

Annual Report 2014



In town. In touch.



In 2004 a group of local business and professional people felt there was a need for a local bank. One that was part of the community. One that understood the unique needs of businesses in this area. Working totally with local investments, 1st State Bank was launched and brought together a team of the region's most experienced business bankers.

The Bank has assembled a management team and board of directors with strong business and banking experience in this region and a shared vision and commitment to the future growth and success of our customers. 1st State Bank has been growing ever since. By providing a full range of personal and business banking services. By being flexible enough to meet the needs of Great Lakes Bay Region businesses and professionals. By being trusted advisors. And by being in town and in touch.

Today, 1st State Bank has two locations in Saginaw and two in Bay City. Our focus remains the same, to be the bank of choice for businesses in the Great Lakes Bay Region.



To Our Shareholders,

For the second year in a row deposit growth greatly exceeded our expectations. Year-over-year deposits grew by \$31.4 million, or just over 20%. Total assets grew \$27.4 million, or 14.5%. This growth allowed us to pay down our maturing long term, higher cost liabilities by 32%. Additionally, we retired \$1 million of preferred shares owned by the Department of Treasury's Small Business Lending Fund. Our plan is to retire the other half of these shares in 2015.

A number of factors contributed to our tremendous deposit growth in 2014. Our Public Funds initiative resulted in a \$9.6 million increase, more than doubling from 2013. Efforts to gain market share in Bay County contributed \$11 million in deposits, or 43% over the previous year. 1st State Bank also benefited from changes made by some of the larger banks in our area, changes that caused people to understand the value of having their relationship with a locally owned and managed bank.

As we grow, we continue to assess our resources. We now have a full year at our newest location on Wilder Road and hired a business banking veteran from Bay City to aid in expanding our reach in Bay County. In November we appointed Mike Hanisko of Bay City to our Board of Directors. Due to continued deposit growth, we added a person to strengthen our deposit operations and project management. Lastly, we have a dedicated person to manage our Public Funds portfolio and Business Charge Cards.

Stock transactions increased in 2014 over prior year from eight trades of 16,309 shares to 15 trades representing 51,201 shares. The average sale price increased from \$9.30 to \$10.06, or 8.2%. Book value at year end 2014 was \$11.48, compared to \$10.80 at year end 2013. Our third party valuation for year end 2014 is \$11.00, versus \$10.75 in 2013.

Net income available to shareholders was \$1,110,000 in 2014, a decrease from 2013's level of \$1,411,000. With the low interest rate environment, 2015 brings similar challenges to profitability as those seen in 2014. We are anticipating a small increase year-over-year. We continue to move ahead with initiatives that position us to better compete in our market. In 2014 we upgraded our Business Charge Cards to offer a Reward Points benefit. In 2015 we will improve our wire transfer service, ACH systems, and our overall business online service. Security measures for debit cards and charge cards will be upgraded with the installation of the EMV chip. 1st State also has plans to offer additional financing options for our business customers such as leasing and equity financing for growing companies and ownership transfers. Watch for progress updates in our quarterly shareholder newsletters throughout 2015.

We are excited about the prospects for the continued success of 1st State Bank.

Sincerely,

A handwritten signature in black ink that reads "Rick Goedert". The signature is written in a cursive, flowing style.

President and CEO

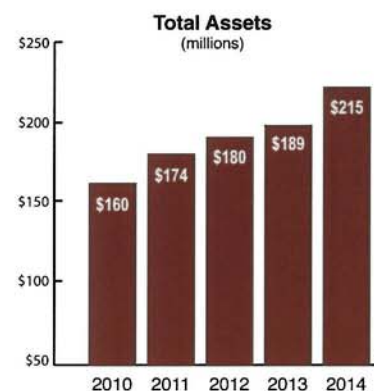
2014 FINANCIAL REPORT

Earnings for Valley Financial Group and 1st State Bank eclipsed the \$1 million mark for the 3rd consecutive year as net income available to shareholders totaled \$1,110,000 in 2014. A challenging rate environment and lower mortgage origination income due to reduced refinance activity, combined with increased expense supporting our growth initiatives in Bay County contributed to the decrease in earnings from 2013. Despite a declining net interest margin due to extended low interest rates, growth in earning assets helped the Company grow net interest income after provision by \$256,000 to \$6,570,000 in 2014. The Company's return on average assets ratio was .57% this year versus .78% in 2013.

The Company grew total assets by 14.5% in 2014. Net loans grew a modest 2.2% in 2014. However, Valley Financial enjoyed significant growth in core deposits. Total deposits increased \$31.4 million or 20.2% this year. As a result, the Company was able to fund \$3.1 million of net loan growth, redeem \$1 million of preferred stock from the Small Business Lending Fund, and reduce other borrowings by \$8.7 million. Current earnings, the redemption of preferred stock, and large growth in total assets contributed to the decrease in the Company's equity to asset ratio to 9.0% from 10.1% in 2013. Please review the Consolidated Selected Financial Data for additional information regarding Valley's financial performance.

CONSOLIDATED BALANCE SHEETS

	12/31/2014	12/31/2013
Assets		
Cash and cash equivalents	\$42,513,217	\$21,404,784
Investments	18,573,386	15,732,308
Loans, net of reserve for loan losses	143,640,032	140,558,512
Premises and equipment, net	7,453,997	7,478,458
Repossessed assets	1,770,646	1,241,638
Other assets	<u>1,896,563</u>	<u>1,988,781</u>
Total Assets	\$215,847,841	\$188,404,481
Liabilities and Shareholders' Equity		
Interest bearing deposits	\$130,484,084	\$115,838,645
Non-interest bearing deposits	55,695,780	38,965,559
FHLB and other borrowings	9,341,788	13,722,837
Other Liabilities	<u>1,121,495</u>	<u>837,314</u>
Total Liabilities	196,643,147	169,364,355
Total Shareholders' Equity	<u>19,204,694</u>	<u>19,040,126</u>
Total Liabilities and Shareholders' Equity	\$215,847,841	\$188,404,481



CONSOLIDATED STATEMENTS OF INCOME

	Year ended December 31	
	2014	2013
Interest Income	\$7,959,219	\$8,054,760
Interest Expense	<u>1,079,440</u>	<u>1,365,267</u>
Net Interest Income	6,879,779	6,689,493
Provision for loan losses	<u>310,000</u>	<u>375,000</u>
Net Interest Income After Provision for Loan Losses	6,569,779	6,314,493
Other Income	794,081	1,024,176
Other Expense	<u>5,637,608</u>	<u>5,183,888</u>
Net Income Before Federal Income Tax	1,726,252	2,154,781
Federal income tax expense	<u>596,800</u>	<u>724,000</u>
Net Income	<u>\$1,129,452</u>	<u>\$1,430,781</u>
Preferred Stock Dividends	18,972	20,000
Net Income Available to Common Shareholders	<u>\$1,110,480</u>	<u>\$1,410,781</u>

