

MIDSOUTH BANCORP INC  
Form 10-Q  
November 07, 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 September 30, 2014

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

COMMISSION FILE NUMBER 1-11826

MIDSOUTH BANCORP, INC.

(Exact name of registrant as specified in its charter)

Louisiana

(State or other jurisdiction of incorporation or organization)

72 -1020809

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

102 Versailles Boulevard, Lafayette, Louisiana 70501

(Address of principal executive offices, including zip code)

(337) 237-8343

(Registrant's telephone number, including area code)

Indicate by checkmark 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 subject to such filing requirements for the past 90 days.

YES  NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 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 small reporting company.

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.)

YES  NO

As of November 7, 2014, there were 11,337,891 shares of the registrant's Common Stock, par value \$0.10 per share, outstanding.



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## Part I – Financial Information

## Item 1. Financial Statements.

## MidSouth Bancorp, Inc. and Subsidiaries

## Consolidated Balance Sheets

(dollars in thousands, except share data)

	September 30, 2014 (unaudited)	December 31, 2013* (audited)
<b>Assets</b>		
Cash and due from banks, including required reserves of \$9,922 and \$9,542, respectively	\$41,191	\$43,488
Interest-bearing deposits in banks	10,999	13,993
Federal funds sold	2,025	2,250
Securities available-for-sale, at fair value (cost of \$284,572 at September 30, 2014 and \$341,828 at December 31, 2013)	288,397	341,665
Securities held-to-maturity (fair value of \$144,597 at September 30, 2014 and \$151,168 at December 31, 2013)	145,030	155,523
Other investments	12,091	11,526
Loans	1,248,373	1,137,554
Allowance for loan losses	(9,425 )	(8,779 )
Loans, net	1,238,948	1,128,775
Bank premises and equipment, net	71,115	72,343
Accrued interest receivable	6,647	6,692
Goodwill	42,171	42,171
Intangibles	7,111	7,941
Cash surrender value of life insurance	13,565	13,450
Other real estate	4,663	6,687
Other assets	7,807	4,656
<b>Total assets</b>	<b>\$1,891,760</b>	<b>\$1,851,160</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Liabilities:</b>		
<b>Deposits:</b>		
Non-interest-bearing	\$396,263	\$383,257
Interest-bearing	1,124,581	1,135,546
<b>Total deposits</b>	<b>1,520,844</b>	<b>1,518,803</b>
Securities sold under agreements to repurchase	70,964	53,916
Short-term Federal Home Loan Bank advances	35,000	25,000
Notes payable	26,384	27,703
Junior subordinated debentures	22,167	29,384
Other liabilities	10,387	5,605
<b>Total liabilities</b>	<b>1,685,746</b>	<b>1,660,411</b>
<b>Commitments and contingencies</b>		
<b>Shareholders' equity:</b>		
Series B Preferred stock, no par value; 5,000,000 shares authorized, 32,000 shares issued and outstanding at September 30, 2014 and December 31, 2013	32,000	32,000
Series C Preferred stock, no par value; 100,000 shares authorized, 94,046 and 99,971 issued and 93,959 and 99,971 outstanding at September 30, 2014 and December 31, 2013, respectively; 87 shares in treasury at September 30, 2014 and none at December 31, 2013	9,405	9,997
Common stock, \$0.10 par value; 30,000,000 shares authorized, 11,487,078 and 11,407,196 issued and 11,336,594 and 11,256,712 outstanding at September 30, 2014 and December	1,149	1,141

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31, 2013, respectively; 150,484 shares in treasury at September 30, 2014 and December 31, 2013

Additional paid-in capital	112,567	111,017
Unearned ESOP shares	(267 )	-
Accumulated other comprehensive income (loss)	2,486	(106 )
Treasury stock, at cost	(3,295 )	(3,286 )
Retained earnings	51,969	39,986
Total shareholders' equity	206,014	190,749
Total liabilities and shareholders' equity	\$1,891,760	\$1,851,160

See notes to unaudited consolidated financial statements.

\* Derived from audited financial statements.

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MidSouth Bancorp, Inc. and Subsidiaries  
 Consolidated Statements of Earnings (unaudited)  
 (in thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Interest income:				
Loans, including fees	\$18,273	\$17,652	\$53,525	\$52,966
Securities and other investments:				
Taxable	1,965	2,171	6,164	6,481
Nontaxable	652	785	2,007	2,436
Federal funds sold	2	1	4	6
Time and interest bearing deposits in other banks	15	15	42	70
Other investments	109	80	268	230
Total interest income	21,016	20,704	62,010	62,189
Interest expense:				
Deposits	859	976	2,588	3,044
Federal funds purchased	-	-	2	3
Securities sold under agreements to repurchase	210	204	588	565
Other borrowings and payables	108	118	318	345
Junior subordinated debentures	327	335	994	1,007
Total interest expense	1,504	1,633	4,490	4,964
Net interest income	19,512	19,071	57,520	57,225
Provision for loan losses	1,175	450	2,925	2,250
Net interest income after provision for loan losses	18,337	18,621	54,595	54,975
Non-interest income:				
Service charges on deposits	2,556	2,352	7,385	6,794
Gain on securities, net	-	25	128	229
ATM and debit card income	1,808	1,719	5,375	4,713
Executive officer life insurance proceeds	-	-	3,000	-
Other charges and fees	1,830	892	3,484	2,687
Total non-interest income	6,194	4,988	19,372	14,423
Non-interest expenses:				
Salaries and employee benefits	8,287	8,640	25,588	25,401
Occupancy expense	3,834	3,874	11,314	11,196
FDIC insurance	269	265	783	854
Other	5,467	5,702	14,997	16,728
Total non-interest expenses	17,857	18,481	52,682	54,179
Income before income taxes	6,674	5,128	21,285	15,219
Income tax expense	2,202	1,588	5,839	4,588
Net earnings	4,472	3,540	15,446	10,631
Dividends on preferred stock	174	468	524	1,152
Net earnings available to common shareholders	\$4,298	\$3,072	\$14,922	\$9,479

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Earnings per share:

Basic	\$0.38	\$0.27	\$1.32	\$0.84
Diluted	\$0.37	\$0.27	\$1.28	\$0.83
Weighted average number of shares outstanding:				
Basic	11,314	11,253	11,283	11,243
Diluted	11,955	11,869	11,904	11,853
Dividends declared per common share	\$0.09	\$0.08	\$0.26	\$0.23

See notes to unaudited consolidated financial statements.

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MidSouth Bancorp, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income (unaudited)

(in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net earnings	\$4,472	\$3,540	\$15,446	\$10,631
Other comprehensive income (loss), net of tax:				
Unrealized gains (losses) on securities available-for-sale:				
Unrealized holding gains (losses) arising during the year	(405 )	(95 )	4,116	(10,203)
Less: reclassification adjustment for gains on sales of securities available-for-sale	-	(25 )	(128 )	(229 )
Total other comprehensive income (loss), before tax	(405 )	(120 )	3,988	(10,432)
Income tax effect related to items of other comprehensive income (loss)	(142 )	(42 )	1,396	(3,651 )
Total other comprehensive income (loss), net of tax	(263 )	(78 )	2,592	(6,781 )
Total comprehensive income	\$4,209	\$3,462	\$18,038	\$3,850

See notes to unaudited consolidated financial statements.



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MidSouth Bancorp, Inc. and Subsidiaries

Consolidated Statement of Shareholders' Equity (unaudited)

For the Nine Months Ended September 30, 2014

(in thousands, except share and per share data)

	Preferred Stock		Common Stock		Additional Paid-in Capital	Unearned ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Retained Earnings	Total
	Shares	Amount	Shares	Amount	Capital	Shares	(Loss)	Stock	Earnings	Total
Balance - December 31, 2013	131,971	\$41,997	11,407,196	\$1,141	\$111,017	\$ -	\$(106 )	\$(3,286)	\$39,986	\$190,749
Net earnings	-	-	-	-	-	-	-	-	15,446	15,446
Dividends on Series B and Series C preferred stock	-	-	-	-	-	-	-	-	(524 )	(524 )
Dividends on common stock, \$0.26 per share	-	-	-	-	-	-	-	-	(2,939 )	(2,939 )
Conversion of Series C preferred stock to common stock	(5,925 )	(592 )	32,917	3	589	-	-	-	-	-
Repurchase of preferred stock, 87 shares	-	-	-	-	-	-	-	(9 )	-	(9 )
Increase in ESOP obligation	-	-	-	-	-	(267)	-	-	-	(267 )
Exercise of stock options	-	-	46,965	5	605	-	-	-	-	610
Tax benefit resulting from issuance of stock options, net adjustment	-	-	-	-	1	-	-	-	-	1
Stock option expense	-	-	-	-	355	-	-	-	-	355
Change in accumulated other comprehensive income (loss)	-	-	-	-	-	-	2,592	-	-	2,592
Balance - September 30, 2014	126,046	\$41,405	11,487,078	\$1,149	\$112,567	\$(267)	\$2,486	\$(3,295)	\$51,969	\$206,014

See notes to unaudited consolidated financial statements.



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MidSouth Bancorp, Inc. and Subsidiaries  
 Consolidated Statements of Cash Flows (unaudited)  
 (in thousands)

	For the Nine Months Ended September 30,	
	2014	2013
Cash flows from operating activities:		
Net earnings	\$15,446	\$10,631
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	4,518	4,106
Accretion of purchase accounting adjustments	(1,924 )	(4,631 )
Provision for loan losses	2,925	2,250
Provision for deferred tax expense	2,034	2,181
Amortization of premiums on securities, net	2,432	3,432
Amortization of other investments	4	11
Stock option expense	355	212
Restricted stock expense	-	21
Net gain on sale of investment securities	(128 )	(229 )
Net (gain) loss on sale of other real estate owned	(1,081 )	205
Net write down of other real estate owned	31	380
Net (gain) loss on sale/disposal of premises and equipment	232	118
Change in accrued interest receivable	45	(174 )
Change in accrued interest payable	(240 )	(348 )
Change in other assets & other liabilities, net	(2,006 )	189
Net cash provided by operating activities	22,643	18,354
Cash flows from investing activities:		
Net decrease in time deposits in other banks	-	881
Proceeds from maturities and calls of securities available-for-sale	33,466	59,430
Proceeds from maturities and calls of securities held-to-maturity	10,778	19,617
Proceeds from sale of securities available-for-sale	22,153	55,808
Purchases of securities available-for-sale	-	(68,043)
Purchases of securities held-to-maturity	(1,104 )	(26,382)
Proceeds from redemptions of other investments	150	1,000
Redemption of Capital Securities related to MidSouth Statutory Trust I	217	-
Purchases of other investments	(567 )	(2,653 )
Net change in loans	(111,329)	(90,091)
Purchases of premises and equipment	(4,265 )	(10,955)
Proceeds from sale of premises and equipment	743	45
Proceeds from sale of other real estate owned	3,315	940
Net cash used in investing activities	(46,443 )	(60,403)
Cash flows from financing activities:		
Change in deposits	2,244	(45,232)
Change in securities sold under agreements to repurchase	17,048	32,462
Change in federal funds purchased	-	3,900
Borrowings on Federal Home Loan Bank advances	10,000	25,000
Repayments of FHLB advance	(45 )	(43 )
Redemption of MidSouth Statutory Trust I	(7,217 )	-
Repayments of notes payable	(1,000 )	(750 )

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Purchase of treasury stock	(9	)	-
Proceeds and tax benefit from exercise of stock options	611		30
Tax benefit from issuance of restricted stock	-		14
Payment of dividends on preferred stock	(530	)	(1,052 )
Payment of dividends on common stock	(2,818	)	(2,419 )
Net cash provided by financing activities	18,284		11,910
Net increase (decrease) in cash and cash equivalents	(5,516	)	(30,139)
Cash and cash equivalents, beginning of period	59,731		73,573
Cash and cash equivalents, end of period	\$54,215		\$43,434
Supplemental cash flow information:			
Interest paid	\$4,730		\$5,106
Income taxes paid	5,815		3,500
Noncash investing and financing activities:			
Transfer of loans to other real estate	317		701
Change in accrued common stock dividends	121		167
Change in accrued preferred stock dividends	(6	)	100
Financed sales of other real estate	84		-
Net change in loan to ESOP	(267	)	-

See notes to unaudited consolidated financial statements.

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MidSouth Bancorp, Inc. and Subsidiaries  
 Notes to Interim Consolidated Financial Statements  
 September 30, 2014

## 1. Basis of Presentation

The accompanying unaudited consolidated financial statements and notes thereto contain all adjustments, consisting only of normal recurring adjustments, necessary to present fairly, in accordance with accounting principles generally accepted in the United States of America (“GAAP”), the financial position of MidSouth Bancorp, Inc. (the “Company”) and its subsidiaries as of September 30, 2014 and the results of their operations and their cash flows for the periods presented. The interim financial information should be read in conjunction with the annual consolidated financial statements and the notes thereto included in the Company’s 2013 Annual Report on Form 10-K.

The results of operations for the nine-month period ended September 30, 2014 are not necessarily indicative of the results to be expected for the entire year.

Use of Estimates — The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

Summary of Significant Accounting Policies — The accounting and reporting policies of the Company conform with GAAP and general practices within the banking industry. There have been no material changes or developments in the application of accounting principles or in our evaluation of the accounting estimates and the underlying assumptions or methodologies that we believe to be Critical Accounting Policies and Estimates as disclosed in our 2013 Annual Report on Form 10-K.

Recently Adopted Accounting Pronouncements — ASU 2014-04, Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force) provides guidance on when an in-substance repossession or foreclosure occurs, which requires the mortgage loan to be derecognized and the related real estate be recognized. Creditors must disclose the amount of foreclosed residential real estate held as well as the amount of collateralized loans for which foreclosure is in process. The effective date of this Update is for fiscal years beginning on or after December 15, 2014 and interim periods within those annual periods. Adoption of this Update is not expected to have a material effect on the Company’s consolidated financial statements or the interim notes to the consolidated financial statements.

## 2. Investment Securities

The portfolio of investment securities consisted of the following (in thousands):

	September 30, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Government sponsored enterprises	\$10,418	\$ -	\$ 126	\$10,292
Obligations of state and political subdivisions	48,053	1,820	26	49,847
GSE mortgage-backed securities	110,482	2,787	623	112,646
Collateralized mortgage obligations: residential	64,946	299	1,872	63,373

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Collateralized mortgage obligations: commercial	25,803	308	117	25,994
Other asset-backed securities	24,406	411	-	24,817
Collateralized debt obligation	464	964	-	1,428
	\$284,572	\$ 6,589	\$ 2,764	\$288,397

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	December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Government sponsored enterprises	\$ 11,455	\$ 1	\$ 191	\$ 11,265
Obligations of state and political subdivisions	57,925	2,296	243	59,978
GSE mortgage-backed securities	146,129	2,029	2,193	145,965
Collateralized mortgage obligations: residential	73,569	212	2,894	70,887
Collateralized mortgage obligations: commercial	27,082	416	152	27,346
Other asset-backed securities	25,204	351	66	25,489
Collateralized debt obligation	464	271	-	735
	\$ 341,828	\$ 5,576	\$ 5,739	\$ 341,665

	September 30, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Held-to-maturity:				
Obligations of state and political subdivisions	\$ 46,608	\$ 203	\$ 324	\$ 46,487
GSE mortgage-backed securities	69,886	715	412	70,189
Collateralized mortgage obligations: residential	13,106	-	547	12,559
Collateralized mortgage obligations: commercial	15,430	49	117	15,362
	\$ 145,030	\$ 967	\$ 1,400	\$ 144,597

	December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Held-to-maturity:				
Obligations of state and political subdivisions	\$ 47,377	\$ 38	\$ 2,586	\$ 44,829
GSE mortgage-backed securities	78,272	148	1,079	77,341
Collateralized mortgage obligations: residential	14,189	-	979	13,210
Collateralized mortgage obligations: commercial	15,685	103	-	15,788
	\$ 155,523	\$ 289	\$ 4,644	\$ 151,168

With the exception of three private-label collateralized mortgage obligations (“CMOs”) with a combined balance remaining of \$47,000 at September 30, 2014, all of the Company’s CMOs are government-sponsored enterprise (“GSE”) securities.

The amortized cost and fair value of debt securities at September 30, 2014 by contractual maturity are shown in the following table (in thousands) with the exception of other asset-backed securities, mortgage-backed securities, CMOs, and the collateralized debt obligation. Expected maturities may differ from contractual maturities for mortgage-backed securities and CMOs because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

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	Amortized Cost	Fair Value
Available-for-sale:		
Due in one year or less	\$ 8,533	\$ 8,625
Due after one year through five years	32,867	33,763
Due after five years through ten years	13,969	14,631
Due after ten years	3,102	3,120
Other asset-backed securities	24,406	24,817
Mortgage-backed securities and collateralized mortgage obligations:		
Residential	175,428	176,019
Commercial	25,803	25,994
Collateralized debt obligation	464	1,428
	\$ 284,572	\$ 288,397

	Amortized Cost	Fair Value
Held-to-maturity:		
Due in one year or less	\$ 106	\$ 105
Due after one year through five years	3,105	3,130
Due after five years through ten years	7,829	7,787
Due after ten years	35,568	35,465
Mortgage-backed securities and collateralized mortgage obligations:		
Residential	82,992	82,748
Commercial	15,430	15,362
	\$ 145,030	\$ 144,597

Details concerning investment securities with unrealized losses are as follows (in thousands):

	September 30, 2014		September 30, 2014		Total	Gross Unrealized Loss
	Securities with losses under 12 months		Securities with losses over 12 months			
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
Available-for-sale:						
U.S. Government sponsored enterprises	\$-	\$ -	\$ 10,292	\$ 126	\$ 10,292	\$ 126
Obligations of state and political subdivisions	-	-	3,739	26	3,739	26
GSE mortgage-backed securities	10,873	68	32,344	555	43,217	623
Collateralized mortgage obligations:						
residential	4,483	16	43,689	1,856	48,172	1,872
Collateralized mortgage obligations:						
commercial	-	-	3,952	117	3,952	117
	\$ 15,356	\$ 84	\$ 94,016	\$ 2,680	\$ 109,372	\$ 2,764



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	December 31, 2013					
	Securities with losses under 12 months		Securities with losses over 12 months		Total	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
Available-for-sale:						
U.S. Government sponsored enterprises	\$10,463	\$ 191	\$-	\$ -	\$10,463	\$ 191
Obligations of state and political subdivisions	4,256	243	-	-	4,256	243
GSE mortgage-backed securities	68,028	2,193	-	-	68,028	2,193
Collateralized mortgage obligations:						
residential	56,975	2,563	4,371	331	61,346	2,894
Collateralized mortgage obligations:						
commercial	4,282	152	-	-	4,282	152
Other asset-backed securities	13,099	66	-	-	13,099	66
	\$157,103	\$ 5,408	\$4,371	\$ 331	\$161,474	\$ 5,739
	September 30, 2014					
	Securities with losses under 12 months		Securities with losses over 12 months		Total	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
Held-to-maturity:						
Obligations of state and political subdivisions	\$7,808	\$ 43	\$21,085	\$ 281	\$28,893	\$ 324
GSE mortgage-backed securities	-	-	28,591	412	28,591	412
Collateralized mortgage obligations: residential	-	-	12,559	547	12,559	547
Collateralized mortgage obligations:						
commercial	7,772	117	-	-	7,772	117
	\$15,580	\$ 160	\$62,235	\$ 1,240	\$77,815	\$ 1,400
	December 31, 2013					
	Securities with losses under 12 months		Securities with losses over 12 months		Total	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
Held-to-maturity:						
Obligations of state and political subdivisions	\$42,246	\$ 2,569	\$685	\$ 17	\$42,931	\$ 2,586
GSE mortgage-backed securities	31,042	1,079	-	-	31,042	1,079
Collateralized mortgage obligations: residential	13,210	979	-	-	13,210	979
	\$86,498	\$ 4,627	\$685	\$ 17	\$87,183	\$ 4,644

Management evaluates each quarter whether unrealized losses on securities represent impairment that is other than temporary. For debt securities, the Company considers its intent to sell the securities or if it is more likely than not the Company will be required to sell the securities. If such impairment is identified, based upon the intent to sell or the more likely than not threshold, the carrying amount of the security is reduced to fair value with a charge to earnings. Upon the result of the aforementioned review, management then reviews for potential other than temporary

impairment based upon other qualitative factors. In making this evaluation, management considers changes in market rates relative to those available when the security was acquired, changes in market expectations about the timing of cash flows from securities that can be prepaid, performance of the debt security, and changes in the market's perception of the issuer's financial health and the security's credit quality. If determined that a debt security has incurred other than temporary impairment, then the amount of the credit related impairment is determined. If a credit loss is evident, the amount of the credit loss is charged to earnings and the non-credit related impairment is recognized through other comprehensive income.

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As of September 30, 2014, 74 securities had unrealized losses totaling 2.18% of the individual securities' amortized cost basis and 0.97% of the Company's total amortized cost basis. Of the 74 securities, 62 had been in an unrealized loss position for over twelve months at September 30, 2014. These 62 securities had an amortized cost basis and unrealized loss of \$160.1 million and \$3.9 million, respectively. The unrealized losses on debt securities at September 30, 2014 resulted from changing market interest rates over the yields available at the time the underlying securities were purchased. Management identified no impairment related to credit quality. At September 30, 2014, management had the intent and ability to hold impaired securities and no impairment was evaluated as other than temporary. As a result, no other than temporary impairment losses were recognized during the nine months ended September 30, 2014.

During the nine months ended September 30, 2014, the Company sold four securities classified as available-for-sale at a net gain of \$128,000. All of the securities were sold at a gain. During the nine months ended September 30, 2013, the Company sold 33 securities classified as available-for-sale at a net gain of \$229,000. Of the 33 securities sold, 29 securities were sold with gains totaling \$242,000 and four securities were sold at a loss of \$13,000.

Securities with an aggregate carrying value of approximately \$276.7 million and \$259.9 million at September 30, 2014 and December 31, 2013, respectively, were pledged to secure public funds on deposit and for other purposes required or permitted by law.

### 3. Credit Quality of Loans and Allowance for Loan Losses

The loan portfolio consisted of the following (in thousands):

	September 30, 2014	December 31, 2013
Commercial, financial and agricultural	\$452,065	\$403,976
Real estate - construction	86,315	82,691
Real estate – commercial	430,930	397,135
Real estate – residential	153,915	146,841
Installment loans to individuals	116,340	97,459
Lease financing receivable	5,285	5,542
Other	3,523	3,910
	1,248,373	1,137,554
Less allowance for loan losses	(9,425 )	(8,779 )
	\$1,238,948	\$1,128,775

The Company monitors loan concentrations and evaluates individual customer and aggregate industry leverage, profitability, risk rating distributions, and liquidity for each major standard industry classification segment. At September 30, 2014, one industry segment concentration, the oil and gas industry, constituted more than 10% of the loan portfolio. The Company's exposure in the oil and gas industry, including related service and manufacturing industries, totaled approximately \$255.6 million, or 20.5% of total loans. Additionally, the Company's exposure to loans secured by commercial real estate is monitored. At September 30, 2014, loans secured by commercial real estate (including commercial construction, farmland and multifamily loans) totaled approximately \$491.3 million. Of the \$491.3 million, \$395.1 million represent CRE loans, 63.2% of which are secured by owner-occupied commercial properties. Of the \$395.1 million in loans secured by commercial real estate, \$3.4 million, or 0.9%, were on nonaccrual status at September 30, 2014.

#### Allowance for Loan Losses

The allowance for loan losses is a valuation account available to absorb probable losses on loans. All losses are charged to the allowance for loan losses when the loss actually occurs or when a determination is made that a loss is likely to occur. Recoveries are credited to the allowance for loan losses at the time of recovery. Quarterly, the probable level of losses in the existing portfolio is estimated through consideration of various factors. Based on these estimates, the allowance for loan losses is increased by charges to earnings and decreased by charge offs (net of recoveries).

The allowance is composed of general reserves and specific reserves. General reserves are determined by applying loss percentages to segments of the portfolio. The loss percentages are based on each segment's historical loss experience, generally over the past twelve to eighteen months, and adjustment factors derived from conditions in the Company's internal and external environment. All loans considered to be impaired are evaluated on an individual basis to determine specific reserve allocations in accordance with GAAP. Loans for which specific reserves are provided are excluded from the calculation of general reserves.

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Loans acquired in business combinations are initially recorded at fair value, which includes an estimate of credit losses expected to be realized over the remaining lives of the loans, and therefore no corresponding allowance for loan losses is recorded for these loans at acquisition. Methods utilized to estimate any subsequently required allowance for loan losses for acquired loans not deemed credit-impaired at acquisition are similar to originated loans; however, the estimate of loss is based on the unpaid principal balance and then compared to any remaining unaccreted purchase discount. To the extent that the calculated loss is greater than the remaining unaccreted purchase discount, an allowance is recorded for such difference.

The Company has an internal loan review department that is independent of the lending function to challenge and corroborate the loan grade assigned by the lender and to provide additional analysis in determining the adequacy of the allowance for loan losses.

A rollforward of the activity within the allowance for loan losses by loan type and recorded investment in loans for the nine months ended September 30, 2014 and 2013 is as follows (in thousands):

	September 30, 2014							Total
	Coml, Fin, and Agric	Real Estate Constructi	Commercial	Residential	Consumer	Finance Leases Coml	Other	
Allowance for loan losses:								
Beginning balance	\$3,906	\$1,046	\$1,389	\$1,141	\$1,273	\$21	\$3	\$8,779
Charge-offs	2,084	1	93	188	566	-	-	2,932
Recoveries	101	-	398	44	110	-	-	653
Provision	2,731	103	(345)	(8)	450	(6)	-	2,925
Ending balance	\$4,654	\$1,148	\$1,349	\$989	\$1,267	\$15	\$3	\$9,425
Ending balance:								
individually evaluated for impairment	\$853	\$3	\$55	\$87	\$140	\$-	\$-	\$1,138
Ending balance:								
collectively evaluated for impairment	\$3,801	\$1,145	\$1,294	\$902	\$1,127	\$15	\$3	\$8,287
Loans:								
Ending balance	\$452,065	\$86,315	\$430,930	\$153,915	\$116,340	\$5,285	\$3,523	\$1,248,373
Ending balance:								
individually evaluated for impairment	\$2,662	\$106	\$3,312	\$1,073	\$426	\$-	\$-	\$7,579
Ending balance:								
collectively evaluated for impairment	\$449,403	\$86,209	\$426,942	\$152,742	\$115,914	\$5,285	\$3,523	\$1,240,018
Ending balance: loans acquired with deteriorated credit quality	\$-	\$-	\$676	\$100	\$-	\$-	\$-	\$776

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	September 30, 2013							
	Real Estate					Finance		
	Coml, Fin, and Agric	Constructi	Commercial	Residential	Consumer	Coml Leases	Other	Total
Allowance for loan losses:								
Beginning balance	\$1,535	\$2,147	\$2,166	\$936	\$543	\$41	\$2	\$7,370
Charge-offs	(461 )	-	(18 )	(129 )	(558 )	-	-	(1,166 )
Recoveries	61	5	21	34	92	-	-	213
Provision	3,090	(1,081 )	(661 )	(46 )	962	(16 )	2	2,250
Ending balance	\$4,225	\$1,071	\$1,508	\$795	\$1,039	\$25	\$4	\$8,667
Ending balance:								
individually evaluated for impairment	\$419	\$36	\$54	\$55	\$134	\$-	\$-	\$698
Ending balance:								
collectively evaluated for impairment	\$3,806	\$1,035	\$1,454	\$740	\$905	\$25	\$4	\$7,969
Loans:								
Ending balance	\$423,073	\$76,213	\$401,080	\$142,431	\$94,722	\$5,340	\$2,164	\$1,145,023
Ending balance:								
individually evaluated for impairment	\$1,450	\$164	\$2,285	\$994	\$322	\$-	\$-	\$5,215
Ending balance:								
collectively evaluated for impairment	\$421,623	\$76,049	\$398,080	\$141,136	\$94,400	\$5,340	\$2,164	\$1,138,792
Ending balance: loans acquired with deteriorated credit quality	\$-	\$-	\$715	\$301	\$-	\$-	\$-	\$1,016

## Non-Accrual and Past Due Loans

Loans are considered past due if the required principal and interest payment have not been received as of the date such payments were due. Loans are placed on non-accrual status when, in management's opinion, the probability of collection of interest is deemed insufficient to warrant further accrual. For loans placed on non-accrual status, the accrual of interest is discontinued and subsequent payments received are applied to the principal balance. Interest income is recorded after principal has been satisfied and as payments are received. Non-accrual loans may be returned to accrual status if all principal and interest amounts contractually owed are reasonably assured of repayment within a reasonable period and there is a period of at least six months to one year of repayment performance by the borrower depending on the contractual payment terms.

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An age analysis of past due loans (including both accruing and non-accruing loans) is as follows (in thousands):

September 30, 2014

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due	Total Past Due	Current	Total Loans	Recorded Investment > 90 days and Accruing
Commercial, financial, and agricultural	\$1,692	\$1,435	\$2,443	\$5,570	\$446,495	\$452,065	\$ 11
Commercial real estate - construction	548	651	73	1,272	59,078	60,350	-
Commercial real estate - other	913	200	2,513	3,626	427,304	430,930	-
Residential - construction	-	-	-	-	25,965	25,965	-
Residential - prime	973	1,030	712	2,715	151,200	153,915	-
Consumer - credit card	34	9	12	55	5,763	5,818	12
Consumer - other	644	101	413	1,158	109,364	110,522	-
Lease financing receivable	-	-	-	-	5,285	5,285	-
Other loans	106	-	-	106	3,417	3,523	-
	\$4,910	\$3,426	\$6,166	\$14,502	\$1,233,871	\$1,248,373	\$ 23

December 31, 2013

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due	Total Past Due	Current	Total Loans	Recorded Investment > 90 days and Accruing
Commercial, financial, and agricultural	\$4,350	\$208	\$1,256	\$5,814	\$398,162	\$403,976	\$ 26
Commercial real estate - construction	36	-	63	99	64,794	64,893	-
Commercial real estate - other	1,230	1,447	2,395	5,072	392,063	397,135	141
Residential - construction	149	-	-	149	17,649	17,798	-
Residential - prime	2,984	870	307	4,161	142,680	146,841	-
Consumer - credit card	36	-	7	43	6,163	6,206	7
Consumer - other	767	102	269	1,138	90,115	91,253	4
Lease financing receivable	-	-	-	-	5,542	5,542	-
Other loans	125	-	-	125	3,785	3,910	-
	\$9,677	\$2,627	\$4,297	\$16,601	\$1,120,953	\$1,137,554	\$ 178

Non-accrual loans are as follows (in thousands):

	September 30, 2014	December 31, 2013
Commercial, financial, and agricultural	\$ 2,649	\$ 1,272
Commercial real estate - construction	106	100
Commercial real estate - other	3,358	2,290
Residential - construction	-	-
Residential - prime	1,206	1,153
Consumer - credit card	-	-
Consumer - other	431	284
Lease financing receivable	-	-
Other	-	-
	\$ 7,750	\$ 5,099





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The amount of interest that would have been recorded on non-accrual loans, had the loans not been classified as non-accrual, totaled approximately \$392,000 and \$431,000 for the nine months ended September 30, 2014 and 2013, respectively. Interest actually received on non-accrual loans at September 30, 2014 and 2013 was \$93,000 and \$246,000, respectively.

## Impaired Loans

Loans are considered impaired when, based upon current information, it is probable the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. All loans classified as special mention, substandard, or doubtful, based on credit risk rating factors, and are reviewed for impairment. An allowance for each impaired loan is calculated based on the present value of expected future cash flows discounted at the loan's effective interest rate or at the loan's observable market price or the fair value of the collateral if the loan is collaterally dependent. All impaired loans are reviewed, at a minimum, on a quarterly basis. Existing valuations are reviewed to determine if additional discounts or new appraisals are required. After this review, when comparing the resulting collateral valuation to the outstanding loan balance, if the discounted collateral value exceeds the loan balance no specific allocation is reserved. Acquired impaired loans are generally not subject to individual evaluation for impairment and are not reported with impaired loans or troubled debt restructurings, even if they would otherwise qualify for such treatment.

Loans that are individually evaluated for impairment are as follows (in thousands):

	September 30, 2014			Average	Interest
	Recorded	Unpaid Principal	Related	Recorded	Income
	Investment	Balance	Allowance	Investment	Recognized
With no related allowance recorded:					
Commercial, financial, and agricultural	\$441	\$ 524	\$ -	\$ 474	\$ -
Commercial real estate – construction	67	67	-	69	-
Commercial real estate – other	2,947	2,947	-	2,908	19
Residential – prime	554	554	-	511	4
Residential – construction	-	-	-	22	-
Consumer – other	184	184	-	124	-
Subtotal:	4,193	4,276	-	4,108	23
With an allowance recorded:					
Commercial, financial, and agricultural	2,221	2,336	853	1,753	32
Commercial real estate – construction	39	39	3	39	1
Commercial real estate – other	365	365	55	365	-
Residential – prime	519	539	87	632	10
Consumer – other	242	257	140	260	1
Subtotal:	3,386	3,536	1,138	3,049	44
Totals:					
Commercial	5,974	6,172	908	5,500	51
Residential	1,073	1,093	87	1,143	14
Construction	106	106	3	130	1
Consumer	426	441	140	384	1
Grand total:	\$7,579	\$ 7,812	\$ 1,138	\$ 7,157	\$ 67

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	December 31, 2013				
	Recorded	Unpaid	Principal	Average	Interest
	Investment	Balance	Related	Recorded	Income
			Allowance	Investment	Recognized
With no related allowance recorded:					
Commercial, financial, and agricultural	\$ 671	\$ 1,107	\$ -	\$ 617	\$ 3
Commercial real estate – construction	61	61	-	416	-
Commercial real estate – other	1,850	2,324	-	2,190	8
Residential – prime	525	525	-	1,050	14
Consumer – other	66	66	-	90	1
Subtotal:	3,173	4,083	-	4,363	26
With an allowance recorded:					
Commercial, financial, and agricultural	570	570	168	821	3
Commercial real estate – construction	39	39	3	102	1
Commercial real estate – other	363	363	54	372	11
Residential – prime	375	395	60	214	4
Consumer – other	205	205	120	211	2
Subtotal:	1,552	1,572	405	1,720	21
Totals:					
Commercial	3,454	4,364	222	4,000	25
Residential	900	920	60	1,264	18
Construction	100	100	3	518	1
Consumer	271	271	120	301	3
Grand total:	\$ 4,725	\$ 5,655	\$ 405	\$ 6,083	\$ 47

## Credit Quality

The Company manages credit risk by observing written underwriting standards and lending policy established by the Board of Directors and management to govern all lending activities. The risk management program requires that each individual loan officer review his or her portfolio on a quarterly basis and assign recommended credit ratings on each loan. These efforts are supplemented by independent reviews performed by a loan review officer and other validations performed by the internal audit department. The results of the reviews are reported directly to the Audit Committee of the Board of Directors.

Loans can be classified into the following three risk rating grades: pass, special mention, and substandard/doubtful. Factors considered in determining a risk rating grade include debt service capacity, capital structure/liquidity, management, collateral quality, industry risk, company trends/operating performance, repayment source, revenue diversification/customer concentration, quality of financial information, and financing alternatives. Pass grade signifies the highest quality of loans to loans with reasonable credit risk, which may include borrowers with marginally adequate financial performance, but have the ability to repay the debt. Special mention loans have potential weaknesses that warrant extra attention from the loan officer and other management personnel, but still have the ability to repay the debt. Substandard classification includes loans with well-defined weaknesses with risk of potential loss. Loans classified as doubtful are considered to have little recovery value and are charged off.

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The following tables present the classes of loans by risk rating (in thousands):

September 30, 2014

## Commercial Credit Exposure

## Credit Risk Profile by Creditworthiness Category

	Commercial, financial, and agricultural	Commercial real estate - construction	Commercial real estate -other	Total	% of Total
Pass	\$439,626	\$ 60,087	\$ 406,546	\$906,259	96.07 %
Special mention	6,130	151	4,839	11,120	1.18 %
Substandard	5,777	112	19,545	25,434	2.69 %
Doubtful	532	-	-	532	.06 %
	\$452,065	\$ 60,350	\$ 430,930	\$943,345	100.00 %

## Residential Credit Exposure

## Credit Risk Profile by Creditworthiness Category

	Residential -construction	Residential - prime	Total	% of Total
Pass	\$ 25,965	\$ 149,167	\$175,132	97.36 %
Special mention	-	1,504	1,504	.84 %
Substandard	-	3,244	3,244	1.80 %
	\$ 25,965	\$ 153,915	\$179,880	100.00 %

## Consumer and Commercial Credit Exposure

## Credit Risk Profile Based on Payment Activity

	Consumer - credit card	Consumer -other	Lease financing receivable	Other	Total	% of Total
Performing	\$ 5,806	\$110,096	\$ 5,285	\$3,523	\$124,710	99.65 %
Nonperforming	12	426	-	-	438	.35 %
	\$ 5,818	\$110,522	\$ 5,285	\$3,523	\$125,148	100.00 %

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December 31, 2013

## Commercial Credit Exposure

## Credit Risk Profile by Creditworthiness Category

	Commercial, financial, and agricultural	Commercial real estate - construction	Commercial real estate -other	Total	% of Total
Pass	\$397,513	\$ 63,577	\$ 371,618	\$832,708	96.15 %
Special mention	2,962	49	8,781	11,792	1.36 %
Substandard	3,272	1,267	16,736	21,275	2.46 %
Doubtful	229	-	-	229	0.03 %
	\$403,976	\$ 64,893	\$ 397,135	\$866,004	100.00 %

## Residential Credit Exposure

## Credit Risk Profile by Creditworthiness Category

	Residential -construction	Residential - prime	Total	% of Total
Pass	\$ 17,798	\$ 143,790	\$161,588	98.15 %
Special mention	-	548	548	0.33 %
Substandard	-	2,503	2,503	1.52 %
	\$ 17,798	\$ 146,841	\$164,639	100.00 %

## Consumer and Commercial Credit Exposure

## Credit Risk Profile Based on Payment Activity

	Consumer - credit card	Consumer -other	Lease financing receivable	Other	Total	% of Total
Performing	\$ 6,196	\$ 90,978	\$ 5,542	\$3,910	\$106,626	99.73 %
Nonperforming	10	275	-	-	285	0.27 %
	\$ 6,206	\$ 91,253	\$ 5,542	\$3,910	\$106,911	100.00 %

## Troubled Debt Restructurings

A troubled debt restructuring (“TDR”) is a restructuring of a debt made by the Company to a debtor for economic or legal reasons related to the debtor’s financial difficulties that it would not otherwise consider. The Company grants the concession in an attempt to protect as much of its investment as possible.

Information about the Company’s TDRs is as follows (in thousands):

	September 30, 2014			
	Past Due Greater Than 30 Current Days	Nonaccrual TDRs	Total TDRs	Total TDRs
Commercial, financial and agricultural	\$22	\$ -	\$ 236	\$ 258
Real estate - commercial	158	-	-	158
	\$180	\$ -	\$ 236	\$ 416



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	December 31, 2013			
	Past Due Greater Than 30 Days		Nonaccrual TDRs	Total TDRs
Commercial, financial and agricultural	\$-	\$ 23	\$ 233	\$ 256
Real estate - commercial	156	-	-	156
	\$156	\$ 23	\$ 233	\$ 412

During the three months ended September 30, 2014, there were no loans identified as a TDR, and there were no defaults on any loans that were modified as TDRs during the preceding twelve months. During the three months ended September 30, 2013, there were no loans identified as a TDR, and there were no defaults on any loans that were modified as TDRs during the preceding twelve months. During the nine months ended September 30, 2014, there was one loan relationship with a pre-modification balance of \$1.2 million identified as a TDR through a modification of the original loan terms. The loan was paid off during the second quarter of 2014 and, therefore, is not reflected in the balance of TDRs at September 30, 2014. During the nine months ended September 30, 2014, there were no defaults on any loans that were modified as TDRs during the preceding twelve months. During the nine months ended September 30, 2013, one loan with a pre-modification balance of \$27,000 was identified as a TDR, and there were no defaults on any loans that were modified as TDRs during the preceding twelve months. For purposes of the determination of an allowance for loan losses on these TDRs, as an identified TDR, the Company considers a loss probable on the loan and, as a result is reviewed for specific impairment in accordance with the Company's allowance for loan loss methodology. If it is determined losses are probable on such TDRs, either because of delinquency or other credit quality indicator, the Company establishes specific reserves for these loans. As of September 30, 2014, there were no commitments to lend additional funds to debtors owing sums to the Company whose terms have been modified in TDRs.

## 4. Other Comprehensive Income (Loss)

The following is a summary of the tax effects allocated to each component of other comprehensive income (loss) (in thousands):

	Three Months Ended September 30,					
	2014		2013			
	Before Tax	Net of Tax Effect	Before Tax	Net of Tax	Before Tax	Net of Tax
Other comprehensive income (loss):						
Securities available-for-sale:						
Change in unrealized gain during period	\$ (405)	\$ 142	\$ (263 )	\$ (95 )	\$ 33	\$ (62 )
Reclassification adjustment for gains included in net income	-	-	-	(25 )	9	(16 )
Total other comprehensive income (loss)	\$ (405)	\$ 142	\$ (263 )	\$ (120)	\$ 42	\$ (78 )

	Nine Months Ended September 30,					
	2014		2013			
	Before Tax	Net of Tax Effect	Before Tax	Net of Tax	Before Tax	Net of Tax
Other comprehensive income (loss):						
Securities available-for-sale:						

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Change in unrealized gain during period	\$4,116	\$(1,441)	\$ 2,675	\$(10,203)	\$3,571	\$(6,632 )
Reclassification adjustment for gains included in net income	(128 )	45	(83 )	(229 )	80	(149 )
Total other comprehensive income (loss)	\$3,988	\$(1,396)	\$ 2,592	\$(10,432)	\$3,651	\$(6,781 )

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The reclassifications out of accumulated other comprehensive income into net income are presented below (in thousands):

	Three Months Ended September 30,	
	2014	2013
	Reclassifications	Reclassifications
	Out	Out
	of	of
	Accumulated	Accumulated
	Other	Other
Details about Accumulated Other Comprehensive Income Components	Comprehensive Statement Line Item	Comprehensive Statement Line Item
Unrealized gains and losses on securities available-for-sale:		
	\$- Gain on securities, net	\$(25) Gain on securities, net
	- Tax expense	9 Tax expense
	\$- Net of tax	\$(16) Net of tax

	Nine Months Ended September 30,	
	2014	2013
	Reclassifications	Reclassifications
	Out	Out
	of	of
	Accumulated	Accumulated
	Other	Other
Details about Accumulated Other Comprehensive Income Components	Comprehensive Statement Line Item	Comprehensive Statement Line Item
Unrealized gains and losses on securities available-for-sale:		
	\$(128) Gain on securities, net	\$(229) Gain on securities, net
	45 Tax expense	80 Tax expense
	\$(83 ) Net of tax	\$(149) Net of tax

5. Earnings Per Common Share

Following is a summary of the information used in the computation of earnings per common share (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net earnings available to common shareholders	\$4,298	\$3,072	\$14,922	\$9,479
Dividends on Series C preferred stock	94	100	284	300
Adjusted net earnings available to common shareholders	\$4,392	\$3,172	\$15,206	\$9,779
Weighted average number of common shares outstanding used in computation of basic earnings per common share	11,314	11,253	11,283	11,243
Effect of dilutive securities:				
Stock options	92	51	77	47
Convertible preferred stock	549	565	544	563
	11,955	11,869	11,904	11,853



Weighted average number of common shares outstanding plus effect of dilutive securities – used in computation of diluted earnings per share

Options to acquire 7,355 and 134,611 shares of common stock were not included in computing diluted earnings per share for the quarters ended September 30, 2014 and 2013, respectively, because the effects of these shares were anti-dilutive as a result of the exercise price of such options. Options to acquire 24,855 and 134,611 shares of common stock were not included in computing diluted earnings per share for the nine months ended September 30, 2014 and 2013, respectively, because the effects of these shares were anti-dilutive as a result of the exercise price of such options.

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## 6. Declaration of Dividends

A first quarter dividend of \$0.08 per share for holders of common stock of record on March 14, 2014 was declared on January 15, 2014, and was paid on April 1, 2014. On January 15, 2014, the Company also declared a 1.00% dividend for holders of its Series C preferred stock of record on April 1, 2014, which was paid on April 15, 2014. On May 21, 2014, the Company declared a second quarter dividend of \$0.09 per share for holders of common stock of record on June 13, 2014, and was paid on July 1, 2014. On May 21, 2014, the Company also declared a 1.00% dividend for holders of its Series C preferred stock of record on July 1, 2014, which was paid on July 15, 2014. On July 16, 2014, the Company declared a third quarter dividend of \$0.09 per share for holders of common stock of record on September 15, 2014 to be paid on October 1, 2014. On July 16, 2014, the Company also declared a 1.00% dividend for holders of its Series C preferred stock of record on October 1, 2014 to be paid on October 15, 2014.

## 7. Intangibles

A summary of core deposit intangible assets as of September 30, 2014 and December 31, 2013 is as follows (in thousands):

	September 30, 2014	December 31, 2013
Gross carrying amount	\$ 11,674	\$ 11,674
Less accumulated amortization	(4,563 )	(3,733 )
Net carrying amount	\$ 7,111	\$ 7,941

## 8. Fair Value Measurement

The Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1 – Valuation is based upon quoted prices for identical instruments traded in active markets.

Level 2 – Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 – Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

Following is a description of valuation methodologies used for assets and liabilities which are either recorded or disclosed at fair value.

Cash and Cash Equivalents—The carrying value of cash and cash equivalents is a reasonable estimate of fair value.

Securities Available-for-Sale—Securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange and U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter market funds. Securities

are classified as Level 2 within the valuation hierarchy when the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information, and the bond's terms and conditions, among other things. Level 2 inputs are used to value U.S. Agency securities, mortgage-backed securities, asset-backed securities, municipal securities, single issue trust preferred securities, certain pooled trust preferred securities, collateralized debt obligations and certain equity securities that are not actively traded.

**Securities Held-to-Maturity**—The fair value of securities held-to-maturity is estimated using the same measurement techniques as securities available-for-sale.

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Other Investments—The carrying value of other investments is a reasonable estimate of fair value.

Loans—For disclosure purposes, the fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings. For variable rate loans, the carrying amount is a reasonable estimate of fair value. The Company does not record loans at fair value on a recurring basis. No adjustment to fair value is taken related to illiquidity discounts. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management uses one of three methods to measure impairment, which, include collateral value, market value of similar debt, and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. Impaired loans where an allowance is established based on the fair value of collateral or where the loan balance has been charged down to fair value require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and adjusts the appraisal value by taking an additional discount for market conditions and there is no observable market price, the Company records the impaired loan as nonrecurring Level 3.

For non-performing loans, collateral valuations currently in file are reviewed for acceptability in terms of timeliness and applicability. Although each determination is made based on the facts and circumstances of each credit, generally valuations are no longer considered acceptable when there has been physical deterioration of the property from when it was last appraised, or there has been a significant change in the underlying assumptions of the appraisal. If the valuation is deemed to be unacceptable, a new appraisal is ordered. New appraisals are typically received within 4-6 weeks. While awaiting new appraisals, the valuation in the file is utilized, net of discounts. Discounts are derived from available relevant market data, selling costs, taxes, and insurance. Any perceived collateral deficiency utilizing the discounted value is specifically reserved (as required by ASC Topic 310) until the new appraisal is received or charged off. Thus, provisions or charge-offs are recognized in the period the credit is identified as non-performing.

The following sources are utilized to set appropriate discounts: in-market real estate agents, current local sales data, bank history for devaluation of similar property, Sheriff's valuations and buy/sell contracts. If a real estate agent is used to market and sell the property, values are discounted 10% for selling costs. Additional discounts may be applied if research from the above sources indicates a discount is appropriate given devaluation of similar property from the time of the initial valuation.

Other Real Estate—Other real estate (“ORE”) properties are adjusted to fair value upon transfer of the loans to other real estate, and annually thereafter to insure other real estate assets are carried at the lower of carrying value or fair value. Exceptions to obtaining initial appraisals are properties where a buy/sell agreement exists for the loan value or greater, or where a Sheriff's valuation has been received for properties liquidated through a Sheriff sale. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the ORE as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and adjusts the appraisal value by taking an additional discount for market conditions and there is no observable market prices, the Company records the ORE asset as nonrecurring Level 3.

Cash Surrender Value of Life Insurance Policies—Fair value for life insurance cash surrender value is based on cash surrender values indicated by the insurance companies.

Deposits—The fair value of demand deposits, savings accounts, NOW accounts, and money market deposits is the amount payable on demand at the reporting date. The fair value of fixed maturity certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities. The estimated fair value does not include customer related intangibles.

Securities Sold Under Agreements to Repurchase—The fair value approximates the carrying value of securities sold under agreements to repurchase due to their short-term nature.

Short-term Federal Home Loan Bank Advances—The fair value approximates the carrying value of short-term FHLB advances due to their short-term nature.

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Notes Payable—The fair value approximates the carrying value of short-term notes payable due to their short-term nature. The fair value of long-term notes payable is estimated using a discounted cash flow analysis that applies interest rates currently being offered on similar types of borrowings with similar terms.

Junior Subordinated Debentures—For junior subordinated debentures that bear interest on a floating basis, the carrying amount approximates fair value. For junior subordinated debentures that bear interest on a fixed rate basis, the fair value is estimated using a discounted cash flow analysis that applies interest rates currently being offered on similar types of borrowings.

Commitments to Extend Credit, Standby Letters of Credit and Credit Card Guarantees—Because commitments to extend credit and standby letters of credit are generally short-term and made using variable rates, the carrying value and estimated fair value associated with these instruments are immaterial.

## Assets Recorded at Fair Value

The table below presents information about certain assets and liabilities measured at fair value on a recurring basis (in thousands):

Description	Assets / Liabilities Measured at Fair Value at September 30, 2014	Fair Value Measurements at September 30, 2014		
		Level 1	Level 2	Level 3
Available-for-sale securities:				
U.S. Government sponsored enterprises	\$ 10,292	\$-	\$ 10,292	\$ -
Obligations of state and political subdivisions	49,847	-	49,847	-
GSE mortgage-backed securities	112,646	-	112,646	-
Collateralized mortgage obligations: residential	63,373	-	63,373	-
Collateralized mortgage obligations: commercial	25,994	-	25,994	-
Other asset-backed securities	24,817	-	24,817	-
Collateralized debt obligation	1,428	-	1,428	-
Description	Assets / Liabilities Measured at Fair Value at December 31, 2013	Fair Value Measurements at December 31, 2013		
		Level 1	Level 2	Level 3
Available-for-sale securities:				
U.S. Government sponsored enterprises	\$ 11,265	\$-	\$ 11,265	\$ -
Obligations of state and political subdivisions	59,978	-	59,978	-
GSE mortgage-backed securities	145,965	-	145,965	-
Collateralized mortgage obligations: residential	70,887	-	70,887	-
Collateralized mortgage obligations: commercial	27,346	-	27,346	-
Other asset-backed securities	25,489	-	25,489	-

Collateralized debt obligation	735	-	735	-
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Certain assets and liabilities are measured at fair value on a nonrecurring basis and are included in the table below (in thousands). Impaired loans are Level 2 assets measured using appraisals from external parties of the collateral less any prior liens. Other real estate properties are also Level 2 assets measured using appraisals from external parties.

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Description	Assets / Liabilities Measured at Fair Value at September 30, 2014	Fair Value Measurements at September 30, 2014		
		Level 1	Level 2	Level 3
Impaired loans	\$ 2,529	\$-	\$2,529	\$ -
Other real estate	4,663	-	4,663	-

Description	Assets / Liabilities Measured at Fair Value at December 31, 2013	Fair Value Measurements at December 31, 2013		
		Level 1	Level 2	Level 3
Impaired loans	\$ 1,973	\$-	\$1,973	\$ -
Other real estate	6,687	-	6,687	-

**Limitations**

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

Fair value estimates are based on existing on and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial instruments include deferred income taxes and premises and equipment. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates. The carrying amounts and estimated fair values of the Company's financial instruments are as follows at September 30, 2014 and December 31, 2013 (in thousands):

Carrying	Fair Value Measurements at September 30, 2014 Using:		
	Level 1	Level 2	Level 3



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	Value			
Financial assets:				
Cash and cash equivalents	\$54,215	\$54,215	\$-	\$-
Securities available-for-sale	288,397	-	288,397	-
Securities held-to-maturity	145,030	-	144,597	-
Other investments	12,091	12,091	-	-
Loans, net	1,238,948	-	-	1,247,751
Cash surrender value of life insurance policies	13,565	-	13,565	-
Financial liabilities:				
Non-interest-bearing deposits	396,263	-	396,263	-
Interest-bearing deposits	1,124,581	-	909,014	215,623
Securities sold under agreements to repurchase	70,964	70,964	-	-
Short-term Federal Home Loan Bank advances	35,000	-	35,000	-
Notes payable	26,384	-	-	27,297
Junior subordinated debentures	22,167	-	22,167	-

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	Carrying Value	Fair Value Measurements at December 31, 2013 Using:		
		Level 1	Level 2	Level 3
Financial assets:				
Cash and cash equivalents	\$59,731	\$59,731	\$-	\$-
Securities available-for-sale	341,665	-	341,665	-
Securities held-to-maturity	155,523	-	151,168	-
Other investments	11,526	11,526	-	-
Loans, net	1,128,775	-	-	1,139,740
Cash surrender value of life insurance policies	13,450	-	13,450	-
Financial liabilities:				
Non-interest-bearing deposits	383,257	-	383,257	-
Interest-bearing deposits	1,135,546	-	895,346	241,359
Securities sold under agreements to repurchase	53,916	53,916	-	-
Short-term Federal Home Loan Bank advances	25,000	-	25,000	-
Notes payable	27,703	-	-	28,813
Junior subordinated debentures	29,384	-	22,167	7,776

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

MidSouth Bancorp, Inc. (the "Company") is a financial holding company headquartered in Lafayette, Louisiana that conducts substantially all of its business through its wholly owned subsidiary bank, MidSouth Bank, N.A. (the "Bank"). We offer complete banking services to commercial and retail customers in Louisiana and south and central Texas with 58 locations and are connected to a worldwide ATM network that provides customers with access to more than 55,000 surcharge-free ATMs. We are community oriented and focus primarily on offering commercial and consumer loan and deposit services to individuals, small businesses, and middle market businesses.

The following discussion and analysis identifies significant factors that have affected our financial position and operating results during the periods included in the financial statements accompanying this report. We encourage you to read this discussion in conjunction with our consolidated financial statements and the notes thereto presented herein and with the financial statements, the notes thereto, and related Management's Discussion and Analysis of Financial Condition and Results of Operation in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

Forward-Looking Statements

Certain statements included in this Report, other than statements of historical fact, are forward-looking statements (as such term is defined in Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and the regulations thereunder), which are intended to be covered by the safe harbors created thereby. Forward-looking statements include, but are not limited to certain statements under the captions "Business," "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations."

The words "anticipate," "believe," "estimate," "expect," "intend," "may," "plan," "will," "would," "could," "should," "guidance," "continue," "project," "forecast," "confident," and similar expressions are typically used to identify forward-looking statements. These statements are based on assumptions and assessments made by management in light of their experience and their perception of historical trends, current conditions, expected future developments and other factors they believe to be appropriate. Any forward-looking statements are not guarantees of our future performance and are subject to risks and uncertainties and may be affected by various factors that may cause actual results, developments and business decisions to differ materially from those in the forward-looking statements. Some of the factors that may cause actual results, developments and business decisions to differ materially from those contemplated by such forward-looking statements include the factors discussed under the caption "Risk Factors" in our 2013 Annual Report on form 10-K and under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" in this Report and the following:

- changes in interest rates and market prices that could affect the net interest margin, asset valuation, and expense levels;
- changes in local economic and business conditions, including, without limitation, changes related to the oil and gas industries, that could adversely affect customers and their ability to repay borrowings under agreed upon terms, adversely affect the value of the underlying collateral related to their borrowings, and reduce demand for loans;
- increased competition for deposits and loans which could affect compositions, rates and terms;
  - changes in the levels of prepayments received on loans and investment securities that adversely affect the yield and value of the earning assets;
- a deviation in actual experience from the underlying assumptions used to determine and establish our allowance for loan losses ("ALL"), which could result in greater than expected loan losses;
- changes in the availability of funds resulting from reduced liquidity or increased costs;
- the timing, ability to complete and the impact of proposed and/or future acquisitions, the success or failure of integrating acquired operations, and the ability to capitalize on growth opportunities upon entering new markets;

- the timing, ability to complete and the impact of proposed and/or future efficiency initiatives;
- the ability to acquire, operate, and maintain effective and efficient operating systems;
- increased asset levels and changes in the composition of assets that would impact capital levels and regulatory capital ratios;
- loss of critical personnel and the challenge of hiring qualified personnel at reasonable compensation levels;

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legislative and regulatory changes, including the changes in the regulatory capital framework under the Federal Reserve Board's Basel III regulatory capital reforms, the impact of regulations under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), including the implementation of the Consumer Financial Protection Bureau, and other changes in banking, securities and tax laws and regulations and their application by our regulators, changes in the scope and cost of Federal Deposit Insurance Corporation ("FDIC") insurance and other coverage;

regulations and restrictions resulting from our participation in government sponsored programs such as the U.S. Treasury's Small Business Lending Fund, including potential retroactive changes in such programs;

changes in accounting principles, policies, and guidelines applicable to financial holding companies and banking;

acts of war, terrorism, cyber intrusion, weather, or other catastrophic events beyond our control; and

the ability to manage the risks involved in the foregoing.

We can give no assurance that any of the events anticipated by the forward-looking statements will occur or, if any of them does, what impact they will have on our results of operations and financial condition. We disclaim any intent or obligation to publicly update or revise any forward-looking statements, regardless of whether new information becomes available, future developments occur or otherwise.

## Critical Accounting Policies

Certain critical accounting policies affect the more significant judgments and estimates used in the preparation of the consolidated financial statements. Our significant accounting policies are described in the notes to the consolidated financial statements included in this report. The accounting principles we follow and the methods of applying these principles conform to accounting principles generally accepted in the United States of America ("GAAP") and general banking practices. Our most critical accounting policy relates to the determination of the allowance for loan losses, which reflects the estimated losses resulting from the inability of its borrowers to make loan payments. The determination of the adequacy of the allowance involves significant judgment and complexity and is based on many factors. If the financial condition of our borrowers were to deteriorate, resulting in an impairment of their ability to make payments, the estimates would be updated and additional provisions for loan losses may be required. See Asset Quality – Nonperforming Assets and Allowance for Loan Losses and Note 1 and Note 3 of the footnotes to the consolidated financial statements.

Another of our critical accounting policies relates to the valuation of goodwill, intangible assets and other purchase accounting adjustments. We account for acquisitions in accordance with ASC Topic No. 805, which requires the use of the purchase method of accounting. Under this method, we are required to record assets acquired and liabilities assumed at their fair value, including intangible assets. Determination of fair value involves estimates based on internal valuations of discounted cash flow analyses performed, third party valuations, or other valuation techniques that involve subjective assumptions. Additionally, the term of the useful lives and appropriate amortization periods of intangible assets is subjective. Resulting goodwill from an acquisition under the purchase method of accounting represents the excess of the purchase price over the fair value of net assets acquired. Goodwill is not amortized, but is evaluated for impairment annually or more frequently if deemed necessary. If the fair value of an asset exceeds the carrying amount of the asset, no charge to goodwill is made. If the carrying amount exceeds the fair value of the asset, goodwill will be adjusted through a charge to earnings. Given the instability of the economic environment, it is reasonably possible that the methodology of the assessment of potential loan losses and goodwill impairment could change in the near-term or could result in impairment going forward.

A third critical accounting policy relates to deferred tax assets and liabilities. We record deferred tax assets and deferred tax liabilities for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Future tax benefits, such as net operating loss carry forwards, are recognized to the extent that realization of such benefits is more likely than not. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which

the assets and liabilities are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income tax expense in the period that includes the enactment date. In the event the future tax consequences of differences between the financial reporting bases and the tax bases of our assets and liabilities results in deferred tax assets, an evaluation of the probability of being able to realize the future benefits indicated by such assets is required. A valuation allowance is provided when it is more likely than not that a portion or the full amount of the deferred tax asset will not be realized. In assessing the ability to realize the deferred tax assets, management considers the scheduled reversals of deferred tax liabilities, projected future taxable income, and tax planning strategies. A deferred tax liability is not recognized for portions of the allowance for loan losses for income tax purposes in excess of the financial statement balance. Such a deferred tax liability will only be recognized when it becomes apparent that those temporary differences will reverse in the foreseeable future. A tax position is recognized as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% more likely of being realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded.

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Results of Operations

Earnings Analysis

We reported net earnings available to common shareholders of \$4.3 million for the third quarter of 2014, compared to net earnings available to common shareholders of \$3.1 million reported for the third quarter of 2013. Diluted earnings for the third quarter of 2014 were \$0.37 per common share, compared to \$0.27 per common share reported for the third quarter of 2013.

Revenues from consolidated operations increased \$1.6 million in quarterly comparison. Net interest income increased \$441,000 in quarterly comparison, from \$19.1 million for the third quarter of 2013 to \$19.5 million for the third quarter of 2014. Decreases of \$342,000 in loan valuation income and \$339,000 in interest income on investment securities were offset primarily by a \$963,000 increase in interest income earned on a higher volume of loans. Noninterest income increased \$1.2 million in quarterly comparison, from \$5.0 million for the three months ended September 30, 2013 to \$6.2 million for the three months ended September 30, 2014. The increase in noninterest income resulted primarily from a \$1.1 million gain on the sale of a commercial property held as ORE. Additionally, increases of \$204,000 in service charges on deposit accounts, \$89,000 in ATM/debit card income, and \$52,000 in mortgage lending fees were partially offset by decreases in other noninterest income, including a \$159,000 decrease in third party investment advisory income.

Noninterest expenses decreased \$624,000 for the third quarter 2014 compared to third quarter 2013 despite non-operating charges which included a \$258,000 charge on the TRUPS redemption, \$394,000 of losses on disposal of fixed assets, and \$200,000 of efficiency consultant expenses. Excluding these non-operating expenses, third quarter 2014 noninterest expenses decreased \$1.5 million compared to third quarter 2013 and primarily consisted of decreases of \$353,000 in salaries and benefits costs, \$343,000 in marketing expenses, \$166,000 in expenses on ORE and other repossessed assets, and \$119,000 in courier expense, combined with decreases in several other noninterest expense categories. The provision for loan losses increased \$725,000, primarily due to an increase in charged-off loans, net of recoveries for the third quarter of 2014. Income tax expense increased \$614,000 in quarterly comparison as a result of the improvement in earnings.

Dividends paid on the Series B Preferred Stock issued to the Treasury as a result of our participation in the Small Business Lending Fund ("SBLF") totaled \$80,000 for the third quarter of 2014 based on a dividend rate of 1.00%. The dividend rate is set at 1.00% through February 25, 2016. The Series C Preferred Stock issued with the December 28, 2012 acquisition of PSB Financial Corporation ("PSB") paid dividends totaling \$94,000 for the three months ended September 30, 2014.

In year-over-year comparison, net earnings available to common shareholders totaled \$14.9 million at September 30, 2014, an increase of \$5.4 million compared to \$9.5 million at September 30, 2013. The \$5.4 million included the \$1.1 million gain on sale of ORE and \$3.0 million of executive life insurance proceeds following the unexpected passing of former Vice Chairman and Chief Operating Officer Jerry Reaux in February 2014. Excluding these non-operating income items, increases in noninterest income consisted primarily of \$591,000 in service charges on deposit accounts and \$662,000 in ATM and debit card income. Net interest income remained relatively flat year-over-year due to a \$2.7 million decrease in purchase accounting adjustments. Noninterest expense decreased \$1.5 million primarily due to decreases of \$678,000 in marketing expenses, \$356,000 in the cost of printing and supplies, \$278,000 in courier expense, \$259,000 in corporate development, travel and training costs, and \$159,000 in check fraud losses. The decreased expenses were partially offset by a \$498,000 increase in ATM/debit card expense and an increase of \$187,000 in salaries and benefit costs, primarily due to an increase in group health insurance expense.

A reduction in the dividend rate paid on the Series B preferred stock issued in connection with SBLF resulted in a \$628,000 decrease in dividends on preferred stock in year-over-year comparison, resulting in a positive impact on net

earnings available to common shareholders.

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Although there were a number of non-operating income and expense items during the three and nine months ended September 30, 2014, our underlying operating earnings per share continued to show significant progress, with growth in core revenues, stable core margins and good expense control. Our focus on efficiency improvements is transitioning from internally generated projects to a second phase of working with experienced industry consultants to further enhance our productivity. Implementation of recommendations resulting from the process will be on-going throughout 2014 and 2015.

### Other Events

On October 31, 2014, we closed two banking centers, bringing the total to three centers closed during 2014. Customers will continue to have access to an ATM at the two locations and full service access at our 58 MidSouth banking centers.

### Net Interest Income

Our primary source of earnings is net interest income, which is the difference between interest earned on loans and investments and interest paid on deposits and other interest-bearing liabilities. Changes in the volume and mix of earning assets and interest-bearing liabilities combined with changes in market rates of interest greatly affect net interest income. Our net interest margin on a taxable equivalent basis, which is net interest income as a percentage of average earning assets, was 4.61% and 4.60% for the three months ended September 30, 2014 and 2013, respectively. Tables 1 and 3 and tables 2 and 4 below analyze the changes in net interest income in the three months ended September 30, 2014 and 2013 and the nine months ended September 30, 2014 and 2013, respectively.

Fully taxable-equivalent (“FTE”) net interest income totaled \$19.9 million and \$19.5 million for the quarters ended September 30, 2014 and 2013, respectively. The FTE net interest income increased \$370,000 in prior year quarterly comparison primarily due to a \$621,000 increase in interest income on loans despite a \$342,000 reduction in purchase accounting adjustments on acquired loans. The increased interest income on loans resulted from a \$109.1 million increase in the average volume of loans in quarterly comparison. The average yield on loans decreased 36 basis points, from 6.24% to 5.88%. The purchase accounting adjustments added 22 basis points to the average yield on loans for the third quarter of 2014 and 39 basis points to the average yield on loans for the third quarter of 2013. Net of the impact of the purchase accounting adjustments, average loan yields declined 19 basis points in prior year quarterly comparison, from 5.85% to 5.66%. Loan yields have declined primarily as the result of a sustained low interest rate environment.

Investment securities totaled \$433.4 million, or 22.9% of total assets at September 30, 2014, versus \$517.8 million, or 27.8% of total assets at September 30, 2013. The investment portfolio had an effective duration of 2.9 years and a net unrealized gain of \$3.8 million at September 30, 2014. The average volume of investment securities decreased \$82.0 million in prior year quarterly comparison. The average tax equivalent yield on investment securities increased 11 basis points, from 2.59% to 2.70%. The \$82.0 million decrease in the average volume of investment securities was used to fund loan growth during the same period.

The average yield on all earning assets decreased 3 basis points in prior year quarterly comparison, from 4.99% for the third quarter of 2013 to 4.96% for the third quarter of 2014. Net of the impact of purchase accounting adjustments, the average yield on total earning assets increased 6 basis points, from 4.74% to 4.80% for the three month periods ended September 30, 2013 and 2014, respectively, due to a favorable shift in earning assets from investment securities to loans.

The impact to interest expense of a \$4.2 million increase in the average volume of interest-bearing liabilities was offset by a 5 basis point decrease in the average rate paid on interest-bearing liabilities, from 0.51% at September 30, 2013 to 0.46% at September 30, 2014. Net of purchase accounting adjustments on acquired certificates of deposit and

FHLB borrowings, the average rate paid on interest-bearing liabilities was 0.58% for the third quarter of 2013 and declined to 0.51% for the third quarter of 2014.

The notes payable average volume of \$26.6 million consists of FHLB advances and a note payable with First National Bankers Bank. The FHLB advances are fixed rate advances with rates ranging from 1.99% to 5.06% and have a range of maturities from October 2014 to January 2019. The FHLB advances are collateralized by a blanket lien on first mortgages and other qualifying loans. The remaining balance on the note payable with First National Bankers Bank in the amount of \$500,000 was paid off in the third quarter of 2014. The interest rate on the note was equal to New York Prime. Short-term FHLB advances totaled \$35.0 million at September 30, 2014. The rate on these short-term advances range from 0.15% to 0.17%, and they mature in November 2014 and December 2014. The short-term advances partially funded the loan growth we experienced in the nine months ended September 30, 2014.

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We redeemed in full the \$7.2 million fixed rate junior subordinated debentures carrying a 10.20% interest rate on August 22, 2014. In the fourth quarter of 2014, the average yield on the junior subordinated debentures will reflect a full quarter's impact of the payoff of the higher yield fixed rate debenture. The variable rate debentures carry a floating rate tied to the 3-month LIBOR with added rate variances ranging from plus 170 basis points to plus 330 basis points, adjustable and payable quarterly.

As a result of these changes in volume and yield on earning assets and interest bearing liabilities, the FTE net interest margin increased 1 basis point, from 4.60% for the third quarter of 2013 to 4.61% for the third quarter of 2014. Net of purchase accounting adjustments on loans, deposits and FHLB borrowings, the FTE margin increased 12 basis points, from 4.30% for the third quarter of 2013 to 4.42% for the third quarter of 2014.

In year-to-date comparison, FTE net interest income remained relatively flat due to a \$2.7 million decrease in purchase accounting adjustments. Of the \$2.7 million, a \$2.4 million decrease impacted interest income on loans for the nine months ended September 30, 2014 and resulted in a decrease in the average yield on loans, from 6.54% at September 30, 2013 to 5.99% at September 30, 2014. The average yield on earning assets decreased in year-to-date comparison, from 5.11% at September 30, 2013 to 4.97% at September 30, 2014. The purchase accounting adjustments added 64 basis points to the average yield on loans for the first nine months of 2013 and 29 basis points for the first nine months of 2014. Net of purchase accounting adjustments, the average yield on earning assets increased 7 basis points, from 4.70% at September 30, 2013 to 4.77% at September 30, 2014.

Interest expense decreased \$474,000 in year-over-year comparison primarily due to a decrease in the average rate paid on interest-bearing liabilities. The average rate paid on interest-bearing liabilities decreased 6 basis points, from 0.53% at September 30, 2013 to 0.47% at September 30, 2014. Net of purchase accounting adjustments, the average rate paid on interest-bearing liabilities decreased 10 basis points, from 0.62% at September 30, 2013 to 0.52% at September 30, 2014. The FTE net interest margin decreased 9 basis points, from 4.71% for the nine months ended September 30, 2013 to 4.62% for the nine months ended September 30, 2014. Net of purchase accounting adjustments, the FTE net interest margin increased 14 basis points, from 4.24% to 4.38% for the nine months ended September 30, 2013 and 2014, respectively, due to a favorable shift in earning assets from investment securities to loans.

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## Table 1

## Consolidated Average Balances, Interest and Rates

(in thousands)

	Three Months Ended September 30,						Average Yield/Rate		
	2014			2013					
	Average Volume	Interest	Average Yield/Rate		Average Volume	Interest			
<b>Assets</b>									
<b>Investment securities<sup>1</sup></b>									
Taxable	\$351,645	\$1,965	2.24	%	\$418,964	\$2,171	2.07	%	
Tax exempt <sup>2</sup>	86,528	996	4.60	%	101,226	1,200	4.74	%	
Total investment securities	438,173	2,961	2.70	%	520,190	3,371	2.59	%	
Federal funds sold	3,143	2	0.25	%	2,180	1	0.18	%	
<b>Time and interest bearing deposits in other banks</b>									
	22,922	15	0.26	%	22,519	15	0.26	%	
Other investments	12,090	109	3.61	%	10,948	80	2.92	%	
Total loans <sup>3</sup>	1,232,196	18,273	5.88	%	1,123,086	17,652	6.24	%	
Total earning assets	1,708,524	21,360	4.96	%	1,678,923	21,119	4.99	%	
Allowance for loan losses	(8,978 )				(8,479 )				
Nonearning assets	193,063				192,646				
Total assets	\$1,892,609				\$1,863,090				
<b>Liabilities and shareholders' equity</b>									
Total interest bearing deposits	\$1,132,132	\$859	0.30	%	\$1,133,126	\$976	0.34	%	
Securities sold under repurchase agreements	70,587	210	1.18	%	64,274	204	1.26	%	
Federal funds purchased	70	-	-		354	-	-		
Short-term FHLB advances	28,913	13	0.18	%	25,000	11	0.17	%	
Notes payable	26,640	95	1.40	%	28,301	107	1.48	%	
Junior subordinated debentures	26,247	327	4.88	%	29,384	335	4.46	%	
Total interest bearing liabilities	1,284,589	1,504	0.46	%	1,280,439	1,633	0.51	%	