

FENTURA FINANCIAL INC

Form 10-Q

August 13, 2010

Table of Contents

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

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2010

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE EXCHANGE ACT
For the transition period from _____ to _____
Commission file number 000-23550
Fentura Financial, Inc.
(Exact name of registrant as specified in its charter)

Michigan

38-2806518

(State or other jurisdiction of
incorporation or organization)

(IRS Employee Identification No.)

175 N Leroy, P.O. Box 725, Fenton, Michigan 48430

(Address of Principal Executive Offices)

(810) 629-2263

(Registrant's telephone number)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files.) Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting
company

(Do not check if a smaller
reporting company)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: July 22, 2010

Class Common Stock

Shares Outstanding 2,276,441

**Fentura Financial Inc.
Index to Form 10-Q**

| | Page |
|---|-------------|
| <u>Part I Financial Information</u> | 3 |
| <u>Item 1 Consolidated Financial Statements (Unaudited)</u> | 3-25 |
| <u>Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 26-38 |
| <u>Item 3 Quantitative and Qualitative Disclosures about Market Risk</u> | 38-40 |
| <u>Item 4T Controls and Procedures</u> | 40 |
| <u>Part II Other Information</u> | 41 |
| <u>Item 1 Legal Proceedings</u> | 41 |
| <u>Item 1A Risk Factors</u> | 41 |
| <u>Item 2 Unregistered Sales of Equity Securities and Use of Proceeds</u> | 41 |
| <u>Item 3 Defaults Upon Senior Securities</u> | 41 |
| <u>Item 4 [Reserved]</u> | 41 |
| <u>Item 5 Other Information</u> | 41 |
| <u>Item 6 Exhibits</u> | 41 |
| <u>Signatures</u> | 42 |
| <u>Exhibit Index</u> | 43 |
| <u>EX-31.1</u> | |
| <u>EX-31.2</u> | |
| <u>EX-32.1</u> | |
| <u>EX-32.2</u> | |

Table of Contents

PART I FINANCIAL INFORMATION
ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS
FENTURA FINANCIAL, INC.
CONSOLIDATED BALANCE SHEETS
(000s omitted except share and per share data)

| | June 30, 2010 (unaudited) | Dec 31, 2009 |
|--|--|-------------------------|
| ASSETS | | |
| Cash and due from banks | \$ 15,535 | \$ 18,459 |
| Federal funds sold | 28,050 | 23,650 |
| Total cash & cash equivalents | 43,585 | 42,109 |
| Securities-available for sale | 45,604 | 43,608 |
| Securities-held to maturity, (fair value of \$4,744 at June 30, 2010 and \$5,493 at December 31, 2009) | 4,697 | 5,456 |
| Total securities | 50,301 | 49,064 |
| Loans held for sale | 1,259 | 831 |
| Loans: | | |
| Commercial | 244,672 | 252,764 |
| Real estate loans construction | 17,578 | 26,295 |
| Real estate loans mortgage | 24,465 | 28,058 |
| Consumer loans | 43,567 | 48,313 |
| Total loans | 330,282 | 355,430 |
| Less: Allowance for loan losses | (14,227) | (10,726) |
| Net loans | 316,055 | 344,704 |
| Bank owned life insurance | 7,318 | 7,221 |
| Bank premises and equipment | 15,471 | 15,914 |
| Federal Home Loan Bank stock | 1,900 | 1,900 |
| Accrued interest receivable | 1,743 | 1,813 |
| Other real estate owned | 7,948 | 7,967 |
| Assets of discontinued operations | 0 | 37,919 |
| Other assets | 9,710 | 12,637 |
| Total assets | \$ 455,290 | \$ 522,079 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Deposits: | | |
| Non-interest bearing deposits | \$ 69,955 | \$ 64,530 |
| Interest bearing deposits | 341,429 | 376,245 |
| Total deposits | 411,384 | 440,775 |
| Short term borrowings | 10 | 164 |
| Federal Home Loan Bank advances | 7,954 | 7,981 |

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| | | |
|--|-------------------|-------------------|
| Subordinated debentures | 14,000 | 14,000 |
| Liabilities of discontinued operations | 0 | 35,217 |
| Accrued taxes, interest and other liabilities | 4,047 | 3,410 |
| Total liabilities | 437,395 | 501,547 |
| Shareholders' equity | | |
| Common stock - no par value 2,276,441 shares issued (2,248,553 at December 31, 2009) | 42,974 | 42,913 |
| Retained deficit | (24,920) | (21,657) |
| Accumulated other comprehensive loss | (159) | (724) |
| Total shareholders' equity | 17,895 | 20,532 |
| Total liabilities and shareholders' equity | \$ 455,290 | \$ 522,079 |

See notes to consolidated financial statements

3

Table of Contents

FENTURA FINANCIAL, INC.
CONSOLIDATED STATEMENTS OF INCOME (Unaudited)
(000s omitted except per share data)

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|----------------|------------------|-----------------|
| | June 30 | | June 30 | |
| | 2010 | 2009 | 2010 | 2009 |
| Interest income | | | | |
| Interest and fees on loans | \$ 5,200 | \$ 6,000 | \$ 10,506 | \$ 12,463 |
| Interest and dividends on securities: | | | | |
| Taxable | 297 | 390 | 589 | 809 |
| Tax-exempt | 104 | 138 | 228 | 283 |
| Interest on federal funds sold | 10 | 0 | 15 | 0 |
| Total interest income | 5,611 | 6,528 | 11,338 | 13,555 |
| Interest expense | | | | |
| Deposits | 1,594 | 2,613 | 3,411 | 5,226 |
| Borrowings | 198 | 291 | 395 | 602 |
| Total interest expense | 1,792 | 2,904 | 3,806 | 5,828 |
| Net interest income | 3,819 | 3,624 | 7,532 | 7,727 |
| Provision for loan losses | 3,619 | 7,711 | 5,409 | 9,366 |
| Net interest income after provision for loan losses | 200 | (4,087) | 2,123 | (1,639) |
| Non-interest income | | | | |
| Service charges on deposit accounts | 403 | 480 | 877 | 917 |
| Gain on sale of mortgage loans | 135 | 277 | 228 | 512 |
| Trust and investment services income | 338 | 463 | 727 | 827 |
| Gain on sale of securities | 75 | 0 | 75 | 0 |
| Loss on equity investment | 0 | (874) | 0 | (1,360) |
| Other income and fees | 607 | 480 | 998 | 1,069 |
| Total non-interest income | 1,558 | 826 | 2,905 | 1,965 |
| Non-interest expense | | | | |
| Salaries and employee benefits | 2,063 | 2,071 | 4,178 | 4,623 |
| Occupancy | 431 | 447 | 880 | 950 |
| Furniture and equipment | 386 | 403 | 757 | 827 |
| Loan and collection | 433 | 933 | 990 | 1,318 |
| Advertising and promotional | 45 | 47 | 73 | 88 |
| Loss on security impairment | 0 | 200 | 0 | 200 |
| Other operating expenses | 1,012 | 1,211 | 2,059 | 2,441 |
| Total non-interest expense | 4,370 | 5,312 | 8,937 | 10,447 |
| Loss from continuing operations before income tax | (2,612) | (8,573) | (3,909) | (10,121) |
| Federal income tax/(benefit) | 53 | 5,952 | (274) | 5,360 |

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| | | | | |
|---|------------|-------------|------------|-------------|
| Net loss from continuing operations | \$ (2,665) | \$ (14,525) | \$ (3,635) | \$ (15,481) |
| Net income/(loss) from discontinued operations, net of tax | (115) | (839) | 372 | (1,542) |
| Net loss | \$ (2,780) | \$ (15,364) | \$ (3,263) | \$ (17,023) |
| Loss per share from continuing operations Basic and diluted | \$ (1.16) | \$ (6.61) | \$ (1.61) | \$ (7.06) |
| Income/(loss) per share from discontinued operations Basic and diluted | \$ (0.07) | \$ (0.38) | \$ 0.17 | \$ (0.71) |
| Net loss per share Basic and diluted | \$ (1.23) | \$ (6.99) | \$ (1.44) | \$ (7.77) |
| Cash Dividends declared | \$ 0.00 | \$ 0.00 | \$ 0.00 | \$ 0.00 |

See notes to consolidated financial statements.

Table of Contents

Fentura Financial, Inc.
Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

| (000s omitted) | Six Months Ended June 30, | |
|--|--------------------------------------|-------------|
| | 2010 | 2009 |
| Common Stock | | |
| Balance, beginning of period | \$ 42,913 | \$ 42,778 |
| Issuance of shares under Director stock purchase plan & Dividend reinvestment program (27,888 and 23,418 shares) | 61 | 72 |
| Balance, end of period | 42,974 | 42,850 |
| Retained Deficit | | |
| Balance, beginning of period | (21,657) | (4,677) |
| Net loss | (3,263) | (17,023) |
| Balance, end of period | (24,920) | (21,700) |
| Accumulated Other Comprehensive Loss | | |
| Balance, beginning of period | (724) | (1,977) |
| Change in unrealized loss on securities, net of tax | 565 | 37 |
| Balance, end of period | (159) | (1,940) |
| Total shareholders' equity | \$ 17,895 | \$ 19,210 |

See notes to consolidated financial statements.

Table of Contents

Fentura Financial, Inc.
Consolidated Statements of Cash Flows (Unaudited)

| (000s omitted) | Six Months Ended June 30, | |
|--|--------------------------------------|-------------|
| | 2010 | 2009 |
| OPERATING ACTIVITIES: | | |
| Net loss | \$ (3,263) | \$ (17,023) |
| Adjustments to reconcile net loss to cash Provided by Operating Activities: | | |
| Depreciation and amortization | 266 | 581 |
| Establishment of deferred tax asset valuation allowance | 0 | 6,617 |
| Provision for loan losses | 5,409 | 9,366 |
| Loans originated for sale | (13,821) | (42,302) |
| Proceeds from the sale of loans | 13,621 | 42,368 |
| Gain on sales of loans | (228) | (512) |
| Loss on sale of other real estate owned | 37 | 200 |
| Loss on security impairment | 0 | 200 |
| Loss on equity investment | 0 | 1,360 |
| Gain on sale of securities | (75) | 0 |
| Earnings from bank owned life insurance | (97) | (103) |
| Net (increase) decrease in interest receivable & other assets | 2,706 | 4,911 |
| Net increase (decrease) in interest payable & other liabilities | 637 | (4,079) |
| Net change in discontinued operations operating activities | 806 | 3,120 |
| Total Adjustments | 9,261 | 21,727 |
| Net cash provided by/(used in) operating activities | 5,998 | 4,704 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from maturities of securities HTM | 575 | 1,108 |
| Proceeds from maturities of securities AFS | 5,577 | 4,726 |
| Proceeds from calls of securities HTM | 380 | 0 |
| Proceeds from calls of securities AFS | 3,500 | 2,000 |
| Proceeds from sales of securities AFS | 7,105 | 0 |
| Proceeds from sales of equity securities | 5 | 0 |
| Purchases of securities AFS | (17,156) | (10,646) |
| Proceeds from sale of bank subsidiary | 1,900 | 0 |
| Net decrease in loans | 20,907 | 23,466 |
| Proceeds from bank owned life insurance | 0 | 297 |
| Sales of other real estate owned | 2,315 | 865 |
| Acquisition of premises and equipment, net | (115) | (71) |
| Net change in discontinued operations investing activities | (548) | 304 |
| Net cash provided by investing activities | 24,445 | 22,049 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net increase (decrease) in deposits | (29,391) | 9,711 |
| Net (decrease) in short term borrowings | (154) | (1,023) |
| Repayment of notes payable | 0 | (250) |

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| | | |
|--|-----------|-----------|
| Purchase of advances from FHLB | 0 | 55,495 |
| Repayments of advances from FHLB | (27) | (58,221) |
| Net proceeds from stock issuance and purchase | 61 | 72 |
| Net change in discontinued operations financing activities | 544 | (2,518) |
| Net cash provided by (used in) financing activities | (28,967) | 3,266 |
| Net change in cash and cash equivalents | \$ 1,476 | \$ 30,019 |
| Cash and cash equivalents Beginning | 42,109 | 13,626 |
| Cash and cash equivalents Ending | \$ 43,585 | \$ 43,645 |
| Less cash and cash equivalents of discontinued operations | 0 | 2,569 |
| Cash and cash equivalents of continuing operations | \$ 43,585 | \$ 41,076 |

Table of Contents

Fentura Financial, Inc.
Consolidated Statements of Cash Flows (Unaudited)

| (000s omitted) | Six Months Ended June 30 | |
|--|-----------------------------|----------|
| | 2010 | 2009 |
| Cash paid for: | | |
| Interest | \$ 3,677 | \$ 5,655 |
| Income taxes | \$ 0 | \$ 3,715 |
| Non-cash Disclosures: | | |
| Transfers from loans to other real estate | \$ 2,333 | \$ 750 |
| See notes to consolidated financial statements | | |

Fentura Financial, Inc.
Consolidated Statements of Comprehensive Income (Unaudited)

| (000s omitted) | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|-------------|------------------------------|-------------|
| | 2010 | 2009 | 2010 | 2009 |
| Net loss | \$ (2,780) | \$ (15,364) | \$ (3,263) | \$ (17,023) |
| Other comprehensive income (loss), net of tax: | | | | |
| Unrealized holding gains (losses) arising during period | 669 | 1,038 | 856 | 56 |
| Tax effect | (266) | (353) | (291) | (19) |
| Other comprehensive income (loss) | 403 | 685 | 565 | 37 |
| Comprehensive loss | \$ (2,377) | \$ (14,679) | \$ (2,698) | \$ (16,986) |

Fentura Financial, Inc.
Notes to Consolidated Financial Statements (Unaudited)

NOTE 1 BASIS OF PRESENTATION

The consolidated financial statements at December 31, 2009, June 30, 2009 and June 30, 2010 include Fentura Financial, Inc. (the Corporation) and its wholly owned subsidiaries, The State Bank in Fenton, Michigan and West Michigan Community Bank in Hudsonville, Michigan (the Banks), as well as West Michigan Mortgage Company, LLC, and the other subsidiaries of the Banks. Intercompany transactions and balances are eliminated in consolidation. On March 17, 2009, The Corporation entered into an agreement to sell all of the stock of one of its bank subsidiaries, Davison State Bank, to a private, non-affiliated, investor group. The Corporation recorded an estimated loss on the sale of Davison State Bank of \$700,000 in the first quarter of 2009. As a result of the amended sales agreement, the estimated loss of \$700,000 was reversed in the first quarter of 2010. On April 30, 2010, the sale of Davison State Bank closed and the assets and liabilities were transferred to the investor group. As a result of the timing of the sale, held for sale operations reflect one month of income on the income statement for the current quarter. Financial statements are presented with discontinued operations sequestered on the balance sheet and income statement. The presentations have been updated for June 30, 2010, December 31, 2009 and June 30, 2009 to reflect the discontinued operations results.

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all

Table of Contents**NOTE 1 BASIS OF PRESENTATION (continued)**

of the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the six months ended June 30, 2010 are not necessarily indicative of the results that may be expected for the year ending December 31, 2010. For further information, refer to the consolidated financial statements and footnotes thereto included in the Corporation's annual report on Form 10-K for the year ended December 31, 2009.

Reclassifications

Some items in the prior year financial statements were reclassified to conform to the current presentation. For the six month period ending June 30, 2009, a \$700,000 impairment charge on discontinued operations was reclassified in the prior year presentation from non-interest expense of continuing operations to discontinued operations. This reclassification reduced the loss from continuing operations by \$700,000, net of tax, and had no impact on net income.

Securities: Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Securities are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of tax.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method without anticipating prepayments, except for mortgage-backed securities, where prepayments are anticipated. Gains and losses on sales are based on the amortized cost of the security sold. Securities are written down to fair value when a decline in fair value is not temporary.

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation.

In determining OTTI management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

When OTTI occurs, the amount of the OTTI recognized in earnings depends on whether an entity intends to sell the security or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss. If an entity intends to sell or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the OTTI shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of the total OTTI related to other factors is recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings becomes the new amortized cost basis of the investment.

Table of Contents

NOTE 1 BASIS OF PRESENTATION (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 less recoveries. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, 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.

A loan is impaired when full payment under the loan terms is not expected. Impairment is evaluated in total for smaller-balance loans of similar nature such as residential mortgage, consumer, and on an individual loan basis for other loans. If a loan is 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 existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosures. Loans for which the terms have been modified and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and are classified as impaired. Troubled debt restructurings are measured at the present value of estimated future cash flows using the loans effective rate at inception.

Other Real Estate Owned and Foreclosed Assets: Assets acquired through or instead of loan foreclosure are initially recorded at fair value less estimated selling costs when acquired, establishing a new cost basis. If fair value declines, a valuation allowance is recorded through expense. Costs after acquisition are expensed.

Income Taxes

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

The Corporation recognizes interest and/or penalties related to income tax matters in income tax expense.

There were no unrecognized tax benefits at June 30, 2010 or December 31, 2009, and the Corporation does not expect the total amount of unrecognized tax benefits to significantly increase in the next twelve months.

Dividend Restriction

Banking regulations require maintaining certain capital levels and may limit the dividends paid by the Banks to the Corporation or by the Corporation to shareholders. West Michigan Community Bank and The State Bank have been restricted from dividend payments due to the signing of Consent Orders with the Federal Deposit Insurance Corporation (FDIC).

Stock Option Plans

The Nonemployee Director Stock Option Plan provides for granting options to nonemployee directors to purchase the Corporation's common stock. The purchase price of the shares is the fair market value at the date of the grant, and there is a three-year vesting period before options may be exercised. Options to acquire no more than 8,131 shares of stock may be granted under the Plan in any calendar year and options to acquire not more than 73,967 shares in the aggregate may be outstanding at any one time. No options have been granted in 2010 or 2009.

Table of Contents**NOTE 1 BASIS OF PRESENTATION (continued)**

The Employee Stock Option Plan grants options to eligible employees to purchase the Corporation's common stock at or above, the fair market value of the stock at the date of the grant. Awards granted under this plan are limited to an aggregate of 86,936 shares. The administrator of the plan is a committee of directors. The administrator has the power to determine the number of options to be granted, the exercise price of the options and other terms of the options, subject to consistency with the terms of the Plan.

The fair value of each option award is estimated on the date of grant using a closed form option valuation (Black-Scholes) model. Expected volatilities are based on historical volatilities of the Corporation's common stock. The Corporation uses historical data to estimate option exercise and post-vesting termination behavior. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. Shares that are issued upon option exercise come from authorized but unissued shares.

The following table summarizes stock option activity:

| | Number of Options | Weighted Average Price |
|--|----------------------------------|---------------------------------------|
| Options outstanding at December 31, 2009 | 20,297 | \$ 29.55 |
| Options granted 2010 | 0 | \$ 0.00 |
| Options forfeited 2010 | (3,542) | \$ 25.04 |
| Options outstanding and exercisable at June 30, 2010 | 16,755 | \$ 30.51 |

Going Concern

As a result of the Corporation's net losses and non-compliance with the higher capital requirements of the Consent Orders, our auditors added an explanatory paragraph to their opinion on the Corporation's December 31, 2009 consolidated financial statements, expressing substantial doubt about the Corporation's ability to continue as a going concern. In 2010, the Banks have come in to compliance with substantially all areas of the Consent Orders, except for capital requirements. Management's strategies to improve profitability and to meet the capital requirements of the Consent Orders, discussed in Note 10, include shrinking assets, reducing costs, and sales of subsidiary banks. The capital positions of the Banks have improved as of June 30, 2010. The sale of Davison State Bank, which closed on April, 30, 2010, generated \$2.8 million, of which a portion was reinvested in The State Bank. On April 27, 2010, an agreement was signed for the sale of West Michigan Community Bank which is expected to generate additional capital to strengthen The State Bank. See Note 11 for details regarding the definitive agreement to sell West Michigan Community Bank.

These financial statements do not include any adjustments that might be necessary if the Corporation is unable to continue as a going concern.

NOTE 2 ADOPTION OF NEW ACCOUNTING STANDARDS**New Accounting Pronouncements:**

In June 2009, the FASB amended previous guidance relating to transfers of financial assets and eliminates the concept of a qualifying special purpose entity. This guidance must be applied as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. This guidance must be applied to transfers occurring on or after the effective date. Additionally, on and

Table of Contents**NOTE 2 ADOPTION OF NEW ACCOUNTING STANDARDS (continued)**

after the effective date, the concept of a qualifying special-purpose entity is no longer relevant for accounting purposes. Therefore, formerly qualifying special-purpose entities should be evaluated for consolidation by reporting entities on and after the effective date in accordance with the applicable consolidation guidance. The disclosure provisions were also amended and apply to transfers that occurred both before and after the effective date of this guidance. The effect of adopting this new guidance was not material to the Corporation.

In June 2009, the FASB amended guidance for consolidation of variable interest entity guidance by replacing the quantitative-based risks and rewards calculation for determining which enterprise, if any, has a controlling financial interest in a variable interest entity with an approach focused on identifying which enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance and (1) the obligation to absorb losses of the entity or (2) the right to receive benefits from the entity. Additional disclosures about an enterprise's involvement in variable interest entities are also required. This guidance is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Early adoption is prohibited. The effect of adopting this new guidance was not material to the Corporation.

NOTE 3 SECURITIES

Securities are as follows:

| (000s omitted) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|-------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| Available for Sale | | | | |
| June 30, 2010 | | | | |
| U.S. Government & federal agency | \$ 8,715 | \$ 44 | \$ 0 | \$ 8,759 |
| State and municipal | 901 | 12 | 0 | 913 |
| Mortgage-backed residential | 12,947 | 306 | 0 | 13,253 |
| Collateralized mortgage obligations | 21,324 | 367 | (524) | 21,167 |
| Equity securities | 1,956 | 45 | (489) | 1,512 |
| | \$ 45,843 | \$ 774 | \$ (1,013) | \$ 45,604 |
| December 31, 2009 | | | | |
| U.S. Government & federal agency | \$ 6,543 | \$ 38 | \$ (67) | \$ 6,514 |
| State and municipal | 7,034 | 102 | (41) | 7,095 |
| Mortgage-backed residential | 13,482 | 298 | 0 | 13,780 |
| Collateralized mortgage obligations | 15,369 | 199 | (878) | 14,690 |
| Equity securities | 1,971 | 21 | (463) | 1,529 |
| | \$ 44,399 | \$ 658 | \$ (1,449) | \$ 43,608 |

Table of Contents**NOTE 3 SECURITIES (continued)**

| (000s omitted) | Amortized Cost | Gross Unrecognized Gains | Gross Unrecognized Losses | Fair Value |
|-----------------------------|-------------------|--------------------------------|---------------------------------|---------------|
| Held to Maturity | | | | |
| June 30, 2010 | | | | |
| State and municipal | \$ 4,697 | \$ 52 | \$ (5) | \$ 4,744 |
| December 31, 2009 | | | | |
| State and municipal | \$ 5,455 | \$ 55 | \$ (18) | \$ 5,492 |
| Mortgage-backed residential | 1 | 0 | 0 | 1 |
| | \$ 5,456 | \$ 55 | \$ (18) | \$ 5,493 |

The amortized cost and fair value of the securities portfolio are shown by expected maturity. Expected maturities may differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Contractual maturities of securities at June 30, 2010 were as follows:

| (000s omitted) | Amortized Cost | Available for Sale Fair Value |
|-------------------------------------|-------------------|-------------------------------------|
| Due in one year or less | \$ 9,616 | \$ 9,672 |
| Due from one to five years | 0 | 0 |
| Due from five to ten years | 0 | 0 |
| Mortgage-backed securities | 12,947 | 13,253 |
| Collateralized mortgage obligations | 21,324 | 21,167 |
| Equity securities | 1,956 | 1,512 |
| | \$ 45,843 | \$ 45,604 |

| (000s omitted) | Amortized Cost | Held to Maturity Fair Value |
|----------------------------|-------------------|-----------------------------------|
| Due in one year or less | \$ 2,616 | \$ 2,624 |
| Due from one to five years | 2,081 | 2,120 |
| Due from five to ten years | 0 | 0 |
| Due after ten years | 0 | 0 |
| | \$ 4,697 | \$ 4,744 |

At June 30, 2010, there were 2 private label CMO securities, with holdings totaling \$4,175,000, which exceeded 10% of shareholders' equity. At June 30, 2009, there were no holdings of securities of any one issuer, other than the U.S. Government and its agencies, in an amount greater than 10% of shareholders' equity.

For the six months ended June 30, 2010, the Corporation sold 19 securities with a net gain of \$75,000. For the six months ended June 30, 2009 the Corporation did not sell securities and therefore had no gain or loss on securities.

Securities with unrealized losses at June 30, 2010 and December 31, 2009, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position are as follows:

12

Table of Contents**NOTE 3 SECURITIES (continued)
2010**

| (000s omitted) | Less than 12 Months | | 12 Months or More | | Fair Value | Total Unrealized Loss |
|-------------------------------------|---------------------|-----------------|-------------------|-----------------|------------|-----------------------|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | | |
| Collateralized mortgage obligations | 0 | 0 | 4,854 | (524) | 4,854 | (524) |
| Equity securities | 0 | 0 | 717 | (489) | 717 | (489) |
| Total temporarily impaired | \$ 0 | \$ 0 | \$ 5,571 | \$ (1,013) | \$ 5,571 | \$ (1,013) |

2009

| (000s omitted) | Less than 12 Months | | 12 Months or More | | Fair Value | Total Unrealized Loss |
|-------------------------------------|---------------------|-----------------|-------------------|-----------------|------------|-----------------------|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | | |
| US Government & federal agency | \$ 3,475 | \$ (67) | \$ 0 | \$ 0 | \$ 3,475 | \$ (67) |
| State & municipal | 497 | (18) | 659 | (41) | 1,156 | (59) |
| Collateralized mortgage obligations | 0 | 0 | 4,872 | (878) | 4,872 | (878) |
| Equity securities | 0 | 0 | 1,009 | (463) | 1,009 | (463) |
| Total temporarily impaired | \$ 3,972 | \$ (85) | \$ 6,540 | \$ (1,382) | \$ 10,512 | \$ (1,467) |

Other-Than-Temporary-Impairment

Management evaluates securities for other-than-temporary impairment (OTTI) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. In evaluating OTTI, management considers the factors presented in Note 1.

As of June 30, 2010, the Corporation's security portfolio consisted of 109 securities, 13 of which were in an unrealized loss position. All unrealized losses are related to the Corporation's collateralized mortgage obligations (CMOs) and equity securities, as discussed below.

Credit losses recognized in earnings on debt securities totaled \$288,000 at December 31, 2009 and there were no additional OTTI losses recognized through earnings during the period ending June 30, 2010.

Collateralized Mortgage Obligations (CMOs)

Gross unrealized losses relating to collateralized mortgage obligation securities were \$524,000 at June 30, 2010. The decline in fair value is primarily attributable to temporary illiquidity and the financial crisis affecting these markets and not necessarily the expected cash flows of the individual securities. These investments consist of three private label securities with an amortized cost of \$5.3 million. The ratings held on the private label securities are AA, A- and CCC. The Corporation has been closely monitoring the performance of the CMO portfolio. In 2009, there were several CMOs that were downgraded in the market. The underlying collateral of these CMOs is comprised largely of 1-4 family residences. In each of these securities, the Corporation lies in the senior tranche and receives payments before other tranches. For private label securities, management completes an analysis to review the recent performance of the mortgage pools underlying the instruments. On a quarterly basis, management reviews historical and projected payment streams, delinquency ratios, geographic distribution, ratings, projected future cash flows and general market conditions. Management uses multiple assumptions to project the expected future cash flows of the private label CMOs, which include prepayment speeds, projected default rates and loss severity rates. The cash flows are then discounted using the effective rate on the securities determined at acquisition. Recent historical experience is

the base for determining the cash flow assumptions and are adjusted when appropriate after considering characteristics of the underlying loans collateralizing the private label CMO security. As a result of its review, in the fourth quarter of 2009, the

Table of Contents**NOTE 3 SECURITIES (continued)**

Corporation recognized a \$79,000 other-than-temporary impairment as a result of incurred credit losses which was reflected in the income statement. The security with the credit loss is the Corporation's sole CCC rated security and has a remaining amortized cost of \$691,000 at June 30, 2010. The remaining unrealized loss of \$207,000 on this security has been reflected in accumulated other comprehensive loss. Following the June 30, 2010 analysis, management's review did not indicate any additional OTTI on these securities.

Equity securities

The Corporation also holds investments in equity securities which had gross unrealized losses of \$489,000 at June 30, 2010. The majority of the equity securities are investments into bank holding companies within Michigan. On a quarterly basis, management reviews the Corporation's investment in these equity securities. Management reviews current market prices on publicly traded equity securities and compares the current price to the book price. Any difference is adjusted as a temporary valuation difference, unless other resources provide other information. Equity securities that are not publicly traded receive a multi-faceted review utilizing call report data. Management reviews such performance indicators as earnings, ROE, ROA, non-performing assets, brokered deposits and capital ratios. Management draws conclusions from this information, as well as any published information or trading activity received from the individual institutions, to assist in determining if a temporary valuation adjustment is warranted. The equity securities portfolio has an amortized cost of \$1,956,000. Currently, the equity securities have a net unrecognized loss of \$444,000, for a fair value of \$1,512,000. The performance of the bank holding companies remained relatively stable thus far in 2010. As a result, no OTTI was recognized during the quarter as management anticipates improved performance of these institutions as economic conditions stabilize.

NOTE 4 LOANS AND ALLOWANCE FOR LOAN LOSSES

Major categories of loans at June 30, 2010 and December 31, 2009, are as follows:

| (000s omitted) | June 30, 2010 | December 31, 2009 |
|--------------------------------|------------------|----------------------|
| Commercial | \$ 83,004 | \$ 81,425 |
| Real estate commercial | 161,668 | 171,339 |
| Real estate construction | 17,578 | 26,295 |
| Real estate mortgage | 24,465 | 28,058 |
| Consumer | 43,567 | 48,313 |
| | 330,282 | 355,430 |
| Less allowance for loan losses | 14,227 | 10,726 |
| | \$ 316,055 | \$ 344,704 |

The Corporation has originated primarily residential and commercial real estate loans, commercial, and installment loans. Construction lending has curtailed given the present economy. The Corporation estimates that the majority of their loan portfolio is based in Genesee, Oakland and Livingston counties within southeast Michigan; in Kent and Ottawa counties in west Michigan, with the remainder of the portfolio distributed throughout Michigan. The ability of the Corporation's debtors to honor their contracts is dependent upon the real estate and general economic conditions in these areas.

Table of Contents**NOTE 4 LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)**

Activity in the allowance for loan losses, for the six month periods ended June 30, 2010 and June 30, 2009 is as follows:

| (000s omitted) | June 30, 2010 | June 30, 2009 |
|---------------------------|------------------|------------------|
| Balance, January 1, | \$ 10,726 | \$ 10,455 |
| Provision for loan losses | 5,409 | 9,366 |
| Loans charged off | (2,646) | (5,958) |
| Loan recoveries | 738 | 107 |
| Balance, end of period | \$ 14,227 | \$ 13,970 |

Activity in the allowance for loan losses, for the three month periods ended June 30, 2010 and June 30, 2009 is as follows:

| (000s omitted) | June 30, 2010 | June 30, 2009 |
|---------------------------|------------------|------------------|
| Balance, January 1, | \$ 12,338 | \$ 11,405 |
| Provision for loan losses | 3,619 | 7,711 |
| Loans charged off | (1,863) | (5,194) |
| Loan recoveries | 133 | 48 |
| Balance, end of period | \$ 14,227 | \$ 13,970 |

Loan impairment is measured by valuing the underlying collateral or by estimating the expected future cash flows and discounting them at the respective effective interest rate.

The recorded investment in these loans is as follows:

| (000s omitted) | June 30, 2010 | December 31, 2009 |
|---|------------------|----------------------|
| Period end loans not requiring allocation | \$ 14,329 | \$ 15,874 |
| Period end loans requiring allocation | 25,278 | 23,059 |
| | \$ 39,607 | \$ 38,933 |
| Amount of the allowance for loan losses allocated | \$ 8,105 | \$ 5,683 |

Non-accrual loans and loans past due 90 days still on accrual were as follows:

| (000s omitted) | June 30, 2010 | December 31, 2009 |
|--|------------------|----------------------|
| Loans past due over 90 days still on accrual | \$ 1,673 | \$ 319 |
| Renegotiated loans | 2,324 | 3,822 |
| Non-accrual loans | 16,661 | 16,507 |

Non-accrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

NOTE 5 FAIR VALUE

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values.

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Table of Contents

NOTE 5 FAIR VALUE (continued)

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data. Securities classified as available for sale are generally reported at fair value utilizing Level 2 inputs where the Corporation obtains fair value measurements from an independent pricing service which uses matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows and the bonds' terms and conditions, among other things. The fair value of the Corporation's equity securities, which primarily consists of the common stock in other Michigan bank holding companies, is based on the prices of recent stock trades and is considered Level 2 because these stocks are not actively traded in public markets (Level 2 inputs).

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing and asset or liability.

The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). The remaining fair values of securities (Level 3 inputs) are based on the reporting entity's own assumptions and basic knowledge of market conditions and individual investment performance.

Impaired Loans: The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Other Real Estate Owned: Non-recurring adjustments to certain commercial and residential real estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

Table of Contents**NOTE 5 FAIR VALUE (continued)**Assets Measured on a Recurring Basis

Assets measured at fair value on a recurring basis are summarized below:

| | Total | Fair Value Measurements Using Significant | | |
|-------------------------------------|-----------|--|-----------------------------------|---|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| (000s omitted) | | | | |
| June 30, 2010 | | | | |
| Available for sale securities | | | | |
| US Government and federal agency | \$ 8,759 | \$ 0 | \$ 8,759 | \$ 0 |
| State and municipal | 913 | 0 | 913 | 0 |
| Mortgage-backed residential | 13,253 | 0 | 13,253 | 0 |
| Collateralized mortgage obligations | 21,167 | 0 | 21,167 | 0 |
| Equity securities | 1,512 | 7 | 1,505 | 0 |
| | \$ 45,604 | \$ 7 | \$ 45,597 | \$ 0 |

| | Total | Fair Value Measurements Using Significant | | |
|-------------------------------------|-----------|--|-----------------------------------|---|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| (000s omitted) | | | | |
| December 31, 2009 | | | | |
| Available for sale securities | | | | |
| US Government and federal agency | \$ 6,514 | \$ 0 | \$ 6,514 | \$ 0 |
| State and municipal | 7,095 | 0 | 7,095 | 0 |
| Mortgage-backed residential | 13,780 | 0 | 13,780 | 0 |
| Collateralized mortgage obligations | 14,690 | 0 | 14,690 | 0 |
| Equity securities | 1,529 | 18 | 1,511 | 0 |
| | \$ 43,608 | \$ 18 | \$ 43,590 | \$ 0 |

The table below presents a reconciliation and income statement classification of gains and losses for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the six months ended June 30, 2009. The Corporation did not hold any Level 3 assets during 2010.

Fair Value Measurements Using Significant

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| (000s omitted) | Unobservable Inputs (Level 3) | | Total |
|---|----------------------------------|-----------|----------|
| | Asset | Liability | |
| Beginning balance, Jan. 1, 2009 | \$ 1,229 | \$ 0 | \$ 1,229 |
| Total gains or losses (realized / unrealized) Included in earnings | | | |
| Loss on security impairment | 200 | 0 | 200 |
| Included in other comprehensive income | (356) | 0 | (356) |
| Purchases, issuances, and settlements | | | |
| Transfers in and / or out of Level 3 | (1,385) | 0 | (1,385) |
| Ending balance, June 30, 2009 | \$ 0 | \$ 0 | \$ 0 |

Table of Contents**NOTE 5 FAIR VALUE (continued)**Assets Measured on a Non-Recurring Basis

Assets measured at fair value on a non-recurring basis are summarized below:

| (000s omitted) | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|-------------------------|-----------|--|------|---|--|
| | | | | | |
| At June 30, 2010 | | | | | |
| Impaired loans | \$ 17,355 | \$ 0 | \$ 0 | \$ 17,355 | |
| Other real estate owned | 540 | 0 | 0 | 540 | |
| At December 31, 2009 | | | | | |
| Impaired loans | \$ 17,376 | \$ 0 | \$ 0 | \$ 17,376 | |
| Other real estate owned | 1,274 | 0 | 0 | 1,274 | |

The following represent impairment charges recognized during the period:

At June 30, 2010, impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a principal amount of \$25,278,000 with a valuation allowance of \$8,105,000 resulting in an additional provision for loan losses of \$2,580,000 for the three month period, and \$3,010,000 for the six month period, ending June 30, 2010. This is compared to December 31, 2009 when the principal amount of impaired loans was \$23,059,000 with a valuation allowance of \$5,683,000.

Other real estate owned which is measured at the lower of carrying value or fair value less costs to sell, had a net carrying amount of \$7,948,000, of which \$540,000 was at fair value at June 30, 2010, resulting from write-downs totaling \$72,000 for the three month period and \$151,000 for the six month period. At December 31, 2009, other real estate owned had a net carrying amount of \$7,967,000, of which \$1,274,000 was at fair value.

Carrying amount and estimated fair value of financial instruments, not previously presented were as follows:

| (000s omitted) | June 30, 2010 | | December 31, 2009 | |
|----------------------------------|--------------------|------------|--------------------|------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Assets: | | | | |
| Cash and cash equivalents | \$ 43,585 | \$ 43,585 | \$ 42,109 | \$ 42,109 |
| Securities held to maturity | 4,697 | 4,744 | 5,456 | 5,493 |
| FHLB stock | 1,900 | n/a | 1,900 | n/a |
| Loans held for sale | 1,259 | 1,259 | 831 | 831 |
| Loans (including impaired loans) | 316,055 | 306,413 | 344,704 | 326,422 |
| Accrued interest receivable | 1,743 | 1,743 | 1,813 | 1,813 |
| Liabilities: | | | | |
| Deposits | \$ 411,384 | \$ 409,814 | \$ 440,775 | \$ 441,827 |
| Short-term borrowings | 10 | 10 | 164 | 164 |
| FHLB advances | 7,954 | 8,376 | 7,981 | 8,488 |
| Subordinated debentures | 14,000 | 12,613 | 14,000 | 12,656 |
| Accrued interest payable | 1,021 | 1,021 | 892 | 892 |

Table of Contents

NOTE 5 FAIR VALUE (continued)

The following methods and assumptions were used by the Corporation in estimating its fair value disclosures for financial instruments:

Cash and cash equivalents

The carrying amounts reported in the balance sheet for cash and short-term instruments approximate their fair values.

Securities

Fair values for securities held to maturity are based on similar information previously presented for securities available for sale.

FHLB Stock

It was not practical to determine the fair value of FHLB stock due to restrictions placed on its transferability.

Loans held for sale

The fair values of these loans are determined in the aggregate on the basis of existing forward commitments or fair values attributable to similar loans.

Loans

For variable rate loans that re-price frequently and with no significant change in credit risk, fair values are based on carrying values. The fair value for other loans is estimated using discounted cash flow analysis. The carrying amount of accrued interest receivable approximates its fair value.

Off-balance-sheet instruments

The fair value of off-balance sheet items is not considered material.

Deposit liabilities

The fair values disclosed for demand deposits are, by definition equal to the amount payable on demand at the reporting date. The carrying amounts for variable rate, fixed term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed certificates of deposit are estimated using discounted cash flow calculation that applies interest rates currently being offered on similar certificates. The carrying amount of accrued interest payable approximates its fair value.

Short-term borrowings

The carrying amounts of federal funds purchased and other short-term borrowings approximate their fair values.

FHLB advances

Rates currently available for FHLB debt with similar terms and remaining maturities are used to estimate the fair value of the existing debt.

Subordinated Debentures

The estimated fair value of the existing subordinated debentures is calculated by comparing a current market rate for the instrument compared to the book rate. The difference between these rates computes the fair value.

Table of Contents**NOTE 5 FAIR VALUE (continued)****Limitations**

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Corporation's financial instruments, fair value estimates are based on management's judgments regarding future expected loss experience, current economic conditions, risk characteristics and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

NOTE 6 INCOME TAXES

A valuation allowance related to deferred tax assets is required when it is considered more likely than not that all or part of the benefit related to such assets will not be realized. Management has reviewed the deferred tax position for the Corporation at June 30, 2010 and December 31, 2009. The Corporation's evaluation of taxable events, losses in recent years and the continuing deterioration of the Michigan economy led management to conclude that it was more likely than not that all or part of the benefit would not be realized. During the second quarter of 2009, the Corporation established a full valuation allowance against our deferred tax assets. The valuation allowance against our deferred tax assets may be reversed to income in future periods to the extent that the related deferred income tax assets are realized or the valuation allowance is otherwise no longer required. Management will continue to monitor our deferred tax assets quarterly for changes affecting their realizability.

Normally, the calculation for the income tax expense (benefit) does not consider the tax effects of changes in other categories of income such as other comprehensive income (OCI), which is a component of shareholders' equity on the balance sheet. However, an exception is warranted when there is a pre-tax loss in continuing operations. When this is the case, pre-tax income from other categories, such as changes in OCI and discontinued operations, are included in the calculation of the tax expense or benefit for the current year. For the first six months of 2010, this resulted in an income tax benefit recorded to continuing operations.

There were no unrecognized tax benefits at June 30, 2010 or December 31, 2009, and the Corporation does not expect the total amount of unrecognized tax benefits to significantly increase in the next twelve months.

NOTE 7 EARNINGS PER COMMON SHARE

The factors in the earnings per share computation follow.

| (000s omitted except share and per share data) | Three Months Ended | | Six Months Ended | |
|--|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| Basic | | | | |
| Net loss | \$ (2,780) | \$ (15,364) | \$ (3,263) | \$ (17,023) |
| Weighted average common shares outstanding | 2,268,791 | 2,196,743 | 2,259,406 | 2,191,940 |
| Basic loss per common share | \$ (1.23) | \$ (6.99) | \$ (1.44) | \$ (7.77) |
| Diluted | | | | |
| Net loss | \$ (2,780) | \$ (15,364) | \$ (3,263) | \$ (17,023) |
| Weighted average common shares outstanding for basic earnings per common share | 2,268,791 | 2,196,743 | 2,259,406 | 2,191,940 |
| Add: Dilutive effects of assumed exercises of stock Options | 0 | 0 | 0 | 0 |
| Average shares and dilutive potential common shares | 2,268,791 | 2,196,743 | 2,259,406 | 2,191,940 |

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| | | | | | | | | |
|-------------------------------|----|--------|----|--------|----|--------|----|--------|
| Diluted loss per common share | \$ | (1.23) | \$ | (6.99) | \$ | (1.44) | \$ | (7.77) |
| | | 20 | | | | | | |

Table of Contents**NOTE 7 EARNINGS PER COMMON SHARE (continued)**

There were no stock options for the three or six month periods ended June 30, 2010 or 2009 that were dilutive, as a result of the net loss for both periods.

NOTE 8 COMMITMENTS AND CONTINGENCIES

There are various contingent liabilities that are not reflected in the financial statements including claims and legal actions arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, the ultimate disposition of these matters is not expected to have a material effect on the Corporation's consolidated financial condition or results of operations.

NOTE 9 DISCONTINUED OPERATIONS

On March 17, 2009, The Corporation entered into an agreement to sell all of the stock of one of its bank subsidiaries, Davison State Bank, to a private, non-affiliated, investor group. The Corporation recorded an estimated loss on the sale of Davison State Bank of \$700,000 in the first quarter of 2009. As a result of the amended sales agreement, the estimated loss of \$700,000 was reversed in the first quarter of 2010. This transaction will have minimal impact to 2010 core earnings due to the proportionate size of Davison State Bank. On April 30, 2010, the sale of Davison State Bank closed and the assets and liabilities were transferred to the investor group.

A condensed balance sheet of held for sale operations is presented below for the period ended and December 31, 2009. As of April 30, 2010, Davison State Bank was sold to an independent financial group. As a result, there is no balance sheet for presentation at June 30, 2010.

DAVISON STATE BANK
CONDENSED BALANCE SHEET OF DISCONTINUED OPERATIONS
(Unaudited)
(000s omitted)

| | Dec 31, 2009 |
|--|---------------|
| ASSETS | |
| Cash and cash equivalents | \$ 2,537 |
| Securities available for sale | 7,082 |
| Securities held to maturity | 405 |
| Loans, net of allowance (\$679-2009) | 24,396 |
| Other assets | 3,499 |
| Total assets | \$ 37,919 |
| LIABILITIES AND SHAREHOLDERS EQUITY | |
| Deposits: | |
| Non-interest bearing | \$ 9,012 |
| Interest bearing | 26,265 |
| Total deposits | 35,277 |
| Accrued taxes, interest and other liabilities | (60) |
| Shareholders equity | 2,702 |
| Total liabilities and shareholders Equity | \$ 37,919 |

A condensed statement of income of held for sale operations are presented for the three and six month periods ended June 30, 2010 and June 30, 2009. At April 30, 2010, Davison State Bank was sold to an independent investor group. As a result, the three month period ended June 30, 2010, is representative of one month of income, while the six month period is representative of four months of income. These are compared to the 2009 periods which are full three and six month period representations, respectively.

Table of Contents**NOTE 9 DISCONTINUED OPERATIONS (continued)**

DAVISON STATE BANK
CONDENSED STATEMENT OF INCOME OF DISCONTINUED OPERATIONS
(Unaudited)
(000s omitted)

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|----------|------------------|------------|
| | June 30 | | June 30 | |
| | 2010 | 2009 | 2010 | 2009 |
| Interest income | \$ 150 | \$ 513 | \$ 607 | \$ 1,062 |
| Interest expense | 27 | 171 | 116 | 359 |
| Net interest income | 123 | 342 | 491 | 703 |
| Provision for loan losses | 0 | 156 | (5) | 155 |
| Net interest income after provision for loan losses | 123 | 186 | 496 | 548 |
| Non-interest income | 51 | 141 | 178 | 263 |
| Non-interest expense | 351 | 490 | 121 | 1,677 |
| Income/(loss) before federal income tax | (177) | (163) | 553 | (866) |
| Federal income tax expense/(benefit) | (62) | 676 | 181 | 676 |
| Net income/(loss) | \$ (115) | \$ (839) | \$ 372 | \$ (1,542) |

NOTE 10-REGULATORY MATTERS

The Corporation (on a consolidated basis) and its Bank subsidiaries are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Banks' financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation and the Banks must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance-sheet items are calculated under regulatory accounting practices. The capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require the Banks to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). As of December 31, 2009 the most recent notification from Federal Deposit Insurance Corporation categorized the Banks as adequately capitalized under the regulatory framework for prompt corrective action.

As of December 31, 2009, The State Bank was required by regulatory authorities to maintain certain minimum capital ratios. The State Bank's required capital ratios were those required in the Consent Order that was effective January 10, 2010 which is discussed later in this note.

In March 2009, West Michigan Community Bank entered into a Consent Order with federal and state banking regulators that contain provisions to foster improvement in West Michigan Community Bank's earnings, lower non performing loan levels, and increase capital. Under regulatory guidelines, when a bank is issued a Consent Order the capital status of the bank is automatically reduced to adequately capitalized. The Consent Order requires West

Michigan Community Bank to retain a Tier 1 capital to average assets ratio of a minimum of 8.0%. As of June 30, 2010, West Michigan Community Bank has a Tier 1 capital to average assets ratio of 6.4%, as compared to Tier 1 capital to average assets ratio of 6.9%

Table of Contents**NOTE 10-REGULATORY MATTERS (continued)**

at December 31, 2009. At both June 30, 2010 and December 31, 2009, West Michigan Community Bank was not in compliance with the Consent Order capital requirements.

Effective January 10, 2010, The State Bank entered into a Consent Order with federal and state banking regulators that contain provisions to foster improvement in The State Bank's earnings, lower nonperforming loan levels, increase capital, and require revisions to various policies. The Consent Order requires The State Bank to maintain a Tier 1 capital to average asset ratio of a minimum of 8.0%. It also requires The State Bank to maintain a total capital to risk weighted asset ratio of 12.0%. At June 30, 2010, The State Bank had a Tier 1 capital to average assets ratio of 6.8% and a total capital to risk-weighted assets ratio of 9.8%. This is compared to ratios at December 31, 2009, of a Tier 1 capital to average assets ratio of 6.2% and a total capital to risk-weighted assets ratio of 8.9%. At June 30, 2010 and at December 31, 2009, The State Bank was not in compliance with the Consent Order capital requirements. However, The State Bank is making progress as illustrated by the increase in capital ratios.

The Consent Orders restrict the Banks from issuing or renewing brokered deposits. The Consent Orders also restrict dividend payments from The State Bank and West Michigan Community Bank to the Corporation. The Consent Orders do not place any restrictions on the Corporation. The Corporation, the Board of Directors and management continue to work on plans to come into compliance with the Consent Orders. From the sale of Davison State Bank, a portion of the \$2.8 million of proceeds was distributed to The State Bank during the second quarter of 2010. While below the compliance level required by the Orders, both Banks maintain capital levels considered adequate by regulatory standards. Non-compliance with Consent Order requirements may cause the Banks to be subject to further enforcement actions by the FDIC.

As illustrated in the table below, at June 30, 2010, the Consolidated Corporation's total capital to risk weighted assets ratio indicates that it is slightly under capitalized. The Corporation is at a ratio of 7.8%, while adequately capitalized has a minimum requirement of 8.0%. At December 31, 2009, the Consolidated Corporation's total capital to risk weighted assets ratio indicates that it is under capitalized. The Corporation is at a ratio of 7.8%, while adequately capitalized has a minimum requirement of 8.0%. With the current capital levels, the Corporation is required to obtain written approval prior to payments of any dividends or for any increase or decrease to outstanding debt.

The Corporation's principal source of funds for dividend payments is dividends received from the Banks. Banking regulations limit the amount of dividends that may be paid without prior approval of regulatory agencies. Under these regulations, the amount of dividends that may be paid in any calendar year is limited to the current year's net profits, combined with the retained net profits of the preceding two years, subject to the limitations described above.

Table of Contents**NOTE 10-REGULATORY MATTERS (continued)**

| (000s omitted) | Actual | | For Capital Adequacy Purposes | | Regulatory Agreement Requirements | |
|--|-----------|-------|-------------------------------|-------|-----------------------------------|----------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of June 30, 2010 | | | | | | |
| Total Capital (to Risk Weighted Assets) | | | | | | |
| Consolidated | \$ 28,691 | 7.8% | \$ 29,586 | 8.0% | NA | NA |
| The State Bank | 24,863 | 9.8 | 20,269 | 8.0 | \$ 30,403 | 12.0%(1) |
| West Michigan Community Bank | 10,668 | 9.3 | 9,152 | 8.0 | NA | NA |
| Tier 1 Capital (to Risk Weighted Assets) | | | | | | |
| Consolidated | 23,967 | 6.5 | 14,793 | 4.0 | NA | NA |
| The State Bank | 21,595 | 8.5 | 10,134 | 4.0 | NA | NA |
| West Michigan Community Bank | 9,231 | 8.1 | 4,576 | 4.0 | NA | NA |
| Tier 1 Capital (to Average Assets) | | | | | | |
| Consolidated | 23,967 | 5.1 | 18,957 | 4.0 | NA | NA |
| The State Bank | 21,595 | 6.8 | 12,640 | 4.0 | 25,280 | 8.0 |
| West Michigan Community Bank | 9,231 | 6.4 | 5,770 | 4.0 | 11,540 | 8.0 |
| | | | | | | |
| (000s omitted) | Actual | | For Capital Adequacy Purposes | | Regulatory Agreement Requirements | |
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of December 31, 2009 | | | | | | |
| Total Capital (to Risk Weighted Assets) | | | | | | |
| Consolidated | \$ 33,661 | 7.8% | \$ 34,636 | 8.0% | NA | NA |
| The State Bank | 24,334 | 8.9 | 21,961 | 8.0 | \$ 32,810 | 12.0%(1) |
| Davison State Bank | 3,328 | 9.9 | 2,692 | 8.0 | NA | NA |
| West Michigan Community Bank | 11,841 | 9.4 | 10,063 | 8.0 | NA | NA |
| Tier 1 Capital (to Risk Weighted Assets) | | | | | | |
| Consolidated | 28,164 | 6.5 | 17,318 | 4.0 | NA | NA |
| The State Bank | 20,830 | 7.6 | 10,981 | 4.0 | NA | NA |
| Davison State Bank | 2,904 | 8.6 | 1,346 | 4.0 | NA | NA |
| West Michigan Community Bank | 10,262 | 8.2 | 5,031 | 4.0 | NA | NA |
| Tier 1 Capital (to Average Assets) | | | | | | |

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| | | | | | | |
|------------------------------|--------|-----|--------|-----|--------|-----|
| Consolidated | 28,164 | 5.0 | 22,491 | 4.0 | NA | NA |
| The State Bank | 20,830 | 6.2 | 13,535 | 4.0 | 27,069 | 8.0 |
| Davison State Bank | 2,904 | 7.2 | 1,620 | 4.0 | 3,240 | 8.0 |
| West Michigan Community Bank | 10,262 | 6.9 | 5,923 | 4.0 | 11,845 | 8.0 |

(1) Effective
April 10, 2010

Table of Contents

NOTE 11-DEFINITIVE AGREEMENT

On April 28, 2010, at the Annual Shareholder Meeting, a formal announcement was made regarding the signing of a definitive agreement to sell West Michigan Community Bank. The intended purchasers are affiliated with Northstar Financial Group, Inc. headquartered in Bad Axe, Michigan. The Corporation anticipates the receipt of \$10.4 million from the sale of West Michigan Community Bank (an approximate 10% premium to book). As a condition of the sale, the Corporation will acquire all the non-performing assets of West Michigan Community Bank. The assets will be housed in a newly formed holding company subsidiary of the Corporation. The transaction is expected to close in the fourth quarter of 2010; however regulatory approval is required for the sale and for the Corporation to acquire the non-performing assets. Regulatory approval has not yet been obtained. It is expected that the Corporation will utilize a portion of the proceeds from the sale of West Michigan Community Bank to improve the capital position of The State Bank. At June 30, 2010, West Michigan Community Bank is not considered to have the status of discontinued operations due to uncertainties with the final transaction.

Table of Contents

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Results of Operations

As indicated in the income statement, the loss for the three months ended June 30, 2010 was \$2,780,000 compared to a loss of \$15,364,000 for the same period in 2009. Net interest income in the second quarter of 2010, was \$195,000 below net interest income for the same quarter in 2009. The second quarter 2010 provision for loan losses was down \$4,092,000 compared to the first quarter of 2009. Management feels the allowance for loan losses is adequate and has increased \$257,000 when comparing the period ended June 30, 2010 to the period ended June 30, 2009.

On March 17, 2009, the Corporation entered into an agreement to sell all of the stock of one of its bank subsidiaries, Davison State Bank, to a private, non-affiliated, investor group. The Corporation recorded an estimated loss on the sale of Davison State Bank of \$700,000 in the first quarter of 2009. As a result of the amended sales agreement, the estimated loss of \$700,000 was reversed in the first quarter of 2010. On April 30, 2010, the sale of Davison State Bank closed and the assets and liabilities were transferred to the investor group.

The banking industry uses standard performance indicators to help evaluate a banking institution's performance. Return on average assets is one of these indicators. For the three months ended June 30, 2010, the Corporation's return on average assets (annualized) was (2.33%) compared to (10.63%) for the same period in 2009. For the six months ended June 30, 2010, the Corporation's return on average assets (annualized) was (1.37%) compared to (5.89%) for the same period in 2009. Net loss per share, basic and diluted, was (\$1.23) in the second quarter of 2010 compared to (\$6.99) net loss per share basic and diluted for the same period in 2009. Net loss per share, basic and diluted, was (\$1.44) in the six month period ended June 30, 2010 compared to (\$7.77) net loss per share basic and diluted for the same period in 2009.

Net Interest Income

Net interest income and average balances and yields on major categories of interest-earning assets and interest-bearing liabilities for the six months ended June 30, 2010 and 2009 are summarized in Table 2. Net interest income and average balances and yields on major categories of interest-earning assets and interest-bearing liabilities for the three months ended June 30, 2010 and 2009 are summarized in Table 3. The effects of changes in average interest rates and average balances are detailed in Table 1 below.

As indicated in Table 1, during the six months ended June 30, 2010, net interest income decreased compared to the same period in 2009. Interest rates and volume on loans continued to decrease over the past year. As an offset, deposit interest expense was also decreased. The deposit interest rate reduction was achieved by reduction of offering rates on time deposits, which assisted in encouraging high rate instruments from renewing, with some funds exiting, thus reducing interest bearing liability costs.

Table of Contents**Table 1**

| | SIX MONTHS ENDED JUNE 30 2010 COMPARED TO 2009 INCREASE (DECREASE) DUE TO | | |
|------------------------------------|---|----------|----------|
| | VOL | RATE | TOTAL |
| (000s omitted) | | | |
| Taxable securities | \$ (68) | \$ (130) | \$ (198) |
| Tax-exempt securities | (82) | (2) | (84) |
| Other securities | (1) | (21) | (22) |
| Federal funds sold | 15 | 0 | 15 |
| | | | |
| Total loans | (2,263) | 329 | (1,934) |
| | | | |
| Loans held for sale | (28) | 1 | (27) |
| | | | |
| Total earning assets | (2,427) | 177 | (2,250) |
| | | | |
| Interest bearing demand deposits | (23) | (218) | (241) |
| Savings deposits | (5) | (155) | (160) |
| Time CDs \$100,000 and over | (565) | (244) | (809) |
| Other time deposits | (157) | (448) | (605) |
| Other borrowings | (96) | (111) | (207) |
| | | | |
| Total interest bearing liabilities | (846) | (1,176) | (2,022) |
| | | | |
| Net Interest Income | \$ (1,581) | \$ 1,353 | \$ (228) |

As indicated in Table 2, for the six months ended June 30, 2010, the Corporation's net interest margin (with consideration of full tax equivalency) was 3.66% compared with 3.35% for the same period in 2009. This increase is a result of management's ability to make continuing downward repricing steps on interest bearing liabilities.

Additionally non-interest bearing deposits decreased less than 0.5% when comparing the period ended June 30, 2010 to the period ended June 30, 2009.

Average earning assets decreased 11.0% or \$52,098,000 comparing the six months of 2010 to the same time period in 2009. Management continues to strategically work to shrink both sides of the balance sheet. Loans, the highest yielding component of earning assets, represented 81.6% of earning assets in 2010 compared to 88.5% in 2009.

Average interest bearing liabilities decreased 11.7% or \$50,593,000 comparing the first six months of 2010 to the same time period in 2009. Non-interest bearing deposits amounted to 15.7% of average earning assets in the first six months of 2010 compared with 14.1% in the same time period of 2009.

Net interest income (displayed with consideration of full tax equivalency), average balance sheet amounts, and the corresponding yields for the three months ended June 30, 2010 and 2009 are shown in Table 3. Net interest income for the three months ended June 30, 2010 was \$3,885,000, an increase of \$175,000, or 4.7%, from the same period in 2009. Net interest margin increased as a result of increases in loan portfolio yields, which were assisted by a large decrease in the interest bearing liability yield.

Management reviews economic forecasts and strategy on a monthly basis. Accordingly, the Corporation will continue to strategically manage the balance sheet structure in an effort to create stability in net interest income. The

Corporation expects to continue to seek out new loan opportunities while continuing to maintain sound credit quality. Management continually monitors the Corporation's balance sheet in an effort to insulate net interest income from significant swings caused by interest rate volatility. If market rates change in 2010, corresponding changes in funding costs will be considered to avoid the potential negative impact on net interest income. The Corporation's policies in this regard are further discussed in the section titled Interest Rate Sensitivity Management.

Table of Contents**Table 2 Average Balance and Rates**

| (000s omitted)(Annualized) | SIX MONTHS ENDED JUNE 30, | | | | | |
|---|---------------------------|----------------------------|----------------|--------------------|----------------------------|----------------|
| | AVERAGE BALANCE | 2010 INCOME/ EXPENSE | YIELD/ RATE | AVERAGE BALANCE | 2009 INCOME/ EXPENSE | YIELD/ RATE |
| ASSETS | | | | | | |
| Securities: | | | | | | |
| U.S. Treasury and Government | | | | | | |
| Agencies | \$ 33,285 | \$ 561 | 3.40% | \$ 36,818 | \$ 759 | 4.16% |
| State and Political (1) | 11,428 | 345 | 6.09% | 14,143 | 429 | 6.11% |
| Other | 3,423 | 28 | 1.65% | 3,526 | 50 | 2.86% |
| Total Securities | 48,136 | 934 | 3.91% | 54,487 | 1,238 | 4.58% |
| Fed Funds Sold | 29,552 | 15 | 0.10% | 0 | 0 | 0.00% |
| Loans: | | | | | | |
| Commercial | 269,922 | 8,279 | 6.19% | 328,220 | 9,777 | 6.01% |
| Tax Free (1) | 2,325 | 74 | 6.42% | 2,724 | 85 | 6.29% |
| Real Estate-Mortgage | 26,694 | 837 | 6.32% | 36,339 | 1,117 | 6.20% |
| Consumer | 45,871 | 1,320 | 5.80% | 51,693 | 1,465 | 5.72% |
| Total loans | 344,812 | 10,510 | 6.15% | 418,976 | 12,444 | 5.99% |
| Allowance for Loan Losses | (11,744) | | | (10,772) | | |
| Net Loans | 333,068 | 10,510 | 6.36% | 408,204 | 12,444 | 6.15% |
| Loans Held for Sale | 844 | 21 | 5.02% | 1,979 | 48 | 4.89% |
| TOTAL EARNING ASSETS | | | | | | |
| CONTINUING OPERATIONS | \$ 423,344 | 11,480 | 5.47% | \$ 475,442 | 13,730 | 5.82% |
| Cash Due from Banks | 16,090 | | | 27,794 | | |
| Assets of discontinued operations | 24,716 | | | 44,138 | | |
| All Other Assets | 43,290 | | | 41,605 | | |
| TOTAL ASSETS | \$ 495,696 | | | \$ 578,207 | | |
| LIABILITIES & SHAREHOLDERS EQUITY: | | | | | | |
| Deposits: | | | | | | |
| Interest bearing DDA | \$ 82,842 | \$ 170 | 0.41% | \$ 87,954 | \$ 411 | 0.94% |
| Savings Deposits | 71,260 | 45 | 0.13% | 73,027 | 205 | 0.57% |
| Time CDs \$100,000 and Over | 102,648 | 1,986 | 3.90% | 130,946 | 2,795 | 4.30% |
| Other Time CDs | 103,576 | 1,210 | 2.36% | 114,204 | 1,815 | 3.20% |
| Total Deposits | 360,326 | 3,411 | 1.91% | 406,131 | 5,226 | 2.59% |
| Other Borrowings | 22,305 | 395 | 3.57% | 27,093 | 602 | 4.48% |

| | | | | | | |
|---|------------|----------|-------|------------|----------|-------|
| INTEREST BEARING LIABILITIES | \$ 382,631 | 3,806 | 2.01% | \$ 433,224 | 5,828 | 2.71% |
| Non-Interest bearing DDA Liabilities of discontinued operations | 66,532 | | | 66,897 | | |
| All Other Liabilities | 24,716 | | | 40,845 | | |
| Shareholders Equity | 3,346 | | | 1,853 | | |
| | 18,471 | | | 35,388 | | |
| TOTAL LIABILITIES & SHAREHOLDERS EQUITY | \$ 495,696 | | | \$ 578,207 | | |
| Net Interest Rate Spread | | | 3.12% | | | 3.79% |
| Net Interest Income /Margin | | \$ 7,674 | 3.66% | | \$ 7,902 | 3.35% |

(1) Presented on a fully taxable equivalent basis using a federal income tax rate of 34%.

Table of Contents**Table 3 Average Balance and Rates**

| (000s omitted)(Annualized) | THREE MONTHS ENDED JUNE 30, | | | | | |
|---|-----------------------------|----------------------------|----------------|--------------------|----------------------------|----------------|
| | AVERAGE BALANCE | 2010 INCOME/ EXPENSE | YIELD/ RATE | AVERAGE BALANCE | 2009 INCOME/ EXPENSE | YIELD/ RATE |
| ASSETS | | | | | | |
| Securities: | | | | | | |
| U.S. Treasury and Government | | | | | | |
| Agencies | \$ 33,408 | \$ 283 | 3.40% | \$ 37,664 | \$ 383 | 4.08% |
| State and Political (1) | 10,319 | 158 | 6.14% | 13,889 | 209 | 6.04% |
| Other | 2,907 | 14 | 1.93% | 2,905 | 7 | 0.97% |
| Total Securities | 46,634 | 455 | 3.91% | 54,458 | 599 | 4.41% |
| Fed Funds Sold | 33,429 | 10 | 0.12% | 0 | 0 | 0.00% |
| Loans: | | | | | | |
| Commercial | 265,246 | 4,104 | 6.21% | 323,183 | 4,693 | 5.82% |
| Tax Free (1) | 2,265 | 37 | 6.55% | 2,697 | 44 | 6.53% |
| Real Estate-Mortgage | 25,796 | 415 | 6.45% | 36,957 | 525 | 5.70% |
| Consumer | 44,533 | 644 | 5.80% | 49,295 | 730 | 5.94% |
| Total loans | 337,840 | 5,200 | 6.17% | 412,132 | 5,992 | 5.83% |
| Allowance for Loan Losses | (12,330) | | | (11,101) | | |
| Net Loans | 325,510 | 5,200 | 6.41% | 401,031 | 5,992 | 5.99% |
| Loans Held for Sale | 975 | 12 | 4.94% | 1,870 | 23 | 4.93% |
| TOTAL EARNING ASSETS CONTINUING OPERATIONS | \$ 418,878 | \$ 5,677 | 5.44% | \$ 468,460 | \$ 6,614 | 5.66% |
| Cash Due from Banks | 16,923 | | | 38,776 | | |
| Assets of discontinued operations | 12,353 | | | 43,405 | | |
| All Other Assets | 41,937 | | | 41,224 | | |
| TOTAL ASSETS | \$ 477,761 | | | \$ 580,764 | | |
| LIABILITIES & SHAREHOLDERS EQUITY: | | | | | | |
| Deposits: | | | | | | |
| Interest bearing DDA | \$ 82,733 | \$ 75 | 0.36% | \$ 85,972 | \$ 194 | 0.91% |
| Savings Deposits | 72,847 | 23 | 0.13% | 76,644 | 111 | 0.58% |
| Time CDs \$100,000 and Over | 95,852 | 941 | 3.94% | 129,979 | 1,381 | 4.26% |
| Other Time CDs | 100,838 | 555 | 2.21% | 118,665 | 927 | 3.13% |
| Total Deposits | 352,270 | 1,594 | 1.81% | 411,260 | 2,613 | 2.55% |
| Other Borrowings | 22,279 | 198 | 3.56% | 24,406 | 291 | 4.78% |

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| | | | | | | |
|---|------------|----------|-------|------------|----------|-------|
| INTEREST BEARING LIABILITIES | \$ 374,549 | \$ 1,792 | 1.92% | \$ 435,666 | \$ 2,904 | 2.67% |
| Non-Interest bearing DDA Liabilities of discontinued operations | 68,662 | | | 68,798 | | |
| All Other Liabilities | 12,353 | | | 40,334 | | |
| Shareholders Equity | 3,255 | | | 1,798 | | |
| | 18,942 | | | 34,168 | | |
| TOTAL LIABILITIES & SHAREHOLDERS EQUITY | \$ 477,761 | | | \$ 580,764 | | |
| Net Interest Rate Spread | | | 2.85% | | | 2.99% |
| Net Interest Income /Margin | | \$ 3,885 | 3.72% | | \$ 3,710 | 3.18% |

Table of Contents**Allowance and Provision For Loan Losses**

The Corporation maintains formal policies and procedures to control and monitor credit risk. Management believes the allowance for loan losses is adequate to provide for probable incurred losses in the loan portfolio. While the Corporation's loan portfolio has no significant concentrations in any one industry or any exposure in foreign loans, the loan portfolio had a concentration connected with construction and land development loans. Specific strategies have been deployed to reduce the concentration level and limit exposure to this type of lending in the future. The Michigan economy, employment levels and other economic conditions in the Corporation's local markets may have a significant impact on the level of credit losses. Management continues to identify and devote attention to credits that are not performing as agreed. Of course, deterioration of economic conditions could have an impact on the Corporation's credit quality, which could impact the need for greater provision for loan losses and the level of the allowance for loan losses as a percentage of gross loans. Non-performing loans are discussed further in the section titled "Non-Performing Assets."

The allowance for loan losses reflects management's judgment as to the level considered appropriate to absorb probable losses in the loan portfolio. The Corporation's methodology in determining the adequacy of the allowance is based on ongoing quarterly assessments and relies on several key elements, which include specific allowances for identified problem loans and a formula-based risk-allocated allowance for the remainder of the portfolio. This includes a review of individual loans, size, and composition of the loan portfolio, historical loss experience, current economic conditions, financial condition of borrowers, the level and composition of non-performing loans, portfolio trends, estimated net charge-offs and other pertinent factors. While we consider the allowance for loan losses to be adequate based on information currently available, future adjustments to the allowance may be necessary due to changes in economic conditions, delinquencies, or loss rates. Although portions of the allowance have been allocated to various portfolio segments, the allowance is general in nature and is available for the portfolio in its entirety. At June 30, 2010, the allowance was \$14,227,000, or 4.31% of total loans compared to \$10,726,000, or 3.01%, at December 31, 2009, increasing the allowance \$3,501,000 during the first six months of 2010. Non performing loan levels, discussed later, increased \$10,000 during the period and net charge-offs have decreased to \$1,908,000 during the first six months of 2010 compared to \$5,851,000 during the first six months of 2009. The provision for loan losses remains high as a result of continued weaknesses in the local economy, elevated amounts of non-performing loans and elevated charge-off levels over the past three years. Rolling twelve quarter periods of historical charge off experience is considered when calculating the current required level of the allowance for loan losses and as prior periods with less loan losses are replaced with periods with higher loan losses the required level of allowance increases. Additionally the amount of the allowance for loan losses specifically allocated to impaired loans increased by \$2,422,000 during the quarter as a result of updated collateral evaluations and a migration to the impaired status.

Table 4 below summarizes loan losses and recoveries for the first six months of 2010 and 2009. During the first six months of 2010, the Corporation experienced net charge-offs of \$1,908,000 or .58% of gross loans compared with net charge-offs of \$5,851,000 or 1.46% of gross loans in the first six months of 2009. The provision for loan loss was \$5,409,000 in the first six months of 2010 and \$9,366,000 for the same time period in 2009. The application of historical loss rates to the current portfolio has the potential to be a lagging indicator and management evaluates whether these allocations should be adjusted. While there are indicators that asset quality is improving, such as a decrease on non-performing loans, management still feels there is enough uncertainty given the current economic conditions to use these high historical loss rates in estimating the required level of allowance for loan losses.

Table of Contents**Table 4 Analysis of the Allowance for Loan Losses**

| (000s omitted) | Six Months Ended June | |
|---|-----------------------|-------------|
| | 2010 | 30, 2009 |
| Balance at Beginning of Period | \$ 10,726 | \$ 10,455 |
| Charge-Offs: | | |
| Commercial, Financial and Agriculture | (2,081) | (5,063) |
| Real Estate-Mortgage | (179) | (476) |
| Installment Loans to Individuals | (386) | (418) |
| Total Charge-Offs | (2,646) | (5,957) |
| Recoveries: | | |
| Commercial, Financial and Agriculture | 651 | 60 |
| Real Estate-Mortgage | 39 | 2 |
| Installment Loans to Individuals | 48 | 44 |
| Total Recoveries | 738 | 106 |
| Net Charge-Offs | (1,908) | (5,851) |
| Provision | 5,409 | 9,366 |
| Balance at End of Period | \$ 14,227 | \$ 13,970 |
| Ratio of Net Charge-Offs to Gross Loans | 0.58% | 1.46% |

Non-Interest Income

Non-interest income increased during the three months ended June 30, 2010 as compared to the same period in 2009. Overall non-interest income, of continuing operations, was \$1,558,000 for the three months ended June 30, 2010 compared to \$826,000 for the same period in 2009. This represents an increase of 88.6%. The largest component of increase was in 2009, the Corporation recorded a loss on equity investment of \$874,000, which did not occur in 2010. On a year to date basis, non-interest income at June 30, 2010 was \$2,905,000 compared with \$1,965,000 at June 30, 2009; an increase of 47.8%.

The most significant category of non-interest income is service charges on deposit accounts. These fees from continuing operations were \$403,000 in the second quarter of 2010, compared to \$480,000 for the same period of 2009. This represents a decrease of 16.0% from year to year. The decrease is a result of an 18.5% decrease in NSF charges collected. On a year to date basis, service charges on deposit accounts, decreased 4.4% to \$877,000 at June 30, 2010.

Gain on the sale of mortgage loans originated by the Banks and sold into the secondary market decreased to \$135,000 in the second quarter of 2010 compared to \$277,000 in the same period in 2009. As anticipated in 2009, this was a short term rise in mortgage refinance. Management believes for the remainder of 2010, for this income to remain relatively flat as many governmental incentives have expired and property values continue to decrease. On a year to date basis, the gain on the sale of mortgage loans has decreased 55.5% from the first six months of 2009.

Trust, investment and financial planning services income decreased \$125,000 or 27.0% in the second quarter of 2010 compared to the same period in the prior year. The decrease is attributable to unfavorable changes in market value, which resulted in lower fee income. On a year to date basis, trust and wealth management income has decreased 12.1% compared to 2009.

Other operating income increased by \$127,000 or 26.5% to \$607,000 in the second quarter of 2010 compared to \$480,000 in the same time period in 2009. On a year to date basis, other operating income decreased \$71,000 or 6.6%. A reduction of other operating income was the 2009 benefit received by one of the Banks for proceeds from a bank owned life insurance policy totaling \$203,000. This benefit was not received in 2010.

Table of Contents**Non-Interest Expense**

Total non-interest expense from continued operations, decreased 17.7% to \$4,370,000 in the three months ended June 30, 2010, compared with \$5,312,000 in the same period of 2009. Decreases in all categories, which include: salaries and benefits, furniture and equipment depreciation, advertising expenses, loan and collection expenses related to other real estate owned. For the six month period ended June 30, 2010, total non-interest expense from continued operations decreased. This decrease was also in all categories, with the largest decreases in loan and collection expenses, charges related to other-than-temporary-impairment on a single security and the impairment of held for sale operations.

Salary and benefit costs, the Corporation's largest non-interest expense category, were \$2,063,000 in the second quarter of 2010, compared with \$2,071,000, or a decrease of 0.4%, for the same time period in 2009. Staff reductions late in the second quarter of 2010 are reflected in this decrease. For the six months ended June 30, 2010, salary and benefit costs were \$4,178,000, compared with \$4,623,000 for the same time period in 2009. This reduction of 9.6% or \$445,000 was related to the elimination of the 401(k) match for retirement benefits.

Occupancy expenses, at \$431,000, decreased in the three months ended June 30, 2010 compared to the same period in 2009 by \$16,000 or 3.6%. The decrease in occupancy expenses is related to reductions in building repairs and maintenance; these decreases were partially offset by increases in property insurance costs. For the six month period ended June 30, 2010, occupancy expenses were \$880,000, compared to \$950,000 for the same time period in 2009. This represents a decrease of 7.4%. For the six month period ended June 30, 2010, the decrease in occupancy expenses is related to reductions in building repairs and maintenance, primarily due to lower snow removal costs in 2010.

During the three months ended June 30, 2010, furniture and equipment expenses were \$386,000 compared to \$403,000 for the same period in 2009, a decrease of 4.2%. For the six month period ended June 30, 2010, furniture and equipment expenses were \$757,000 compared to \$827,000 for the same period in 2009. This represents a decrease of 8.5% for the six month period comparison.

Loan and collection expenses, from continuing operations, at \$433,000, were down \$500,000 or 53.6% during the three months ended June 30, 2010 compared to the same time period in 2009. The decrease was related to other loan expense on other real estate owned, in the form of property taxes and property maintenance decreased loan and collection expenses. For the six month period ended June 30, 2010, loan and collection expenses totaled \$990,000 compared to \$1,318,000 for the same period in 2009. This represents a decrease of 24.9%. The decrease during the six month period was also related to decreases in other real estate owned expenses.

Advertising expenses remained stable for the three months ended June 30, 2010 compared to the same period in 2009. For the three months ended June 30, 2010, advertising expenses were \$45,000 compared to \$47,000 for the same period in 2009. This is a decrease of 4.3%. The Corporation continues review the sponsorships and donations shared with the local communities and events. As a result, we have reduced our advertising in local markets and reduced the level of sponsorships in community events, while still remaining a participating sponsor. For the six month period ended June 30, 2010, advertising expenses totaled \$73,000, compared to \$88,000 for the same time in 2009. This is a decrease of 17.0%.

Other operating expenses, from continued operations, were \$1,012,000 in the three months ended June 30, 2010 compared to \$1,211,000 in the same time period in 2009, a decrease of \$199,000 or 16.4%. Increases year over year include increases in our general insurance of \$60,000 from second quarter 2009 totals. Partially offsetting these increases were reductions in FDIC assessment, supplies expense, director fees, ATM/Debit card expenses, business development expenses, and conferences and education. In the six months ended June 30, 2010, other operating expenses, from continued operations, were \$2,059,000 compared to \$2,441,000 in the same time period in 2009, a decrease of \$382,000 or 15.6%. The largest components of this decrease was the 2009 recognition of other-than-temporary impairment of \$200,000 on a single investment.

Table of Contents**Financial Condition**

Proper management of the volume and composition of the Corporation's earning assets and funding sources is essential for ensuring strong and consistent earnings performance, maintaining adequate liquidity and limiting exposure to risks caused by changing market conditions. The Corporation's securities portfolio is structured to provide a source of liquidity through maturities and to generate an income stream with relatively low levels of principal risk. The Corporation does not engage in securities trading. Loans comprise the largest component of earning assets and are the Corporation's highest yielding assets. Customer deposits are the primary source of funding for earning assets while short-term debt and other sources of funds could be further utilized if market conditions and liquidity needs change. The Corporation's total assets were \$455 million at June 30, 2010 compared to total assets of \$522 million at December 31, 2009. This includes assets from discontinued operations of \$38 million at December 31, 2009. Loans comprised 72.5% of total assets at June 30, 2010 compared to 68.1% at December 31, 2009. Loans shrank \$25.1 million during the first six months of 2010. On the liability side of the balance sheet, the ratio of non-interest bearing deposits to total deposits was 17.0% at June 30, 2010 and 14.6% at December 31, 2009. Interest bearing deposit liabilities totaled \$341.4 million at June 30, 2010 compared to \$376.2 million at December 31, 2009. Total deposits decreased \$29.4 million with non-interest bearing demand deposits increasing \$5.4 million and interest bearing deposits decreasing \$34.8 million. Short-term borrowings decreased \$154,000 due to the decrease in treasury tax and loan payments outstanding at the end of the two periods. FHLB advances decreased \$27,000 at June 30, 2010 compared to December 31, 2009. This was due to the annual payment on a long-term advance held at one of the Banks.

Non-Performing Assets

Non-performing assets include loans on which interest accruals have ceased, loans past due 90 days or more and still accruing, loans that have been renegotiated, and real estate acquired through foreclosure. Table 5 reflects the levels of these assets at June 30, 2010 and December 31, 2009.

Non-performing assets decreased from December 31, 2009 to June 30, 2010. The decrease of \$2,189,000 was primarily due to decreases in renegotiated loans and REO in redemption. Loans past due 90 days or more and still accruing increased \$1,354,000 from year end and non-accrual loans increased \$154,000. REO in redemption balance is comprised of ten commercial properties and three residential properties for a total of \$2,792,000 at June 30, 2010. Marketability of these properties is dependent on the real estate market. Renegotiated loans decreased \$1,498,000 from December 31, 2009 to a total of \$2,324,000 at June 30, 2010.

Table of Contents**Table 5 Non-Performing Assets and Past Due Loans**

| (000s omitted) | June 30, 2010 | December 31, 2009 |
|--|------------------|----------------------|
| Non-Performing Loans: | | |
| Loans Past Due 90 Days or More & Still Accruing | \$ 1,673 | \$ 319 |
| Non-Accrual Loans | 16,661 | 16,507 |
| Renegotiated Loans | 2,324 | 3,822 |
| Total Non-Performing Loans | 20,658 | 20,648 |
| Other Non-Performing Assets: | | |
| Other Real Estate | 7,948 | 7,967 |
| REO in Redemption | 2,792 | 4,972 |
| Total Other Non-Performing Assets | 10,740 | 12,939 |
| Total Non-Performing Assets | \$ 31,398 | \$ 33,587 |
| Non-Performing Loans as a % of Total Loans | 6.23% | 5.80% |
| Non-Performing Loans as a % of Total Loans and Other Real Estate | 6.09% | 5.67% |
| Allowance for Loan Losses as a % of Non-Performing Loans | 68.87% | 51.95% |
| Accruing Loans Past Due 90 Days or More to Total Loans | 0.50% | 0.09% |
| Non-performing Assets as a % of Total Assets | 6.90% | 6.43% |

The level and composition of non-performing assets are affected by economic conditions in the Corporation's local markets. Non-performing assets, charge-offs, and provisions for loan losses tend to decline in a strong economy and increase in a weak economy, potentially impacting the Corporation's operating results. In addition to non-performing loans, management carefully monitors other credits that are current in terms of principal and interest payments but, in management's opinion, may deteriorate in quality if economic conditions change.

Certain portions of the Corporation's non-performing loans included in Table 5 are considered impaired. The Corporation measures impairment on all large balance non-accrual commercial loans. Certain large balance accruing loans rated watch or lower are also measured for impairment. Impairment losses are believed to be adequately covered by the allowance for loan losses.

The Corporation maintains policies and procedures to identify and monitor non-accrual loans. A loan is placed on non-accrual status when there is doubt regarding collection of principal or interest, or when principal or interest is past due 90 days or more. Interest accrued but not collected is reversed against income for the current quarter when the loan is placed on non-accrual status.

Liquidity and Interest Rate Risk Management

Asset/Liability management is designed to assure liquidity and reduce interest rate risks. The goal in managing interest rate risk is to maintain a strong and relatively stable net interest margin. It is the responsibility of the Asset/Liability Management Committee (ALCO) to set policy guidelines and to establish short-term and long-term strategies with respect to interest rate exposure and liquidity. The ALCO, which is comprised of key members of management, meets regularly to review financial performance and soundness, including interest rate risk and liquidity exposure in relation to present and prospective markets, business conditions, and product lines. Accordingly, the committee adopts funding and balance sheet management strategies that are intended to maintain earnings, liquidity, and growth rates consistent with policy and prudent business standards.

Table of Contents

Liquidity maintenance together with a solid capital base and strong earnings performance are key objectives of the Corporation. The Corporation's liquidity is derived from a strong deposit base comprised of individual and business deposits. Deposit accounts of customers in the mature market represent a substantial portion of deposits of individuals. The Banks' deposit base plus other funding sources (short-term borrowings, FHLB advances, other liabilities and shareholders' equity) provided primarily all funding needs in the first six months of 2010. While these sources of funds are expected to continue to be available to provide funds in the future, the mix and availability of funds will depend upon future economic conditions.

Primary liquidity is provided through short-term investments or borrowings (including federal funds sold and purchased) while the securities portfolio provides secondary liquidity. The securities portfolio has increased \$1.2 million since December 31, 2009 due to restructure of the investment portfolio. Multiple available for sale securities with elevated credit risk were sold and the proceeds used to purchase mortgage backed instruments with lower credit risk. The Corporation has re-invested some of the funds, from the call of these securities, back into the securities portfolio to increase yield and manage the asset ratios on the balance sheet. The Corporation regularly monitors liquidity to ensure adequate cash flows to cover unanticipated reductions in the availability of funding sources.

Interest rate risk is managed by controlling and limiting the level of earnings volatility arising from rate movements. The Corporation regularly performs reviews and analysis of those factors impacting interest rate risk. Factors include maturity and re-pricing frequency of balance sheet components, impact of rate changes on interest margin and prepayment speeds, market value impacts of rate changes, and other issues. Both actual and projected performance are reviewed, analyzed, and compared to policy and objectives to assure present and future financial viability.

The Corporation used cash in financing activities resulting primarily from the decrease of deposits. In the first six months of 2010 deposits decreased \$29,391,000. Cash provided by investing activities was \$24,445,000 in first six months of 2010 compared to cash provided of \$22,049,000 in first six months of 2009. The change in investing activities was due maturities of available for sale securities totaling \$5,577,000, calls on available for sale securities totaling \$3,500,000 and sales of available for sale securities totaling \$7,105,000. Those proceeds were utilized in the purchase of \$17,156,000 of available for sale securities. These transactions reduced credit risk within the investment portfolio, while slightly improving yield. In addition, payments of loans totaled \$20,907,000 of the cash provided by investing activities.

Capital Resources

Management closely monitors capital levels to provide for current and future business needs and to comply with regulatory requirements. Regulations prescribed under the Federal Deposit Insurance Corporation Improvement Act of 1991 have defined "adequately capitalized" institutions as those having total risk-based ratios, tier 1 risk-based capital ratios and tier 1 leverage ratios of at least 8%, 4%, and 4%, respectively. At June 30, 2010, the Corporation and subsidiary Banks were in excess of the minimum capital and leverage requirements as defined by federal law; however The State Bank and West Michigan Community Bank were not in compliance with the capital requirements prescribed by their respective Consent Orders.

Total shareholders' equity decreased 12.8% to \$17,895,000 at June 30, 2010 compared with \$20,532,000 at December 31, 2009. The decline was due to a net loss in the first six months of 2010, partially offset by improvements to other comprehensive income as noted below. The Corporation's equity to asset ratio was 3.9% at June 30, 2010 and 3.9% at December 31, 2009.

As indicated on the balance sheet at December 31, 2009, the Corporation had an accumulated other comprehensive loss of \$724,000 compared to accumulated other comprehensive loss at June 30, 2010 of \$159,000. The decrease in the loss position is attributable to a combination of the fluctuation of the

Table of Contents

market price of securities held in the available for sale portfolio as well as restructuring of the investment portfolio composition.

Regulatory Orders

In December 2009, The State Bank entered into a formal enforcement action with federal and state banking regulators that contain provisions to foster improvement in The State Bank's earnings, lower nonperforming loan levels, increase capital, and require revisions to various policies.

The stipulation and consent to the issuance of a consent order (the "Stipulation and Consent") among The State Bank, the FDIC and the Michigan Office of Financial and Insurance Regulation ("OFIR") contains several provisions which pertain to The State Bank's asset quality. Specifically, The State Bank is required to maintain an adequate allowance for loan losses and to adopt a plan to reduce The State Bank's risk position in each asset in excess of \$500,000 which was then classified as substandard or doubtful. In addition, while the Stipulation and Consent is in effect, The State Bank may not extend additional credit to any borrower who is already obligated on any extension of credit that has been charged-off so long as the credit remains uncollected. Likewise, The State Bank may not extend any additional credit to any borrower whose loan has been classified as substandard or doubtful and is uncollected, unless The State Bank's board of directors has adopted a plan giving the reasons why such extension of credit is in its best interest. The Stipulation and Consent also requires The State Bank to implement or improve certain plans. Specifically, The State Bank must implement a plan and budget for 2010 and 2011 to improve The State Bank's overall earnings. The State Bank must also adopt a written contingency funding plan identifying sources of liquid assets to meet contingency funding needs over the near term.

With respect to capital and management generally, The State Bank is required to have and maintain its level of Tier 1 capital as a percentage of its total assets at a minimum of 8%, its total capital to total risk-adjusted assets as a minimum of 12%, and not pay or declare any dividends without the prior consent of the FDIC and the OFIR. The State Bank must also retain qualified management and obtain approval of the FDIC and the OFIR of any changes in The State Bank's directors or senior executive officers. The capital position of The State Bank improved from its December 31, 2009 position due to the injection of \$1,900,000 from the sale of Davison State Bank at April 30, 2010. Other improvements to capital ratios at The State Bank are a result of the ongoing strategy to reduce the size of the institution.

A substantially similar formal enforcement action was entered into among West Michigan Community Bank and its regulators in February 2009. The banks have begun addressing substantially all of the requirements of the respective enforcement actions. As of June 30, 2010, the Banks have made progress in addressing several of the Consent Order stipulations. Non-performing assets have decreased \$2,189,000. The change in non-performing assets consists of a decrease of \$2,199,000 in other non-performing assets and an increase of \$10,000 in non-performing loans since December 31, 2009. Concentrations of construction and land development loans have decreased \$8,700,000 or 33.2% since December 31, 2009. As a result, these favorable changes have lead to a stabilization of the net interest margin. Net interest margin has improved .24% from December 31, 2009 to 3.66% at June 30, 2010.

The Corporation's primary source of cash to service its subordinated debt is dividends from the subsidiary banks. As the subsidiary banks are working to preserve capital and not upstream dividends to the Holding Company, the Corporation has elected to defer interest payments for five years on \$14,000,000 of subordinated debentures. The reason for the interest deferral is to maintain liquidity at the Holding Company. The Corporation is not in default under either of the indentures. During this five year period, the Corporation is precluded from paying dividends on its outstanding common stock. The Corporation subsequently may give notice that it elects to shorten the deferral period, pay accrued interest and return to the normal course of dividend payments.

Table of Contents

Critical Accounting Policies and Estimates

The Management's Discussion and Analysis of financial condition and results of operations are based on the Corporation'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 financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, income and expenses. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, income taxes, other real estate owned, and investment securities valuation. Actual results could differ from those estimates.

The allowance for loan losses is maintained at a level we believe is adequate to absorb probable losses identified and inherent in the loan portfolio. Our evaluation of the adequacy of the allowance for loan losses is an estimate based on reviews of individual loans, assessments of the impact of current and anticipated economic conditions on the portfolio, and historical loss experience. The allowance for loan losses represents management's best estimate, but significant downturns in circumstances relating to loan quality or economic conditions could result in a requirement for an increased allowance for loan losses in the near future. Likewise, an upturn in loan quality or improved economic conditions may result in a decline in the required allowance for loan losses. In either instance unanticipated changes could have a significant impact on operating earnings.

The allowance for loan losses is increased through a provision charged to operating expense. Uncollectible loans are charged-off through the allowance for loan losses. Recoveries of loans previously charged-off are added to the allowance for loan losses. A loan is considered impaired when it is probable that contractual interest and principal payments will not be collected either for the amounts or by the dates as scheduled in the loan agreement.

Our accounting for income taxes involves the valuation of deferred tax assets and liabilities primarily associated with differences in the timing of the recognition of revenues and expenses for financial reporting and tax purposes. A valuation allowance related to deferred tax assets is required when it is considered more likely than not that all or part of the benefit related to such assets will not be realized. Management has reviewed the deferred tax position for the Corporation at June 30, 2010 and December 31, 2009. During the second quarter of 2009, the Corporation recognized a valuation allowance. The valuation allowance against our deferred tax assets may be reversed to income in future periods to the extent that the related deferred income tax assets are realized or the valuation allowance is otherwise no longer required. Management will continue to monitor our deferred tax assets quarterly for changes affecting their realizability.

Other Real Estate Owned and Foreclosed Assets are acquired through or instead of loan foreclosure. They are initially recorded at fair value less estimated selling costs when acquired, establishing a new cost basis. If fair value declines, a valuation allowance is recorded through expense. Costs after acquisition are expensed.

The Corporation evaluates securities for other-than-temporary impairment (OTTI) at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. In determining other-than-temporary impairment (OTTI) management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

Table of Contents**Off Balance Sheet Arrangements**

Some financial instruments, such as loan commitments, credit lines, letters of credit, and overdraft protection, are issued to meet customer financing needs. These are agreements to provide credit or to support the credit of others, as long as conditions established in the contract are met, and usually have expiration dates. Commitments may expire without being used. Off-balance-sheet risk to credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, including obtaining collateral at exercise of the commitment.

The contractual amount of financial instruments with off-balance-sheet risk was as follows at:

| (000s omitted) | June 30, 2010 | December 31, 2009 |
|--|------------------|----------------------|
| Commitments to make loans (at market rates) | \$ 5,812 | \$ 2,939 |
| Unused lines of credit and letters of credit | 44,659 | 53,941 |

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

The information concerning quantitative and qualitative disclosures about market risk contained on page 61 in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2009, is incorporated herein by reference.

Fentura Financial, Inc. faces market risk to the extent that both earnings and the fair value of its financial instruments are affected by changes in interest rates. The Corporation manages this risk with static GAP analysis and simulation modeling. For the first six months of 2010, the results of these measurement techniques were within the Corporation's policy guidelines. The Corporation does not believe that there has been a material change in the nature of the Corporation's primary market risk exposures, including the categories of market risk to which the Corporation is exposed and the particular markets that present the primary risk of loss to the Corporation, or in how those exposures have been managed in 2010 compared to 2009.

The Corporation's market risk exposure is mainly comprised of its vulnerability to interest rate risk. Prevailing interest rates and interest rate relationships in the future will be primarily determined by market factors, which are outside of the Corporation's control. All information provided in this section consists of forward-looking statements. Reference is made to the section captioned "Forward Looking Statements" in this quarterly report for a discussion of the limitations on the Corporation's responsibility for such statements.

Interest Rate Sensitivity Management

Interest rate sensitivity management seeks to maximize net interest income as a result of changing interest rates, within prudent ranges of risk. The Corporation attempts to accomplish this objective by structuring the balance sheet so that re-pricing opportunities exist for both assets and liabilities in roughly equivalent amounts at approximately the same time intervals. Imbalances in these re-pricing opportunities at any point in time constitute a bank's interest rate sensitivity. The Corporation currently does not utilize derivatives in managing interest rate risk.

An indicator of the interest rate sensitivity structure of a financial institution's balance sheet is the difference between rate sensitive assets and rate sensitive liabilities, and is referred to as "GAP." Table 5 sets forth the distribution of re-pricing of the Corporation's earning assets and interest bearing liabilities as of June 30, 2010, the interest rate sensitivity GAP, as defined above, the cumulative interest rate sensitivity GAP, the interest rate sensitivity GAP ratio (i.e. interest rate sensitive assets divided by interest rate sensitive liabilities) and the cumulative sensitivity GAP ratio. The table also sets forth the time

Table of Contents

periods in which earning assets and liabilities will mature or may re-price in accordance with their contractual terms.

Table 6 GAP Analysis June 30, 2010

| (000s omitted) | Within Three Months | Three Months to One Year | One to Five Years | After Five Years | Total |
|---|---------------------------|--------------------------------|-------------------------|------------------------|-------------------|
| Earning Assets: | | | | | |
| Federal Funds Sold | \$ 28,050 | \$ 0 | \$ 0 | \$ 0 | \$ 28,050 |
| Securities | 5,815 | 13,314 | 11,961 | 19,211 | 50,301 |
| Loans | 76,065 | 59,985 | 152,187 | 42,045 | 330,282 |
| Loans Held for Sale | 1,259 | 0 | 0 | 0 | 1,259 |
| FHLB Stock | 1,900 | 0 | 0 | 0 | 1,900 |
| Total Earning Assets | \$ 113,089 | \$ 73,299 | \$ 164,148 | \$ 61,256 | \$ 411,792 |
| Interest Bearing Liabilities: | | | | | |
| Interest Bearing Demand Deposits | \$ 80,878 | \$ 0 | \$ 0 | \$ 0 | \$ 80,878 |
| Savings Deposits | 74,869 | 0 | 0 | 0 | 74,869 |
| Time Deposits Less than \$100,000 | 19,831 | 42,325 | 34,726 | 98 | 96,980 |
| Time Deposits Greater than \$100,000 | 6,766 | 42,385 | 39,551 | 0 | 88,702 |
| Short term borrowings | 10 | 0 | 0 | 0 | 10 |
| Other Borrowings | 2,000 | 5,030 | 148 | 776 | 7,954 |
| Subordinated debentures | 14,000 | 0 | 0 | 0 | 14,000 |
| Total Interest Bearing Liabilities | \$ 198,354 | \$ 89,740 | \$ 74,425 | \$ 874 | \$ 363,393 |
| Interest Rate Sensitivity GAP | \$ (85,265) | \$ (16,441) | \$ 89,723 | \$ 60,382 | \$ 48,399 |
| Cumulative Interest Rate Sensitivity GAP | \$ (85,265) | \$ (101,706) | \$ (11,983) | \$ 48,399 | |
| Interest Rate Sensitivity GAP Ratio | 0.57 | 0.82 | 2.21 | 70.09 | |
| Cumulative Interest Rate Sensitivity GAP Ratio | 0.57 | 0.65 | 0.97 | 1.13 | |

As indicated in Table 6, the short-term (one year and less) cumulative interest rate sensitivity gap is negative. Accordingly, if market interest rates increase, this negative gap position could have a short-term negative impact on interest margin. Conversely, if market rates decline this should theoretically have a short-term positive impact. However, gap analysis is limited and may not provide an accurate indication of the impact of general interest rate movements on the net interest margin since the re-pricing of various categories of assets and liabilities is subject to the Corporation's needs, competitive pressures, and the needs of the Corporation's customers. In addition, various assets and liabilities indicated as re-pricing within the same period may in fact re-price at different times within such period and at different rate indices. The Prime Rate has remained steady over the past twelve months. This steadiness allowed management to close the gap related to interest rate sensitivity. Management was able to reduce liquid interest bearing liability rates to extremely low rates, while maintaining relatively similar volumes. The Banks were also able to re-price maturing time deposits, usually in a downward fashion as longer term certificates at higher rates matured during the year. On the asset side of the balance sheet, rates on the investment portfolios remained relatively steady, however the yields on loans decreased slightly. Management worked to re-price loans favorably as they renewed and were priced accordingly for risk, however overall loan yields decreased. This was due to increases in non-performing loans. The Corporation expects to continue to make strides in managing interest rate sensitivity.

Forward Looking Statements

This report includes forward-looking statements as that term is used in the securities laws. All statements regarding our expected financial position, business and strategies are forward-looking statements. In addition, the words anticipates, believes, estimates, seeks, expects, plans, intends, and similar expressions, as they relate to us management, are intended to identify

Table of Contents

forward-looking statements. The presentation and discussion of the provision and allowance for loan losses and statements concerning future profitability or future growth or increases, are examples of inherently forward looking statements in that they involve judgments and statements of belief as to the outcome of future events. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse affect on our operations and our future prospects include, but are not limited to, changes in: interest rates, general economic conditions, legislative/regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality or composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in our market area and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Further information concerning us and our business, including additional factors that could materially affect our financial results, is included in our other filings with the Securities and Exchange Commission.

ITEM 4T: CONTROLS AND PROCEDURES

- (a) Evaluation of Disclosure Controls and Procedures. The Corporation's Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of the Corporation's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this Form 10-Q Quarterly Report, have concluded that the Corporation's disclosure controls and procedures were adequate and effective to ensure that material information relating to the Corporation would be made known to them by others within the Corporation, particularly during the period in which this Form 10-Q was being prepared.
- (b) Changes in Internal Controls. During the period covered by this report, there have been no changes in the Corporation's internal control over financial reporting that have materially affected or are reasonably likely to materially affect the Corporation's internal control over financial reporting.

Table of Contents

PART II OTHER INFORMATION

Item 1. Legal Proceedings. - None

Item 1A. Risk Factors This item is not applicable to smaller reporting companies.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds. None

Item 3. Defaults Upon Senior Securities. None

Item 4. [Reserved]

Item 5. Other Information. None

Item 6. Exhibits.

(a) Exhibits

- 10.1 Stock purchase agreement for sale of West Michigan Community Bank dated April 27, 2010 (incorporated by reference from Form 8-K filed on May 3, 2010).
- 31.1 Certificate of the President and Chief Executive Officer of Fentura Financial, Inc. pursuant to 15 U.S.C. Section 7241, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certificate of the Chief Financial Officer of Fentura Financial, Inc. pursuant to 15 U.S.C. Section 7241, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certificate of the Chief Executive Officer of Fentura Financial, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certificate of the Chief Financial Officer of Fentura Financial, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Table of Contents

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Fentura Financial, Inc.

Dated: August 13, 2010

/s/Donald L. Grill
Donald L. Grill
President & CEO

Dated: August 13, 2010

/s/Douglas J. Kelley
Douglas J. Kelley
Chief Financial Officer
42

Table of Contents

EXHIBIT INDEX

| Exhibit | Description |
|---------|---|
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