

ConnectOne Bancorp, Inc.
Form 10-Q
May 10, 2013

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2013

or

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

For the transition period from _____ to _____

Commission file number **001-35812**

CONNECTONE BANCORP, INC.

(Exact name of Registrant as Specified in Its Charter)

NEW JERSEY

(State or other jurisdiction of incorporation or organization)

26-1998619

(I.R.S. Employer Identification Number)

301 Sylvan Avenue

Englewood Cliffs, New Jersey 07632

(Address of Principal Executive Offices)

(201) 816-8900

(Issuer's Telephone Number, including area code)

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities and 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 SD-T 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 or a smaller reporting company. See definition of large accelerated filer, accelerated filer and small reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

As of May 4, 2013 there were 5,021,142 shares of common stock, no par value, outstanding.

ConnectOne Bancorp, Inc.

FORM 10-Q

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PART I – FINANCIAL INFORMATION**Item 1. Financial Statements**

ConnectOne Bancorp, Inc.
CONSOLIDATED BALANCE SHEETS
(dollars in thousands)

	March 31, 2013	December 31, 2012
Assets		
Cash and due from banks	\$3,119	\$3,242
Interest-bearing deposits with banks	73,238	47,387
Cash and cash equivalents	76,357	50,629
Securities available for sale	17,565	19,252
Securities held to maturity, fair value of \$1,767 at 2013 and \$2,084 at 2012	1,680	1,985
Loans held for sale	285	405
Loans receivable	901,286	848,842
Less: Allowance for loan losses	(13,637)	(13,246)
Net loans receivable	887,649	835,596
Investment in restricted stock, at cost	4,516	4,744
Bank premises and equipment, net	8,308	7,904
Accrued interest receivable	3,518	3,361
Other real estate owned	433	433
Goodwill	260	260
Other assets	5,200	5,357
Total assets	\$1,005,771	\$929,926
Liabilities		
Deposits		
Non-interest-bearing	\$167,998	\$170,355
Interest-bearing	631,080	598,963
Total deposits	799,078	769,318
Long-term borrowings	74,406	79,568
Accrued interest payable	2,677	2,803
Capital lease obligation	3,167	3,185
Other liabilities	4,004	2,690
Total liabilities	883,332	857,564
Stockholders' Equity		
Common stock, no par value; authorized 10,000,000 shares at March 31, 2013 and December 31, 2012; issued and outstanding 5,021,142 at March 31, 2013 and 3,166,217 at December 31, 2012	99,019	51,205

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Retained earnings	22,997	20,661
Accumulated other comprehensive income	423	496
Total stockholders' equity	122,439	72,362
Total liabilities and stockholders' equity	\$1,005,771	\$929,926

See accompanying notes to unaudited consolidated financial statements.

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ConnectOne Bancorp, Inc.
CONSOLIDATED STATEMENTS OF INCOME
(dollars in thousands, except per share data)

	Three Months Ended March 31,	
	2013	2012
Interest income		
Loans receivable, including fees	\$10,696	\$9,006
Securities	195	281
Other interest income	21	17
Total interest income	10,912	9,304
Interest expense		
Deposits	1,146	1,196
Long-term borrowings	334	316
Capital lease	48	49
Total interest expense	1,528	1,561
Net interest income	9,384	7,743
Provision for loan losses	925	750
Net interest income after provision for loan losses	8,459	6,993
Non-interest income		
Service fees	100	90
Gains on sales of loans	83	98
Gains/(losses) on sales of securities	—	—
Other income	76	57
Total non-interest income	259	245
Non-interest expenses		
Salaries and employee benefits	2,480	2,095
Occupancy and equipment	729	724
Professional fees	271	207
Advertising and promotion	103	79
Data processing	447	408
Other expenses	711	635
Total non-interest expenses	4,741	4,148
Income before income tax expense	3,977	3,090
Income tax expense	1,641	1,248
Net income	2,336	1,842
Dividends on preferred shares	—	146
Net income available to common stockholders	\$2,336	\$1,696
Earnings per common share		
Basic	\$0.58	\$0.76
Diluted	0.56	0.62
Weighted average common shares outstanding		
Basic	4,055,908	2,243,740

Diluted

4,178,214 2,977,879

See accompanying notes to unaudited consolidated financial statements.

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ConnectOne Bancorp, Inc.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

	Three Months Ended March 31,	
	2013	2012
Net income	\$2,336	\$1,842
Unrealized holdings (losses)/gains on available for sale securities arising during the period	(122)	273
Tax effect	(49)	108
Other comprehensive (loss) income	(73)	165
Comprehensive income	\$2,263	\$2,007

See accompanying notes to unaudited consolidated financial statements.

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ConnectOne Bancorp, Inc.**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**

(dollars in thousands)

	Common Stock	Preferred Stock, Series A	Preferred Stock, Series B	Preferred Stock Series C	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance at January 1, 2012	\$ 27,149	\$ 2,500	\$ 14,004	\$ —	\$ 12,594	\$ 610	\$ 56,857
Net income	—	—	—	—	8,421	—	8,421
Other comprehensive loss, net of taxes	—	—	—	—	—	(114)	(114)
Issuance of convertible preferred stock; Series C, 7,500 shares	—	—	—	7,500	—	—	7,500
Conversion of preferred stock; Series A, Series B, and Series C	24,004	(2,500)	(14,004)	(7,500)	—	—	—
Cash dividends paid on preferred stock	—	—	—	—	(354)	—	(354)
Equity-based compensation	52	—	—	—	—	—	52
Balance at December 31, 2012	51,205	—	—	—	20,661	496	72,362
Net income	—	—	—	—	2,336	—	2,336
Other comprehensive loss, net of taxes	—	—	—	—	—	(73)	(73)
Issuance of 1,840,000 shares, net of expenses	47,715	—	—	—	—	—	47,715
Equity-based compensation	99	—	—	—	—	—	99
Balance at March 31, 2013	\$ 99,019	\$ —	\$ —	\$ —	\$ 22,997	\$ 423	\$ 122,439

See accompanying notes to unaudited consolidated financial statements.

ConnectOne Bancorp, Inc.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Three Months Ended March 31,	
	2013	2012
Cash flows from operating activities		
Net income	\$2,336	\$1,842
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	925	750
Depreciation and amortization	297	326
Net amortization of securities discounts and premiums	20	12
Stock compensation earned	99	—
Amortization of intangible assets	—	5
Proceeds from sale of loans	4,352	4,788
Origination of loans held for sale	(4,149)	(6,437)
Gain on sales of loans	(83)	(98)
Increase in accrued interest receivable	(157)	(126)
Increase (decrease) in accrued interest payable	(126)	287
Increase (decrease) in other liabilities	1,314	(713)
Decrease in other assets	205	140
Net cash provided by operating activities	5,033	776
Cash flows from investing activities		
Net increase in loans	(52,978)	(59,146)
Maturities, calls and principal repayments of securities held to maturity and available for sale	1,851	3,527
Net decrease (increase) in investments in restricted stock, at cost	228	(736)
Purchases of premises and equipment	(701)	(103)
Net cash used in investing activities	(51,600)	(56,458)
Cash flows from financing activities		
Net increase in deposits	29,760	16,139
Proceeds from long-term borrowing	5,000	35,000
Repayments of long-term borrowings	(10,162)	(25,245)
Net proceeds from initial public offering	47,715	—
Proceeds from sale of preferred stock	—	6,010
Decrease in capital lease obligation	(18)	(18)
Preferred stock dividends	—	(146)
Net cash provided by financing activities	72,295	31,740
Net increase (decrease) in cash and cash equivalents	25,728	(23,942)
Cash and cash equivalents – beginning	50,629	59,176
Cash and cash equivalents – ending	\$76,357	\$35,234
Supplementary cash flows information:		
Interest paid	\$1,654	\$1,274
Income taxes paid	\$900	\$1,602

See accompanying notes to unaudited consolidated financial statements.

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ConnectOne Bancorp, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations and Principles of Consolidation: The consolidated financial statements include ConnectOne Bancorp, Inc. and its wholly owned subsidiary, ConnectOne Bank (“the Bank”), together referred to as “the Company.” Intercompany transactions and balances are eliminated in consolidation.

The Company provides financial services through its offices in Bergen, Hudson, and Monmouth counties, New Jersey. Its primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are residential mortgage, commercial, and installment loans. Substantially all loans are secured by specific items of collateral including business assets, consumer assets, and commercial and residential real estate. Commercial loans are expected to be repaid from cash flow from business operations. There are no significant concentrations of loans to any one industry or customer. However, the customers’ ability to repay their loans is dependent on the cash flows, real estate and general economic conditions in the area.

The consolidated financial information included herein as of and for the periods ended March 31, 2013 and 2012 is unaudited. The accompanying unaudited consolidated financial statements included herein have been prepared by the Company in accordance with U.S. generally accepted accounting principles and pursuant to the rules and regulations of the Securities and Exchange Commission and reflect all adjustments which, in the opinion of management, are considered necessary for a fair presentation of the financial condition and results of operations for the periods presented. All adjustments made were of a normal and recurring nature. Operating results for the three months ended March 31, 2013 are not necessarily indicative of the results that may be expected for the year ended December 31, 2013. These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto, included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2012.

Adoption of New Accounting Guidance: In February 2013, the FASB amended existing guidance to require an entity to provide information about amounts reclassified out of other comprehensive income by component. In addition, an entity is required to present, either on the face of the income statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under United States generally accepted accounting principles to be reclassified to net income in its entirety in the same reporting period. For all other amounts, an entity is required to cross-reference to other disclosures that provide additional details about these amounts. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2012. The adoption of the guidance did not have a material impact on the Company’s results of operation or financial position.

NOTE 2 - SECURITIES

The amortized cost, gross unrealized gains and losses and fair value of securities available for sale at March 31, 2013 and December 31, 2012, are as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<u>March 31, 2013</u>				
Securities available for sale:				
U.S. Government agencies	\$ 1,000	\$ 2	\$ —	\$ 1,002
Mortgage-backed securities – residential	9,856	535	—	10,391
CRA investment fund	6,000	172	—	6,172
	\$ 16,856	\$ 709	\$ —	\$ 17,565

December 31, 2012

Securities available for sale:

U.S. Government agencies	\$ 1,000	\$ 5	\$ —	\$ 1,005
Mortgage-backed securities – residential	11,421	608	—	12,029
CRA investment fund	6,000	218	—	6,218
	\$ 18,421	\$ 831	\$ —	\$ 19,252

The amortized cost, gross unrecognized gains and losses and fair value of securities held to maturity at March 31, 2013 and December 31, 2012, are as follows (dollars in thousands):

	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Fair Value
<u>March 31, 2013</u>				
Securities held to maturity:				
Mortgage-backed securities – residential	\$ 1,680	\$ 87	\$ —	\$ 1,767

December 31, 2012

Securities held to maturity:

Mortgage-backed securities – residential	\$ 1,985	\$ 99	\$ —	\$ 2,084
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NOTE 2 - SECURITIES

(continued)

The amortized cost and fair value of debt securities available for sale and held to maturity at March 31, 2013, by contractual maturity, are shown below (dollars in thousands). Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities do not have a specific maturity date and are shown separately.

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
<u>March 31, 2013</u>				
U.S. Government agencies:				
Due in under one year or less	\$ 1,000	\$ 1,002	\$ —	\$ —
Due after one year through five years	—	—	—	—
Due after five years through ten years	—	—	—	—
Due after ten years	—	—	—	—
Mortgage-backed securities – residential	9,856	10,391	1,680	1,767
	\$ 10,856	\$ 11,393	\$ 1,680	\$ 1,767

There were no sales of available for sale securities for the quarters ended March 31, 2013 and 2012.

Securities with a carrying value of \$293,317 and \$322,272 at March 31, 2013 and December 31, 2012, respectively, were pledged to secure public deposits, securities sold under agreements to repurchase and for other purposes as required or permitted by law.

There were no securities in an unrealized loss position at March 31, 2013 and December 31, 2012.

NOTE 3 – LOANS RECEIVABLE

The composition of loans receivable (which excludes loans held for sale) at March 31, 2013 and December 31, 2012 are as follows (dollars in thousands):

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	March 31, 2013	December 31, 2012
Commercial	\$ 168,172	\$ 147,455
Commercial real estate	580,362	549,218
Commercial construction	29,096	36,872
Residential real estate	91,148	82,962
Home equity	31,325	30,961
Consumer	1,721	1,801
Gross loans	901,824	849,269
Unearned net origination fees and costs	(538)	(427)
Loans receivable	901,286	848,842
Less: Allowance for loan losses	(13,637)	(13,246)
Net loans receivable	\$ 887,649	\$ 835,596

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NOTE 3 – LOANS RECEIVABLE

(continued)

The portfolio classes in the above table have unique risk characteristics with respect to credit quality:

The repayment of commercial loans is generally dependent on the creditworthiness and cash flow of borrowers, and if applicable, guarantors, which may be negatively impacted by adverse economic conditions. While the majority of these loans are secured, collateral type, marketing, coverage, valuation and monitoring is not as uniform as in other portfolio classes and recovery from liquidation of such collateral may be subject to greater variability.

Payment on commercial real estate loans is driven principally by operating results of the managed properties or underlying business and secondarily by the sale or refinance of such properties. Both primary and secondary sources of repayment, and value of the properties in liquidation, may be affected to a greater extent by adverse conditions in the real estate market or the economy in general.

Properties underlying commercial construction loans often do not generate sufficient cash flows to service debt and thus repayment is subject to ability of the borrower and, if applicable, guarantors, to complete development or construction of the property and carry the project, often for extended periods of time until the property can be sold. As a result, the performance of these loans is contingent upon future events whose probability at the time of origination is uncertain.

The ability of borrowers to service debt in the residential, home equity and consumer loan portfolios is generally subject to personal income which may be impacted by general economic conditions, such as increased unemployment levels. These loans are predominately collateralized by first and/or second liens on single family properties. If a borrower cannot maintain the loan, the Company's ability to recover against the collateral in sufficient amount and in a timely manner may be significantly influenced by market, legal and regulatory conditions.

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NOTE 3 – LOANS RECEIVABLE

(continued)

The following table represents the allocation of allowance for loan losses and the related loans by loan portfolio segment disaggregated based on the impairment methodology at March 31, 2013 and December 31, 2012 (dollars in thousands):

	Commercial	Commercial	Commercial	Residential	Home			
	Commercial	Real	Commercial	Real	Equity	Consumer	Unallocated	Total
	Estate	Estate	Construction	Estate	Lines of	Unallocated		
					Credit			
<u>March 31, 2013</u>								
Allowance for loan losses:								
Individually evaluated for impairment	\$ 648	\$ 612	\$ —	\$ 45	\$ —	\$ —	\$ —	\$ 1,305
Collectively evaluated for impairment	2,596	6,937	370	1,519	625	33	252	12,332
Total	\$ 3,244	\$ 7,549	\$ 370	\$ 1,564	\$ 625	\$ 33	\$ 252	\$ 13,637
Loans receivable:								
Individually evaluated for impairment	\$ 3,135	\$ 5,666	\$ —	\$ 3,662	\$ 119	\$ —	\$ —	\$ 12,582
Collectively evaluated for impairment	165,037	574,696	29,096	87,486	31,206	1,721	—	889,242
Total	\$ 168,172	\$ 580,362	\$ 29,096	\$ 91,148	\$ 31,325	\$ 1,721	\$ —	\$ 901,824
<u>December 31, 2012</u>								
Allowance for loan losses:								
Individually evaluated for impairment	\$ 165	\$ 1,006	\$ 27	\$ —	\$ —	\$ —	\$ —	\$ 1,198
Collectively evaluated for impairment	2,237	6,712	633	1,542	617	41	266	12,048
Total	\$ 2,402	\$ 7,718	\$ 660	\$ 1,542	\$ 617	\$ 41	\$ 266	\$ 13,246
Loans receivable:								
Individually evaluated for impairment	\$ 3,124	\$ 4,697	\$ 395	\$ 2,995	\$ 119	\$ —	\$ —	\$ 11,330
Collectively evaluated for impairment	144,331	544,521	36,477	79,967	30,842	1,801	—	837,939

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Total	\$ 147,455	\$ 549,218	\$ 36,872	\$ 82,962	\$ 30,961	\$ 1,801	\$ —	\$ 849,269
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NOTE 3 – LOANS RECEIVABLE

(continued)

The following tables present information related to impaired loans by class of loans (dollars in thousands):

	Unpaid Principal Balance	Recorded Investment(1)	Allowance for Loan Losses Allocated	Average Recorded Investment(1)	Interest Income Recognized	Cash Basis Interest Recognized
<u>March 31, 2013</u>						
With no related allowance recorded:						
Commercial	\$ 273	\$ 276	—	\$ 286	\$ —	\$ —
Commercial real estate	2,392	2,434	—	1,666	16	—
Commercial construction	—	—	—	—	—	—
Residential real estate	3,023	3,068	—	3,058	—	—
Home equity lines of credit	119	121	—	121	1	—
Consumer	—	—	—	—	—	—
	5,807	5,899	—	5,131	17	—
With an allowance recorded:						
Commercial	2,862	2,862	648	2,895	32	32
Commercial real estate	3,274	3,326	612	3,442	35	—
Commercial construction	—	—	—	—	—	—
Residential real estate	639	647	45	660	8	—
Home equity lines of credit	—	—	—	—	—	—
Consumer	—	—	—	—	—	—
	6,775	6,835	1,305	6,997	75	32
Total	\$ 12,582	\$ 12,734	\$ 1,305	\$ 12,128	\$ 92	\$ 32
<u>December 31, 2012</u>						
With no related allowance recorded:						
Commercial	\$ 273	\$ 291	—	\$ 285	\$ —	\$ —
Commercial real estate	1,705	1,738	—	1,354	46	—
Commercial construction	—	—	—	—	—	—
Residential real estate	2,995	3,196	—	3,047	119	—
Home equity lines of credit	119	125	—	121	7	—
Consumer	—	—	—	—	—	—
	5,092	5,350	—	4,807	172	—
With an allowance recorded:						
Commercial	2,851	2,984	165	2,895	135	33

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Commercial real estate	2,992	3,206	1,006	3,200	26	—
Commercial construction	395	424	27	414	29	—
Residential real estate	—	—	—	—	—	—
Home equity lines of credit	—	—	—	—	—	—
Consumer	—	—	—	—	—	—
	6,238	6,614	1,198	6,509	190	33
Total	\$ 11,330	\$ 11,964	\$ 1,198	\$ 11,316	\$ 362	\$ 33

(1) The recorded investment in loans include accrued interest receivable and other capitalized costs such as real estate taxes paid on behalf of the borrower and loan origination fees, net.

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NOTE 3 – LOANS RECEIVABLE

(continued)

The following table presents nonaccrual and loans past due 90 days or greater and still accruing by class of loans (dollars in thousands):

	Nonaccrual		Loans Past Due 90 Days or Greater Still Accruing	
	March 31, 2013	December 31, 2012	March 31, 2013	December 31, 2012
Commercial	\$3,135	\$ 3,124	\$ —	\$ —
Commercial real estate	1,994	2,446	—	—
Commercial construction	—	—	—	—
Residential real estate	2,369	2,369	—	—
Home equity lines of credit	—	—	—	—
Consumer	—	—	—	—
Total	\$7,498	\$ 7,939	\$ —	\$ —

The following tables present past due and current loans by the loan portfolio class (dollars in thousands):

	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Current	Total Gross Loans
<u>March 31, 2013</u>						
Commercial	\$ —	\$ —	\$ 273	\$ 273	\$167,899	\$168,172
Commercial real estate	144	2,605	1,994	4,743	575,619	580,362
Commercial construction	—	—	—	—	29,096	29,096
Residential real estate	2,723	—	2,369	5,092	86,056	91,148
Home equity lines of credit	101	114	—	215	31,110	31,325
Consumer	—	—	—	—	1,721	1,721
Total	\$ 2,968	\$ 2,719	\$ 4,636	\$ 10,323	\$891,501	\$901,824
<u>December 31, 2012</u>						
Commercial	\$ —	\$ —	\$ 273	\$ 273	\$147,182	\$147,455
Commercial real estate	—	142	2,446	2,588	546,630	549,218

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Commercial construction	—	—	—	—	36,872	36,872
Residential real estate	1,769	—	2,369	4,138	78,824	82,962
Home equity lines of credit	35	—	—	35	30,926	30,961
Consumer	—	—	—	—	1,801	1,801
Total	\$ 1,804	\$ 142	\$ 5,088	\$ 7,034	\$ 842,235	\$ 849,269

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NOTE 3 – LOANS RECEIVABLE

(continued)

There were no trouble debt restructurings that occurred during the quarters ended March 31, 2013 and 2012. There were no troubled debt restructurings for which there was a payment default within twelve months following the modification during the quarters ended March 31, 2013 and 2012. A loan is considered to be in payment default once it is 90 days contractually past due under the modified terms.

Credit Quality Indicators

The Bank categorizes loans into risk categories based on relevant information about the quality and realizable value of collateral, if any, and the ability of borrowers to service their debts such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Bank analyzes loans individually by classifying the loans as to credit risk. This analysis is performed whenever a credit is extended, renewed or modified, or when an observable event occurs indicating a potential decline in credit quality, and no less than annually for large balance loss. The Bank used the following definitions for risk ratings:

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

Substandard: Loans classified as substandard are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the repayment and liquidation of the debt. They are characterized by distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Normal payment from the borrower is in jeopardy, although loss of principal, while still possible, is not imminent.

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

The following table presents the risk category of loans by class of loans based on the most recent analysis performed as of March 31, 2013 and December 31, 2012 (dollars in thousands):

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Credit Risk Profile by Internally Assigned Grades	Pass	Special Mention	Substandard	Doubtful	Total
<u>March 31, 2013</u>					
Commercial	\$149,162	\$12,319	\$6,691	\$—	\$168,172
Commercial real estate	562,104	7,380	10,878	—	580,362
Commercial construction	28,200	—	896	—	29,096
Total	\$739,466	\$19,699	\$18,465	\$—	\$777,630
<u>December 31, 2012</u>					
Commercial	\$131,887	\$11,733	\$3,835	\$—	\$147,455
Commercial real estate	529,453	6,602	13,163	—	549,218
Commercial construction	35,985	—	887	—	36,872
Total	\$697,325	\$18,335	\$17,885	\$—	\$733,545

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NOTE 3 – LOANS RECEIVABLE

(continued)

Residential real estate, home equity lines of credit, and consumer loans are not rated. The Company evaluates credit quality of those loans by aging status of the loan and by payment activity, which was previously presented.

The following table presents the activity in the Company's allowance for loan losses by class of loans (dollars in thousands):

	Commercial Real Estate	Commercial Construction	Residential Real Estate	Home Equity Lines of Credit	Consumer	Unallocated	Total	
Allowance for loan losses:								
Beginning balance at January 1, 2013	\$ 2,402	\$ 7,718	\$ 660	\$ 1,542	\$ 617	\$ 41	\$ 266	\$13,246
Charge-offs	—	(452)	—	—	(79)	(3)	—	(534)
Recoveries	—	—	—	—	—	—	—	—
Provision for loan losses	842	283	(290)	22	87	(5)	(14)	925
Total ending balance at March 31, 2013	\$ 3,244	\$ 7,549	\$ 370	\$ 1,564	\$ 625	\$ 33	\$ 252	\$13,637
Allowance for loan losses:								
Beginning balance at January 1, 2012	\$ 653	\$ 5,658	\$ 447	\$ 2,517	\$ 339	\$ 3	\$ —	\$9,617
Charge-offs	(1)	—	(15)	—	—	—	—	(16)
Recoveries	—	1	—	—	—	30	—	31
Provision for loan losses	989	(67)	556	(728)	25	(25)	—	750
Total ending balance at March 31, 2012	\$ 1,641	\$ 5,592	\$ 988	\$ 1,789	\$ 364	\$ 8	\$ —	\$10,382

NOTE 4 - STOCK OPTION PLANS AND EQUITY COMPENSATION PLAN

At March 31, 2013, there were 235,084 shares available for awards under the Company's equity plans. Awards may be in the form of options, restricted stock or other equity awards. A summary of the stock option activity in the Company's equity plans for the three months ended March 31, 2013 are as follows:

	Shares	Weighted Average Exercised Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2013	300,438	\$ 12.32		
Granted	—	—		
Exercised	—	—		
Forfeited	—	—		
Expired	—	—		
Outstanding at March 31, 2013	300,438	\$ 12.32	4.16	\$5,687,654
Fully vested and expected to vest	300,438	\$ 12.32	4.16	\$5,687,654
Exercisable at March 31, 2013	282,638	\$ 11.95	3.86	\$5,455,013

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NOTE 4 - STOCK OPTION PLANS AND EQUITY COMPENSATION PLAN

(continued)

As of March 31, 2013 and December 31, 2012, there was \$6,282 and \$4,200, respectively, of total unrecognized compensation cost related to nonvested stock options granted under the Company's plan. The cost is expected to be recognized over a weighted-average period of less than one month. Aggregate intrinsic value is based on a fair value share price of \$31.25, which is derived from the closing price of our common stock at March 31, 2013.

In conjunction with the Company's equity plans, the Company granted restricted shares to certain executive officers. Compensation expense is recognized over the vesting period of the awards based on the fair value of the stock at issue date. The fair value of the stock was based on the book value of stock on the date of the award. Generally, grants of restricted shares vest one-third, each, on the first, second and third anniversaries of the grant date.

A summary of changes in the Company's nonvested restricted shares for the quarter ended March 31, 2013 is as follows:

Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value
Nonvested at December 31, 2012	10,075	\$ 18.26
Granted	14,925	
Vested	(3,737)	
Forfeited	—	
Nonvested at March 31, 2013	21,263	\$ 21.71

As of March 31, 2013, there was \$415,283 of total unrecognized compensation cost related to nonvested shares granted under the plans. The cost is expected to be recognized over a weighted average period of 2.3 years. The total fair value of shares vested during the quarter ended March 31, 2013 was \$61,988.

NOTE 5 - FAIR VALUE MEASUREMENTS AND FAIR VALUE OF FINANCIAL INSTRUMENTS

Management uses its best judgment in estimating the fair value of the Company's financial instruments; however, there are inherent weaknesses in any estimation technique. The estimated fair value amounts have been measured as of March 31, 2013 and December 31, 2012, and have not been re-evaluated or updated for purposes of these consolidated financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each year end.

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

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

Level 2: Significant 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.

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

NOTE 5 - FAIR VALUE MEASUREMENTS AND FAIR VALUE OF FINANCIAL INSTRUMENTS

(continued)

The Company used the following methods and significant assumptions to estimate fair value:

An asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

Investment Securities: The fair values for investment securities are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3). Discounted cash flows are calculated using spread to swap and LIBOR curves that are updated to incorporate loss severities, volatility, credit spread and optionality. During times when trading is more liquid, broker quotes are used (if available) to validate the model. Rating agency and industry research reports as well as defaults and deferrals on individual securities are reviewed and incorporated into the calculations.

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 independent 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.

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at March 31, 2013 and December 31, 2012 are as follows (dollars in thousands):

Assets and Liabilities Measured on a Recurring Basis

	Fair Value Measurements Using
Quoted Significant	Significant
Prices Other	Unobservable
In Observable	Inputs
Inputs	(Level 3)

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Marked (Level 2)
for
Identical
Assets
(Level
1)

March 31, 2013

Securities:

U.S. Government Agencies	\$—\$ 1,002	\$	—
Mortgage-backed – residential	— 10,391		—
CRA mutual fund	— 6,172		—

December 31, 2012

Securities:

U.S. Government Agencies	\$—\$ 1,005	\$	—
Mortgage-backed – residential	— 12,029		—
CRA mutual fund	— 6,218		—

NOTE 5 - FAIR VALUE MEASUREMENTS AND FAIR VALUE OF FINANCIAL INSTRUMENTS

(continued)

Assets and Liabilities Measured on a Non-recurring Basis

Assets measured at fair value on a non-recurring basis are summarized below (dollars in thousands):

	Fair Value Measurements Using		
	Quoted		
	Prices		
	In	Significant	Significant
	Active	Other	Unobservable
	Markets	Observable	Inputs
	for	Inputs	(Level 3)
	Identical	(Level 2)	
	Assets		
	(Level		
	1)		
<u>March 31, 2013</u>			
Impaired loans:			
Commercial	\$—	\$ —	\$ —
Commercial real estate	—	—	2,662
Commercial construction	—	—	—
Residential real estate	—	—	594
<u>March 31, 2012</u>			
Impaired loans:			
Commercial	\$—	\$ —	\$ 1,014
Commercial real estate	—	—	709
Commercial construction	—	—	—
Residential real estate	—	—	—

As of March 31, 2013, impaired loans, which have a specific reserve and are measured for impairment using the fair value of the collateral, had an unpaid principal balance of \$3,913,000 with a valuation allowance of \$657,000, resulting in an additional provision for loan losses of \$76,000 for the quarter ended March 31, 2013.

As of March 31, 2012, impaired loans, which have a specific reserve and are measured for impairment using the fair value of the collateral, had an unpaid principal balance of \$2,542,000 with a valuation allowance of \$819,000, resulting in an additional provision for loan losses of \$264,000 for the quarter ended March 31, 2012.

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at March 31, 2013 (dollars in thousands):

	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Discount Range
<u>Impaired loans:</u>				
Commercial real estate	\$2,662	Sales comparison and income approach.	Adjustments for maintenance, property type, selling, legal costs and taxes.	10% - 65 %
Residential real estate	\$594	Sales comparison approach.	Adjustments for selling and other costs.	7 %

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NOTE 5 - FAIR VALUE MEASUREMENTS AND FAIR VALUE OF FINANCIAL INSTRUMENTS

(continued)

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at March 31, 2012 (dollars in thousands):

	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Discount Range	
<u>Impaired loans:</u>					
Commercial real estate	\$709	Sales comparison and income approach.	Adjustments for maintenance, property type, selling, legal costs, taxes and date of appraisal.	20	%
Commercial	\$1,014	Sales comparison and income approach.	Adjustments for maintenance, selling, legal costs, taxes and date of appraisal.	17	%

The carrying value and estimated fair value of financial instruments as of March 31, 2013 and December 31, 2012 are summarized below (dollars in thousands):

	Carrying Value	Fair Value Measurements at March 31, 2013 Using		
		Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>Financial assets:</u>				
Cash and due from banks	\$ 3,119	\$3,119	\$ —	\$ —
Interest bearing deposits	73,238	73,238	—	—
Securities available for sale	17,565	—	17,565	—
Securities held to maturity	1,680	—	1,767	—
Loans held for sale	285	—	289	—
Loans receivable, gross	901,824	—	—	922,521
Accrued interest receivable	3,518	—	65	3,452
<u>Financial liabilities:</u>				
Deposits:				
Demand, NOW, money market and savings	\$ 504,432	\$504,432	\$ —	\$ —
Certificates of deposit	294,646	—	296,684	—

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Long-term borrowings	74,406	—	79,415	—
Accrued interest payable	2,677	—	2,677	—