deposits at year-end follows (in thousands):

	<u>2021</u>	<u>2020</u>
Non-interest bearing checking	\$ 262,980	\$ 220,786
Interest bearing checking	377,217	275,879
Savings	109,892	92,668
Money market accounts	121,935	127,419
Time deposits	102,328	121,546
<b>Totals</b>	<u>\$ 974,352</u>	<u>\$ 838,298</u>

The carrying amount of time deposits over \$250,000 at December 31, 2021, and 2020, was \$45,845,000 and \$52,832,000, respectively. Interest expense on these deposits was \$510,000, \$1,151,000, and \$1,227,000 for the years ended December 31, 2021, 2020, and 2019, respectively.

At December 31, 2021, scheduled maturities of time deposits were as follows for the years ending December 31 (in thousands):

2022	\$ 67,918
2023	20,851
2024	6,205
2025	3,520
2026	3,834
<b>Total</b>	<u>\$ 102,328</u>

Related party deposits were \$6,660,000 and \$15,278,000 at December 31, 2021, and 2020, respectively.

**NOTE H – OTHER BORROWINGS**

Other borrowings at December 31, 2021, and 2020, included \$20,000,000 in advances from the Federal Home Loan Bank (FHLB) of Indianapolis consisting of two \$10,000,000 advances maturing in April 2027 and May 2029 with a fixed interest rate of 1.73% and 1.96%, respectively, and a weighted average rate of 1.85%.

Advances from the FHLB are secured by a blanket collateral agreement, which gives the FHLB an unperfected security interest in certain 1-4 family mortgage, home equity, and commercial real estate loans. Eligible FHLB loan collateral at December 31, 2021, and 2020, was approximately \$154,936,000 and \$160,086,000, respectively.

At December 31, 2020, the Company had a term loan with United Bankers' Bank with an outstanding balance of \$6,500,000 payable in quarterly installments of \$250,000, plus interest at 4.0% fixed. The loan was fully repaid in April 2021.

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE I – SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE AND OVERNIGHT BORROWINGS**

Securities sold under agreements to repurchase (repurchase agreements) are direct obligations and are secured by securities held in safekeeping at a correspondent bank. Repurchase agreements are offered primarily to certain large deposit customers as deposit equivalent investments. Information relating to securities sold under agreements to repurchase is as follows (in thousands):

	<u>2021</u>	<u>2020</u>
At December 31:		
Outstanding balance	\$ 20,609	\$ 20,083
Average interest rate	0.16%	0.17%
Daily average for the year:		
Outstanding balance	\$ 15,523	\$ 15,695
Average interest rate	0.19%	0.20%
Maximum outstanding at any month-end	\$ 20,609	\$ 22,914

At December 31, 2021, and 2020, the Bank has \$53,000,000 and \$38,000,000, respectively, in line of credit arrangements available to purchase federal funds, with no outstanding borrowings.

**NOTE J – SUBORDINATED DEBENTURES AND TRUST PREFERRED SECURITIES**

In March 2004, Southern Michigan Bancorp Capital Trust I, a trust formed by the Company, closed a pooled, private offering of 5,000 trust-preferred securities with a liquidation amount of \$1,000 per security. The Company issued \$5,155,000 of subordinated debentures to the trust in exchange for ownership of all the common securities of the trust and the proceeds of the preferred securities sold by the trust. The Company is not considered the primary beneficiary of this trust, therefore the trust is not consolidated in the Company's financial statements. Rather the subordinated debentures are shown as a liability. The Company may redeem the subordinated debentures, subject to the receipt by the Company of the proper approval of the Federal Reserve, if such approval is required under applicable capital guidelines or policies of the Federal Reserve. The subordinated debentures may be redeemed on January 7, April 7, July 7, and October 7 of each year, either in whole or in integrals of \$1,000 at 100% of the principal amount, plus accrued and unpaid interest. The subordinated debentures mature on April 6, 2034. The subordinated debentures are also redeemable in whole, but not in part, from time to time upon the occurrence of specific events defined within the trust indenture. The Company has the option to defer interest payments on the subordinated debentures from time to time for a period not to exceed 20 consecutive quarters.

The \$5,000,000 in trust preferred securities may be included in Tier I capital (with certain limitations applicable) under current regulatory guidelines and interpretations. The trust preferred securities and subordinated debentures have a variable rate of interest equal to the three-month London Interbank Offered Rate (LIBOR), plus 2.75%. The rate on December 31, 2021, was 2.87%. Interest expense related to the subordinated debentures amounted to \$148,000 in 2021, \$184,000 in 2020, and \$262,000 in 2019. The Company's investment in the common stock of the trust is \$155,000 and is included in other assets.

On April 16, 2021, the Company completed a private placement of \$30,000,000 in aggregate principal amount of 3.75% Fixed-to-Floating Rate Subordinated Notes due April 16, 2031 (the "Notes"). The Notes will initially bear interest at a fixed rate of 3.75% through April 16, 2026, after which time, until maturity, the rate will reset quarterly to an annual floating rate equal to the then-current 3-month SOFR plus 302 basis points. The Notes are redeemable by the Company at its option, in whole or in part, on or after April 16, 2026. The Notes are not subject to redemption at the option of the holders. The balance of the notes, net of unamortized issuance costs of \$641,000, amounted to \$29,359,000 at December 31, 2021. Amortization of debt issuance costs, which is included in interest expense, will be \$69,000 for each of the five years subsequent to December 31, 2021.



**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE K – INCOME TAXES**

Income tax provision consists of the following (in thousands):

	<u>2021</u>	<u>2020</u>	<u>2019</u>
Current	\$ 2,717	\$ 2,695	\$ 1,782
Deferred	(354)	(1,292)	(95)
<b>Total income tax provision</b>	<u>\$ 2,363</u>	<u>\$ 1,403</u>	<u>\$ 1,687</u>

Income tax provision calculated at the statutory federal income tax rate of 21% for 2021, 2020, and 2019, differs from actual income tax provision as follows (in thousands):

	<u>2021</u>	<u>2020</u>	<u>2019</u>
Income tax at statutory rate	\$ 2,965	\$ 1,846	\$ 2,165
Tax-exempt interest income, net	(234)	(144)	(140)
Earnings on life insurance assets	(146)	(81)	(93)
Low income housing partnership tax credits	(98)	(84)	(61)
Captive insurance	(174)	(160)	(164)
Stock-based compensation	(15)	(44)	(55)
Other items, net	65	70	35
<b>Totals</b>	<u>\$ 2,363</u>	<u>\$ 1,403</u>	<u>\$ 1,687</u>

Deferred tax assets and liabilities consist of the following at December 31 (in thousands):

	<u>2021</u>	<u>2020</u>
Deferred tax assets:		
Allowance for loan losses	\$ 1,957	\$ 1,636
Deferred compensation and supplemental retirement liability	1,194	1,120
Nonaccrual loan interest	46	114
Stock-based compensation	260	241
Lease liability	578	590
Deferred loan fees	538	596
Accrued expense	252	155
Other	24	32
Total deferred tax assets	<u>4,849</u>	<u>4,484</u>
Deferred tax liabilities:		
Mortgage servicing rights	(322)	(289)
Goodwill	(130)	(130)
Purchase accounting adjustments	(19)	(23)
Depreciation	(347)	(407)
Prepaid expenses	(181)	(134)
Right-of-use asset	(556)	(575)
Net unrealized gain on available-for-sale securities	(227)	(1,160)
Other	(70)	(56)
Total deferred tax liabilities	<u>(1,852)</u>	<u>(2,774)</u>
<b>Net deferred tax assets included in other assets</b>	<u>\$ 2,997</u>	<u>\$ 1,710</u>

The Company and its subsidiaries file U.S. federal and certain state tax returns. In general, tax returns are no longer subject to tax examinations by tax authorities for years before 2018.

SMB Risk Management, Inc. has elected, under IRC Section 831(b), to be taxed only on its investment income, which excludes the premium payments received under its insurance contracts from taxable income.

The Company believes that it had no significant uncertain tax positions as of December 31, 2021, and 2020.

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE L – BENEFIT PLANS**

**Employee Stock Ownership Plan:** The Company has an employee stock ownership plan (ESOP) for substantially all full-time employees. The ESOP includes a 401(k) provision with the Company's matching contribution provided in Company stock. The Board of Directors determines the Company's contribution level annually. Expense charged to operations for contributions to the ESOP totaled \$415,000, \$400,000, and \$364,000 in 2021, 2020, and 2019, respectively.

Shares held by the ESOP at year-end are as follows:

	<u>2021</u>	<u>2020</u>
Allocated shares	282,836	141,079
Unallocated shares	<u>10,640</u>	<u>7,680</u>
<b>Total ESOP shares</b>	<u><u>293,476</u></u>	<u><u>148,759</u></u>

The fair value of allocated shares held by the ESOP is \$5,713,000 and \$4,797,000 at December 31, 2021, and 2020, respectively. Upon distribution of shares to a participant, the participant has the right to require the Company to purchase shares at their fair value, in accordance with terms and conditions of the plan.

**Deferred Compensation Plan:** Directors and certain officers of the Bank may defer a portion of their director fees or compensation in a non-qualified deferred compensation plan. An account is established for each participant in the plan and credited with the participant's annual deferred compensation, plus interest, based on the stated rate determined annually. Upon retirement, participants receive the balance in their account over 15 years. Participants also continue to earn interest during retirement based on their remaining account balance. Participants are immediately vested in their account balances. The plan is intended to be funded by certain bank-owned life insurance contracts. The interest rate paid on deferred compensation balances, as of December 31, 2021, was 2.70%. Deferred compensation expense was \$328,000, \$273,000, and \$298,000 in 2021, 2020, and 2019, respectively. The liability for deferred compensation benefits was \$3,535,000 and \$3,320,000 at December 31, 2021, and 2020, respectively, and is included in accrued expenses and other liabilities in the accompanying consolidated balance sheets.

**Supplemental Retirement Plans:** In December 2011, the Board of Directors approved the Defined Contribution Supplemental Executive Retirement Plan (2011 SERP), which is intended to provide select executive officers with a retirement benefit that is competitive with industry practices for bank executives when combined with the executive's other employer-funded retirement benefits. The 2011 SERP is a defined contribution arrangement which gives the Bank the discretion to make a specific annual, nonqualified, deferred compensation contribution to the account of participating executives. Whether an annual deferred compensation contribution will be made to the account balance of a participating executive, as well as the amount of the contribution, is at the discretion of the Bank's Board of Directors. The contribution that will be made by the Bank to the account of each executive is determined based on a percentage of base salary. Participants are generally entitled to receive payment of the benefit in their account in 120 equal monthly installments, commencing at age 65. Expense associated with the 2011 SERP amounted to \$212,000 in 2021, \$345,000 in 2020, and \$151,000 in 2019. Liabilities associated with the 2011 SERP totaled \$2,151,000 and \$2,014,000 at December 31, 2021, and 2020, respectively, and are included in accrued expenses and other liabilities in the accompanying consolidated balance sheets.

## SOUTHERN MICHIGAN BANCORP, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

#### NOTE M – STOCK-BASED COMPENSATION

The Company has stock-based compensation plans as described below. Total compensation cost charged against income for those plans, was \$1,018,000, \$867,000, and \$832,000 in 2021, 2020, and 2019, respectively.

The Southern Michigan Bancorp, Inc. Stock Incentive Plan of 2014 was created to advance the interest of the Company and its shareholders by affording to directors, officers, and other employees of the Company an opportunity for increased stock ownership. The plan permits the grant and award of stock options, stock appreciation rights, restricted stock, and stock awards. A maximum of 800,000 shares of common stock are available under the plan as a result of the May 2021 100% stock dividend. At December 31, 2021, 305,099 shares were available for issuance under the plan.

The fair value of each option award is estimated on the date of grant, using a Black-Scholes option valuation model that uses the weighted average assumptions noted in the following table. The expected volatility and life assumptions are based on historical experience. The interest rate is based on the U.S. Treasury yield curve and the dividend yield assumption is based on the Company's history and expected dividend payouts. Forfeitures are recognized as they occur.

	2021	2020	2019
Risk-free interest rate	0.11%	1.53%	2.72 %
Expected option life	8 years	8 years	8 years
Expected stock price volatility	18.78%	16.43%	22.69 %
Dividend yield	2.55%	2.52%	2.65 %
Weighted-average fair value of options granted during year	\$ 3.87	\$ 4.70	\$ 7.79

A summary of the activity in the stock-based compensation plans for 2021 follows:

#### Stock Options

	Shares Subject to Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at beginning of year	54,800	\$ 35.59		
Granted	14,950	33.11		
Stock dividend	68,700	17.64		
Exercised	(3,450)	12.59		
Forfeited	(200)	17.90		
Outstanding at end of year	134,800	\$ 17.79	7.1 years	\$ 236,000
Exercisable at year-end	76,600	\$	6.0 years	\$ 195,000

	2021	2020	2019
Intrinsic value of options exercised	\$ 30,000	\$ 7,000	\$ 2,000
Cash received from options exercised	44,000	3,000	3,000
Tax benefit realized from options exercised	15,000	44,000	55,000

As of December 31, 2021, there was \$27,000 of total, unrecognized compensation cost related to non-vested stock options granted under the plans. The cost is expected to be recognized over a weighted average period of one year.

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE M – STOCK-BASED COMPENSATION (CONTINUED)**

**Restricted Stock** – Restricted shares may be issued under the 2014 plan described above. Compensation expense is recognized over the vesting period of the shares, based on the market value of the shares on the issue date. The total fair value of shares vested during the years ended December 31, 2021, 2020, and 2019 was \$973,000, \$932,000, and \$950,000, respectively. As of December 31, 2021, there was \$1,093,000 of total unrecognized compensation cost related to unvested shares granted under the plan. The cost is expected to be recognized over a weighted average period of 2.4 years.

A summary of activity for restricted stock for 2021 follows:

	<u>Shares</u>	<u>Weighted Average Grant Date Fair Value</u>
Non-vested at January 1, 2021	60,490	\$ 33.66
Granted	23,650	33.83
Stock dividend	59,320	17.28
Vested	(32,029)	31.70
Forfeited	(1,971)	28.28
Non-vested at December 31, 2021	<u>109,460</u>	\$ 17.23

**NOTE N – COMMITMENTS**

Various commitments arise in the normal course of business, such as commitments under commercial letters of credit, standby letters of credit, and commitments to extend credit. These arrangements have credit risk essentially the same as that involved in extending loans to customers and are subject to the Bank's normal credit policies. Collateral generally consists of receivables, inventory, and equipment and is obtained based on management's credit assessment of the customer.

At December 31, 2021, and 2020, the Company had no commitments under commercial letters of credit used to facilitate customers' trade transactions.

Under standby letter of credit agreements, the Company agrees to honor certain commitments in the event that its customers are unable to do so. At December 31, 2021, and 2020, commitments under outstanding standby letters of credit were \$13,197,000 and \$13,161,000, respectively.

Loan commitments outstanding to extend credit are detailed below (in thousands):

	<u>2021</u>	<u>2020</u>
Fixed rate	\$ 82,917	\$ 43,747
Variable rate	94,073	151,313
<b>Totals</b>	<u>\$ 176,990</u>	<u>\$ 195,060</u>

The fixed rate commitments have stated interest rates ranging from 2.00% to 15.0%. The terms of the above commitments range from 1 to 181 months.

Management does not anticipate any losses due to these transactions; however, the above amount represents the maximum exposure to credit loss for loan commitments, as well as commercial and standby letters of credit.

Certain executives of the Bank have employment contracts containing change of control clauses. The employment contracts provide for the payment of 2.99 times the officers' base salaries and bonuses, should the officers be terminated in the event of a change of control.

# **SOUTHERN MICHIGAN BANCORP, INC.** **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

## **NOTE O – RESTRICTIONS ON TRANSFERS FROM SUBSIDIARIES**

Capital guidelines adopted by federal and state regulatory agencies and restrictions imposed by law, limit the amount of cash dividends the Bank can pay to the Company. At December 31, 2021, using the most restrictive of these conditions, the aggregate cash dividends the Bank could pay the Company without prior regulatory approval was approximately \$28.8 million.

## **NOTE P – ACCUMULATED OTHER COMPREHENSIVE INCOME**

Accumulated other comprehensive income amounted to \$856,000 at December 31, 2021, and \$4,362,000 at December 31, 2020, consisting of the following (in thousands):

	<u>2021</u>	<u>2020</u>
Unrealized gain on available-for-sale securities, net of income taxes of \$227 in 2021, and \$1,160 in 2020	\$ 856	\$ 4,362

## **NOTE Q – SOUTHERN MICHIGAN BANCORP, INC. (PARENT COMPANY ONLY) FINANCIAL INFORMATION**

Condensed financial statements of Southern Michigan Bancorp, Inc. follow (in thousands):

### **Balance Sheets**

	<u>December 31,</u> <u>2021</u>	<u>2020</u>
<b>Assets</b>		
Cash and cash equivalents	\$ 8,484	\$ 1,329
Investment in subsidiary bank	120,635	100,341
Investment in non-banking subsidiaries	2,070	1,936
Premises and equipment, net	604	635
Other assets	1,050	1,014
<b>Total Assets</b>	<u>\$ 132,843</u>	<u>\$ 105,255</u>
<b>Liabilities and Shareholders' Equity</b>		
Dividends payable	\$ 542	\$ 531
Other liabilities	38	92
Other borrowings	-	6,500
Subordinated debentures	34,514	5,155
Shareholders' equity	97,749	92,977
<b>Total Liabilities and Shareholders' Equity</b>	<u>\$ 132,843</u>	<u>\$ 105,255</u>

### **Statements of Income**

	<u>Year ended December 31,</u> <u>2021</u>	<u>2020</u>	<u>2019</u>
Dividends from subsidiary bank	\$ 3,885	\$ 2,993	\$ 4,358
Dividends from non-banking subsidiaries	710	730	640
Interest income	7	9	10
Interest expense	(1,057)	(505)	(626)
Rental income from subsidiary bank	137	137	137
Other expenses	(1,330)	(1,119)	(996)
	<u>2,352</u>	<u>2,245</u>	<u>3,523</u>
Federal income tax credit	(471)	(311)	(310)
	<u>2,823</u>	<u>2,556</u>	<u>3,833</u>
Equity in net income, less dividends received from:			
Subsidiary bank	8,800	4,772	4,617
Non-banking subsidiaries	134	58	172
<b>Net Income</b>	<u>\$ 11,757</u>	<u>\$ 7,386</u>	<u>\$ 8,622</u>



**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE Q – SOUTHERN MICHIGAN BANCORP, INC. (PARENT COMPANY ONLY) FINANCIAL INFORMATION**  
**(CONTINUED)**

**Statements of Cash Flows**

	<b>Year ended December 31,</b>		
	<b>2021</b>	<b>2020</b>	<b>2019</b>
<b>Operating Activities</b>			
Net income	\$ 11,757	\$ 7,386	\$ 8,622
Adjustments to reconcile net income to net cash from operating activities:			
Equity in net income, less dividends received from:			
Subsidiary bank	(8,800)	(4,772)	(4,617)
Non-banking subsidiary	(134)	(58)	(172)
Stock option and restricted stock grant compensation expense	1,018	867	832
Depreciation of premises and equipment	31	32	31
Amortization of subordinated debt issuance costs	52	-	-
Decrease in ESOP obligation	80	99	166
Other, net	(90)	(97)	455
Net cash from operating activities	<u>3,914</u>	<u>3,457</u>	<u>5,317</u>
<b>Investing Activities</b>			
Capital contribution to bank subsidiary	<u>(15,000)</u>	<u>-</u>	<u>-</u>
<b>Financing Activities</b>			
Repayments of other borrowings	(6,500)	(1,000)	(1,000)
Proceeds from subordinated debt, net of issuance costs	29,307	-	-
Cash dividends paid	(2,175)	(2,131)	(2,087)
Stock options exercised	44	3	3
Purchase of ESOP shares	-	-	(382)
Repurchase of common stock	(2,435)	(1,008)	(562)
Net cash from financing activities	<u>18,241</u>	<u>(4,136)</u>	<u>(4,028)</u>
<b>Net change in cash and cash equivalents</b>	<u>7,155</u>	<u>(679)</u>	<u>1,289</u>
Beginning cash and cash equivalents	<u>1,329</u>	<u>2,008</u>	<u>719</u>
<b>Ending cash and cash equivalents</b>	<u>\$ 8,484</u>	<u>\$ 1,329</u>	<u>\$ 2,008</u>

**NOTE R – SUPPLEMENTAL CASH FLOW DISCLOSURES**

The following supplemental cash flow disclosures are provided for the years ended December 31, 2021, 2020, and 2019 (in thousands):

	<b>2021</b>	<b>2020</b>	<b>2019</b>
Cash paid during the year for:			
Interest	\$ 3,916	\$ 5,226	\$ 6,401
Income taxes	3,610	1,850	1,780
<b>Supplemental non-cash disclosures:</b>			
Change in deferred income taxes on net unrealized gain (loss) on available-for-sale securities	(933)	1,174	333
Lease liabilities arising from obtaining right-of-use assets	-	-	2,895
Transfer from fixed assets to real estate owned	-	-	62
Change in unrealized gain (loss) on available-for-sale securities	(4,439)	5,588	1,582
Transfers from loans to other real estate owned	-	57	60

## SOUTHERN MICHIGAN BANCORP, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

#### NOTE S – FAIR VALUE INFORMATION

The following methods and assumptions were used by the Company in estimating fair values for financial instruments, as well as for gaining an indication of where the instruments fall within the fair value hierarchy. This is described in greater detail in Note T.

**Cash and cash equivalents:** The carrying amount reported in the balance sheet approximates fair value and results in a Level 1 classification.

**Securities available-for-sale:** Fair values for securities available-for-sale are based on quoted market prices, where available. For all other securities, the Company obtains a current price from a broker trade desk. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information, and bond terms and conditions, among other things. Securities are classified as either Level 1, 2, or 3. See Footnote T for the hierarchy level breakdown.

**Loans, net:** For variable-rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values and result in a Level 3 classification. The fair values for other loans are estimated using discounted cash flows analyses and interest rates currently offered for loans with similar terms to borrowers of similar credit quality. Such loans result in a Level 3 classification.

**Loans held for sale:** The fair value of loans held for sale is estimated based upon binding contracts and quotes from third party investors and results in a Level 2 classification.

**Accrued interest receivable:** The carrying amount reported in the balance sheet approximates fair value.

**Off-balance-sheet financial instruments:** The estimated fair value of off-balance-sheet financial instruments is based on current fees or costs that would be charged to enter or terminate the arrangements. The estimated fair value is not considered significant for this presentation.

**Deposits:** The fair values disclosed for demand deposits (e.g., interest and non-interest checking, savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts) and result in a Level 2 classification. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates based on the FHLB yield curve, resulting in a Level 2 classification.

**Securities sold under agreements to repurchase, overnight borrowings, and federal funds sold:** The carrying amount reported in the balance sheet approximates fair value and results in a Level 2 classification.

**Other borrowings:** The fair value of other borrowings is estimated using discounted cash flows analyses using the FHLB yield curve. This results in a Level 2 classification.

**Subordinated debentures:** The carrying amount reported in the balance sheet approximates fair value of the variable-rate subordinated debentures. The fair value is estimated using discounted cash flow analyses. Such analyses are based on the current borrowing rates for similar types of borrowing arrangements. This results in a Level 3 classification.

**Accrued interest payable:** The carrying amount reported in the balance sheet approximates fair value.

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE S – FAIR VALUE INFORMATION (CONTINUED)**

While these estimates of fair value are based on management's judgment of appropriate factors, there is no assurance that if the Company had disposed of such items at December 31, 2021, and 2020, the estimated fair values would have been achieved. Market values may differ depending on various circumstances not taken into consideration in this methodology. The estimated fair values at December 31, 2021, and 2020, should not necessarily be considered to apply at subsequent dates.

In addition, other assets and liabilities that are not defined as financial instruments are not included in the following disclosures, such as property and equipment. Furthermore, non-financial instruments typically not recognized in financial statements may have value but are not included in the following disclosures. These include, among other items, the estimated earnings power of core deposit accounts, the trained work force, customer goodwill, and similar items.

The estimated fair values of the Company's financial instruments at year-end are as follows (in thousands):

	Fair Value Hierarchy	2021		2020	
		Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:					
Cash and cash equivalents	Level 1	\$ 119,389	\$ 119,389	\$ 99,610	\$ 99,610
Federal funds sold	Level 2	271	271	231	231
Securities available-for-sale	See Note T	245,846	245,846	208,380	208,380
Loans held for sale	Level 2	1,146	1,146	1,691	1,691
Loans, net of allowance for loan losses	Level 3	732,088	733,249	628,081	631,919
Accrued interest receivable	Level 1	4,193	4,193	4,749	4,749
Financial liabilities:					
Deposits	Level 2	\$ (974,352)	\$ (973,927)	\$ (838,298)	\$ (839,085)
Securities sold under agreements to repurchase and overnight borrowings	Level 2	(20,609)	(20,609)	(20,083)	(20,083)
Other borrowings	Level 2	(20,000)	(20,120)	(26,500)	(27,236)
Subordinated debentures	Level 3	(34,514)	(33,661)	(5,155)	(5,155)
Accrued interest payable	Level 1	(38)	(38)	(187)	(187)

The preceding table does not include net cash surrender value of life insurance and dividends payable, which are also considered financial instruments. The estimated fair value of such items is considered to be their carrying amount.

The Company also has unrecognized financial instruments related to commitments to extend credit and standby letters of credit, as described in Note N. The contract amount of such instruments is considered to be the fair value.

**NOTE T – FAIR VALUE MEASUREMENTS**

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability. In the absence of a principal market, the most advantageous market for the asset or liability is used. The price in the principal (or most advantageous) market, used to measure the fair value of the asset or liability, shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent; (ii) knowledgeable; (iii) able to transact; and (iv) willing to transact.

## SOUTHERN MICHIGAN BANCORP, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

#### NOTE T – FAIR VALUE MEASUREMENTS (CONTINUED)

Fair value must be determined using valuation techniques consistent with the market approach, the income approach, and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement cost). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be either: (i) observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability, developed based on market data obtained from independent sources; or (ii) unobservable, meaning those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability, developed based on the best information available in the circumstances. A fair value hierarchy for valuation inputs has been established that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs.

The fair value hierarchy is as follows:

*Level 1 Inputs* – Unadjusted, quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

*Level 2 Inputs* – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include: 1) quoted prices for similar assets or liabilities in active markets; 2) quoted prices for identical, or similar, assets or liabilities in markets that are not active; 3) inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.); or 4) inputs derived principally from, or corroborated by, market data by correlation or other means.

*Level 3 Inputs* – Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments, pursuant to the valuation hierarchy, follows. These valuation methodologies were applied to all of the Company's financial and non-financial assets and liabilities carried at fair value.

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality, the company's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

*Securities Available-for-Sale:* Securities classified as available-for-sale are reported at fair value utilizing Level 1, Level 2, and Level 3 inputs. Unadjusted, quoted prices in active markets for identical assets are utilized to determine fair value at the measurement date for Level 1 securities. For all other securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information, and the bond's terms and conditions, among other things. When there are unobservable inputs, such securities are classified as Level 3.

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE T – FAIR VALUE MEASUREMENTS (CONTINUED)**

Securities available-for-sale, when classified as Level 3 inputs, represent non-publicly traded municipal issues with limited trading activity from entities within the Company's market area. The fair value of these investments was determined using Level 3 valuation techniques, as there is no market available to price these investment securities. The method used for determining the fair value for these investment securities included a comparison to the fair value of other investment securities valued with Level 2 inputs with similar characteristics (credit, time to maturity, call structure, etc.) and the interest yield curve for comparable debt investment securities.

*Impaired Loans:* The Company does not record impaired loans at fair value on a recurring basis. However, periodically, a loan is considered impaired and is reported at the fair value of the underlying collateral, less estimated costs to sell if repayment is expected solely from the collateral, or at estimated discounted cash flows if the credit is performing. Impaired loans measured at fair value typically consist of loans on nonaccrual status and loans with a portion of the allowance for loan losses allocated specific to the loan. Some loans may be included in both categories, whereas other loans may only be included in one category. Collateral values are estimated using Level 2 and Level 3 inputs, including recent appraisals and customized discounting criteria, which include the discounting of appraisals based on age, changes in the property, or market conditions. These discounts generally range from 10% to 25%, and include a discount for estimated selling costs of 10%. Estimated cash flows are discounted considering the loan rate and current market rates; such discounts generally range from 3.9% to 6.4%. Due to the significance of the Level 3 inputs, impaired loans have been classified as Level 3.

*Other Real Estate Owned (OREO):* The Company values OREO at the fair value of the underlying collateral, less expected selling costs. Collateral values are estimated primarily using discounted appraisals and reflect a market value approach. These discounts generally range from 25% to 55%. Due to the significance of unobservable inputs used in estimating fair value, OREO has been classified as Level 3.

*Interest Rate Swaps:* Interest rate swap valuations are determined using proprietary pricing models with inputs that are observable in the market or can be derived principally from or corroborated by observable market data. The valuations utilize certain Level 3 inputs, such as estimates of current credit spreads to evaluate the likelihood of default by the Company and its counterparties. These credit valuation adjustments do not significantly impact the overall valuation of swap positions and the swap valuations are classified as Level 2 in the fair value hierarchy.

The following table summarizes financial and non-financial assets, as well as non-financial liabilities, measured at fair value as of December 31, 2021, and 2020. Information is segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (in thousands):



**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE T – FAIR VALUE MEASUREMENTS (CONTINUED)**

<b>2021</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
<b>Recurring:</b>	<b>Inputs</b>	<b>Inputs</b>	<b>Inputs</b>	<b>Fair Value</b>
Assets:				
Securities available-for-sale:				
Mortgage-backed securities	\$ -	\$ 59,383	\$ -	\$ 59,383
States and political subdivisions	-	129,330	33,299	162,629
Corporate securities	-	2,033	-	2,033
Asset-backed securities	-	21,801	-	21,801
Total available-for-sale	<u>\$ -</u>	<u>\$ 212,547</u>	<u>\$ 33,299</u>	<u>\$ 245,846</u>
Interest rate swaps	\$ -	\$ 915	\$ -	\$ 915
Liabilities				
Interest rate swaps	\$ -	\$ 915	\$ -	\$ 915
<b>Nonrecurring assets:</b>				
Impaired loans	\$ -	\$ -	\$ 770	\$ 770
<b>2020</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
<b>Recurring:</b>	<b>Inputs</b>	<b>Inputs</b>	<b>Inputs</b>	<b>Fair Value</b>
Assets:				
Securities available-for-sale:				
Mortgage-backed securities	\$ -	\$ 49,366	\$ -	\$ 49,366
States and political subdivisions	-	106,768	25,693	132,461
Asset-backed securities	-	26,553	-	26,553
Total available-for-sale	<u>\$ -</u>	<u>\$ 182,687</u>	<u>\$ 25,693</u>	<u>\$ 208,380</u>
Interest rate swaps	\$ -	\$ 1,598	\$ -	\$ 1,598
Liabilities				
Interest rate swaps	\$ -	\$ 1,598	\$ -	\$ 1,598
<b>Nonrecurring assets:</b>				
Impaired loans	\$ -	\$ -	\$ 3,820	\$ 3,820

Impaired loans are reported net of an allowance for loan losses of \$400,000 at December 31, 2021, and \$524,000 at December 31, 2020.

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE T – FAIR VALUE MEASUREMENTS (CONTINUED)**

The following is a reconciliation of the beginning and ending balances of securities available-for-sale measured at fair value on a recurring basis, using significant unobservable (Level 3) inputs during the years ended December 31, 2021, and 2020 (in thousands):

	<u>2021</u>	<u>2020</u>
Balance at January 1	\$ 25,693	\$ 25,618
Net maturities and calls	(7,558)	(6,639)
Change in unrealized net gains included in other comprehensive income	(495)	1,070
Purchases	<u>15,659</u>	<u>5,644</u>
Balance at December 31	<u>\$ 33,299</u>	<u>\$ 25,693</u>

**NOTE U – REGULATORY MATTERS**

Banks and bank holding companies are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action that could have a direct, material adverse effect on the consolidated financial statements. Prompt corrective action provisions are not applicable to bank holding companies. These capital requirements were modified in 2013 with the Basel III capital rules, which established a new comprehensive capital framework for U.S. banking organizations.

The prompt corrective action regulations provide five capital categories, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized or worse, regulatory approval is required to, among other things, accept brokered deposits. If undercapitalized, capital distributions and asset growth are limited, while plans for capital restoration are required.

Under the amended Small Bank Holding Company Policy Statement (Regulation Y, Appendix C) (the “Policy Statement”) the Company qualifies for treatment as a small bank holding company and is no longer subject to consolidated capital rules.

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE U – REGULATORY MATTERS (CONTINUED)**

At year-end, actual capital levels and minimum required levels were as follows (in thousands):

	<b>Actual</b>		<b>Minimum Required For Capital Adequacy Purposes</b>		<b>Minimum Required To Be Well Capitalized Under Prompt Corrective Action Regulations</b>	
	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>
<b>2021</b>						
Total Capital to risk weighted assets:						
Consolidated	\$ 127,572	14.6%	N/A	N/A	N/A	N/A
Bank	115,458	13.3	\$ 69,293	8.0%	\$ 86,617	10.0%
Tier 1 (Core) Capital to risk weighted assets:						
Consolidated	88,252	10.1	N/A	N/A	N/A	N/A
Bank	106,138	12.3	51,970	6.0	69,293	8.0
Common Tier 1 Capital to risk weighted assets (CET1):						
Consolidated	88,252	10.1	N/A	N/A	N/A	N/A
Bank	106,138	12.3	38,977	4.5	56,301	6.5
Tier 1 (Core) Capital to average assets:						
Consolidated	88,252	7.8	N/A	N/A	N/A	N/A
Bank	106,138	9.4	45,199	4.0	56,499	5.0
<b>2020</b>						
Total Capital to risk weighted assets:						
Consolidated	\$ 87,727	12.7%	N/A	N/A	N/A	N/A
Bank	90,091	13.1	\$ 55,165	8.0%	\$ 68,956	10.0%
Tier 1 (Core) Capital to risk weighted assets:						
Consolidated	79,938	11.6	N/A	N/A	N/A	N/A
Bank	82,302	11.9	41,374	6.0	55,165	8.0
Common Tier 1 Capital to risk weighted assets (CET1):						
Consolidated	79,938	11.6	N/A	N/A	N/A	N/A
Bank	82,302	11.9	31,030	4.5	44,822	6.5
Tier 1 (Core) Capital to average assets:						
Consolidated	79,938	8.5	N/A	N/A	N/A	N/A
Bank	82,302	8.7	37,743	4.0	47,178	5.0

## **SOUTHERN MICHIGAN BANCORP, INC.**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

#### **NOTE V – QUALIFIED AFFORDABLE HOUSING PROJECT INVESTMENTS**

The Company invests in qualified investment housing projects. At December 31, 2021, and 2020, the balance of the investment for qualified affordable housing projects was \$579,000 and \$676,000, respectively. These balances are reflected in other assets in the consolidated balance sheets. Total unfunded commitments related to the investments in qualified affordable housing projects totaled \$50,000 and \$225,000 at December 31, 2021, and 2020. The Company expects to fulfill these commitments by the year ending 2033.

During the years ended December 31, 2021, 2020, and 2019, the Company recognized amortization expense of \$97,000, \$94,000, and \$69,000, respectively, which was included in the income tax provision in the consolidated statements of income.

Additionally, during the years ended December 31, 2021, 2020, and 2019, the Company recognized tax credits and other benefits from its investment in affordable housing tax credits of \$98,000, \$84,000, and \$61,000, respectively.

#### **NOTE W – REVENUE FROM CONTRACTS WITH CUSTOMERS**

The Company's primary sources of revenue include net interest income, service charges and fees, trust fees, gains on the sale of loans, earnings on life insurance assets, and ATM and debit card fee income. Net interest income, gains on the sale of loans, securities and other assets, as well as earnings on life insurance assets are outside of the scope of ASC 606, *Revenue from Contracts with Customers*. Other sources of revenue fall within the scope of ASC 606 and are primarily recognized within "Non-interest income" in the Consolidated Statements of Income.

The Company recognizes revenue when the performance obligations related to the transfer of goods or services under the terms of a contract are satisfied. Some obligations are satisfied at a point in time, while others are satisfied over a period of time. Revenue is recognized as the amount of consideration expected to be received in exchange for transferring goods or services to a customer and is segregated based on the nature of products and services offered as part of contractual arrangements. Generally, these sources of revenue are earned at the time the service is delivered or over the course of a monthly period; they do not result in any contract asset or liability balance at any given period end. As a result, there were no contract assets or liabilities recorded. Revenue within the scope of ASC 606 is discussed in the following paragraphs.

*Service charges on deposit accounts* include fees and other charges the Company receives to provide various services. The charges include, but are not limited to, monthly service fees, account analysis fees, providing overdraft services, and accepting and executing stop-payment orders. The consideration includes both fixed (e.g., monthly service fees) and transaction fees (i.e., stop-payment fees). Fixed fees are recognized over the period of time the service is provided while transaction fees are recognized when a specific service is rendered to the customer.

*Trust fees* include fee income generated from investment management services. Services are rendered over a period of time, over which revenue is recognized.

*ATM and debit card fees* primarily include debit card interchange and network revenues. Debit card interchange and network revenues are earned on debit card transactions conducted through payment networks such as MasterCard and Pulse. Interchange income is recognized concurrently with the delivery of services on a daily basis. Interchange and network revenues are presented gross of interchange expenses, which are presented separately as a component of non-interest expense.

*Other non-interest income* includes check orders, wire transfer fees, check cashing fees, cash management fees, and other service charges totaling \$558,000, \$486,000, and \$453,000 during 2021, 2020, and 2019, respectively. The Company's performance obligation for cash management fees is generally satisfied, and therefore, revenue is recognized over the period in which the service is provided. Check orders, wire transfer fees, check cashing fees, and other deposit account related fees are largely transaction based. Therefore, the performance obligation is satisfied and related revenue is recognized at a point in time. These fees are included in the Other category of "Non-interest income".

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE W - REVENUE FROM CONTRACTS WITH CUSTOMERS (CONTINUED)**

*Contract Balances*

A contract asset balance occurs when an entity performs a service for a customer before the customer pays consideration (resulting in a contract receivable) or before payment is due (resulting in a contract asset). A contract liability balance is an entity's obligation to transfer a service to a customer for which the entity has already received payment (or payment is due) from the customer. The Company's non-interest income streams are largely based on transactional activity, or standard month-end revenue accruals, such as asset management fees based on month-end market values. Consideration is most often received immediately or shortly after the Company satisfies its performance obligation and revenue is recognized. The Company does not typically enter into long-term revenue contracts with customers, and therefore, does not experience significant contract balances. As of December 31, 2021, and 2020, the Company did not have a material amount of contract balances.

**NOTE X – LEASES**

The Company enters into leases in the normal course of business primarily for business development offices and bank branches. The Company's leases have remaining terms ranging from 17 to 22 years, some of which include renewal options to extend the lease for up to 10 years. The weighted average remaining lease term at December 31, 2021, was 19.75 years.

The Company includes lease extension options in the lease term if, after considering relevant economic factors, it is reasonably certain the Company will exercise the option.

Lease expense for operating leases is recognized on a straight-line basis over the lease term. Right-of-use assets represent the right to use an underlying asset for the lease term. Lease liabilities represent the Company's obligation to make lease payments arising from the lease. Right-of-use assets and lease liabilities are recognized at the lease commencement date based on the estimated present value of lease payments over the lease term.

The Company used its incremental borrowing rate at lease commencement to calculate the present value of lease payments when the rate implicit in a lease is not known. The Company's incremental borrowing rate is based on the prime rate. The weighted average discount rate at December 31, 2021, was 4.29%.

Right-of-use assets are included in other assets and lease liabilities are included in accrued expenses and other liabilities in the consolidated balance sheets. At December 31, 2021, and 2020, the right-of-use assets totaled \$2,649,000 and \$2,739,000, respectively, and lease liabilities totaled \$2,798,000 and \$2,807,000, respectively.

Rent expense under operating leases amounted to \$188,000, \$185,000, and \$145,000 in 2021, 2020, and 2019, respectively. Amortization of right-of-use assets totaled \$90,000 and \$87,000 in 2021 and 2020, respectively.

Lease commitments under non-cancelable operating leases at December 31, 2021, were as follows (in thousands):

2022	\$ 190
2023	190
2024	194
2025	194
2026	194
Thereafter	3,238
Total future minimum lease payments	<u>4,200</u>
Amounts representing interest	1,402
<b>Total lease liabilities</b>	<b><u>\$ 2,798</u></b>

**SOUTHERN MICHIGAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**NOTE Y – DERIVATIVE FINANCIAL INSTRUMENTS**

The Bank has entered into an interest rate swap agreement with a commercial customer to accommodate their borrowing needs. To offset exposure and manage its own interest rate risk, the Bank simultaneously entered into an interest rate swap agreement with a correspondent bank counterparty with offsetting terms. By definition, these agreements are considered to be derivative instruments but are not designated as accounting hedges. As a result, any changes in the net fair value of the instruments are recognized in non-interest income or expense. Due to the nature of the offset in value between the agreements with the customer and the counterparty, the Bank does not expect to have any interest rate risk relating to these agreements and no amount was recognized as non-interest income or expense in 2021 or 2020. The fair value of the instruments, amounting to \$915,000 and \$1,598,000 are included in other assets and accrued expense and other liabilities in the 2021 and 2020 consolidated balance sheets.

The following tables present the derivative financial instruments as of December 31, 2021, and December 31, 2020, (Notional Amount and Fair Value in thousands):

<b>December 31, 2021</b>	<b><u>Notional Amount</u></b>	<b><u>Fixed Rate</u></b>	<b><u>Floating Rate</u></b>	<b><u>Maturity</u></b>	<b><u>Fair Value</u></b>
Customer interest rate swap Receive fixed/pay floating	\$ 10,564	4.5%	1 Month LIBOR +1.70%	6.2 yrs	\$ 915
Correspondent interest rate swap Pay fixed/receive floating	10,564	4.5%	1 Month LIBOR +1.70 %	6.2 yrs	915

<b>December 31, 2020</b>	<b><u>Notional Amount</u></b>	<b><u>Fixed Rate</u></b>	<b><u>Floating Rate</u></b>	<b><u>Maturity</u></b>	<b><u>Fair Value</u></b>
Customer interest rate swap Receive fixed/pay floating	\$ 10,856	4.5%	1 Month LIBOR +1.70%	7.2 yrs	\$ 1,598
Correspondent interest rate swap Pay fixed/receive floating	10,856	4.5%	1 Month LIBOR + 1.70%	7.2 yrs	1,598

**NOTE Z – QUARTERLY FINANCIAL DATA (IN THOUSANDS, EXCEPT PER SHARE DATA) (UNAUDITED)**

	<b><u>Interest Income</u></b>	<b><u>Net Interest Income</u></b>	<b><u>Provision for Loan Losses</u></b>	<b><u>Net Income</u></b>	<b><u>Earnings Per Share</u></b>	
					<b><u>Basic</u></b>	<b><u>Fully Diluted</u></b>
<b><u>2021</u></b>						
First Quarter	\$ 8,801	\$ 7,893	\$ 0	\$ 3,088	\$ 0.68	\$ 0.67
Second Quarter	8,849	7,848	400	3,009	0.66	0.66
Third Quarter	9,802	8,835	650	3,138	0.69	0.69
Fourth Quarter	9,688	8,743	450	2,522	0.56	0.56
<b><u>2020</u></b>						
First Quarter	\$ 7,977	\$ 6,401	\$ 1,000	\$ 1,513	\$ 0.33	\$ 0.33
Second Quarter	8,025	6,691	750	1,831	0.40	0.40
Third Quarter	7,753	6,568	500	2,018	0.44	0.44
Fourth Quarter	8,063	7,017	350	2,024	0.44	0.44



**SOUTHERN MICHIGAN BANCORP, INC.****SELECTED FINANCIAL DATA**

(in thousands, except per share data)

	Year Ended December 31				
	2021	2020	2019	2018	2017
Total interest income	\$ 37,140	\$ 31,818	\$ 32,553	\$ 29,782	\$ 25,351
Net interest income	33,319	26,677	26,126	25,284	22,583
Provision for loan losses	1,500	2,600	225	250	175
Net income	11,757	7,386	8,622	8,125	5,421
Per share data (1):					
Basic earnings per share	2.59	1.61	1.87	1.76	1.15
Cash dividends declared	0.48	0.46	0.46	0.44	0.42
Balance sheet data:					
Gross loans	741,408	635,870	562,864	531,974	523,447
Deposits	974,352	838,298	655,762	605,893	577,144
Subordinated debentures	34,514	5,155	5,155	5,155	5,155
Other borrowings	20,000	26,500	37,500	28,500	39,500
Equity	97,749	92,977	83,345	75,527	70,037
Total assets	1,161,154	997,574	809,716	738,831	712,345
Return on average assets	1.06%	0.82%	1.09%	1.11%	0.80%
Return on average equity (2)	12.32	8.36	10.74	11.21	7.64
Dividend payout ratio (3)	18.60	28.82	24.47	24.87	36.08
Average equity to average assets (2)	8.62	9.80	10.20	9.92	10.52

(1) Per share data for years 2017 – 2020 has been restated for 2021 100% stock dividend.

(2) Average equity in the above table includes common shares subject to a repurchase obligation held in the Company's ESOP plan and includes average, unrealized appreciation or depreciation on securities available-for-sale.

(3) Dividends declared, divided by net income.

**COMMON STOCK MARKET PRICES AND DIVIDENDS**

The Company's common stock is regularly quoted on the OTC Pink under the symbol SOMC. The sale prices described below are quotations reflecting inter-dealer prices without retail markups, markdowns, or commissions; they may not necessarily represent actual transactions. As of March 14, 2022, there were 4,539,744 shares of Southern common stock, issued and outstanding, held by 287 holders of record.

The following table sets forth the range of high and low closing sales prices and dividends declared on the Company's common stock for the two most recent fiscal years:

Quarter Ended	2021			2020		
	Closing Price		Cash Dividends Declared	Closing Price		Cash Dividends Declared
	High	Low		High	Low	
March 31	\$ 19.88	\$ 16.50	\$ 0.12	\$ 19.90	\$ 13.00	\$ 0.11
June 30	21.50	16.88	0.12	15.00	12.53	0.11
September 30	19.95	18.65	0.12	18.25	13.88	0.12
December 31	21.50	19.50	0.12	17.00	14.51	0.12

There are restrictions that currently limit the Company's ability to pay cash dividends. Information regarding dividend payment restrictions is described in Note O to the consolidated financial statements.

# Our Locations

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**Battle Creek Branch**

5350 East Beckley Road  
Battle Creek, MI 49015

**Centreville Branch**

235 East Main Street  
Centreville, MI 49032

**Coldwater Main Office**

51 West Pearl Street  
Coldwater, MI 49036

**Coldwater West Chicago**

2 West Chicago Street  
Coldwater, MI 49036

**Coldwater East Chicago**

*\*Drive Thru Location Only*  
441 East Chicago Street  
Coldwater, MI 49036

**Constantine Branch**

345 North Washington Street  
Constantine, MI 49042

**Hillsdale Branch**

10 East Carleton Road  
Hillsdale, MI 49242

**Marshall Branch**

1110 West Michigan Avenue  
Marshall, MI 49068

**Mendon Branch**

136 North Nottawa Street  
Mendon, MI 49072

**Portage Branch**

531 West Kilgore Road  
Portage, MI 49024

**Portage Trade Centre**

650 Trade Centre Way, Suite 120  
Portage, MI 49002

**Sturgis Branch**

*\*Opening May 2022*  
200 Johns Street  
Sturgis MI, 49091

**Tekonsha Branch**

202 North Main Street  
Tekonsha MI, 49092

**Three Rivers Branch**

225 US 131  
Three Rivers, MI 49093

**Union City Branch**

225 North Broadway Street  
Union City, MI 49094

In addition to our nearby locations, Southern offers a number of convenient branchless banking alternatives:  
Online and Mobile Banking,  
Online Mortgage Applications,  
Telephone Banking, Personal  
Teller Machines (PTMs) & more!

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Scan the QR Code to find  
a location near you:



SOUTHERN MICHIGAN  
**BANCORP, INC.**

51 West Pearl Street | Coldwater, MI 49036 | 517.279.5500 | [www.smb-t.com](http://www.smb-t.com)