

NORTHEAST BANCORP /ME/  
Form 10-Q  
February 12, 2014  
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**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 December 31, 2013**

**Commission File Number: 1-14588**

**Northeast Bancorp**

(Exact name of registrant as specified in its charter)

**Maine**

(State or other jurisdiction of incorporation or organization)

**01-0425066**

(I.R.S. Employer Identification No.)

**500 Canal Street, Lewiston, Maine**  
(Address of Principal executive offices)

**04240**  
(Zip Code)

**(207) 786-3245**

Registrant's telephone number, including area code

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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 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 subjected 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, a non-accelerated filer or a smaller reporting company. See definition of "accelerated filer", "large accelerated filer" and "smaller 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 by 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. As of January 31, 2014 the registrant had outstanding 9,551,531 shares of voting common stock, \$1.00 par value per share and 880,963 shares of non-voting common stock, \$1.00 par value per share.

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## PART 1- FINANCIAL INFORMATION

## Item 1. Financial Statements (Unaudited)

**NORTHEAST BANCORP AND SUBSIDIARY****CONSOLIDATED BALANCE SHEETS**

(Unaudited)

(Dollars in thousands, except share and per share data)

|  | December 31, 2013 | June 30, 2013 |
|--|-------------------|---------------|
| <b>Assets</b>  |                   |               |
| Cash and due from banks  | \$ 2,948          | \$ 3,238      |
| Short-term investments   | 60,479            | 62,696        |
| Total cash and cash equivalents                                | 63,427            | 65,934        |
| Available-for-sale securities, at fair value                   | 114,717           | 121,597       |
| Loans held for sale  | 6,826             | 8,594         |
| Loans  | 501,709           | 435,376       |
| Less: Allowance for loan losses                                | 1,350             | 1,143         |
| Loans, net   | 500,359           | 434,233       |
| Premises and equipment, net                                    | 9,624             | 10,075        |
| Real estate owned and other possessed collateral, net          | 3,211             | 2,134         |
| Federal Home Loan Bank and Federal Reserve Bank stock, at cost | 5,721             | 5,721         |
| Intangible assets, net   | 3,124             | 3,544         |
| Bank owned life insurance                                      | 14,619            | 14,385        |
| Other assets   | 10,997            | 4,422         |
| Total assets   | \$ 732,625        | \$ 670,639    |
| <b>Liabilities and Stockholders Equity</b>                     |                   |               |
| Deposits   |                   |               |
| Demand   | \$ 47,015         | \$ 46,425     |
| Savings and interest checking                                  | 93,394            | 90,970        |
| Money market   | 88,156            | 84,416        |
| Time   | 307,957           | 262,812       |
| Total deposits   | 536,522           | 484,623       |
| Federal Home Loan Bank advances                                | 42,931            | 28,040        |
| Wholesale repurchase agreements                                | 15,290            | 25,397        |
| Short-term borrowings  | 2,468             | 625           |
| Junior subordinated debentures issued to affiliated trusts     | 8,352             | 8,268         |
| Capital lease obligation                                       | 1,650             | 1,739         |
| Other liabilities  | 11,029            | 8,145         |
| Total liabilities  | 618,242           | 556,837       |

## Commitments and contingencies

## Stockholders' equity

Preferred stock, \$1.00 par value, 1,000,000 shares authorized; no shares issued and outstanding at December 31, 2013 and June 30, 2013

Voting common stock, \$1.00 par value, 25,000,000 shares authorized; 9,551,531 and 9,565,680 shares issued and outstanding at December 31, 2013 and June 30, 2013, respectively

Non-voting common stock, \$1.00 par value, 3,000,000 shares authorized; 880,963 shares issued and outstanding at December 31, 2013 and June 30, 2013

Additional paid-in capital

Retained earnings

Accumulated other comprehensive loss

Total stockholders' equity

Total liabilities and stockholders' equity

9,552

9,566

881

881

93,230

92,745

12,358

12,524

(1,638)

(1,914)

114,383

113,802

\$

732,625

\$

670,639

*The accompanying notes are an integral part of these unaudited consolidated financial statements.*

Table of Contents**NORTHEAST BANCORP AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF INCOME**

(Unaudited)

(Dollars in thousands, except share and per share data)

|   | Three Months Ended December 31, |          | Six Months Ended December 31, |           |
|---|---------------------------------|----------|-------------------------------|-----------|
|   | 2013                            | 2012     | 2013                          | 2012      |
| <b>Interest and dividend income:</b>  |                                 |          |                               |           |
| Interest on loans   | \$ 10,282                       | \$ 8,267 | \$ 18,739                     | \$ 15,608 |
| Interest on available-for-sale securities   | 262                             | 348      | 544                           | 695       |
| Other interest and dividend income  | 96                              | 109      | 147                           | 198       |
| Total interest and dividend income  | 10,640                          | 8,724    | 19,430                        | 16,501    |
| <b>Interest expense:</b>  |                                 |          |                               |           |
| Deposits  | 979                             | 1,028    | 2,026                         | 2,006     |
| Federal Home Loan Bank advances   | 327                             | 259      | 651                           | 518       |
| Wholesale repurchase agreements   | 98                              | 161      | 192                           | 380       |
| Short-term borrowings   | 6                               | 5        | 11                            | 11        |
| Junior subordinated debentures issued to affiliated trusts                        | 192                             | 191      | 385                           | 384       |
| Obligation under capital lease agreements   | 21                              | 23       | 43                            | 47        |
| Total interest expense  | 1,623                           | 1,667    | 3,308                         | 3,346     |
| <b>Net interest and dividend income before provision for loan losses</b>          |                                 |          |                               |           |
|   | 9,017                           | 7,057    | 16,122                        | 13,155    |
| Provision for loan losses   | 151                             | 247      | 227                           | 475       |
| Net interest and dividend income after provision for loan losses                  | 8,866                           | 6,810    | 15,895                        | 12,680    |
| <b>Noninterest income:</b>  |                                 |          |                               |           |
| Fees for other services to customers  | 421                             | 462      | 861                           | 772       |
| Net securities gains  |                                 |          |                               | 792       |
| Gain on sales of loans held for sale  | 341                             | 914      | 880                           | 1,670     |
| Gain on sales of portfolio loans  | 13                              | 998      | 230                           | 998       |
| (Loss) gain recognized on real estate owned and other repossessed collateral, net | (77)                            |          | (115)                         | 451       |
| Bank-owned life insurance income  | 116                             | 358      | 234                           | 481       |
| Other noninterest income  | 21                              | 13       | 34                            | 56        |
| Total noninterest income  | 835                             | 2,745    | 2,124                         | 5,220     |
| <b>Noninterest expense:</b>   |                                 |          |                               |           |
| Salaries and employee benefits  | 4,253                           | 3,843    | 8,885                         | 7,483     |
| Occupancy and equipment expense   | 1,311                           | 1,104    | 2,625                         | 2,123     |
| Professional fees   | 323                             | 399      | 749                           | 822       |
| Data processing fees  | 256                             | 220      | 513                           | 432       |
| Marketing expense   | 103                             | 247      | 139                           | 429       |
| Loan acquisition and collection expense   | 290                             | 479      | 763                           | 933       |
| FDIC insurance premiums   | 117                             | 122      | 227                           | 239       |
| Intangible asset amortization   | 210                             | 265      | 420                           | 530       |
| Legal settlement recovery   |                                 |          | (250)                         |           |

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|   |            |            |            |            |
|---|------------|------------|------------|------------|
| Other noninterest expense   | 751        | 738        | 1,395      | 1,368      |
| Total noninterest expense   | 7,614      | 7,417      | 15,466     | 14,359     |
| Income from continuing operations before income tax expense             | 2,087      | 2,138      | 2,553      | 3,541      |
| Income tax expense  | 676        | 676        | 832        | 1,121      |
| Net income from continuing operations                                   | 1,411      | 1,462      | 1,721      | 2,420      |
| (Loss) income from discontinued operations before tax (benefit) expense | (27)       | 84         | (12)       | 198        |
| Income tax (benefit) expense  | (9)        | 29         | (4)        | 68         |
| Net (loss) income from discontinued operations                          | (18)       | 55         | (8)        | 130        |
| Net income  | \$ 1,393   | \$ 1,517   | \$ 1,713   | \$ 2,550   |
| Net income available to common stockholders                             | \$ 1,393   | \$ 1,259   | \$ 1,713   | \$ 2,195   |
| Weighted-average shares outstanding:                                    |            |            |            |            |
| Basic   | 10,432,833 | 10,383,441 | 10,436,673 | 10,383,441 |
| Diluted   | 10,432,833 | 10,383,441 | 10,436,673 | 10,383,441 |
| Earnings per common share:  |            |            |            |            |
| Basic:  |            |            |            |            |
| Income from continuing operations                                       | \$ 0.13    | \$ 0.11    | \$ 0.16    | \$ 0.20    |
| Income from discontinued operations                                     |            | 0.01       |            | 0.01       |
| Net Income  | \$ 0.13    | \$ 0.12    | \$ 0.16    | \$ 0.21    |
| Diluted:  |            |            |            |            |
| Income from continuing operations                                       | \$ 0.13    | \$ 0.11    | \$ 0.16    | \$ 0.20    |
| Income from discontinued operations                                     |            | 0.01       |            | 0.01       |
| Net income  | \$ 0.13    | \$ 0.12    | \$ 0.16    | \$ 0.21    |
| Cash dividends declared per common share                                | \$ 0.09    | \$ 0.09    | \$ 0.18    | \$ 0.18    |

*The accompanying notes are an integral part of these unaudited consolidated financial statements.*

Table of Contents**NORTHEAST BANCORP AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(Unaudited)

(Dollars in thousands)

|   | Three Months Ended December 31, |          | Six Months Ended December 31, |          |
|---|---------------------------------|----------|-------------------------------|----------|
|   | 2013                            | 2012     | 2013                          | 2012     |
| Net income  | \$ 1,393                        | \$ 1,517 | \$ 1,713                      | \$ 2,550 |
| Other comprehensive income (loss), before tax:                            |                                 |          |                               |          |
| Available-for-sale securities:  |                                 |          |                               |          |
| Change in net unrealized gain or loss on available-for-sale securities    | (647)                           | (311)    | (130)                         | (154)    |
| Reclassification adjustment for net gains included in net income          |                                 |          |                               | (792)    |
| Total available-for-sale securities                                       | (647)                           | (311)    | (130)                         | (946)    |
| Derivatives and hedging activities:                                       |                                 |          |                               |          |
| Change in accumulated loss on effective cash flow hedges                  | 565                             | 59       | 584                           | 65       |
| Reclassification adjustments for net gains included in net income         | (17)                            | (19)     | (36)                          | (37)     |
| Total derivatives and hedging activities                                  | 548                             | 40       | 548                           | 28       |
| Total other comprehensive (loss) income, before tax                       | (99)                            | (271)    | 418                           | (918)    |
| Income tax expense (benefit) related to other comprehensive (loss) income | (34)                            | (93)     | 142                           | (313)    |
| Other comprehensive (loss) income, net of tax                             | (65)                            | (178)    | 276                           | (605)    |
| Comprehensive income  | \$ 1,328                        | \$ 1,339 | \$ 1,989                      | \$ 1,945 |

*The accompanying notes are an integral part of these unaudited consolidated financial statements.*



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(Unaudited)

(Dollars in thousands, except share and per share data)

|  | Preferred Stock |              | Voting Common Stock |          | Non-voting Common Stock |           | Additional      | Retained   | Accumulated<br>Other<br>Comprehensive | Total                  |
|--|-----------------|--------------|---------------------|----------|-------------------------|-----------|-----------------|------------|---------------------------------------|------------------------|
|  | Shares          | Amount       | Shares              | Amount   | Shares                  | Amount    | Paid-in Capital | Earnings   | Income (Loss)                         | Stockholders<br>Equity |
| Balance at June 30, 2012                                     | 4,227           | \$ 4         | 9,307,127           | \$ 9,307 | 1,076,314               | \$ 1,076  | \$ 96,359       | \$ 12,235  | \$ 158                                | \$ 119,139             |
| Net income   |                 |              |                     |          |                         |           |                 | 2,550      |                                       | 2,550                  |
| Other comprehensive loss, net of tax                         |                 |              |                     |          |                         |           |                 |            | (605)                                 | (605)                  |
| Conversion of non-voting common stock to voting common stock |                 |              | 160,245             | 160      | (160,245)               | (160)     |                 |            |                                       |                        |
| Dividends on preferred stock                                 |                 |              |                     |          |                         |           |                 | (113)      |                                       | (113)                  |
| Dividends on common stock at \$0.18 per share                |                 |              |                     |          |                         |           |                 | (1,870)    |                                       | (1,870)                |
| Offering costs   |                 |              |                     |          |                         |           | (60)            |            |                                       | (60)                   |
| Stock-based compensation                                     |                 |              |                     |          |                         |           | 212             |            |                                       | 212                    |
| Redemption of preferred stock and warrants                   | (4,227)         | (4)          |                     |          |                         |           | (4,318)         |            |                                       | (4,322)                |
| Accretion of preferred stock                                 |                 |              |                     |          |                         |           | 268             | (268)      |                                       |                        |
| Balance at December 31, 2012                                 |                 | \$ 9,467,372 | \$ 9,467            | 916,069  | \$ 916                  | \$ 92,461 | \$ 12,534       | \$ (447)   | \$ 114,931                            |                        |
| Balance at June 30, 2013                                     |                 | \$ 9,565,680 | \$ 9,566            | 880,963  | \$ 881                  | \$ 92,745 | \$ 12,524       | \$ (1,914) | \$ 113,802                            |                        |
| Net income   |                 |              |                     |          |                         |           |                 | 1,713      |                                       | 1,713                  |
| Other comprehensive income, net of tax                       |                 |              |                     |          |                         |           |                 |            | 276                                   | 276                    |
| Dividends on common stock at \$0.18 per share                |                 |              |                     |          |                         |           |                 | (1,879)    |                                       | (1,879)                |
| Stock-based compensation                                     |                 |              |                     |          |                         |           | 471             |            |                                       | 471                    |
| Forfeiture of restricted common stock                        |                 |              | (14,149)            | (14)     |                         |           | 14              |            |                                       |                        |
| Balance at December 31, 2013                                 |                 | \$ 9,551,531 | \$ 9,552            | 880,963  | \$ 881                  | \$ 93,230 | \$ 12,358       | \$ (1,638) | \$ 114,383                            |                        |

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



Table of Contents**NORTHEAST BANCORP AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)

(Dollars in thousands)

|   | <b>Six Months Ended December 31,</b> |             |
|---|--------------------------------------|-------------|
|   | <b>2013</b>                          | <b>2012</b> |
| <b>Operating activities:</b>  |                                      |             |
| Net income  | \$ 1,713                             | \$ 2,550    |
| Adjustments to reconcile net income to net cash (used in) provided by operating activities:   |                                      |             |
| Provision for loan losses   | 227                                  | 475         |
| Loss (gain) on sale and impairment of real estate owned and other repossessed collateral, net | 115                                  | (451)       |
| Accretion of fair value adjustments on loans, net   | (4,099)                              | (3,505)     |
| Accretion of fair value adjustments on deposits, net  | (415)                                | (537)       |
| Accretion of fair value adjustments on borrowings, net  | (132)                                | (703)       |
| Originations of loans held for sale   | (44,651)                             | (73,982)    |
| Net proceeds from sales of loans held for sale  | 47,299                               | 77,272      |
| Gain on sales of loans held for sale  | (880)                                | (1,670)     |
| Gain on sales of portfolio loans  | (230)                                | (998)       |
| Amortization of intangible assets   | 420                                  | 530         |
| Bank-owned life insurance income, net   | (234)                                | (481)       |
| Depreciation of premises and equipment  | 1,035                                | 842         |
| Gain on sale of premises and equipment  | (1)                                  |             |
| Net gain on sale of available-for-sale securities   |                                      | (792)       |
| Stock-based compensation  | 471                                  | 212         |
| Amortization of securities, net   | 668                                  | 794         |
| Changes in other assets and liabilities:  |                                      |             |
| Other assets  | (6,568)                              | 932         |
| Other liabilities   | 3,290                                | 1,159       |
| Net cash (used in) provided by operating activities   | (1,972)                              | 1,647       |
| <b>Investing activities:</b>  |                                      |             |
| Proceeds from sales of available-for-sale securities  |                                      | 159,579     |
| Purchases of available-for-sale securities  | (12,083)                             | (167,294)   |
| Proceeds from maturities and principal payments on available-for-sale securities              | 18,165                               | 6,668       |
| Loan purchases  | (29,967)                             | (63,887)    |
| Loan originations and principal collections, net  | (34,000)                             | 24,193      |
| Purchases of premises and equipment   | (594)                                | (2,071)     |
| Proceeds from sales of premises and equipment   | 11                                   |             |
| Proceeds from sales of real estate owned and other repossessed collateral                     | 528                                  | 907         |
| Proceeds from life insurance benefits   |                                      | 628         |
| Proceeds from sales of portfolio loans  | 216                                  | 5,189       |
| Net cash used in investing activities   | (57,724)                             | (36,088)    |
| <b>Financing activities:</b>  |                                      |             |
| Net increase in deposits  | 52,314                               | 79,867      |
| Net decrease in short-term borrowings   | 1,843                                | 361         |
| Dividends paid on preferred stock   |                                      | (113)       |
| Dividends paid on common stock  | (1,879)                              | (1,870)     |

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|  |           |    |          |
|--|-----------|----|----------|
| Proceeds from FHLB advances  | 15,000    |    |          |
| Stock offering costs   |           |    | (60)     |
| Repayment of wholesale repurchase agreements                               | (10,000)  |    | (40,000) |
| Redemption of preferred stock and warrants                                 |           |    | (4,322)  |
| Repayment of capital lease obligation                                      | (89)      |    | (84)     |
| Net cash provided by financing activities                                  | 57,189    |    | 33,779   |
| Net decrease in cash and cash equivalents                                  | (2,507)   |    | (662)    |
| Cash and cash equivalents, beginning of period                             | 65,934    |    | 128,274  |
| Cash and cash equivalents, end of period                                   | \$ 63,427 | \$ | 127,612  |
| Supplemental schedule of noncash investing and financing activities:       |           |    |          |
| Transfers from loans to real estate owned and other repossessed collateral | \$ 1,727  | \$ | 3,310    |
| Transfers from real estate owned and other repossessed collateral to loans |           |    | 1,055    |

*The accompanying notes are an integral part of these unaudited consolidated financial statements.*

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**NORTHEAST BANCORP AND SUBSIDIARY**

**Notes to Unaudited Consolidated Financial Statements**

**December 31, 2013**

**1. Basis of Presentation**

The accompanying unaudited condensed and consolidated interim financial statements include the accounts of Northeast Bancorp ( Northeast ) or the Company ) and its wholly-owned subsidiary, Northeast Bank (the Bank ).

These financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, the accompanying consolidated financial statements contain all adjustments (consisting principally of normal recurring accruals) considered necessary for a fair presentation of the Company s financial position, results of operations, and cash flows for the interim periods presented. These financial statements and notes should be read in conjunction with the audited consolidated financial statements and notes thereto for the fiscal year ended June 30, 2013 ( Fiscal 2013 ) included in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission.

**2. Recent Accounting Pronouncements**

In December 2011, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities* ( ASU 2011-11 ). The update requires entities to disclose information about offsetting and related arrangements of financial instruments and derivative instruments. The amendments require enhanced disclosures by requiring improved information about financial instruments and derivative instruments that are either (i) offset in accordance with current literature or (ii) subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with current literature. ASU 2011-11 is effective for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. The adoption of this guidance did not have a material impact on the consolidated financial statements.

In January 2013, the FASB issued ASU No. 2013-01, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities* ( ASU 2013-01 ). The amendments clarify that the scope of Update 2011-11 applies to derivatives accounted for in accordance with Topic 815, *Derivatives and Hedging*, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with Section 210-20-45 or Section 815-10-45 or subject to an enforceable master netting arrangement or similar agreement. The new standards are effective for annual periods beginning January 1, 2013 and for interim periods within those annual periods. Retrospective application is required. The adoption of this guidance did not have a material impact on the consolidated financial statements.

In July 2013, the FASB issued ASU No. 2013-10, *Derivatives and Hedging (Topic 815): Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes* ( ASU 2013-30 ). The amendments in ASU 2013-30

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permit the Fed Funds Effective Swap Rate (OIS) to be used as a U.S. benchmark interest rate for hedge accounting purposes under Topic 815, in addition to UST and LIBOR. The amendments also remove the restriction on using different benchmark rates for similar hedges. The amendments are effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. ASU 2013-30 may impact the accounting for interest rate hedging relationships entered into after July 17, 2013.

In January 2014, the FASB issued ASU No. 2014-04, *Receivables (Topic 310): Troubled Debt Restructurings by Creditors* ( ASU 2014-04 ). The amendments clarify that when an in substance repossession or foreclosure occurs, a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments ASU 2013-04 are effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. An entity can elect to adopt the amendments in ASU 2014-04 using either a modified retrospective transition method or a prospective transition method. Under the modified retrospective transition method, an entity should apply the amendments by means of a cumulative-effect adjustment to residential consumer mortgage loans and foreclosed residential real estate properties existing as of the beginning of the annual period for which the amendments are effective. The Company does not expect ASU 2014-04 to have material impact on the consolidated financial statements.

Table of Contents**3. Securities Available-for-Sale**

The following presents a summary of the amortized cost, gross unrealized holding gains and losses, and fair value of securities available for sale.

|                                   | Amortized<br>Cost | December 31, 2013         |                            | Fair<br>Value |
|-----------------------------------|-------------------|---------------------------|----------------------------|---------------|
|                                   |                   | Gross Unrealized<br>Gains | Gross Unrealized<br>Losses |               |
| (Dollars in thousands)            |                   |                           |                            |               |
| U.S. Government agency securities | \$ 45,152         | \$ 13                     | \$ (22)                    | \$ 45,143     |
| Agency mortgage-backed securities | 72,331            |                           | (2,757)                    | 69,574        |
|                                   | \$ 117,483        | \$ 13                     | \$ (2,779)                 | \$ 114,717    |

|                                   | Amortized<br>Cost | June 30, 2013             |                            | Fair<br>Value |
|-----------------------------------|-------------------|---------------------------|----------------------------|---------------|
|                                   |                   | Gross Unrealized<br>Gains | Gross Unrealized<br>Losses |               |
| (Dollars in thousands)            |                   |                           |                            |               |
| U.S. Government agency securities | \$ 45,289         | \$ 44                     | \$                         | \$ 45,333     |
| Agency mortgage-backed securities | 78,944            |                           | (2,680)                    | 76,264        |
|                                   | \$ 124,233        | \$ 44                     | \$ (2,680)                 | \$ 121,597    |

When securities are sold, the adjusted cost of the specific security sold is used to compute the gain or loss on sale. The following table summarizes realized gains and losses on available-for-sale securities.

|                        | Three Months Ended December 31, |      | Six Months Ended December 31, |        |
|------------------------|---------------------------------|------|-------------------------------|--------|
|                        | 2013                            | 2012 | 2013                          | 2012   |
| (Dollars in thousands) |                                 |      |                               |        |
| Gross realized gains   | \$                              | \$   | \$                            | \$ 831 |
| Gross realized losses  |                                 |      |                               | (39)   |
| Net security gains     | \$                              | \$   | \$                            | \$ 792 |

At December 31, 2013, investment securities with a fair value of approximately \$42.0 million were pledged as collateral to secure outstanding borrowings.

The following summarizes the Company's gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position.

| Less than 12 Months | December 31, 2013   |  | Total |
|---------------------|---------------------|--|-------|
|                     | More than 12 Months |  |       |

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|                                   | Fair Value             | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
|-----------------------------------|------------------------|-------------------|------------|-------------------|------------|-------------------|
|                                   | (Dollars in thousands) |                   |            |                   |            |                   |
| U.S. Government agency securities | \$ 9,056               | \$ (22)           | \$         | \$                | \$ 9,056   | \$ (22)           |
| Agency mortgage-backed securities | 33,623                 | (884)             | 35,951     | (1,873)           | 69,574     | (2,757)           |
|                                   | \$ 42,679              | \$ (906)          | \$ 35,951  | \$ (1,873)        | \$ 78,630  | \$ (2,779)        |

|                                   | Less than 12 Months    |                   | June 30, 2013<br>More than 12 Months |                   | Total      |                   |
|-----------------------------------|------------------------|-------------------|--------------------------------------|-------------------|------------|-------------------|
|                                   | Fair Value             | Unrealized Losses | Fair Value                           | Unrealized Losses | Fair Value | Unrealized Losses |
|                                   | (Dollars in thousands) |                   |                                      |                   |            |                   |
| U.S. Government agency securities | \$                     | \$                | \$                                   | \$                | \$         | \$                |
| Agency mortgage-backed securities | 76,264                 | (2,680)           |                                      |                   | 76,264     | (2,680)           |
|                                   | \$ 76,264              | \$ (2,680)        | \$                                   | \$                | \$ 76,264  | \$ (2,680)        |

There were no other-than-temporary impairment losses on securities during the three and six months ended December 31, 2013 or 2012.

At December 31, 2013, the Company had eleven securities in a continuous loss position for greater than twelve months. At December 31, 2013, all of the Company's available-for-sale securities were issued or guaranteed by either government agencies or government-sponsored enterprises. The decline in fair value of the Company's available-for-sale securities at December 31, 2013 is attributable to changes in interest rates.

Management of the Company, in addition to considering current trends and economic conditions that may affect the quality of individual securities within the Company's investment portfolio, also considers the Company's ability and intent to hold such securities to maturity or recovery of cost. Management does not believe any of the Company's available-for-sale securities are other-than-temporarily impaired at December 31, 2013.



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The amortized cost and fair values of available-for-sale debt securities by contractual maturity are shown below as of December 31, 2013. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|  | <b>Amortized<br/>Cost</b>     |    | <b>Fair<br/>Value</b> |
|--|-------------------------------|----|-----------------------|
|  | <b>(Dollars in thousands)</b> |    |                       |
| Due within one year                    | \$ 33,070                     | \$ | 33,082                |
| Due after one year through five years  | 12,081                        |    | 12,061                |
| Due after five years through ten years | 37,599                        |    | 36,684                |
| Due after ten years                    | 34,733                        |    | 32,890                |
|  | \$ 117,483                    | \$ | 114,717               |

Table of Contents**4. Loans, Allowance for Loan Losses and Credit Quality**

Loans are carried at the principal amounts outstanding, or amortized acquired fair value in the case of acquired loans, adjusted by partial charge-offs and net of deferred loan costs or fees. Loan fees and certain direct origination costs are deferred and amortized into interest income over the expected term of the loan using the level-yield method. When a loan is paid off, the unamortized portion is recognized in interest income. Interest income is accrued based upon the daily principal amount outstanding except for loans on nonaccrual status.

Loans purchased by the Company are accounted for under ASC 310-30, *Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality* (ASC 310-30). At acquisition, the effective interest rate is determined based on the discount rate that equates the present value of the Company's estimate of cash flows with the purchase price of the loan. Prepayments are not assumed in determining a purchased loan's effective interest rate and income accretion. The application of ASC 310-30 limits the yield that may be accreted on the purchased loan, or the accretable yield, to the excess of the Company's estimate, at acquisition, of the expected undiscounted principal, interest, and other cash flows over the Company's initial investment in the loan. The excess of contractually required payments receivable over the cash flows expected to be collected on the loan represents the purchased loan's nonaccretable difference. Subsequent improvements in expected cash flows of loans with nonaccretable differences result in a prospective increase to the loan's effective yield through a reclassification of some, or all, of the nonaccretable difference to accretable yield. The effect of subsequent declines in expected cash flows of purchased loans are recorded through a specific allocation in the allowance for loan losses.

Loans are generally placed on nonaccrual status when they are past due 90 days as to either principal or interest, or when in management's judgment the collectability of interest or principal of the loan has been significantly impaired. Loans accounted for under ASC 310-30 are placed on nonaccrual when it is not possible to reach a reasonable expectation of the timing and amount of cash flows to be collected on the loan. When a loan has been placed on nonaccrual status, previously accrued and uncollected interest is reversed against interest on loans. Interest on nonaccrual loans is accounted for on a cash-basis or using the cost-recovery method when collectability is doubtful. A loan is returned to accrual status when collectability of principal is reasonably assured and the loan has performed for a reasonable period of time.

In cases where a borrower experiences financial difficulties and the Company makes certain concessionary modifications to contractual terms, the loan is classified as a troubled debt restructuring (TDR), and therefore by definition is an impaired loan. Concessionary modifications may include adjustments to interest rates, extensions of maturity, and other actions intended to minimize economic loss and avoid foreclosure or repossession of collateral. For loans accounted for under ASC 310-30, the Company evaluates whether it has granted a concession by comparing the restructured debt terms to the expected cash flows at acquisition plus any additional cash flows expected to be collected arising from changes in estimate after acquisition. As a result, if an ASC 310-30 loan is modified to be consistent with, or better than, the Company's expectations at acquisition, the loan would not qualify as a TDR. Nonaccrual loans that are restructured generally remain on nonaccrual status for a minimum period of six months to demonstrate that the borrower can meet the restructured terms. If the restructured loan is on accrual status prior to being modified, it is reviewed to determine if the modified loan should remain on accrual status. If the borrower's ability to meet the revised payment schedule is not reasonably assured, the loan is classified as a nonaccrual loan. With limited exceptions, loans classified as TDRs remain classified as such until the loan is paid off.

The composition of the Company's loan portfolio follows.

|                        | December 31, 2013 |       |            | June 30, 2013 |       |  |
|------------------------|-------------------|-------|------------|---------------|-------|--|
| Originated             | Purchased         | Total | Originated | Purchased     | Total |  |
| (Dollars in thousands) |                   |       |            |               |       |  |

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|                         |    |         |    |         |    |         |    |         |    |         |    |         |
|-------------------------|----|---------|----|---------|----|---------|----|---------|----|---------|----|---------|
| Residential real estate | \$ | 120,814 | \$ | 2,606   | \$ | 123,420 | \$ | 89,734  | \$ | 2,706   | \$ | 92,440  |
| Home equity             |    | 30,065  |    |         |    | 30,065  |    | 35,389  |    |         |    | 35,389  |
| Commercial real estate  |    | 117,986 |    | 174,816 |    | 292,802 |    | 100,402 |    | 164,046 |    | 264,448 |
| Construction            |    |         |    |         |    |         |    | 42      |    |         |    | 42      |
| Commercial business     |    | 43,687  |    | 13      |    | 43,700  |    | 29,686  |    | 34      |    | 29,720  |
| Consumer                |    | 11,722  |    |         |    | 11,722  |    | 13,337  |    |         |    | 13,337  |
| Total loans             | \$ | 324,274 | \$ | 177,435 | \$ | 501,709 | \$ | 268,590 | \$ | 166,786 | \$ | 435,376 |

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Allowance for Loan Losses and Impaired Loans

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. For residential and consumer loans, a charge-off is recorded no later than the point at which a loan is 180 days past due if the loan balance exceeds the fair value of the collateral, less costs to sell. For commercial loans, a charge-off is recorded on a case-by-case basis when all or a portion of the loan is deemed to be uncollectible. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses consists of general, specific, and unallocated reserves and reflects management's estimate of probable loan losses inherent in the loan portfolio at the balance sheet date. Management uses a consistent and systematic process and methodology to evaluate the adequacy of the allowance for loan losses on a quarterly basis. The calculation of the allowance for loan losses is segregated by portfolio segments, which include: commercial real estate, commercial business, consumer, residential real estate, and purchased loans. Risk characteristics relevant to each portfolio segment are as follows:

**Residential real estate:** All loans in this segment are collateralized by residential real estate and repayment is primarily dependent on the credit quality of the individual borrower. The overall health of the economy, particularly unemployment rates and housing prices, has a significant effect on the credit quality in this segment. For purposes of the Company's allowance for loan loss calculation, home equity loans and lines of credit are included in residential real estate.

**Commercial real estate:** Loans in this segment are primarily income-producing properties. For owner-occupied properties, the cash flows are derived from an operating business, and the underlying cash flows may be adversely affected by deterioration in the financial condition of the operating business. The underlying cash flows generated by non-owner occupied properties may be adversely affected by increased vacancy rates. Management periodically obtains rent rolls, with which it monitors the cash flows of these loans. Adverse developments in either of these areas will have an adverse effect on the credit quality of this segment. For purposes of the allowance for loan losses, this segment also includes construction loans.

**Commercial business:** Loans in this segment are made to businesses and are generally secured by the assets of the business. Repayment is expected from the cash flows of the business. Continued weakness in national or regional economic conditions, and a corresponding weakness in consumer or business spending, will have an adverse effect on the credit quality of this segment.

**Consumer:** Loans in this segment are generally secured, and repayment is dependent on the credit quality of the individual borrower. Repayment of consumer loans is generally based on the earnings of individual borrowers, which may be adversely impacted by regional labor market conditions.

**Purchased:** Loans in this segment are typically secured by commercial real estate, multi-family residential real estate, or business assets and have been acquired by the Bank's Loan Acquisition and Servicing Group (LASG). Loans acquired by the LASG are, with limited exceptions, performing loans at the date of purchase. Loans in this segment acquired with specific material credit deterioration since origination are identified as purchased credit-impaired. Repayment of loans in this segment is largely dependent on cash flow from the successful operation of the property, in the case of non-owner occupied property, or operating business, in the case of owner-occupied property. Loan performance may be adversely affected by factors affecting the general economy or conditions specific to the real estate market, such as geographic location or

property type.

The general component of the allowance for loan losses is based on historical loss experience adjusted for qualitative factors stratified by loan segment. The Company does not weight periods used in that analysis to determine the average loss rate in each portfolio segment. This historical loss factor is adjusted for the following qualitative factors:

- Levels and trends in delinquencies and nonperforming loans
  
- Trends in the volume and nature of loans
  
- Trends in credit terms and policies, including underwriting standards, procedures and practices, and the experience and ability of lending management and staff
  
- Trends in portfolio concentration
  
- National and local economic trends and conditions
  
- Effects of changes or trends in internal risk ratings
  
- Other effects resulting from trends in the valuation of underlying collateral

There were no significant changes in the Company's policies or methodology pertaining to the general component of the allowance for loan losses during the three and six months ended December 31, 2013 or 2012.

The allocated component of the allowance for loan losses relates to loans that are classified as impaired. Impairment is measured on a loan-by-loan basis for commercial business and commercial real estate loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent. An allowance is established when the discounted cash flows or collateral value of the impaired loan is lower than the carrying value of that loan. Large groups of smaller-balance homogeneous loans, such as consumer and residential real estate loans are collectively evaluated for impairment based on the group's historical loss experience adjusted for qualitative factors. Accordingly, the Company does not

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separately identify individual consumer and residential loans for individual impairment and disclosure. However, all TDRs are individually reviewed for impairment.

For all portfolio segments, except loans accounted for under ASC 310-30, a loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. For the purchased loan segment, a loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to realize cash flows as estimated at acquisition. For loans accounted for under ASC 310-30, loan impairment is measured based on the decrease in expected cash flows from those estimated at acquisition, excluding changes due to changes in interest rate indices and other non-credit related factors, discounted at the loan's effective rate assumed at acquisition. Factors considered by management in determining impairment include payment status, collateral value, and the probability of the collecting scheduled principal and interest payments when due.

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The following table sets forth activity in the Company's allowance for loan losses.

|                   | Three Months Ended December 31, 2013 |             |            |          |           |             |          | Total |
|-------------------|--------------------------------------|-------------|------------|----------|-----------|-------------|----------|-------|
|                   | Residential                          | Commercial  | Commercial | Consumer | Purchased | Unallocated |          |       |
|                   | Real Estate                          | Real Estate | Business   |          |           |             |          |       |
|                   | (Dollars in thousands)               |             |            |          |           |             |          |       |
| Beginning balance | \$ 695                               | \$ 163      | \$ 50      | \$ 148   | \$ 101    | \$ 67       | \$ 1,224 |       |
| Provision         | (33)                                 | 158         | 2          | (24)     | 106       | (58)        | 151      |       |
| Recoveries        |                                      |             |            | 12       |           |             | 12       |       |
| Charge-offs       | (13)                                 |             |            | (24)     |           |             | (37)     |       |
| Ending balance    | \$ 649                               | \$ 321      | \$ 52      | \$ 112   | \$ 207    | \$ 9        | \$ 1,350 |       |

|                   | Three Months Ended December 31, 2012 |             |            |          |           |             |        | Total |
|-------------------|--------------------------------------|-------------|------------|----------|-----------|-------------|--------|-------|
|                   | Residential                          | Commercial  | Commercial | Consumer | Purchased | Unallocated |        |       |
|                   | Real Estate                          | Real Estate | Business   |          |           |             |        |       |
|                   | (Dollars in thousands)               |             |            |          |           |             |        |       |
| Beginning balance | \$ 301                               | \$ 71       | \$ 53      | \$ 243   | \$        | \$          | \$ 668 |       |
| Provision         | 199                                  | 32          | (6)        | 22       |           |             | 247    |       |
| Recoveries        |                                      |             |            | 5        |           |             | 5      |       |
| Charge-offs       | (8)                                  | (1)         |            | (36)     |           |             | (45)   |       |
| Ending balance    | \$ 492                               | \$ 102      | \$ 47      | \$ 234   | \$        | \$          | \$ 875 |       |

|                   | Six Months Ended December 31, 2013 |             |            |          |           |             |          | Total |
|-------------------|------------------------------------|-------------|------------|----------|-----------|-------------|----------|-------|
|                   | Residential                        | Commercial  | Commercial | Consumer | Purchased | Unallocated |          |       |
|                   | Real Estate                        | Real Estate | Business   |          |           |             |          |       |
|                   | (Dollars in thousands)             |             |            |          |           |             |          |       |
| Beginning balance | \$ 594                             | \$ 173      | \$ 70      | \$ 189   | \$ 76     | \$ 41       | \$ 1,143 |       |
| Provision         | 82                                 | 148         | (24)       | (78)     | 131       | (32)        | 227      |       |
| Recoveries        | 6                                  |             | 6          | 31       |           |             | 43       |       |
| Charge-offs       | (33)                               |             |            | (30)     |           |             | (63)     |       |
| Ending balance    | \$ 649                             | \$ 321      | \$ 52      | \$ 112   | \$ 207    | \$ 9        | \$ 1,350 |       |

|                   | Six Months Ended December 31, 2012 |             |            |          |           |             |        | Total |
|-------------------|------------------------------------|-------------|------------|----------|-----------|-------------|--------|-------|
|                   | Residential                        | Commercial  | Commercial | Consumer | Purchased | Unallocated |        |       |
|                   | Real Estate                        | Real Estate | Business   |          |           |             |        |       |
|                   | (Dollars in thousands)             |             |            |          |           |             |        |       |
| Beginning balance | \$ 214                             | \$ 93       | \$ 292     | \$ 225   | \$        | \$          | \$ 824 |       |
| Provision         | 412                                | 9           | (42)       | 96       |           |             | 475    |       |
| Recoveries        | 1                                  |             |            | 7        |           |             | 8      |       |
| Charge-offs       | (135)                              |             | (203)      | (94)     |           |             | (432)  |       |
| Ending balance    | \$ 492                             | \$ 102      | \$ 47      | \$ 234   | \$        | \$          | \$ 875 |       |

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The following table sets forth information regarding the allowance for loan losses by portfolio segment and impairment methodology.

|                            | December 31, 2013          |                           |                        |                                    |            |             |    | Total      |
|----------------------------|----------------------------|---------------------------|------------------------|------------------------------------|------------|-------------|----|------------|
|                            | Residential<br>Real Estate | Commercial<br>Real Estate | Commercial<br>Business | Consumer<br>(Dollars in thousands) | Purchased  | Unallocated |    |            |
| Allowance for loan losses: |                            |                           |                        |                                    |            |             |    |            |
| Individually evaluated     | \$ 189                     | \$ 108                    | \$ 44                  | \$ 4                               | \$ 86      | \$          | \$ | \$ 431     |
| Collectively evaluated     | 460                        | 213                       | 8                      | 108                                |            | 9           |    | 798        |
| ASC 310-30                 |                            |                           |                        |                                    | 121        |             |    | 121        |
| Total                      | \$ 649                     | \$ 321                    | \$ 52                  | \$ 112                             | \$ 207     | \$ 9        | \$ | \$ 1,350   |
| Loans:                     |                            |                           |                        |                                    |            |             |    |            |
| Individually evaluated     | \$ 2,208                   | \$ 1,637                  | \$ 108                 | \$ 224                             | \$ 5,255   | \$          | \$ | \$ 9,432   |
| Collectively evaluated     | 148,671                    | 116,349                   | 43,579                 | 11,498                             |            |             |    | 320,097    |
| ASC 310-30                 |                            |                           |                        |                                    | 172,180    |             |    | 172,180    |
| Total                      | \$ 150,879                 | \$ 117,986                | \$ 43,687              | \$ 11,722                          | \$ 177,435 | \$          | \$ | \$ 501,709 |

|                            | June 30, 2013              |                           |                        |                                    |            |             |    | Total      |
|----------------------------|----------------------------|---------------------------|------------------------|------------------------------------|------------|-------------|----|------------|
|                            | Residential<br>Real Estate | Commercial<br>Real Estate | Commercial<br>Business | Consumer<br>(Dollars in thousands) | Purchased  | Unallocated |    |            |
| Allowance for loan losses: |                            |                           |                        |                                    |            |             |    |            |
| Individually evaluated     | \$ 235                     | \$ 85                     | \$ 63                  | \$ 23                              | \$ 65      | \$          | \$ | \$ 471     |
| Collectively evaluated     | 359                        | 88                        | 7                      | 166                                |            | 41          |    | 661        |
| ASC 310-30                 |                            |                           |                        |                                    | 11         |             |    | 11         |
| Total                      | \$ 594                     | \$ 173                    | \$ 70                  | \$ 189                             | \$ 76      | \$ 41       | \$ | \$ 1,143   |
| Loans:                     |                            |                           |                        |                                    |            |             |    |            |
| Individually evaluated     | \$ 2,626                   | \$ 1,558                  | \$ 110                 | \$ 149                             | \$ 1,129   | \$          | \$ | \$ 5,572   |
| Collectively evaluated     | 122,497                    | 98,886                    | 29,576                 | 13,188                             |            |             |    | 264,147    |
| ASC 310-30                 |                            |                           |                        |                                    | 165,657    |             |    | 165,657    |
| Total                      | \$ 125,123                 | \$ 100,444                | \$ 29,686              | \$ 13,337                          | \$ 166,786 | \$          | \$ | \$ 435,376 |

The following table sets forth information regarding impaired loans. Loans accounted for under ASC 310-30 that have performed based on cash flow and accretible yield expectations determined at date of acquisition are not considered impaired assets and have been excluded from the tables below.

December 31, 2013  
Unpaid

June 30, 2013  
Unpaid



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|   | Recorded<br>Investment | Principal<br>Balance | Related<br>Allowance<br>(Dollars in thousands) | Recorded<br>Investment | Principal<br>Balance | Related<br>Allowance |
|---|------------------------|----------------------|--|------------------------|----------------------|----------------------|
| Impaired loans without a valuation allowance: |                        |                      |  |                        |                      |                      |
| Originated:                                   |                        |                      |  |                        |                      |                      |
| Residential real estate                       | \$ 837                 | \$ 879               | \$   | \$ 1,158               | \$ 1,225             | \$                   |
| Consumer                                      | 111                    | 121                  |  | 88                     | 93                   |                      |
| Commercial real estate                        | 383                    | 404                  |  | 434                    | 479                  |                      |
| Commercial business                           | 64                     | 118                  |  | 47                     | 101                  |                      |
| Purchased:                                    |                        |                      |  |                        |                      |                      |
| Commercial real estate                        | 3,320                  | 5,436                |  | 928                    | 1,279                |                      |
| Total   | 4,715                  | 6,958                |  | 2,655                  | 3,177                |                      |
| Impaired loans with a valuation allowance:    |                        |                      |  |                        |                      |                      |
| Originated:                                   |                        |                      |  |                        |                      |                      |
| Residential real estate                       | 1,371                  | 1,342                | 189  | 1,468                  | 1,420                | 235                  |
| Consumer                                      | 113                    | 113                  | 4  | 61                     | 61                   | 23                   |
| Commercial real estate                        | 1,254                  | 1,259                | 108  | 1,124                  | 1,131                | 85                   |
| Commercial business                           | 44                     | 78                   | 44   | 63                     | 98                   | 63                   |
| Purchased:                                    |                        |                      |  |                        |                      |                      |
| Commercial real estate                        | 1,935                  | 2,228                | 86   | 201                    | 276                  | 65                   |
| Total   | 4,717                  | 5,020                | 431  | 2,917                  | 2,986                | 471                  |
| Total impaired loans                          | \$ 9,432               | \$ 11,978            | \$ 431   | \$ 5,572               | \$ 6,163             | \$ 471               |

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The following tables set forth information regarding interest income recognized on impaired loans.

|   | 2013                        |       | Three Months Ended December 31, |    | 2012                        |                            |    |    |
|---|-----------------------------|-------|---------------------------------|----|-----------------------------|----------------------------|----|----|
|   | Average Recorded Investment |       | Interest Income Recognized      |    | Average Recorded Investment | Interest Income Recognized |    |    |
| (Dollars in thousands)                        |                             |       |                                 |    |                             |                            |    |    |
| Impaired loans without a valuation allowance: |                             |       |                                 |    |                             |                            |    |    |
| Originated:                                   |                             |       |                                 |    |                             |                            |    |    |
| Residential real estate                       | \$                          | 901   | \$                              | 8  | \$                          | 904                        | \$ | 8  |
| Consumer                                      |                             | 96    |                                 | 1  |                             | 64                         |    | 1  |
| Commercial real estate                        |                             | 413   |                                 | 7  |                             | 1,285                      |    | 19 |
| Commercial business                           |                             | 72    |                                 | 3  |                             | 119                        |    |    |
| Purchased:                                    |                             |       |                                 |    |                             |                            |    |    |
| Commercial real estate                        |                             | 2,833 |                                 | 41 |                             |                            |    |    |
| Total   |                             | 4,315 |                                 | 60 |                             | 2,372                      |    | 28 |

|  |    |       |    |     |    |       |    |    |
|--|----|-------|----|-----|----|-------|----|----|
| Impaired loans with a valuation allowance: |    |       |    |     |    |       |    |    |
| Originated:                                |    |       |    |     |    |       |    |    |
| Residential real estate                    |    | 1,344 |    | 19  |    | 1,178 |    | 17 |
| Consumer                                   |    | 117   |    | 2   |    | 74    |    | 1  |
| Commercial real estate                     |    | 1,186 |    | 19  |    | 628   |    | 7  |
| Commercial business                        |    | 44    |    | 1   |    | 46    |    |    |
| Purchased:                                 |    |       |    |     |    |       |    |    |
| Commercial real estate                     |    | 1,067 |    | 46  |    |       |    |    |
| Total                                      |    | 3,758 |    | 87  |    | 1,926 |    | 25 |
| Total impaired loans                       | \$ | 8,073 | \$ | 147 | \$ | 4,298 | \$ | 53 |

|   | 2013                        |       | Six Months Ended December 31, |    | 2012                        |                            |    |    |
|---|-----------------------------|-------|-------------------------------|----|-----------------------------|----------------------------|----|----|
|   | Average Recorded Investment |       | Interest Income Recognized    |    | Average Recorded Investment | Interest Income Recognized |    |    |
| (Dollars in thousands)                        |                             |       |                               |    |                             |                            |    |    |
| Impaired loans without a valuation allowance: |                             |       |                               |    |                             |                            |    |    |
| Originated:                                   |                             |       |                               |    |                             |                            |    |    |
| Residential real estate                       | \$                          | 986   | \$                            | 14 | \$                          | 700                        | \$ | 13 |
| Consumer                                      |                             | 93    |                               | 2  |                             | 42                         |    | 2  |
| Commercial real estate                        |                             | 420   |                               | 14 |                             | 1,351                      |    | 29 |
| Commercial business                           |                             | 63    |                               | 6  |                             | 205                        |    | 3  |
| Purchased:                                    |                             |       |                               |    |                             |                            |    |    |
| Commercial real estate                        |                             | 2,198 |                               | 48 |                             | 352                        |    |    |
| Total   |                             | 3,760 |                               | 84 |                             | 2,650                      |    | 47 |

|  |  |       |  |    |  |     |  |    |
|--|--|-------|--|----|--|-----|--|----|
| Impaired loans with a valuation allowance: |  |       |  |    |  |     |  |    |
| Originated:                                |  |       |  |    |  |     |  |    |
| Residential real estate                    |  | 1,385 |  | 37 |  | 821 |  | 26 |
| Consumer                                   |  | 98    |  | 3  |  | 49  |  | 2  |
| Commercial real estate                     |  | 1,165 |  | 45 |  | 610 |  | 13 |

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|                        |          |        |          |       |  |  |
|------------------------|----------|--------|----------|-------|--|--|
| Commercial business    | 50       | 1      | 280      |       |  |  |
| Purchased:             |          |        |          |       |  |  |
| Commercial real estate | 778      | 48     |          |       |  |  |
| Total                  | 3,476    | 134    | 1,760    | 41    |  |  |
| Total impaired loans   | \$ 7,236 | \$ 218 | \$ 4,410 | \$ 88 |  |  |

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Credit Quality

The Company utilizes a ten-point internal loan rating system for commercial real estate, construction, commercial business, and certain residential loans as follows:

Loans rated 1 - 6: Loans in these categories are considered pass rated loans. Loans in categories 1-5 are considered to have low to average risk. Loans rated 6 are considered marginally acceptable business credits and have more than average risk.

Loans rated 7: Loans in this category are considered special mention. These loans show signs of potential weakness and are being closely monitored by management.

Loans rated 8: Loans in this category are considered 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. Assets so classified have a well defined weakness or weaknesses that jeopardize the orderly liquidation of the debt.

Loans rated 9: Loans in this category are considered doubtful. Loans classified as doubtful have all the weaknesses inherent in one graded 8 with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

Loans rated 10: Loans in this category are considered loss and of such little value that their continuance as loans is not warranted.

On an annual basis, or more often if needed, the Company formally reviews the ratings of all loans subject to risk ratings. Semi-annually, the Company engages an independent third-party to review a significant portion of loans within these segments. Management uses the results of these reviews as part of its annual review process. Risk ratings on purchased loans, with and without evidence of credit deterioration at acquisition, are determined relative to the Company's recorded investment in that loan, which may be significantly lower than the loan's unpaid principal balance.

The following tables present the Company's loans by risk rating.

|                  | December 31, 2013         |                      |                        |                |                        |            |
|------------------|---------------------------|----------------------|------------------------|----------------|------------------------|------------|
|                  | Commercial<br>Real Estate | Originated Portfolio |                        |                | Purchased<br>Portfolio | Total      |
|                  |                           | Construction         | Commercial<br>Business | Residential(1) |                        |            |
|                  | (Dollars in thousands)    |                      |                        |                |                        |            |
| Loans rated 1- 6 | \$ 107,455                | \$                   | \$ 43,374              | \$ 12,147      | \$ 164,588             | \$ 327,564 |

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|                |            |           |           |            |            |
|----------------|------------|-----------|-----------|------------|------------|
| Loans rated 7  | 8,151      | 41        | 641       | 6,630      | 15,463     |
| Loans rated 8  | 2,380      | 272       | 664       | 6,217      | 9,533      |
| Loans rated 9  |            |           |           |            |            |
| Loans rated 10 |            |           |           |            |            |
|                | \$ 117,986 | \$ 43,687 | \$ 13,452 | \$ 177,435 | \$ 352,560 |

June 30, 2013

|                  | Originated Portfolio   |              |                     |                | Purchased Portfolio | Total      |
|------------------|------------------------|--------------|---------------------|----------------|---------------------|------------|
|                  | Commercial Real Estate | Construction | Commercial Business | Residential(1) |                     |            |
|                  | (Dollars in thousands) |              |                     |                |                     |            |
| Loans rated 1- 6 | \$ 95,834              | \$ 42        | \$ 29,340           | \$ 13,110      | \$ 161,965          | \$ 300,291 |
| Loans rated 7    | 3,537                  |              | 82                  | 638            | 3,226               | 7,483      |
| Loans rated 8    | 1,031                  |              | 264                 | 527            | 1,595               | 3,417      |
| Loans rated 9    |                        |              |                     |                |                     |            |
| Loans rated 10   |                        |              |                     |                |                     |            |
|                  | \$ 100,402             | \$ 42        | \$ 29,686           | \$ 14,275      | \$ 166,786          | \$ 311,191 |

(1) Certain of the Company's loans originated for commercial purposes, but secured by residential collateral, are rated under the Company's risk-rating system.

Table of ContentsPast Due and Nonaccrual Loans

The following is a summary of past due and non-accrual loans:

|                            | December 31, 2013 |               |  |   |                      |                  |                |                          |
|----------------------------|-------------------|---------------|--|---|----------------------|------------------|----------------|--------------------------|
|                            | 30-59<br>Days     | 60-89<br>Days | Past Due<br>90 Days or<br>More-Still<br>Accruing | Past Due<br>90 Days or<br>More-<br>Nonaccrual | Total<br>Past<br>Due | Total<br>Current | Total<br>Loans | Non-<br>Accrual<br>Loans |
| Originated portfolio:      |                   |               |  |   |                      |                  |                |                          |
| Residential real estate    | \$ 786            | \$ 403        | \$   | \$ 1,684                                      | \$ 2,873             | \$ 117,941       | \$ 120,814     | \$ 1,895                 |
| Home equity                | 97                | 212           |  | 186   | 495                  | 29,570           | 30,065         | 204                      |
| Commercial real estate     | 411               | 258           |  | 26  | 695                  | 117,291          | 117,986        | 487                      |
| Construction               |                   |               |  |   |                      |                  |                |                          |
| Commercial business        |                   |               |  | 43  | 43                   | 43,644           | 43,687         | 61                       |
| Consumer                   | 277               | 133           |  | 139   | 549                  | 11,173           | 11,722         | 259                      |
| Total originated portfolio | 1,571             | 1,006         |  | 2,078   | 4,655                | 319,619          | 324,274        | 2,906                    |
| Purchased portfolio:       |                   |               |  |   |                      |                  |                |                          |
| Residential real estate    | 15                |               |  |   | 15                   | 2,591            | 2,606          |                          |
| Commercial business        |                   |               |  |   |                      | 13               | 13             |                          |
| Commercial real estate     | 4                 |               |  | 3,224   | 3,228                | 171,588          | 174,816        | 3,245                    |
| Total purchased portfolio  | 19                |               |  | 3,224   | 3,243                | 174,192          | 177,435        | 3,245                    |
| Total loans                | \$ 1,590          | \$ 1,006      | \$   | \$ 5,302                                      | \$ 7,898             | \$ 493,811       | \$ 501,709     | \$ 6,151                 |

|                            | June 30, 2013 |               |  |   |                      |                  |                |                          |
|----------------------------|---------------|---------------|--|---|----------------------|------------------|----------------|--------------------------|
|                            | 30-59<br>Days | 60-89<br>Days | Past Due<br>90 Days or<br>More-Still<br>Accruing | Past Due<br>90 Days or<br>More-<br>Nonaccrual | Total<br>Past<br>Due | Total<br>Current | Total<br>Loans | Non-<br>Accrual<br>Loans |
| (Dollars in thousands)     |               |               |  |   |                      |                  |                |                          |
| Originated portfolio:      |               |               |  |   |                      |                  |                |                          |
| Residential real estate    | \$ 278        | \$ 408        | \$   | \$ 1,965                                      | \$ 2,651             | \$ 87,083        | \$ 89,734      | \$ 2,346                 |
| Home equity                | 53            | 47            |  | 253   | 353                  | 35,036           | 35,389         | 334                      |
| Commercial real estate     | 91            | 326           |  | 98  | 515                  | 99,887           | 100,402        | 473                      |
| Construction               |               |               |  |   |                      |                  |                |                          |
| Commercial business        |               |               |  | 44  | 44                   | 29,642           | 29,686         | 110                      |
| Consumer                   | 193           | 77            |  | 117   | 387                  | 12,950           | 13,337         | 136                      |
| Total originated portfolio | 615           | 858           |  | 2,477   | 3,950                | 264,640          | 268,590        | 3,399                    |
| Purchased portfolio:       |               |               |  |   |                      |                  |                |                          |
| Residential real estate    |               |               |  |   |                      | 2,706            | 2,706          |                          |
| Commercial business        |               |               |  |   |                      | 34               | 34             |                          |
| Commercial real estate     |               | 2,210         |  | 1,135   | 3,345                | 160,701          | 164,046        | 1,457                    |

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|                           |    |     |       |       |    |       |    |       |    |         |    |         |    |       |
|---------------------------|----|-----|-------|-------|----|-------|----|-------|----|---------|----|---------|----|-------|
| Total purchased portfolio |    |     | 2,210 |       |    | 1,135 |    | 3,345 |    | 163,441 |    | 166,786 |    | 1,457 |
| Total loans               | \$ | 615 | \$    | 3,068 | \$ | 3,612 | \$ | 7,295 | \$ | 428,081 | \$ | 435,376 | \$ | 4,856 |

Table of ContentsTroubled Debt Restructurings

The following table shows the Company's post-modification balance of TDRs by type of modification.

|                          | Three Months Ended December 31, |                        |                        |                        | Six Months Ended December 31, |                        |                        |                        |
|--------------------------|---------------------------------|------------------------|------------------------|------------------------|-------------------------------|------------------------|------------------------|------------------------|
|                          | 2013                            |                        | 2012                   |                        | 2013                          |                        | 2012                   |                        |
|                          | Number of<br>Contracts          | Recorded<br>Investment | Number of<br>Contracts | Recorded<br>Investment | Number of<br>Contracts        | Recorded<br>Investment | Number of<br>Contracts | Recorded<br>Investment |
|                          | (Dollars in thousands)          |                        |                        |                        |                               |                        |                        |                        |
| Extended maturity        | 3                               | \$ 1,763               | 1                      | \$ 242                 | 4                             | \$ 1,777               | 1                      | \$ 242                 |
| Adjusted interest rate   |                                 |                        |                        |                        | 1                             | 82                     |                        |                        |
| Rate and maturity        |                                 |                        | 6                      | 461                    |                               |                        | 7                      | 683                    |
| Principal deferment      |                                 |                        |                        |                        | 2                             | 341                    |                        |                        |
| Court ordered concession |                                 |                        | 1                      | 36                     |                               |                        | 1                      | 36                     |
|                          | 3                               | \$ 1,763               | 8                      | \$ 739                 | 7                             | \$ 2,200               | 9                      | \$ 961                 |

The following table shows loans modified in a TDR and the change in the recorded investment subsequent to the modifications occurring.

|  | Three Months Ended December 31, |   |  |                        |   |        |
|--|---------------------------------|---|--|------------------------|---|--------|
|  | Number of<br>Contracts          | 2013  |  | Number of<br>Contracts | 2012  |        |
| Recorded<br>Investment<br>Pre-Modification |                                 | Recorded<br>Investment<br>Post-Modification | Recorded<br>Investment<br>Pre-Modification |                        | Recorded<br>Investment<br>Post-Modification |        |
|  | (Dollars in thousands)          |   |  |                        |   |        |
| Originated portfolio:                      |                                 |   |  |                        |   |        |
| Residential real estate                    |                                 | \$  | \$   | 3                      | \$ 453                                      | \$ 453 |
| Home equity                                |                                 |   |  | 2                      | 278   | 278    |
| Commercial real estate                     |                                 |   |  |                        |   |        |
| Commercial business                        |                                 |   |  |                        |   |        |
| Consumer                                   | 1                               | 39  | 39   | 3                      | 8   | 8      |
| Total originated portfolio                 | 1                               | 39  | 39   | 8                      | 739   | 739    |
| Purchased portfolio:                       |                                 |   |  |                        |   |        |
| Residential real estate                    |                                 |   |  |                        |   |        |
| Commercial real estate                     | 2                               | 1,685                                       | 1,724                                      |                        |   |        |
| Total purchased portfolio                  | 2                               | 1,685                                       | 1,724                                      |                        |   |        |



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|       |   |    |       |    |       |   |    |     |    |     |
|-------|---|----|-------|----|-------|---|----|-----|----|-----|
| Total | 3 | \$ | 1,724 | \$ | 1,763 | 8 | \$ | 739 | \$ | 739 |
|-------|---|----|-------|----|-------|---|----|-----|----|-----|

|                            | Number of Contracts | Six Months Ended December 31,        |                                       |                     |                                      |                                       |        |
|----------------------------|---------------------|--------------------------------------|---------------------------------------|---------------------|--------------------------------------|---------------------------------------|--------|
|                            |                     | 2013                                 |                                       | 2012                |                                      | Recorded Investment Post-Modification |        |
|                            |                     | Recorded Investment Pre-Modification | Recorded Investment Post-Modification | Number of Contracts | Recorded Investment Pre-Modification | Recorded Investment Post-Modification |        |
| (Dollars in thousands)     |                     |                                      |                                       |                     |                                      |                                       |        |
| Originated portfolio:      |                     |                                      |                                       |                     |                                      |                                       |        |
| Residential real estate    |                     | \$                                   | \$                                    | 4                   | \$                                   | 675                                   | \$ 675 |
| Home equity                | 1                   | 14                                   | 14                                    | 2                   | 278                                  | 278                                   |        |
| Commercial real estate     | 1                   | 323                                  | 323                                   |                     |                                      |                                       |        |
| Commercial business        | 1                   | 18                                   | 18                                    |                     |                                      |                                       |        |
| Consumer                   | 2                   | 121                                  | 121                                   | 3                   | 8                                    | 8                                     |        |
| Total originated portfolio | 5                   | 476                                  | 476                                   | 9                   | 961                                  | 961                                   |        |
| Purchased portfolio:       |                     |                                      |                                       |                     |                                      |                                       |        |
| Residential real estate    |                     |                                      |                                       |                     |                                      |                                       |        |
| Commercial real estate     | 2                   | 1,685                                | 1,724                                 |                     |                                      |                                       |        |
| Total purchased portfolio  | 2                   | 1,685                                | 1,724                                 |                     |                                      |                                       |        |
| Total                      | 7                   | \$ 2,161                             | \$ 2,200                              | 9                   | \$ 961                               | \$ 961                                |        |

The following table shows the loans that have been modified during the past twelve months which have subsequently defaulted during the periods indicated. The Company considers a loan to have defaulted when it reaches 90 days past due.

|                        | Three Months Ended December 31, |                     |                     |                     | Six Months Ended December 31, |                     |                     |                     |
|------------------------|---------------------------------|---------------------|---------------------|---------------------|-------------------------------|---------------------|---------------------|---------------------|
|                        | 2013                            |                     | 2012                |                     | 2013                          |                     | 2012                |                     |
|                        | Number of Contracts             | Recorded Investment | Number of Contracts | Recorded Investment | Number of Contracts           | Recorded Investment | Number of Contracts | Recorded Investment |
| (Dollars in thousands) |                                 |                     |                     |                     |                               |                     |                     |                     |
| Residential            |                                 | \$                  |                     | \$                  | 1                             | \$ 69               |                     | \$                  |
| Home equity            |                                 |                     | 1                   | 36                  |                               |                     | 1                   | 36                  |
| Consumer               |                                 |                     |                     |                     | 1                             | 10                  |                     |                     |
|                        |                                 | \$                  | 1                   | \$ 36               | 2                             | \$ 79               | 1                   | \$ 36               |

As of December 31, 2013, there were no further commitments to lend associated with loans modified in a TDR.

Table of ContentsASC 310-30 Loans

The following table presents a summary of loans accounted for under ASC 310-30 that were acquired by the Company.

|  | <b>Three Months Ended<br/>December 31, 2013</b> | <b>Six Months Ended<br/>December 31, 2013</b> |
|--|---|---|
|  | <b>(Dollars in thousands)</b>                   |   |
| Contractually required payments receivable | \$ 20,865                                       | \$ 43,082                                     |
| Nonaccretable difference                   | (420)   | (593)   |
| Cash flows expected to be collected        | 20,445  | 42,489  |
| Accretable yield                           | (6,826)   | (12,522)                                      |
| Fair value of loans acquired               | \$ 13,619                                       | \$ 29,967                                     |

The following table summarizes the activity in the accretable yield for loans accounted for under ASC 310-30.

|                                       | <b>Three Months Ended<br/>December 31, 2013</b> | <b>Six Months Ended<br/>December 31, 2013</b> |
|---------------------------------------|---|---|
|                                       | <b>(Dollars in thousands)</b>                   |   |
| Beginning balance                     | \$ 106,805                                      | \$ 108,251                                    |
| Acquisitions                          | 6,826   | 12,522  |
| Accretion                             | (3,898)   | (7,636)                                       |
| Reclassifications to accretable yield | 676   | 763   |
| Disposals and other                   | (6,292)   | (9,783)                                       |
| End balance                           | \$ 104,117                                      | \$ 104,117                                    |

The following table provides information related to the unpaid principal balance and carrying amounts of ASC 310-30 loans.

|                          | <b>December 31, 2013</b>      | <b>June 30, 2013</b> |
|--------------------------|-------------------------------|----------------------|
|                          | <b>(Dollars in thousands)</b> |                      |
| Unpaid principal balance | \$ 210,297                    | \$ 203,755           |
| Carrying amount          | \$ 175,416                    | \$ 166,506           |

Table of Contents**5. Earnings Per Share (EPS)**

EPS is computed by dividing net income allocated to common shareholders by the weighted average common shares outstanding. The following table shows the weighted average number of shares outstanding for the periods indicated. Shares issuable relative to stock options granted have been reflected as an increase in the shares outstanding used to calculate diluted EPS, after applying the treasury stock method. The number of shares outstanding for basic and diluted EPS is presented as follows:

|   | Three months Ended December 31,                         |            | Six months Ended December 31, |            |
|---|---|------------|-------------------------------|------------|
|   | 2013  | 2012       | 2013                          | 2012       |
|   | (Dollars in thousands, except share and per share data) |            |                               |            |
| Net income  | \$ 1,393  | \$ 1,517   | \$ 1,713                      | \$ 2,550   |
| Preferred stock dividends and accretion                         |   | (258)      |                               | (355)      |
| Net income available to common shareholders                     | \$ 1,393  | \$ 1,259   | \$ 1,713                      | \$ 2,195   |
| Weighted average shares used in calculation of basic EPS        | 10,432,833  | 10,383,441 | 10,436,673                    | 10,383,441 |
| Incremental shares from assumed exercise of dilutive securities |   |            |                               |            |
| Weighted average shares used in calculation of diluted EPS      | 10,432,833  | 10,383,441 | 10,436,673                    | 10,383,441 |
| Earnings per common share:                                      |   |            |                               |            |
| Income from continuing operations                               | \$ 0.13   | \$ 0.11    | \$ 0.16                       | \$ 0.20    |
| Income from discontinued operations                             |   | 0.01       |                               | 0.01       |
| Earnings per common share                                       | \$ 0.13   | \$ 0.12    | \$ 0.16                       | \$ 0.21    |
| Diluted earnings per common share:                              |   |            |                               |            |
| Income from continuing operations                               | \$ 0.13   | \$ 0.11    | \$ 0.16                       | \$ 0.20    |
| Income from discontinued operations                             |   | 0.01       |                               | 0.01       |
| Diluted earnings per common share                               | \$ 0.13   | \$ 0.12    | \$ 0.16                       | \$ 0.21    |

Average anti-dilutive options and warrants excluded from the calculation of dilutive earnings per share follow.

|               | Three Months Ended December 31, |         | Six Months Ended December 31, |         |
|---------------|---------------------------------|---------|-------------------------------|---------|
|               | 2013                            | 2012    | 2013                          | 2012    |
| Stock options | 1,136,080                       | 783,149 | 1,151,442                     | 787,449 |
| Warrants      |                                 | 65,742  |                               | 66,850  |
|               | 1,136,080                       | 848,891 | 1,151,442                     | 854,299 |

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**6. Fair Value Measurements**

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. The Company uses prices and inputs that are current as of the measurement date, including during periods of market dislocation. In periods of market dislocation, the observability of prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from one level to another. When market assumptions are not readily available, the Company's own assumptions are set to reflect those that market participants would use in pricing the asset or liability at the measurement date. If there has been a significant decrease in the volume and level of activity for the asset or liability, regardless of the valuation technique(s) used, the objective of a fair value measurement remains the same.

ASC 820 defines fair value and establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under ASC 820 are described below:

Level 1 Inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 Valuations based on 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 Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable.

To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgment. Accordingly, the degree of judgment exercised by the Company in determining fair value is greatest for instruments categorized in Level 3. A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

*Valuation techniques* - There have been no changes in the valuation techniques used during the current period.

*Transfers* - There were no transfers of assets and liabilities measured at fair value on a recurring or nonrecurring basis during the current period.

*Assets and Liabilities Measured at Fair Value on a Recurring Basis:*

*Available-for-sale securities* - Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Examples of such instruments include publicly-traded common and preferred stocks. If quoted prices are not available, then fair values are estimated by using pricing models (*i.e.*, matrix pricing) and market interest rates and credit assumptions or quoted prices of securities with similar characteristics and are classified within Level 2 of the valuation hierarchy. Examples of such instruments include government agency and government sponsored agency mortgage-backed securities, as well as certain preferred and trust preferred stocks. Level 3 securities are securities for which significant unobservable inputs are utilized.

*Derivative financial instruments* - The valuation of the Company's interest rate swaps and caps are determined using widely accepted valuation techniques including discounted cash flow analyses on the expected cash flows of derivatives. These analyses reflect the contractual terms of the derivatives, including the period to maturity, and use observable market-based inputs, including interest rate curves and implied volatilities. Unobservable inputs, such as credit valuation adjustments are insignificant to the overall valuation of the Company's derivative financial instruments. Accordingly, the Company has determined that its interest rate derivatives fall within Level 2 of the fair value hierarchy.

The fair value of derivative loan commitments and forward loan sale agreements are estimated using the anticipated market price based on pricing indications provided from syndicate banks. These commitments and agreements are categorized as Level 2. The fair value of such instruments was nominal at each date presented.

*Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis:*

*Impaired Loans* - Valuations of impaired loans measured at fair value are determined by a review of collateral values. Certain inputs used in appraisals are not always observable, and therefore impaired loans are generally categorized as Level 3 within the fair value hierarchy.

*Real Estate Owned and Other Repossessed collateral* - The fair values of real estate owned and other repossessed collateral are estimated based upon appraised values less estimated costs to sell. Certain inputs used in appraisals are not always observable, and therefore may be categorized as Level 3 within the fair value hierarchy. When inputs used in appraisals are primarily observable, they are classified as Level 2.

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*Fair Value of other Financial Instruments:*

*Cash and cash equivalents* - The fair value of cash, due from banks, interest bearing deposits and FHLB overnight deposits approximates their relative book values, as these financial instruments have short maturities.

*FHLB and Federal Reserve stock* - The carrying value of FHLB stock and Federal Reserve stock approximates fair value based on redemption provisions of the FHLB and the Federal Reserve.

*Loans* - Fair values are estimated for portfolios of loans with similar financial characteristics. The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimates of maturity are based on the Company's historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic conditions, lending conditions and the effects of estimated prepayments.

*Loans held for sale* - The fair value of loans held-for-sale is estimated based on bid quotations received from loan dealers.

*Interest receivable* - The fair value of this financial instrument approximates the book value as this financial instrument has a short maturity. It is the Company's policy to stop accruing interest on loans past due by more than 90 days. Therefore, this financial instrument has been adjusted for estimated credit loss.

*Deposits* - The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings, NOW accounts and money market accounts, is equal to the amount payable on demand. The fair values of time deposits are based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities. The fair value estimates do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market. If that value were considered, the fair value of the Company's net assets could increase.

*Borrowings* - The fair value of the Company's borrowings with the FHLB is estimated by discounting the cash flows through maturity or the next re-pricing date based on current rates available to the Company for borrowings with similar maturities. The fair value of the Company's short-term borrowings, capital lease obligations, wholesale repurchase agreements and other borrowings is estimated by discounting the cash flows through maturity based on current rates available to the Company for borrowings with similar maturities.

*Off-Balance Sheet Credit-Related Instruments* - Fair values for off-balance-sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of such instruments was nominal at each date presented.



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Assets and liabilities measured at fair value on a recurring basis are summarized below.

|                                       | Total     | December 31, 2013 |           |         |
|---------------------------------------|-----------|-------------------|-----------|---------|
|                                       |           | Level 1           | Level 2   | Level 3 |
| (Dollars in thousands)                |           |                   |           |         |
| <b>Assets</b>                         |           |                   |           |         |
| Securities available-for-sale:        |           |                   |           |         |
| U.S. Government agency securities     | \$ 45,143 | \$                | \$ 45,143 | \$      |
| Agency mortgage-backed securities     | 69,574    |                   | 69,574    |         |
| Other assets interest rate caps       |           |                   |           |         |
| Other assets interest rate swaps      | 478       |                   | 478       |         |
| <b>Liabilities</b>                    |           |                   |           |         |
| Other liabilities interest rate swaps | \$ 283    | \$                | \$ 283    | \$      |

|                                      | Total     | June 30, 2013 |           |         |
|--------------------------------------|-----------|---------------|-----------|---------|
|                                      |           | Level 1       | Level 2   | Level 3 |
| (Dollars in thousands)               |           |               |           |         |
| <b>Assets</b>                        |           |               |           |         |
| Securities available-for-sale:       |           |               |           |         |
| U.S. Government agency securities    | \$ 45,333 | \$            | \$ 45,333 | \$      |
| Agency mortgage-backed securities    | 76,264    |               | 76,264    |         |
| Other assets interest rate caps      |           |               |           |         |
| <b>Liabilities</b>                   |           |               |           |         |
| Other liabilities interest rate swap | \$ 389    | \$            | \$ 389    | \$      |

Assets measured at fair value on a nonrecurring basis are summarized below.

|  | Total  | December 31, 2013 |         |         |
|--|--------|-------------------|---------|---------|
|  |        | Level 1           | Level 2 | Level 3 |
| (Dollars in thousands)                             |        |                   |         |         |
| Collateral dependent impaired loans                | \$ 538 | \$                | \$      | \$ 538  |
| Real estate owned and other repossessed collateral | 3,211  |                   |         | 3,211   |
| <b>June 30, 2013</b>                               |        |                   |         |         |
|  | Total  | Level 1           | Level 2 | Level 3 |
|  |        |                   |         |         |
| Collateral dependent impaired loans                | \$ 894 | \$                | \$      | \$ 894  |
| Real estate owned and other repossessed collateral | 2,134  |                   |         | 2,134   |



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The following table presents the estimated fair value of the Company's financial instruments.

|                                 | Carrying<br>Amount | Fair Value Measurements at December 31, 2013 |           |         |         |
|---------------------------------|--------------------|--|-----------|---------|---------|
|                                 |                    | Total  | Level 1   | Level 2 | Level 3 |
| (Dollars in thousands)          |                    |  |           |         |         |
| <b>Financial assets:</b>        |                    |  |           |         |         |
| Cash and cash equivalents       | \$ 63,427          | \$ 63,427                                    | \$ 63,427 | \$      | \$      |
| Available-for-sale securities   | 114,717            | 114,717                                      |           | 114,717 |         |
| Regulatory stock                | 5,721              | 5,721  |           | 5,721   |         |
| Loans held for sale             | 6,826              | 6,835  |           | 6,835   |         |
| Loans, net                      | 500,359            | 517,284                                      |           |         | 517,284 |
| Accrued interest receivable     | 1,442              | 1,442  |           | 1,442   |         |
| Interest rate caps              |                    |  |           |         |         |
| Interest rate swaps             | 478                | 478  |           | 478     |         |
| <b>Financial liabilities:</b>   |                    |  |           |         |         |
| Deposits                        | 536,522            | 498,582                                      |           | 498,582 |         |
| FHLB advances                   | 42,931             | 44,162                                       |           | 44,162  |         |
| Wholesale repurchase agreements | 15,290             | 15,715                                       |           | 15,715  |         |
| Short-term borrowings           | 2,468              | 2,468  |           | 2,468   |         |
| Capital lease obligation        | 1,650              | 1,804  |           | 1,804   |         |
| Subordinated debentures         | 8,352              | 7,223  |           |         | 7,223   |
| Interest rate swaps             | 283                | 283  |           | 283     |         |

|                                 | Carrying<br>Amount | Fair Value Measurements at June 30, 2013 |           |         |         |
|---------------------------------|--------------------|--|-----------|---------|---------|
|                                 |                    | Total                                    | Level 1   | Level 2 | Level 3 |
| (Dollars in thousands)          |                    |  |           |         |         |
| <b>Financial assets:</b>        |                    |  |           |         |         |
| Cash and cash equivalents       | \$ 65,934          | \$ 65,934                                | \$ 65,934 | \$      | \$      |
| Available-for-sale securities   | 121,597            | 121,597                                  |           | 121,597 |         |
| Regulatory stock                | 5,721              | 5,721                                    |           | 5,721   |         |
| Loans held for sale             | 8,594              | 8,602                                    |           | 8,602   |         |
| Loans, net                      | 434,233            | 444,988                                  |           |         | 444,988 |
| Accrued interest receivable     | 1,396              | 1,396                                    |           | 1,396   |         |
| Interest rate caps              |                    |  |           |         |         |
| <b>Financial liabilities:</b>   |                    |  |           |         |         |
| Deposits                        | 484,623            | 449,857                                  |           | 449,857 |         |
| FHLB advances                   | 28,040             | 29,404                                   |           | 29,404  |         |
| Wholesale repurchase agreements | 25,397             | 26,092                                   |           | 26,092  |         |
| Short-term borrowings           | 625                | 625                                      |           | 625     |         |
| Capital lease obligation        | 1,739              | 1,926                                    |           | 1,926   |         |
| Subordinated debentures         | 8,268              | 7,594                                    |           |         | 7,594   |
| Interest rate swaps             | 389                | 389                                      |           | 389     |         |

**7. Derivatives and Hedging Activities**

The Company has stand alone derivative financial instruments in the form of interest rate caps that derive their value from a fee paid and are adjusted to fair value based on index and strike rate, and swap agreements that derive their value from the underlying interest rate. These transactions involve both credit and market risk. The notional amounts are amounts on which calculations, payments and the value of the derivative are based. Notional amounts do not represent direct credit exposures. Direct credit exposure arises in the event of nonperformance by the counterparties to these agreements, and is limited to the net difference between the calculated amounts to be received and paid, if any. Such differences, which represent the fair value of the derivative instruments, are reflected on the Company's balance sheet as derivative assets and derivative liabilities. The Company controls the credit risk of its financial contracts through credit approvals, limits and monitoring procedures, and does not expect any counterparties to fail to meet their obligations.

The Company currently holds derivative instruments that contain credit-risk related features that are in a net liability position, which may require that collateral be assigned to dealer banks. At December 31, 2013, the Company had posted cash collateral totaling \$800 thousand with dealer banks related to derivative instruments in a net liability position.

The Company does not offset fair value amounts recognized for derivative instruments. The Company does not net the amount recognized for the right to reclaim cash collateral against the obligation to return cash collateral arising from derivative instruments executed with the same counterparty under a master netting arrangement.

*Risk Management Policies    Derivative Instruments*

The Company evaluates the effectiveness of entering into any derivative instrument agreement by measuring the cost of such an agreement in relation to the reduction in net income volatility within an assumed range of interest rates.

*Interest Rate Risk Management    Cash Flow Hedging Instruments*

The Company uses variable rate debt as a source of funds for use in the Company's lending and investment activities and other general business purposes. These debt obligations expose the Company to variability in interest payments due to changes in interest rates. If interest rates increase, interest expense increases. Conversely, if interest rates decrease, interest expense decreases. Management believes

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it is prudent to limit the variability of a portion of its interest payments and, therefore, generally hedges a portion of its variable-rate interest payments.

Information pertaining to outstanding interest rate caps and swap agreements used to hedge variable rate debt is as follows.

| Notional Amount             | Inception Date | Termination Date | Index       | December 31, 2013 |          | Strike Rate | Unrealized Gain (Loss) | Fair Value | Balance Sheet Location |
|-----------------------------|----------------|------------------|-------------|-------------------|----------|-------------|------------------------|------------|------------------------|
|                             |                |                  |             | Receive Rate      | Pay Rate |             |                        |            |                        |
| <i>Interest rate swaps:</i> |                |                  |             |                   |          |             |                        |            |                        |
| \$ 10,000                   | February 2010  | February 2015    | 3 Mo. LIBOR | 2.16%             | 4.69%    | n/a         | \$ (168)               | \$ (283)   | Other Liabilities      |
| 5,000                       | July 2013      | July 2033        | 3 Mo. LIBOR | 0.27%             | 3.38%    | n/a         | 237                    | 237        | Other Assets           |
| 5,000                       | July 2013      | July 2028        | 3 Mo. LIBOR | 0.27%             | 3.23%    | n/a         | 159                    | 159        | Other Assets           |
| 5,000                       | July 2013      | July 2023        | 3 Mo. LIBOR | 0.27%             | 2.77%    | n/a         | 82                     | 82         | Other Assets           |
| <i>Interest rate caps:</i>  |                |                  |             |                   |          |             |                        |            |                        |
| 6,000                       | September 2009 | September 2014   | 3 Mo. LIBOR | n/a               | n/a      | 2.51%       | (25)                   |            | Other Assets           |
| \$ 31,000                   |                |                  |             |                   |          |             | \$ 285                 | \$ 195     |                        |

| Notional Amount             | Inception Date | Termination Date | Index       | June 30, 2013 |          | Strike Rate | Unrealized Gain (Loss) | Fair Value | Balance Sheet Location |
|-----------------------------|----------------|------------------|-------------|---------------|----------|-------------|------------------------|------------|------------------------|
|                             |                |                  |             | Receive Rate  | Pay Rate |             |                        |            |                        |
| <i>Interest rate swaps:</i> |                |                  |             |               |          |             |                        |            |                        |
| \$ 10,000                   | February 2010  | February 2015    | 3 Mo. LIBOR | 2.16%         | 4.69%    | n/a         | \$ (223)               | \$ (389)   | Other Liabilities      |
| <i>Interest rate caps:</i>  |                |                  |             |               |          |             |                        |            |                        |
| 6,000                       | September 2009 | September 2014   | 3 Mo. LIBOR | n/a           | n/a      | 2.51%       | (40)                   |            | Other Assets           |
| \$ 16,000                   |                |                  |             |               |          |             | \$ (263)               | \$ (389)   |                        |

During the three and six months ended December 31, 2013 and 2012, no interest rate cap or swap agreements were terminated prior to maturity. Changes in the fair value of interest rate caps and swaps designated as hedging instruments of the variability of cash flows associated with variable rate debt are reported in other comprehensive income. These amounts subsequently are reclassified into interest expense as a yield adjustment in the same period in which the related interest on the debt affects earnings. Risk management results for the three and six months ended December 31, 2013 and 2012 related to the balance sheet hedging of variable rate debt indicates that the hedges were effective.

During the periods presented, amounts recognized in income related to hedge ineffectiveness resulted from amortization of the non-zero fair value associated with the Company's single interest rate swap held at the time of the merger with FHB Formation LLC in December 2010. During the periods presented, amounts recognized in income related to amounts excluded from effectiveness testing resulted from amortization of the acquisition price of interest rate caps. The table below presents amounts recognized in income related to both hedge ineffectiveness and amounts excluded from effectiveness testing.

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|                            | Three Months Ended December 31, |        | Six Months Ended December 31, |         |
|----------------------------|---------------------------------|--------|-------------------------------|---------|
|                            | 2013                            | 2012   | 2013                          | 2012    |
| (Dollars in thousands)     |                                 |        |                               |         |
| Interest income (expense): |                                 |        |                               |         |
| Interest rate caps         | \$ (8)                          | \$ (6) | \$ (14)                       | \$ (14) |
| Interest rate swap         | 25                              | 25     | 50                            | 51      |
| Total                      | \$ 17                           | \$ 19  | \$ 36                         | \$ 37   |

The Company expects to record interest income of \$100 thousand related to interest rate swap ineffectiveness in the next twelve months. The Company expects to record interest expense of \$26 thousand related to its purchased interest rate caps in the next twelve months.

Table of Contents**8. Other Comprehensive Income**

The components of other comprehensive income (loss) follow.

|  | Three Months Ended December 31, |                                  |                     |                   |                                  |                     |
|--|---------------------------------|----------------------------------|---------------------|-------------------|----------------------------------|---------------------|
|  | Pre-tax<br>Amount               | 2013<br>Tax Expense<br>(Benefit) | After-tax<br>Amount | Pre-tax<br>Amount | 2012<br>Tax Expense<br>(Benefit) | After-tax<br>Amount |
|  | (Dollars in thousands)          |                                  |                     |                   |                                  |                     |
| Change in net unrealized gain or loss on available-for-sale securities | \$ (647)                        | \$ (220)                         | \$ (427)            | \$ (311)          | \$ (107)                         | \$ (204)            |
| Reclassification adjustment for net gains included in net income       |                                 |                                  |                     |                   |                                  |                     |
| Total available-for-sale securities                                    | (647)                           | (220)                            | (427)               | (311)             | (107)                            | (204)               |
| Change in accumulated loss on effective cash flow hedges               | 565                             | 192                              | 373                 | 59                | 20                               | 39                  |
| Reclassification adjustment for net gains included in net income       | (17)                            | (6)                              | (11)                | (19)              | (6)                              | (13)                |
| Total derivatives and hedging activities                               | 548                             | 186                              | 362                 | 40                | 14                               | 26                  |
| Total other comprehensive loss   | \$ (99)                         | \$ (34)                          | \$ (65)             | \$ (271)          | \$ (93)                          | \$ (178)            |

|  | Six Months Ended December 31, |                                  |                     |                   |                                  |                     |
|--|-------------------------------|----------------------------------|---------------------|-------------------|----------------------------------|---------------------|
|  | Pre-tax<br>Amount             | 2013<br>Tax Expense<br>(Benefit) | After-tax<br>Amount | Pre-tax<br>Amount | 2012<br>Tax Expense<br>(Benefit) | After-tax<br>Amount |
|  | (Dollars in thousands)        |                                  |                     |                   |                                  |                     |
| Change in net unrealized gain or loss on available-for-sale securities | \$ (130)                      | \$ (44)                          | \$ (86)             | \$ (154)          | \$ (52)                          | \$ (102)            |
| Reclassification adjustment for net gains included in net income       |                               |                                  |                     | (792)             | (270)                            | (522)               |
| Total available-for-sale securities                                    | (130)                         | (44)                             | (86)                | (946)             | (322)                            | (624)               |
| Change in accumulated loss on effective cash flow hedges               | 584                           | 198                              | 386                 | 65                | 22                               | 43                  |
| Reclassification adjustment for net gains included in net income       | (36)                          | (12)                             | (24)                | (37)              | (13)                             | (24)                |
| Total derivatives and hedging activities                               | 548                           | 186                              | 362                 | 28                | 9                                | 19                  |
| Total other comprehensive income (loss)                                | \$ 418                        | \$ 142                           | \$ 276              | \$ (918)          | \$ (313)                         | \$ (605)            |

Accumulated other comprehensive loss is comprised of the following.

|  | December 31, 2013      |         | June 30, 2013 |         |
|--|------------------------|---------|---------------|---------|
|  | (Dollars in thousands) |         |               |         |
| Unrealized loss on available-for-sale securities | \$                     | (2,766) | \$            | (2,636) |
| Tax effect                                       |                        | 940     |               | 896     |
| Net-of-tax amount                                |                        | (1,826) |               | (1,740) |
| Unrealized gain (loss) on cash flow hedges       |                        | 285     |               | (263)   |
| Tax effect                                       |                        | (97)    |               | 89      |
| Net-of-tax amount                                |                        | 188     |               | (174)   |
| Accumulated other comprehensive loss             | \$                     | (1,638) | \$            | (1,914) |

Table of Contents**9. Commitments and Contingencies**Commitments

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The contract amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Financial instruments with contract amounts that represent credit risk are as follows:

|   | December 31, 2013      |        | June 30, 2013 |        |
|---|------------------------|--------|---------------|--------|
|   | (Dollars in thousands) |        |               |        |
| Commitments to originate loans:           |                        |        |               |        |
| Residential real estate mortgages         | \$                     | 13,198 | \$            | 12,445 |
| Construction loans                        |                        |        |               |        |
| Consumer                                  |                        |        |               |        |
| Commercial real estate mortgages          |                        | 6,798  |               |        |
| Commercial business loans                 |                        | 8,040  |               | 904    |
|   | \$                     | 28,036 | \$            | 13,349 |
| Unused lines of credit                    |                        |        |               |        |
| Standby letters of credit                 | \$                     | 35,488 | \$            | 30,809 |
| Unadvanced portions of construction loans |                        | 467    |               | 420    |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the counter party. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties.

Contingencies

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The Company and its subsidiary are parties to litigation and claims arising in the normal course of business. Management believes that the liabilities, if any, arising from such litigation and claims will not be material to the Company's consolidated financial position or results of operations.



Table of Contents**10. Discontinued Operations**

The Company concluded all investment brokerage activities in the second quarter of fiscal 2014. Accordingly, operations associated with these activities have been classified in as discontinued operations in the accompanying consolidated statements of income. The following summarizes the operations of the Company's investment brokerage division for the three and six months ended December 31, 2013 and 2012.

|                                 | Three Months Ended December 31, |        | Six Months Ended December 31, |          |
|---------------------------------|---------------------------------|--------|-------------------------------|----------|
|                                 | 2013                            | 2012   | 2013                          | 2012     |
|                                 | (Dollars in thousands)          |        |                               |          |
| Noninterest income:             |                                 |        |                               |          |
| Investment commissions          | \$ 296                          | \$ 799 | \$ 971                        | \$ 1,474 |
| Other noninterest income        |                                 |        |                               |          |
| Total noninterest income        | 296                             | 799    | 971                           | 1,474    |
| Noninterest expense:            |                                 |        |                               |          |
| Salaries and employee benefits  | 261                             | 570    | 793                           | 987      |
| Occupancy and equipment expense | 20                              | 43     | 60                            | 103      |
| Data processing fees            | 25                              | 64     | 82                            | 120      |
| Marketing expense               |                                 | 5      | 8                             | 10       |
| Other noninterest expense       | 17                              | 33     | 40                            | 56       |
| Total noninterest expense       | 323                             | 715    | 983                           | 1,276    |
| (Loss) income before tax        | (27)                            | 84     | (12)                          | 198      |
| Income tax (benefit) expense    | (9)                             | 29     | (4)                           | 68       |
| Net (loss) income               | \$ (18)                         | \$ 55  | \$ (8)                        | \$ 130   |

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion should be read in conjunction with the consolidated financial statements, notes and tables included in Northeast Bancorp's Annual Report on Form 10-K for the fiscal year ended June 30, 2013, filed with the Securities and Exchange Commission.

**A Note about Forward Looking Statements**

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended, such as statements relating to the Company's financial condition, prospective results of operations, future performance or expectations, plans, objectives, prospects, loan loss allowance adequacy, simulation of changes in interest rates, capital spending and finance sources and revenue sources. These statements relate to expectations concerning matters that are not historical facts. Accordingly, statements that are based on management's projections, estimates, assumptions, and judgments constitute forward-looking statements. These forward-looking statements, which are based on various assumptions (some of which are beyond the Company's control), may be identified by reference to a future period or periods, or by the use of forward-looking terminology such as believe, expect, estimate, anticipate, continue, plan, approximately, intend, objective, goal, project, or other similar terms or variations thereof, or the future or conditional verbs such as will, may, should, could, and would. Although the Company believes that these forward-looking statements are based on reasonable estimates and assumptions, they are not guarantees of future performance and are subject to known and unknown risks, uncertainties, contingencies, and other factors. Accordingly, the Company cannot give you any assurance that its expectations will, in fact, occur or that its estimates or assumptions will be correct. The Company cautions you that actual results could differ materially from those expressed or implied by such forward-looking statements as a result of, among other factors, changes in interest rates and real estate values; competitive pressures from other financial institutions; the effects of continuing weakness in general economic conditions on a national basis or in the local markets in which the Company operates, including changes which adversely affect borrowers' ability to service and repay the Company's loans; changes in loan defaults and charge-off rates; changes in the value of securities and other assets, adequacy of loan loss reserves, or deposit levels necessitating increased borrowing to fund loans and investments; changes in government regulation; the risk that the Company may not be successful in the implementation of its business strategy; the risk that intangibles recorded in the Company's financial statements will become impaired; changes in assumptions used in making such forward-looking statements; and the other risks and uncertainties detailed in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2013 as updated in the Company's Quarterly Reports on Form 10-Q and other filings submitted to the Securities and Exchange Commission. These forward-looking statements speak only as of the date of this report and the Company does not undertake any obligation to update or revise any of these forward-looking statements to reflect events or circumstances occurring after the date of this report or to reflect the occurrence of unanticipated events.

**Description of Business and Strategy**

Business Overview

Northeast Bancorp (we, our, us, Northeast or the Company), a Maine corporation chartered in April 1987, is a bank holding company registered with the Board of Governors of the Federal Reserve System (Federal Reserve) under the Bank Holding Company Act of 1956, as amended. The Company's primary subsidiary and principal asset is its wholly-owned banking subsidiary, Northeast Bank (the Bank or Northeast Bank), which has ten banking branches. The Bank, which was originally organized in 1872 as a Maine-chartered mutual savings bank, is a Maine-chartered bank and a member of the Federal Reserve System. As such, the Company and the Bank are currently subject to the regulatory oversight of the Federal Reserve and the State of Maine Bureau of Financial Institutions (the Bureau).

On December 29, 2010, the merger of the Company and FHB Formation LLC, a Delaware limited liability company ( FHB ), was consummated. As a result of the merger, the surviving company received a capital contribution of \$16.2 million (in addition to the approximately \$13.1 million in cash consideration paid to former shareholders), and the former members of FHB collectively acquired approximately 60% of the Company's outstanding common stock. The Company applied the acquisition method of accounting, as described in Accounting Standards Codification ( ASC ) 805, *Business Combinations* ( ASC 805 ) to the merger, which represents an acquisition by FHB of Northeast, with Northeast as the surviving company.

In connection with the transaction, as part of the regulatory approval process, the Company and the Bank made certain commitments to the Federal Reserve, the most significant of which are (i) to maintain a Tier 1 leverage ratio of at least 10%, (ii) to maintain a total risk-based capital ratio of at least 15%, (iii) to limit purchased loans to 40% of total loans, (iv) to fund 100% of the Company's loans with core deposits (defined as non-maturity deposits and non-brokered insured time deposits), and (v) to hold commercial real estate loans (including owner-occupied commercial real estate) to within 300% of total risk-based capital. On June 28, 2013, the Federal Reserve approved the amendment of the commitment to hold commercial real estate loans to within 300% of total risk-based capital to exclude owner-occupied commercial real estate loans. All other commitments made to the Federal Reserve in connection with the merger remain unchanged. The Company and the Bank are currently in compliance with all commitments to the Federal Reserve. The Company's compliance ratios at December 31, 2013 follow.

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| Condition   | Ratios at December 31, 2013 |
|---|-----------------------------|
| (i) Tier 1 leverage ratio   | 16.66%                      |
| (ii) Total risk-based capital ratio                                   | 24.61%                      |
| (iii) Ratio of purchased loans to total loans                         | 34.89%                      |
| (iv) Ratio of loans to core deposits                                  | 95.10%                      |
| (v) Ratio of commercial real estate loans to total risk-based capital | 170.69%                     |

As of December 31, 2013, the Company, on a consolidated basis, had total assets of \$732.6 million, total deposits of \$536.5 million, and stockholders' equity of \$114.4 million. The Company gathers retail deposits through its banking offices in Maine and its online affinity deposit program, ableBanking; originates loans through the Bank's Community Banking Division; and purchases and originates commercial loans through the Bank's Loan Acquisition and Servicing Group (LASG). The Community Banking Division, with ten full-service branches and seven loan production offices, operates from the Bank's headquarters in Lewiston, Maine. The Company operates ableBanking and the LASG from its offices in Boston, Massachusetts.

Unless the context otherwise requires, references herein to the Company include the Company and its subsidiary on a consolidated basis.

Strategy

The Company's goal is to prudently grow its franchise, while maintaining sound operations and risk management, by implementing the following strategies:

*Measured growth of the commercial loan portfolio.* The Company's LASG purchases performing commercial real estate loans, on a nationwide basis, typically at a discount from their outstanding principal balances, producing yields higher than those normally achieved on our originated loan portfolio. Loans are purchased on a nationwide basis from a variety of sources, including banks, insurance companies, investment funds and government agencies, either directly or indirectly through a broker. To a lesser extent, this group also originates, on a nationwide basis, commercial real estate and commercial business loans.

*Focus on core deposits.* The Company offers a full line of deposit products to customers in the Community Banking Division's market area through its ten-branch network. In June 2012, we launched our online affinity deposit program, ableBanking, a division of Northeast Bank, as an additional channel through which to raise core deposits to fund the Company's asset strategy.

*Continuing our community banking tradition.* The Community Banking Division retains a high degree of local autonomy and operational flexibility to better serve its customers. The Community Banking Division's focus on sales and service allows us to attract and retain core deposits in support of balance sheet growth, and to continue to generate new loans, particularly through the efforts of the residential mortgage origination team.

**Critical Accounting Policies**

Critical accounting policies are those that involve significant judgments and assessments by management, and which could potentially result in materially different results under different assumptions and conditions. The reader is encouraged to review each of the policies included in Form 10-K for the year ended June 30, 2013 to gain a better understanding of how Northeast's financial performance is measured and reported. There has been no material change in critical accounting policies during the six months ended December 31, 2013.

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**Overview**

Net income was \$1.4 million for the quarter ended December 31, 2013, compared to \$1.5 million for the quarter ended December 31, 2012. Net income for the six months ended December 31, 2013 was \$1.7 million, compared to \$2.6 million for the six months ended December 31, 2012.

Net income available to common stockholders was \$1.4 million, or \$0.13 per diluted common share, for the quarter ended December 31, 2013, compared to \$1.3 million, or \$0.12 per diluted common share, for the quarter ended December 31, 2012. For the six months ended December 31, 2013, net income available to common stockholders was \$1.7 million, or \$0.16 per diluted common share, compared to \$2.2 million, or \$0.18 per diluted common share, for the six months ended December 31, 2012.

Net interest income before provision increased by \$2.0 million, or 27.8%, to \$9.0 million for the quarter ended December 31, 2013 compared to the quarter ended December 31, 2012, primarily due to growth in the LASG loan portfolio. This result is evident in the net interest margin, which increased to 5.16% for the quarter ended December 31, 2013, compared to 4.28% for the quarter ended December 31, 2012.

Noninterest income decreased by \$1.9 million for the quarter ended December 31, 2013, compared to the quarter ended December 31, 2012, principally due to the following:

- A decrease of \$573 thousand in gain on sales of loans held for sale, a volume related difference principally due to the increased proportion of residential mortgages held in portfolio.
- A decrease of \$985 thousand in gains on sales of portfolio loans. In the quarter ended December 31, 2012, the Company recognized \$817 thousand on the sale of a purchased loan.
- A decrease of \$242 thousand in bank-owned life insurance income. In the quarter ended December 31, 2012, the Company received \$235 thousand in life insurance death benefits.

Noninterest expense increased by \$197 thousand for the quarter ended December 31, 2013, compared to the quarter ended December 31, 2012, principally due to the following:

- An increase of \$410 thousand in salaries and employee benefits principally due to increased incentive compensation and increases in the cost of employee medical insurance benefits.
- An increase of \$207 thousand in occupancy expense resulting from the relocation of the Company's Boston office in the second quarter of fiscal 2013.
- A decrease of \$144 thousand in marketing expenses, principally due to a reduction in deposit marketing.

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- A decrease of \$189 thousand in loan acquisition and collection expenses, principally due to a decreased level of loan purchases in the quarter ended December 31, 2013 when compared to the quarter ended December 31, 2012.

### Financial Condition

#### Overview

Total assets increased by \$62.0 million, or 9.0%, to \$732.6 million at December 31, 2013, compared to June 30, 2013. The principal components of the change in the balance sheet were as follows:

- The loan portfolio grew by \$66.3 million, or 15.2%, compared to June 30, 2013, principally due to net growth of \$50.6 million in commercial loans purchased or originated by the LASG and \$15.7 million of net growth in loans originated by the Community Banking Division. Growth in the Community Banking Division during the quarter was principally due to \$40.4 million of residential loan originations held in portfolio. As has been discussed in the Company's prior SEC filings, the Company made certain commitments to the Board of Governors of the Federal Reserve System in connection with the merger of FHB Formation LLC with and into the Company in December 2010. The Company's loan purchase capacity under these conditions follows.

| Basis for<br>Regulatory Condition | Condition  | Purchased Loan Capacity at<br>December 31, 2013<br>(Dollars in millions) |       |
|-----------------------------------|--|--|-------|
| Total Loans                       | Purchased loans may not exceed 40% of total loans                            | \$   | 43.3  |
| Regulatory Capital                | Commercial real estate loans may not exceed 300% of total risk-based capital | \$   | 159.3 |

An overview of the LASG portfolio follows.

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|  | Three Months Ended December 31, |                    |            |           |                    |            |
|--|---------------------------------|--------------------|------------|-----------|--------------------|------------|
|  | Purchased                       | 2013<br>Originated | Total LASG | Purchased | 2012<br>Originated | Total LASG |
| (Dollars in thousands)                           |                                 |                    |            |           |                    |            |
| Loans purchased or originated during the period: |                                 |                    |            |           |                    |            |
| Unpaid principal balance                         | \$ 15,663                       | \$ 17,138          | \$ 32,801  | \$ 47,295 | \$ 4,026           | \$ 51,321  |
| Net investment basis                             | 13,619                          | 17,138             | 30,757     | 32,864    | 4,026              | 36,890     |
| Loan returns during the period:                  |                                 |                    |            |           |                    |            |
| Yield  | 13.82%                          | 5.14%              | 11.38%     | 13.34%    | 9.72%              | 12.96%     |
| Total Return (1)                                 | 13.76%                          | 5.14%              | 11.35%     | 15.95%    | 9.72%              | 15.30%     |

| (Dollars in thousands)                           |            |           |            |            |           |            |
|--|------------|-----------|------------|------------|-----------|------------|
| Loans purchased or originated during the period: |            |           |            |            |           |            |
| Unpaid principal balance                         | \$ 33,994  | \$ 43,564 | \$ 77,558  | \$ 89,568  | \$ 12,825 | \$ 102,393 |
| Net investment basis                             | 29,967     | 43,564    | 73,531     | 64,213     | 12,825    | 77,038     |
| Loan returns during the period:                  |            |           |            |            |           |            |
| Yield  | 12.00%     | 5.37%     | 10.35%     | 14.09%     | 9.65%     | 13.64%     |
| Total Return (1)                                 | 12.20%     | 5.37%     | 10.51%     | 16.53%     | 9.65%     | 15.83%     |
| Total loans as of period end:                    |            |           |            |            |           |            |
| Unpaid principal balance                         | \$ 212,767 | \$ 78,828 | \$ 291,595 | \$ 172,030 | \$ 15,937 | \$ 187,967 |
| Net investment basis                             | 177,435    | 78,868    | 256,303    | 133,724    | 15,945    | 149,669    |

(1) The total return on purchased loans represents scheduled accretion, accelerated accretion, gains on asset sales, and other noninterest income recorded during the period divided by the average invested balance, on an annualized basis.

- Deposits and borrowings increased by \$51.9 million and \$6.6 million, respectively, from June 30, 2013. Growth in each was tied to the Company's strategy for funding its loan growth, and in particular to mitigate the interest rate risk associated with the increase in its residential loan portfolio. To date, the Company has duration-matched such growth with a mix of term funding raised through deposit listing services and Federal Home Loan Bank ( FHLB ) advances, the latter in conjunction with interest rate swaps.

Assets*Cash, Short-term Investments and Securities*



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Cash and short-term investments were \$63.4 million as of December 31, 2013, a decrease of \$2.5 million, or 3.8%, from \$65.9 million at June 30, 2013.

Available-for-sale securities, consisting of securities issued by government agencies and government-sponsored enterprises, totaled \$114.7 million as of December 31, 2013. At December 31, 2013, securities with a fair value of \$42.0 million were pledged for outstanding borrowings.

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Total loans, excluding loans held for sale, amounted to \$501.7 million as of December 31, 2013, an increase of \$66.3 million, or 15.2%, from \$435.4 million as of June 30, 2013. The increase consisted of net growth in loans purchased or originated by the LASG of \$50.6 million and net growth in loans originated by the Community Banking Division of \$15.7 million. The composition of the Company's loan portfolio follows.

|  |    |         |    |         |            |         |
|--|----|---------|----|---------|------------|---------|
| <b>Originated loans:</b>                   |    |         |    |         |            |         |
| Residential real estate                    | \$ | 120,664 | \$ | 150     | \$ 120,814 | 24.08%  |
| Home equity                                |    | 30,065  |    |         | 30,065     | 5.99%   |
| Commercial real estate: non-owner occupied |    | 47,519  |    | 36,788  | 84,307     | 16.80%  |
| Commercial real estate: owner occupied     |    | 24,134  |    | 9,545   | 33,679     | 6.72%   |
| Construction                               |    |         |    |         |            | 0.00%   |
| Commercial business                        |    | 11,302  |    | 32,385  | 43,687     | 8.71%   |
| Consumer                                   |    | 11,722  |    |         | 11,722     | 2.34%   |
| Subtotal                                   |    | 245,406 |    | 78,868  | 324,274    | 64.64%  |
| <b>Purchased loans:</b>                    |    |         |    |         |            |         |
| Residential real estate                    |    |         |    | 2,606   | 2,606      | 0.52%   |
| Commercial business                        |    |         |    | 13      | 13         | 0.00%   |
| Commercial real estate: non-owner occupied |    |         |    | 125,901 | 125,901    | 25.09%  |
| Commercial real estate: owner occupied     |    |         |    | 48,915  | 48,915     | 9.75%   |
| Subtotal                                   |    |         |    | 177,435 | 177,435    | 35.36%  |
| Total                                      | \$ | 245,406 | \$ | 256,303 | \$ 501,709 | 100.00% |

**June 30, 2013****(Dollars in thousands)**

|  |    |         |    |         |           |        |
|--|----|---------|----|---------|-----------|--------|
| <b>Originated loans:</b>                   |    |         |    |         |           |        |
| Residential real estate                    | \$ | 89,584  | \$ | 150     | \$ 89,734 | 20.61% |
| Home equity                                |    | 35,389  |    |         | 35,389    | 8.13%  |
| Commercial real estate: non-owner occupied |    | 48,428  |    | 18,126  | 66,554    | 15.29% |
| Commercial real estate: owner occupied     |    | 30,487  |    | 3,361   | 33,848    | 7.77%  |
| Construction                               |    | 42      |    |         | 42        | 0.01%  |
| Commercial business                        |    | 12,444  |    | 17,242  | 29,686    | 6.82%  |
| Consumer                                   |    | 13,337  |    |         | 13,337    | 3.06%  |
| Subtotal                                   |    | 229,711 |    | 38,879  | 268,590   | 61.69% |
| <b>Purchased loans:</b>                    |    |         |    |         |           |        |
| Residential real estate                    |    |         |    | 2,706   | 2,706     | 0.62%  |
| Commercial business                        |    |         |    | 34      | 34        | 0.01%  |
|  |    |         |    | 125,496 | 125,496   | 28.83% |

|  |            |            |            |         |
|--|------------|------------|------------|---------|
| Commercial real estate: non-owner occupied |            |            |            |         |
| Commercial real estate: owner occupied     |            | 38,550     | 38,550     | 8.85%   |
| Subtotal                                   |            | 166,786    | 166,786    | 38.31%  |
| Total                                      | \$ 229,711 | \$ 205,665 | \$ 435,376 | 100.00% |

#### *Classification of Assets*

Loans are classified as non-performing when 90 days past due, unless a loan is well-secured and in process of collection. Loans less than 90 days past due, for which collection of principal or interest is considered doubtful, also may be designated as non-performing. In both situations, accrual of interest ceases. The Company typically maintains such loans as non-performing until the respective borrowers have demonstrated a sustained period of payment performance.

In cases where a borrower experiences financial difficulties and the Company makes certain concessionary modifications to contractual terms, the loan is classified as a troubled debt restructuring ( TDR ). Concessionary modifications may include adjustments to interest rates, extensions of maturity, or other actions intended to minimize economic loss and avoid foreclosure or repossession of collateral. Nonaccrual loans that are restructured generally remain on nonaccrual status for a minimum period of six months to demonstrate that the borrower can meet the restructured terms. If the restructured loan is on accrual status prior to being modified, it is reviewed to determine if the modified loan should remain on accrual status. If the borrower's ability to meet the revised payment schedule is not reasonably assured, the loan is classified as a nonaccrual loan. Loans classified as TDRs remain classified as such until the loan is paid off.

Other nonperforming assets include other real estate owned ( OREO ) and other personal property securing loans repossessed by the Bank. The real estate and personal property collateral for commercial and consumer loans is written down to its estimated realizable value upon repossession. Revenues and expenses are recognized in the period when received or incurred on OREO and in substance foreclosures. Gains and losses on disposition are recognized in noninterest income.

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The following table details the Company's nonperforming assets and other credit quality indicators as of December 31, 2013 and June 30, 2013. The net increase in nonperforming assets during the six months ended December 31, 2013 was principally due to three purchased loan relationships. Management believes that, based on their carrying amounts, nonperforming assets are well secured based on the estimated fair value of underlying collateral.

|  |    |       |                   |
|--|----|-------|-------------------|
| Loans:   |    |       |                   |
| Residential real estate                            | \$ | 1,745 | \$ 150 \$ 1,895   |
| Home equity  |    | 204   | 204               |
| Commercial real estate                             |    | 487   | 3,245 3,732       |
| Construction                                       |    |       |                   |
| Commercial business                                |    | 61    | 61                |
| Consumer   |    | 259   | 259               |
| Subtotal   |    | 2,756 | 3,395 6,151       |
| Real estate owned and other repossessed collateral |    | 2,181 | 1,030 3,211       |
| Total  | \$ | 4,937 | \$ 4,425 \$ 9,362 |
| Ratio of nonperforming loans to total loans        |    |       | 1.23%             |
| Ratio of nonperforming assets to total assets      |    |       | 1.28%             |
| Ratio of loans past due to total loans             |    |       | 1.57%             |
| Nonperforming loans that are current               |    |       | \$ 691            |
| Loans risk rated substandard or worse              |    |       | \$ 9,533          |
| Troubled debt restructurings:                      |    |       |                   |
| On accrual status                                  |    |       | \$ 4,832          |
| On nonaccrual status                               |    |       | \$ 957            |

|  |  |       |          |
|--|--|-------|----------|
| Loans:   |  |       |          |
| Home equity  |  | 334   | 334      |
| Construction                                       |  |       |          |
| Consumer   |  | 136   | 136      |
| Real estate owned and other repossessed collateral |  | 2,134 | 2,134    |
| Ratio of nonperforming loans to total loans        |  |       | 1.12%    |
| Ratio of loans past due to total loans             |  |       | 1.68%    |
| Loans risk rated substandard or worse              |  |       | \$ 3,417 |
| On accrual status                                  |  |       | \$ 2,632 |



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In connection with the application of the acquisition method of accounting for the merger on December 29, 2010, the allowance for loan losses was reduced to zero when the loan portfolio was marked to its then current fair value. Since that date, the Company has provided for an allowance for loan losses as new loans are originated or in the event that credit exposure in the pre-merger loan portfolio or other acquired loans exceeds the exposure estimated when initial fair values were determined.

The Company's allowance for loan losses was \$1.4 million as of December 31, 2013, which represents an increase of \$207 thousand from \$1.1 million as of June 30, 2013. The increase during the period was principally due to increases in reserves necessary for loans accounted for under ASC 310-30 and general allowances on newly originated loans.

The following table details ratios related to the allowance for loan losses for the periods indicated.

|  | December 31, 2013 | June 30, 2013 | December, 2012 |
|--|-------------------|---------------|----------------|
| Allowance for loan losses to nonperforming loans       | 21.95%            | 23.54%        | 12.17%         |
| Allowance for loan losses to total loans               | 0.27%             | 0.26%         | 0.22%          |
| Last twelve months of net-charge offs to average loans | 0.09%             | 0.21%         | 0.21%          |

While management believes that it uses the best information available to make its determinations with respect to the allowance, there can be no assurance that the Company will not have to increase its provision for loan losses in the future as a result of changing economic conditions, adverse markets for real estate or other factors.

*Other Assets*

The cash surrender value of the Company's bank-owned life insurance ( BOLI ) assets increased \$234 thousand, or 1.6% to \$14.6 million at December 31, 2013, compared to \$14.4 million at June 30, 2013. Increases in cash surrender value are recognized in other income and are not subject to income taxes. Borrowing on, or surrendering a policy, may subject the Company to income tax expense on the increase in cash surrender value. For these reasons, management considers BOLI an illiquid asset. BOLI represented 11.9% of the Company's total risk-based capital at December 31, 2013.

Intangible assets totaled \$3.1 million and \$3.5 million at December 31, 2013 and June 30, 2013, respectively. The \$420 thousand decrease was the result of core deposit intangible asset amortization during the period.

*Deposits, Borrowed Funds, Capital Resources and Liquidity*

*Deposits*

The Company's principal source of funding is its core deposit accounts. At December 31, 2013, non-maturity accounts and certificates of deposit with balances less than \$250 thousand represented 99.4% of total deposits.

Total deposits increased \$51.9 million to \$536.5 million as of December 31, 2013 from \$484.6 million as of June 30, 2013. The increase, which funded growth in the Company's loan portfolio, was principally from term deposits raised through listing services, which has provided the Bank with longer term funding than can typically be attracted through retail channels. At December 31, 2013, the Bank had \$120.1 million of such deposit funding, with a weighted-average original term of 3.0 years. The composition of total deposits at December 31, 2013 and June 30, 2013 follows.

|   |    |         |         |    |         |         |
|---|----|---------|---------|----|---------|---------|
|   |    |         |         |    |         |         |
| Demand deposits                             | \$ | 47,015  | 8.76%   | \$ | 46,425  | 9.58%   |
| Regular and other savings                   |    | 34,535  | 6.44%   |    | 33,636  | 6.94%   |
| Total non-certificate accounts              |    | 228,565 | 42.60%  |    | 221,811 | 45.77%  |
| Term certificates of \$250 thousand or more |    | 3,200   | 0.60%   |    | 8,428   | 1.74%   |
| Total deposits                              | \$ | 536,522 | 100.00% | \$ | 484,623 | 100.00% |

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Advances from the FHLB were \$42.9 million and \$28.0 million at December 31, 2013 and June 30, 2013, the increase due to \$15.0 million of new advances during the period used to fund residential loan growth. In conjunction with the aforementioned FHLB advances, the Company entered into interest rate swaps with a weighted average pay rate and term of 3.13% and 15 years, respectively. At December 31, 2013, the Company had pledged investment securities with a fair value of \$27.1 million, as well as certain residential real estate loans, commercial real estate loans, and FHLB deposits free of liens or pledges to secure outstanding advances and available additional borrowing capacity.

Wholesale repurchase agreements were \$15.3 million and \$25.4 million at December 31, 2013 and June 30, 2013, respectively. During the six months ended December 31, 2013, the Company repaid at maturity wholesale repurchase agreements totaling \$10.0 million. At December 31, 2013, the Company had pledged investment securities with a fair value of \$14.9 million as collateral for outstanding wholesale repurchase agreements.

Short-term borrowings, consisting of sweep accounts and repurchase agreements, were \$2.5 million and \$625 thousand as of December 31, 2013 and June 30, 2013, respectively.

*Liquidity*

The following table is a summary of the liquidity the Company had the ability to access as of December 31, 2013, in addition to traditional retail deposit products (dollars in thousands).

|  |    |         |   |
|--|----|---------|---|
| Brokered time deposits                                 | \$ | 183,156 | Subject to policy limitation of 25% of total assets |
| Federal Reserve Discount Window<br>Borrower-in-Custody |    | 19      | Subject to the pledge of indirect auto loans        |
| Unencumbered investment securities                     |    | 72,738  |   |

Retail deposits and other core deposit sources including deposit listing services are used by the Company to manage its overall liquidity position. While the Company typically does not seek wholesale funding such as brokered deposits, the ability to raise them remains an important part of its liquidity contingency planning. While management closely monitors and forecasts the Company's liquidity position, it is affected by asset growth, deposit withdrawals and other contractual obligations and commitments. The accuracy of management's forecast assumptions may increase or decrease the Company's overall available liquidity.

At December 31, 2013, the Company had \$320.5 million of immediately accessible liquidity, defined as additional cash that could be raised within seven days through collateralized borrowings, brokered deposits or security sales. This position represented 43.8% of total assets. The Company also had \$63.4 million of cash and cash equivalents at December 31, 2013.



Management believes that there are adequate funding sources to meet its liquidity needs for the foreseeable future. Primary funding sources are the repayment of principal and interest on loans, the renewal of time deposits, the potential for growth in the deposit base, and the credit availability from the FHLB. Management does not believe that the terms and conditions that will be present at the renewal of these funding sources will significantly impact the Company's operations, due to its management of the maturities of its assets and liabilities.

### *Capital*

The carrying amount and unpaid principal balance of junior subordinated debentures totaled \$8.4 million and \$16.5 million, respectively, as of December 31, 2013. This debt represents qualifying Tier 1 capital for the Company, up to a maximum of 25% of total Tier 1 capital. At December 31, 2013, the carrying amounts of the junior subordinated notes, net of the Company's \$496 thousand investment in the affiliated trusts, qualified as Tier 1 capital.

At December 31, 2013, stockholders' equity was \$114.4 million, an increase of \$581 thousand compared to June 30, 2013. Book value per outstanding common share was \$10.96 at December 31, 2013 and \$10.89 at June 30, 2013. Tier 1 capital to total average assets of the Company was 16.66% as of December 31, 2013 and 17.78% at June 30, 2013.

In addition to the risk-based capital requirements, the Federal Reserve requires top-rated bank holding companies to maintain a minimum leverage capital ratio of Tier 1 capital (defined by reference to the risk-based capital guidelines) to its average total consolidated assets of at least 3.0%. For most other bank holding companies (including the Company), the minimum leverage capital ratio is 4.0%. Bank holding companies with supervisory, financial, operational or managerial weaknesses, as well as bank holding companies that are anticipating or experiencing significant growth, are expected to maintain capital ratios well above the minimum levels.

The Federal Reserve's capital adequacy standards also apply to state-chartered banks that are members of the Federal Reserve System, such as the Bank. Moreover, the Federal Reserve has promulgated corresponding regulations to implement the system of prompt corrective action established by Section 38 of the Federal Deposit Insurance Act. Under these regulations, a bank is well capitalized if it has: (i) a total risk-based capital ratio of 10.0% or greater; (ii) a Tier 1 risk-based capital ratio of 6.0% or greater; (iii) a leverage capital

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ratio of 5.0% or greater; and (iv) is not subject to any written agreement, order, capital directive or prompt corrective action directive to meet and maintain a specific capital level for any capital measure. A bank is adequately capitalized if it has: (1) a total risk-based capital ratio of 8.0% or greater; (2) a Tier 1 risk-based capital ratio of 4.0% or greater; and (3) a leverage capital ratio of 4.0% or greater (3.0% under certain circumstances) and does not meet the definition of a well capitalized bank.

The Federal Reserve also must take into consideration: (i) concentrations of credit risk; (ii) interest rate risk; and (iii) risks from non-traditional activities, as well as an institution's ability to manage those risks when determining the adequacy of an institution's capital. This evaluation will be made as a part of the institution's regular safety and soundness examination. The Bank is currently considered well-capitalized under all regulatory definitions.

The Basel Committee on Banking Supervision has also released new capital requirements, known as Basel III, setting forth higher capital requirements, enhanced risk coverage, a global leverage ratio, provisions for counter-cyclical capital, and liquidity standards.

On July 2, 2013, the Federal Reserve, along with the other federal banking agencies, issued a final rule (the Final Capital Rule) implementing the Basel III capital standards and establishing the minimum capital requirements for banks and bank holding companies required under the Dodd-Frank Act. The majority of the provisions of the Final Capital Rule apply to bank holding companies and banks with consolidated assets of \$500 million or more, such as the Company and the Bank. The Final Capital Rule establishes a new capital risk-based capital ratio, a minimum common equity Tier 1 capital ratio of 6.5% of risk-weighted assets to be a well capitalized institution, and increase the minimum total Tier 1 capital ratio to be a well capitalized institution from 6.0% to 8.0%. Additionally, the Final Capital Rule requires that an institution establish a capital conservation buffer of common equity Tier 1 capital in an amount above the minimum risk-based capital requirements for adequately capitalized institutions equal to 2.5% of total risk weight assets, or face restrictions on capital distributions and executive bonuses. The Final Capital Rule increases the required capital for certain categories of assets, including higher-risk construction real estate loans and certain exposures related to securitizations. Under the Final Capital Rule, the Company may make a one-time, permanent election to continue to exclude accumulated other comprehensive income from capital. If the Company does not make this election, unrealized gains and losses would be included in the calculation of its regulatory capital.

The Company must comply with the Final Capital Rule beginning on January 1, 2015.

The Bank and the Company are subject to capital commitments with the Federal Reserve and the Bureau that require higher minimum capital ratios. These commitments require that the Company and the Bank (i) maintain a Tier 1 leverage ratio of at least 10%; and (ii) maintain a total risk-based capital ratio of at least 15%. The Bank and the Company were in compliance with these commitments at December 31, 2013.

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The Company's and the Bank's regulatory capital ratios are set forth below.

|   | Actual     |        | Minimum Capital Requirements |       | Minimum To Be Well Capitalized Under Prompt Correction Action Provisions |        |
|---|------------|--------|------------------------------|-------|--|--------|
|   | Amount     | Ratio  | Amount                       | Ratio | Amount   | Ratio  |
| <b>December 31, 2013:</b>               |            |        |                              |       |  |        |
| Total capital to risk weighted assets:  |            |        |                              |       |  |        |
| Company                                 | \$ 123,154 | 24.61% | \$ 40,026                    | ≥8.0% | \$ N/A   | N/A    |
| Bank                                    | 101,808    | 20.32% | 40,079                       | ≥8.0% | 50,099   | ≥10.0% |
| Tier 1 capital to risk weighted assets: |            |        |                              |       |  |        |
| Company                                 | 121,804    | 24.34% | 20,013                       | ≥4.0% | N/A  | N/A    |
| Bank                                    | 97,746     | 19.51% | 20,040                       | ≥4.0% | 30,060   | ≥6.0%  |
| Tier 1 capital to average assets:       |            |        |                              |       |  |        |
| Company                                 | 121,804    | 16.66% | 29,251                       | ≥4.0% | N/A  | N/A    |
| Bank                                    | 97,746     | 13.42% | 20,040                       | ≥4.0% | 36,427   | ≥5.0%  |
| <b>June 30, 2013:</b>                   |            |        |                              |       |  |        |
| Total capital to risk weighted assets:  |            |        |                              |       |  |        |
| Company                                 | \$ 122,291 | 27.54% | \$ 35,520                    | ≥8.0% | \$ N/A   | N/A    |
| Bank                                    | 99,527     | 22.30% | 35,709                       | ≥8.0% | 44,637   | ≥10.0% |
| Tier 1 capital to risk weighted assets: |            |        |                              |       |  |        |
| Company                                 | 121,148    | 27.29% | 17,760                       | ≥4.0% | N/A  | N/A    |
| Bank                                    | 95,485     | 21.39% | 17,855                       | ≥4.0% | 26,782   | ≥6.0%  |
| Tier 1 capital to average assets:       |            |        |                              |       |  |        |
| Company                                 | 121,148    | 17.78% | 27,255                       | ≥4.0% | N/A  | N/A    |
| Bank                                    | 95,485     | 14.08% | 27,121                       | ≥4.0% | 33,902   | ≥5.0%  |

**Off-balance Sheet Financial Instruments**

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, unused lines of credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amounts recognized in the condensed consolidated balance sheet. The contract or notional amounts of these instruments reflect the extent of the Company's involvement in particular classes of financial instruments.

See Part I. Item I. Notes to Unaudited Consolidated Financial Statements Note 9: Commitments and Contingencies for further discussion.



Table of ContentsResults of Operations – Continuing Operations*General*

Net income decreased by \$124 thousand to \$1.4 million for the quarter ended December 31, 2013, compared to \$1.5 million for the quarter ended December 31, 2012. Net income decreased by \$837 thousand to \$1.7 million for the six months ended December 31, 2013, compared to \$2.6 million for the six months ended December 31, 2012. When compared to the prior year, decreases in net income for both the three and six months ended December 31, 2013 resulted principally from lower transactional income on purchased loans, as well as lower gains on sales of residential mortgages and investment securities.

The following table details the total return on purchased loans, which includes transactional income of \$2.1 million for the quarter ended December 31, 2013, an increase of \$206 thousand from the quarter ended December 31, 2012. Transactional income for the six months ended December 31, 2013 was \$3.0 million, a decrease of \$668 thousand from the six months ended December 31, 2012 principally due to lower than average payoffs in the first quarter of fiscal 2014.

|  |    |       |        |    |       |        |
|--|----|-------|--------|----|-------|--------|
| Regularly scheduled interest and accretion | \$ | 4,014 | 9.02%  | \$ | 2,859 | 9.57%  |
| Transactional income:                      |    |       |        |    |       |        |
| Gains on loan sales                        |    | 11    | 0.02%  |    | 817   | 2.74%  |
| Gain on sale of real estate owned          |    |       | 0.00%  |    |       | 0.00%  |
| Other noninterest income                   |    |       | 0.00%  |    |       | 0.00%  |
| Accelerated accretion and loan fees        |    | 2,098 | 4.72%  |    | 1,086 | 3.64%  |
| Total transactional income                 |    | 2,109 | 4.74%  |    | 1,903 | 6.37%  |
| Total                                      | \$ | 6,123 | 13.76% | \$ | 4,762 | 15.95% |

|  |    |        |        |    |       |        |
|--|----|--------|--------|----|-------|--------|
| Regularly scheduled interest and accretion | \$ | 7,753  | 8.78%  | \$ | 4,770 | 9.32%  |
| Transactional income:                      |    |        |        |    |       |        |
| Gains on loan sales                        |    | 227    | 0.26%  |    | 817   | 1.60%  |
| Gain on sale of real estate owned          |    |        | 0.00%  |    | 473   | 0.92%  |
| Other noninterest income                   |    |        | 0.00%  |    | 36    | 0.07%  |
| Accelerated accretion and loan fees        |    | 2,794  | 3.16%  |    | 2,363 | 4.62%  |
| Total transactional income                 |    | 3,021  | 3.42%  |    | 3,689 | 7.21%  |
| Total                                      | \$ | 10,774 | 12.20% | \$ | 8,459 | 16.53% |

**Net Interest Income***Three Months Ended December 31, 2013 and 2012*

Net interest income for the three months ended December 31, 2013 and 2012 was \$9.0 million and \$7.1 million, respectively. The increase of \$1.9 million was largely attributable to growth in the LASG loan portfolio, which earned a yield of 11.4% for the quarter ended December 31, 2013 on an average outstanding balance of \$243.9 million. The following table summarizes interest income and related yields recognized on the Company's loans for the three months ended December 31, 2013 and 2012.

|                            |    |         |    |        |        |    |         |    |       |        |
|----------------------------|----|---------|----|--------|--------|----|---------|----|-------|--------|
|                            |    |         |    |        |        |    |         |    |       |        |
| Community Banking Division | \$ | 247,057 | \$ | 3,284  | 5.27%  | \$ | 257,837 | \$ | 3,988 | 6.14%  |
| LASG:                      |    |         |    |        |        |    |         |    |       |        |
| Originated                 |    | 68,449  |    | 886    | 5.14%  |    | 13,631  |    | 334   | 9.72%  |
| Purchased                  |    | 175,469 |    | 6,112  | 13.82% |    | 117,365 |    | 3,945 | 13.34% |
| Total LASG                 |    | 243,918 |    | 6,998  | 11.38% |    | 130,996 |    | 4,279 | 12.96% |
| Total                      | \$ | 490,975 | \$ | 10,282 | 8.31%  | \$ | 388,833 | \$ | 8,267 | 8.44%  |

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In the quarter ended December 31, 2013, net interest income was negatively affected by a lower level of noncash accretion of fair value adjustments resulting from the 2010 merger than in the quarter ended December 31, 2012. The effect of such accretion will continue to diminish as financial instruments held at the merger mature or prepay. The following table summarizes the effects of such accretion.

|  |           |                |           |              |           |                |           |              |
|--|-----------|----------------|-----------|--------------|-----------|----------------|-----------|--------------|
| <b>Interest-earning assets:</b>              |           |                |           |              |           |                |           |              |
| Investment securities                        | \$        | 116,888        | \$        | 0.00%        | \$        | 135,663        | \$        | 0.00%        |
| Loans  |           | 490,975        | 47        | 0.04%        |           | 388,833        | 270       | 0.28%        |
| Other interest-earning assets                |           | 84,770         |           | 0.00%        |           | 129,323        |           | 0.00%        |
| <b>Total interest-earning assets</b>         | <b>\$</b> | <b>692,633</b> | <b>\$</b> | <b>0.03%</b> | <b>\$</b> | <b>653,819</b> | <b>\$</b> | <b>0.16%</b> |
| <b>Interest-bearing liabilities:</b>         |           |                |           |              |           |                |           |              |
| Interest-bearing deposits                    |           | 488,562        | 214       | 0.17%        |           | 433,031        | 261       | 0.24%        |
| Short-term borrowings                        |           | 2,397          |           | 0.00%        |           | 1,063          |           | 0.00%        |
| Borrowed funds                               |           | 59,941         | 107       | 0.71%        |           | 78,782         | 302       | 1.52%        |
| Junior subordinated debentures               |           | 8,331          |           | 0.00%        |           | 8,165          |           | 0.00%        |
| <b>Total interest-bearing liabilities</b>    | <b>\$</b> | <b>559,231</b> | <b>\$</b> | <b>0.23%</b> | <b>\$</b> | <b>521,041</b> | <b>\$</b> | <b>0.43%</b> |
| <b>Total effect of noncash accretion on:</b> |           |                |           |              |           |                |           |              |
| Net interest income                          |           |                | \$        | 368          |           |                | \$        | 833          |
| Net interest margin                          |           |                |           | 0.21%        |           |                |           | 0.51%        |

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The Company's interest rate spread and net interest margin increased by 92 basis points and 88 basis points, respectively, for the quarter ended December 31, 2013 compared to the quarter ended December 31, 2012. These increases were principally the result of the aforementioned increase in loan volume. The following sets forth the average balance sheets, interest income and interest expense, and average yields and costs for the three months ended December 31, 2013 and 2012.

|   | Three Months Ended December 31, |                              |  |                 |                              |                    |
|---|---------------------------------|------------------------------|--|-----------------|------------------------------|--------------------|
|   | Average Balance                 | 2013 Interest Income/Expense | Average Yield/Rate<br>(Dollars in thousands) | Average Balance | 2012 Interest Income/Expense | Average Yield/Rate |
| <b>Assets:</b>                                |                                 |                              |  |                 |                              |                    |
| Interest-earning assets:                      |                                 |                              |  |                 |                              |                    |
| Investment securities (1)                     | \$ 116,888                      | \$ 262                       | 0.89%  | \$ 135,663      | \$ 348                       | 1.02%              |
| Loans (2) (3)                                 | 490,975                         | 10,282                       | 8.31%  | 388,833         | 8,267                        | 8.44%              |
| Regulatory stock                              | 5,721                           | 48                           | 3.33%  | 5,473           | 32                           | 2.32%              |
| Short-term investments (4)                    | 79,049                          | 48                           | 0.24%  | 123,850         | 77                           | 0.25%              |
| Total interest-earning assets                 | 692,633                         | 10,640                       | 6.09%  | 653,819         | 8,724                        | 5.29%              |
| Cash and due from banks                       | 3,053                           |                              |  | 2,922           |                              |                    |
| Other non-interest earning assets             | 36,222                          |                              |  | 38,253          |                              |                    |
| Total assets                                  | \$ 731,908                      |                              |  | \$ 694,994      |                              |                    |
| <b>Liabilities &amp; Stockholders Equity:</b> |                                 |                              |  |                 |                              |                    |
| Interest-bearing liabilities:                 |                                 |                              |  |                 |                              |                    |
| NOW accounts                                  | \$ 58,987                       | \$ 40                        | 0.27%  | \$ 54,733       | \$ 37                        | 0.27%              |
| Money market accounts                         | 86,245                          | 114                          | 0.52%  | 52,558          | 66                           | 0.50%              |
| Savings accounts                              | 33,540                          | 12                           | 0.14%  | 31,100          | 11                           | 0.14%              |
| Time deposits                                 | 309,790                         | 813                          | 1.04%  | 294,640         | 914                          | 1.23%              |
| Total interest-bearing deposits               | 488,562                         | 979                          | 0.80%  | 433,031         | 1,028                        | 0.94%              |
| Short-term borrowings                         | 2,397                           | 6                            | 0.99%  | 1,063           | 5                            | 1.87%              |
| Borrowed funds                                | 59,941                          | 446                          | 2.95%  | 78,782          | 443                          | 2.23%              |
| Junior subordinated debentures                | 8,331                           | 192                          | 9.14%  | 8,165           | 191                          | 9.28%              |
| Total interest-bearing liabilities            | 559,231                         | 1,623                        | 1.15%  | 521,041         | 1,667                        | 1.27%              |
| Non-interest bearing liabilities:             |                                 |                              |  |                 |                              |                    |
| Demand deposits and escrow accounts           | 53,184                          |                              |  | 52,297          |                              |                    |
| Other liabilities                             | 5,677                           |                              |  | 4,717           |                              |                    |
| Total liabilities                             | 618,092                         |                              |  | 578,055         |                              |                    |
| Stockholders' equity                          | 113,816                         |                              |  | 116,939         |                              |                    |
| Total liabilities and stockholders' equity    | \$ 731,908                      |                              |  | \$ 694,994      |                              |                    |
| Net interest income                           |                                 | \$ 9,017                     |  |                 | \$ 7,057                     |                    |
| Interest rate spread                          |                                 |                              | 4.94%  |                 |                              | 4.02%              |
| Net interest margin (5)                       |                                 |                              | 5.16%  |                 |                              | 4.28%              |

(1) Interest income and yield are stated on a fully tax-equivalent basis using a 34% tax rate.

(2) Includes loans held for sale.



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- (3) Nonaccrual loans are included in the computation of average, but unpaid interest has not been included for purposes of determining interest income.
- (4) Short term investments include FHLB overnight deposits and other interest-bearing deposits.
- (5) Net interest margin is calculated as net interest income divided by total interest-earning assets.

The following table presents the extent to which changes in volume and interest rates of interest earning assets and interest bearing liabilities have affected the Company's interest income and interest expense during the periods indicated. Information is provided in each category with respect to (i) changes attributable to changes in volume (changes in volume multiplied by prior period rate), (ii) changes attributable to changes in rates (changes in rates multiplied by prior period volume) and (iii) change attributable to a combination of changes in rate and volume (change in rates multiplied by the changes in volume). Changes attributable to the combined impact of volume and rate have been allocated proportionately to the changes due to volume and the changes due to rate.

|  | <b>Three Months Ended December 31, 2013 compared to 2012</b> |                           |                     |
|--|--|---------------------------|---------------------|
|  | <b>Change Due to Volume</b>                                  | <b>Change Due to Rate</b> | <b>Total Change</b> |
|  | <b>(Dollars in thousands)</b>                                |                           |                     |
| <b>Interest earning assets:</b>            |  |                           |                     |
| Investment securities                      | \$ (45)  | \$ (41)                   | \$ (86)             |
| Loans                                      | 2,141  | (126)                     | 2,015               |
| Regulatory stock                           | 1  | 15                        | 16                  |
| Short-term investments                     | (27)   | (2)                       | (29)                |
| <b>Total interest-earning assets</b>       | <b>2,070</b>   | <b>(154)</b>              | <b>1,916</b>        |
| <b>Interest-bearing liabilities:</b>       |  |                           |                     |
| Interest-bearing deposits                  | 91   | (140)                     | (49)                |
| Short-term borrowings                      | 4  | (3)                       | 1                   |
| Borrowed funds                             | (120)  | 123                       | 3                   |
| Junior subordinated debentures             | 4  | (3)                       | 1                   |
| <b>Total interest-bearing liabilities</b>  | <b>(21)</b>  | <b>(23)</b>               | <b>(44)</b>         |
| <b>Total change in net interest income</b> | <b>\$ 2,091</b>  | <b>\$ (131)</b>           | <b>\$ 1,960</b>     |

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Net interest income for the six months ended December 31, 2013 and 2012 was \$16.1 million and \$13.2 million, respectively. The increase of \$3.0 million was largely attributable to growth in the LASG loan portfolio, which earned a yield of 10.4% for the six ended December 31, 2013 on an average outstanding balance of \$232.2 million. The following table summarizes interest income and related yields recognized on the Company's loans for the six months ended December 31, 2013 and 2012.

|                            |    |         |    |        |        |    |         |    |        |        |
|----------------------------|----|---------|----|--------|--------|----|---------|----|--------|--------|
|                            |    |         |    |        |        |    |         |    |        |        |
| Community Banking Division | \$ | 244,880 | \$ | 6,626  | 5.37%  | \$ | 264,298 | \$ | 7,920  | 5.94%  |
| LASG:                      |    |         |    |        |        |    |         |    |        |        |
| Originated                 |    | 57,828  |    | 1,566  | 5.37%  |    | 11,412  |    | 555    | 9.65%  |
| Purchased                  |    | 174,318 |    | 10,547 | 12.00% |    | 100,420 |    | 7,133  | 14.09% |
| Total LASG                 |    | 232,146 |    | 12,113 | 10.35% |    | 111,832 |    | 7,688  | 13.64% |
| Total                      | \$ | 477,026 | \$ | 18,739 | 7.79%  | \$ | 376,130 | \$ | 15,608 | 8.23%  |

In the six months ended December 31, 2013, net interest income was negatively affected by a lower level of noncash accretion of fair value adjustments resulting from the 2010 merger than in the six months ended December 31, 2012. The effect of such accretion will continue to diminish as financial instruments held at the merger mature or prepay. The following table summarizes the effects of such accretion.

|  | Average Balance | Six Months Ended December 31, |   |                 |                       |                        | Effect on Yield / Rate |
|--|-----------------|-------------------------------|---|-----------------|-----------------------|------------------------|------------------------|
|  |                 | 2013 Income (Expense)         | Effect on Yield / Rate (Dollars in thousands) | Average Balance | 2012 Income (Expense) | Effect on Yield / Rate |                        |
| <b>Interest-earning assets:</b>              |                 |                               |   |                 |                       |                        |                        |
| Investment securities                        | \$ 118,093      | \$                            | 0.00%   | \$ 133,730      | \$ (3)                | 0.00%                  |                        |
| Loans  | 477,026         | 83                            | 0.03%   | 376,130         | 374                   | 0.20%                  |                        |
| Other interest-earning assets                | 83,949          |                               | 0.00%   | 135,470         |                       | 0.00%                  |                        |
| Total interest-earning assets                | \$ 679,068      | \$ 83                         | 0.02%   | \$ 645,330      | \$ 371                | 0.11%                  |                        |
| <b>Interest-bearing liabilities:</b>         |                 |                               |   |                 |                       |                        |                        |
| Interest-bearing deposits                    | 475,845         | 415                           | 0.17%   | 413,149         | 537                   | 0.26%                  |                        |
| Short-term borrowings                        | 2,337           |                               | 0.00%   | 1,157           |                       | 0.00%                  |                        |
| Borrowed funds                               | 59,964          | 215                           | 0.71%   | 89,484          | 783                   | 1.74%                  |                        |
| Junior subordinated debentures               | 8,309           |                               | 0.00%   | 8,144           |                       | 0.00%                  |                        |
| Total interest-bearing liabilities           | \$ 546,455      | \$ 630                        | 0.23%   | \$ 511,934      | \$ 1,320              | 0.51%                  |                        |
| <b>Total effect of noncash accretion on:</b> |                 |                               |   |                 |                       |                        |                        |
| Net interest income                          |                 | \$ 713                        |   |                 | \$ 1,691              |                        |                        |

Net interest margin

0.21%

0.52%

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The Company's interest rate spread and net interest margin increased by 70 basis points and 67 basis points, respectively, for the six months ended December 31, 2013 compared to the six months ended December 31, 2012. These increases were principally the result of the aforementioned increase in loan volume. The following sets forth the average balance sheets, interest income and interest expense, and average yields and costs for the six months ended December 31, 2013 and 2012.

|   | Six Months Ended December 31, |                              |                    |                 |                              |                    |
|---|-------------------------------|------------------------------|--------------------|-----------------|------------------------------|--------------------|
|   | Average Balance               | 2013 Interest Income/Expense | Average Yield/Rate | Average Balance | 2012 Interest Income/Expense | Average Yield/Rate |
| (Dollars in thousands)                        |                               |                              |                    |                 |                              |                    |
| <b>Assets:</b>                                |                               |                              |                    |                 |                              |                    |
| Interest-earning assets:                      |                               |                              |                    |                 |                              |                    |
| Investment securities (1)                     | \$ 118,093                    | \$ 544                       | 0.91%              | \$ 133,730      | \$ 695                       | 1.03%              |
| Loans (2) (3)                                 | 477,026                       | 18,739                       | 7.79%              | 376,130         | 15,608                       | 8.23%              |
| Regulatory stock                              | 5,721                         | 52                           | 1.80%              | 5,473           | 38                           | 1.38%              |
| Short-term investments (4)                    | 78,228                        | 95                           | 0.24%              | 129,997         | 160                          | 0.24%              |
| Total interest-earning assets                 | 679,068                       | 19,430                       | 5.68%              | 645,330         | 16,501                       | 5.07%              |
| Cash and due from banks                       | 3,045                         |                              |                    | 3,049           |                              |                    |
| Other non-interest earning assets             |                               |                              |                    |                 |                              |                    |
|   | 35,117                        |                              |                    | 37,973          |                              |                    |
| Total assets                                  | \$ 717,230                    |                              |                    | \$ 686,352      |                              |                    |
| <b>Liabilities &amp; Stockholders Equity:</b> |                               |                              |                    |                 |                              |                    |
| Interest-bearing liabilities:                 |                               |                              |                    |                 |                              |                    |
| NOW accounts                                  | \$ 59,055                     | \$ 80                        | 0.27%              | \$ 55,664       | \$ 79                        | 0.28%              |
| Money market accounts                         | 85,967                        | 226                          | 0.52%              | 49,954          | 119                          | 0.47%              |
| Savings accounts                              | 33,733                        | 24                           | 0.14%              | 31,223          | 22                           | 0.14%              |
| Time deposits                                 | 297,090                       | 1,696                        | 1.13%              | 276,308         | 1,786                        | 1.28%              |
| Total interest-bearing deposits               | 475,845                       | 2,026                        | 0.84%              | 413,149         | 2,006                        | 0.96%              |
| Short-term borrowings                         | 2,337                         | 11                           | 0.93%              | 1,157           | 11                           | 1.89%              |
| Borrowed funds                                | 59,964                        | 886                          | 2.93%              | 89,484          | 945                          | 2.09%              |
| Junior subordinated debentures                | 8,309                         | 385                          | 9.19%              | 8,144           | 384                          | 9.35%              |
| Total interest-bearing liabilities            | 546,455                       | 3,308                        | 1.20%              | 511,934         | 3,346                        | 1.30%              |
| Non-interest bearing liabilities:             |                               |                              |                    |                 |                              |                    |
| Demand deposits and escrow accounts           | 51,788                        |                              |                    | 51,056          |                              |                    |
| Other liabilities                             | 5,619                         |                              |                    | 5,471           |                              |                    |
| Total liabilities                             | 603,862                       |                              |                    | 568,461         |                              |                    |
| Stockholders equity                           | 113,368                       |                              |                    | 117,891         |                              |                    |
| Total liabilities and stockholders equity     | \$ 717,230                    |                              |                    | \$ 686,352      |                              |                    |
| Net interest income                           |                               | \$ 16,122                    |                    |                 | \$ 13,155                    |                    |
| Interest rate spread                          |                               |                              | 4.48%              |                 |                              | 3.78%              |
| Net interest margin (5)                       |                               |                              | 4.71%              |                 |                              | 4.04%              |

- (1) Interest income and yield are stated on a fully tax-equivalent basis using a 34% tax rate.
- (2) Includes loans held for sale.
- (3) Nonaccrual loans are included in the computation of average, but unpaid interest has not been included for purposes of determining interest income.
- (4) Short term investments include FHLB overnight deposits and other interest-bearing deposits.
- (5) Net interest margin is calculated as net interest income divided by total interest-earning assets.

The following table presents the extent to which changes in volume and interest rates of interest earning assets and interest bearing liabilities have affected the Company's interest income and interest expense during the periods indicated. Information is provided in each category with respect to (i) changes attributable to changes in volume (changes in volume multiplied by prior period rate), (ii) changes attributable to changes in rates (changes in rates multiplied by prior period volume) and (iii) change attributable to a combination of changes in rate and volume (change in rates multiplied by the changes in volume). Changes attributable to the combined impact of volume and rate have been allocated proportionately to the changes due to volume and the changes due to rate.

|                                      | Six Months Ended December 31, 2013 compared to 2012 |  |              |
|--------------------------------------|---|--|--------------|
|                                      | Change Due to Volume                                | Change Due to Rate<br>(Dollars in thousands) | Total Change |
| <b>Interest earning assets:</b>      |   |  |              |
| Investment securities                | \$ (76)   | \$ (75)                                      | \$ (151)     |
| Loans                                | 4,000   | (869)  | 3,131        |
| Regulatory stock                     | 2   | 12   | 14           |
| Short-term investments               | (63)  | (2)  | (65)         |
| Total interest-earning assets        | 3,863   | (934)  | 2,929        |
| <b>Interest-bearing liabilities:</b> |   |  |              |
| Interest-bearing deposits            | 224   | (204)  | 20           |
| Short-term borrowings                | 8   | (8)  |              |
| Borrowed funds                       | (368)   | 309  | (59)         |
| Junior subordinated debentures       | 8   | (7)  | 1            |
| Total interest-bearing liabilities   | (128)   | 90   | (38)         |
| Total change in net interest income  | \$ 3,991  | \$ (1,024)                                   | \$ 2,967     |

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***Provision for Loan Losses***

Quarterly, the Company determines the amount of the allowance for loan losses that is adequate to provide for losses inherent in the Company's loan portfolios, with the provision for loan losses determined by the net change in the allowance for loan losses. For loans acquired with deteriorated credit quality, a provision for loan losses is recorded when estimates of future cash flows are lower than had been previously expected. See Part I. Item I. Notes to Unaudited Consolidated Financial Statements Note 4: Loans, Allowance for Loan losses and Credit Quality for further discussion.

The provision for loan losses for periods subsequent to the merger with FHB reflects the impact of adjusting loans to their then fair values, as well as the elimination of the allowance for loan losses in accordance with the acquisition method of accounting. Subsequent to the merger, the provision for loan losses has been recorded based on estimates of inherent losses in newly originated loans and for incremental reserves required for pre-merger loans based on estimates of deteriorated credit quality post-merger.

*Three Months Ended December 31, 2013 and 2012*

The provision for loan losses for the quarter ended December 31, 2013 and 2012 was \$151 thousand and \$247 thousand, respectively. The decrease in the Company's loan loss provision resulted principally from favorable charge-off trends in the originated loan portfolio.

*Six Months Ended December 31, 2013 and 2012*

The provision for loan losses for the six months ended December 31, 2013 and 2012 was \$227 thousand and \$475 thousand, respectively. The decrease in the Company's loan loss provision resulted from favorable charge-off trends in the originated loan portfolio. Net charge-offs for the six months ended December 31, 2013 decreased by \$404 thousand from the six months ended December 31, 2012, principally due to the partial charge-off of one commercial business loan relationship in the first quarter of fiscal 2013.

***Noninterest Income***

*Three Months Ended December 31, 2013 and 2012*

Noninterest income decreased by \$1.9 million for the current quarter, compared to the quarter ended December 31, 2012, principally due to the following:

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- A decrease of \$573 thousand in gain on sales of residential loans ( held for sale loans), a volume related difference principally due to the increased proportion of residential mortgages held in portfolio.
- A decrease of \$985 thousand in gains on sales of portfolio loans. In the quarter ended December 31, 2012, the Company recognized \$817 thousand on the sale of a purchased loan.
- A decrease of \$242 thousand in bank-owned life insurance income. In the quarter ended December 31, 2012, the Company received \$235 thousand in life insurance death benefits.

### *Six Months Ended December 31, 2013 and 2012*

Noninterest income decreased by \$3.1 million for the six months ended December 31, 2013, compared to the six months ended December 31, 2012, principally due to the following:

- A decrease of \$792 thousand in security gains. In the first quarter of fiscal 2013, the Company sold a substantial portion of its available-for-sale investment portfolio and reinvested the sales proceeds in similar securities at lower market yields. There were no security sales in the six months ended December 31, 2013.
- A decrease of \$790 thousand on sales of held for sale loans, a volume related difference principally the result of an increased proportion of residential mortgages held in portfolio.
- A decrease of \$768 thousand in gains on sales of portfolio loans, principally due to lower volume of purchased loan sales during the six months ended December 31, 2013.
- A decrease of \$566 thousand in gains on real estate owned. In the first quarter of fiscal 2013, the Company recognized a gain of \$473 thousand on the sale of real estate previously securing a purchased loan.
- A decrease of \$247 thousand in bank-owned life insurance income. In the second quarter of fiscal 2013, the Company received \$235 thousand in life insurance death benefits.

### *Noninterest Expense*

#### *Three Months Ended December 31, 2013 and 2012*

Noninterest expense increased by \$197 thousand for the current quarter, compared to the quarter ended December 31, 2012, principally due to the following:

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- An increase of \$410 thousand in salaries and employee benefits, principally due to increased incentive compensation and increases in the cost of employee medical insurance benefits.
- An increase of \$207 thousand in occupancy and equipment expense, principally due to the relocation of the Company's Boston office in the second quarter of fiscal 2013.
- A decrease of \$144 thousand in marketing expense, primarily due to a reduction in deposit marketing in fiscal 2014.
- A decrease of \$189 thousand in loan acquisition and collection expenses, principally due to a decreased level of loan purchases in the current quarter when compared to the quarter ended December 31, 2012.

*Six Months Ended December 31, 2013 and 2012*

Noninterest expense increased by \$1.1 million for the current quarter, compared to the quarter ended December 31, 2012, principally due to the following:

- An increase of \$1.4 million in salaries and employee benefits, principally due to an increase in average headcount and base salaries, as well as higher employee benefits and stock-based compensation.
- An increase of \$502 thousand in occupancy and equipment expense, principally due to the relocation of the Company's Boston office in the second quarter of fiscal 2013.
- A decrease of \$290 thousand in marketing expense, primarily due to a reduction in deposit marketing in fiscal 2014.
- A decrease of \$170 thousand in loan acquisition and collection expenses, principally due to a decreased level of loan purchases in the six months ended December 31, 2013 when compared to the six months ended December 31, 2012.
- A decrease of \$110 thousand in intangible asset amortization. The Company's core deposit intangible amortizes on an accelerated basis.
- A legal settlement recovery of \$250 thousand recognized in the six months ended December 31, 2013.

***Income Taxes***

*Three Months Ended December 31, 2013 and 2012*

The Company's income tax expense was \$676 thousand, or an effective rate of 32.4%, for the quarter ended December 31, 2013. The Company's income tax expense was \$676 thousand, or an effective rate of 31.6%, for the quarter ended December 31, 2012. The increased effective rate in



current quarter principally resulted from a lower proportion of non-taxable income.

*Six Months Ended December 31, 2013 and 2012*

The Company's income tax expense was \$832 thousand, or an effective rate of 32.6%, for the six months ended December 31, 2013, as compared to \$1.1 million, or an effective rate of 31.7%, for the six months ended December 31, 2012. The increased effective rate in six months ended December 31, 2013 principally resulted from a lower proportion of non-taxable income.

**Results of Operations – Discontinued Operations**

The Company concluded all investment brokerage activities in the second quarter of fiscal 2014. Accordingly, operations associated with these activities have been classified as discontinued operations.

The Company reported a net loss from discontinued operations of \$18 thousand for the current quarter, compared to net income of \$55 thousand in the quarter ended December 31, 2012.

The Company reported a net loss from discontinued operations of \$8 thousand for the six months ended December 31, 2013, compared to net income of \$130 thousand in the six months ended December 31, 2012.

The net loss in both the quarter and six months ended December 31, 2013 was due to the discontinuance of brokerage activities in November 2013.

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**Item 3. Quantitative and Qualitative Disclosure about Market Risk**

Not required for smaller reporting companies.

**Item 4. Controls and Procedures**

The Company maintains controls and procedures designed to ensure that information required to be disclosed in the reports the Company files or submits under the Securities Exchange Act of 1934 ( Exchange Act ) is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, and that such information is accumulated and communicated to the Company s management, including the Chief Executive Officer and Chief Financial Officer (the Company s principal executive officer and principal financial officer, respectively), as appropriate to allow for timely decisions regarding timely disclosure. In designing and evaluating disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost/benefit relationship of possible controls and procedures.

The Company s management, with the participation of the Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of its disclosure controls and procedures (as defined in Rules 13a - 15(e) and 15d - 15(e) under the Exchange Act) as of the end of the period covered by this Quarterly Report on Form 10-Q.

Based on this evaluation of the Company s disclosure controls and procedures, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures were effective as of December 31, 2013.

There were no changes in the Company s internal controls over financial reporting (as defined in Rule 13a - 15(f) of the Exchange Act) that occurred during the quarter ended December 31, 2013 that have materially affected, or is reasonably likely to materially affect, the Company s internal controls over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

None.

**Item 1A. Risk Factors**

Not required for smaller reporting companies.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

None.

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**Item 6. Exhibits**

**Exhibits**

| No.  | Description  |
|------|--|
| 31.1 | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Rule 13a-14(a)). *   |
| 31.2 | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Rule 13a-14(a)). *   |
| 32.1 | Certificate of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Rule 13a-14(b)). **   |
| 32.2 | Certificate of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Rule 13a-14(b)). **   |
| 101  | The following materials from Northeast Bancorp's Quarterly Report on Form 10-Q for the quarter ended December 31, 2013 formatted in XBRL: (i) Consolidated Balance Sheets at December 31, 2013 and June 30, 2013; (ii) Consolidated Statements of Income for the three and six months ended December 31, 2013 and 2012; (iii) Consolidated Statements of Comprehensive Income for the three and six months ended December 31, 2013 and 2012; (iv) Consolidated Statements of Changes in Shareholders' Equity for the six months ended December 31, 2013 and 2012; (v) Consolidated Statements of Cash Flows for the six months ended December 31, 2013 and 2012; and (v) Notes to Unaudited Consolidated Financial Statements. *** |

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\* Filed herewith

\*\* Furnished herewith

\*\*\* Pursuant to Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933, as amended, and Section 18 of the Securities Exchange Act of 1934, as amended.

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**SIGNATURES**

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

Date: February 12, 2014

**NORTHEAST BANCORP**

By: /s/ Richard Wayne  
Richard Wayne  
President and CEO

By: /s/ Claire S. Bean  
Claire S. Bean  
Chief Financial Officer

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**NORTHEAST BANCORP**

**Index to Exhibits**

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