

COMMUNITY FINANCIAL CORP /MD/
Form 10-Q
November 07, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x 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 0-18279

The Community Financial Corporation

(Exact name of registrant as specified in its charter)

Maryland

52-1652138

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(State of other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

3035 Leonardtown Road, Waldorf, Maryland 20601
(Address of principal executive offices) (Zip Code)

(301) 645-5601

(Registrant's telephone number, including area code)

Not applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities 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 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 the definitions of "large accelerated filer," "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
(Do not check if a smaller reporting company)

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

Yes No

As of October 30, 2014, the registrant had 4,688,579 shares of common stock outstanding.

THE COMMUNITY FINANCIAL CORPORATION

FORM 10-Q

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PART 1 - FINANCIAL INFORMATION**ITEM 1 – FINANCIAL STATEMENTS****CONSOLIDATED BALANCE SHEETS**

(dollars in thousands)	September 30, 2014 (Unaudited)	December 31, 2013
Assets		
Cash and due from banks	\$ 10,631	\$ 11,408
Federal funds sold	2,110	8,275
Interest-bearing deposits with banks	326	4,836
Securities available for sale (AFS), at fair value	43,378	48,247
Securities held to maturity (HTM), at amortized cost	76,851	86,401
Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) stock - at cost	6,435	5,593
Loans receivable - net of allowance for loan losses of \$8,273 and \$8,138	836,980	799,130
Premises and equipment, net	20,383	19,543
Other real estate owned (OREO)	6,334	6,797
Accrued interest receivable	3,051	2,974
Investment in bank owned life insurance	26,813	19,350
Other assets	9,189	11,270
Total Assets	\$ 1,042,481	\$ 1,023,824
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Non-interest-bearing deposits	\$ 101,233	\$ 103,882
Interest-bearing deposits	728,587	717,413
Total deposits	829,820	821,295
Short-term borrowings	2,000	-
Long-term debt	74,686	70,476
Guaranteed preferred beneficial interest in junior subordinated debentures (TRUPs)	12,000	12,000
Accrued expenses and other liabilities	9,210	9,323
Total Liabilities	927,716	913,094
Stockholders' Equity		
Preferred Stock, Senior Non-Cumulative Perpetual, Series C - par value \$1,000; authorized 20,000; issued 20,000	20,000	20,000
	47	46

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Common stock - par value \$.01; authorized - 15,000,000 shares; issued 4,688,152 and 4,647,407 shares, respectively			
Additional paid in capital	46,215		45,881
Retained earnings	49,909		46,523
Accumulated other comprehensive loss	(743)	(1,057
Unearned ESOP shares	(663)	(663
Total Stockholders' Equity	114,765		110,730
Total Liabilities and Stockholders' Equity	\$ 1,042,481		\$ 1,023,824

See notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

(dollars in thousands, except per share amounts)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Interest and Dividend Income				
Loans, including fees	\$ 10,114	\$ 9,340	\$ 29,382	\$ 27,704
Taxable interest and dividends on investment securities	550	632	1,705	1,853
Interest on deposits with banks	3	3	9	8
Total Interest and Dividend Income	10,667	9,975	31,096	29,565
Interest Expense				
Deposits	1,135	1,336	3,502	4,332
Short-term borrowings	3	4	10	13
Long-term debt	525	533	1,576	1,569
Total Interest Expense	1,663	1,873	5,088	5,914
Net Interest Income	9,004	8,102	26,008	23,651
Provision for loan losses	385	285	1,151	640
Net Interest Income After Provision For Loan Losses	8,619	7,817	24,857	23,011
Noninterest Income				
Loan appraisal, credit, and miscellaneous charges	143	56	335	375
Gain on sale of asset	-	-	7	11
Net gains on sale of OREO	56	215	60	215
Net gains on sale of investment securities	-	-	24	-
Income from bank owned life insurance	160	157	463	465
Service charges	555	661	1,631	1,764
Gain on sale of loans held for sale	204	30	348	547
Total Noninterest Income	1,118	1,119	2,868	3,377
Noninterest Expense				
Salary and employee benefits	3,939	3,737	11,960	10,884
Occupancy expense	568	505	1,787	1,557
Advertising	157	118	480	391
Data processing expense	475	237	1,127	967
Professional fees	249	293	767	755
Depreciation of furniture, fixtures, and equipment	181	191	548	581
Telephone communications	41	46	132	149
Office supplies	12	42	166	151
FDIC Insurance	204	285	542	859
Valuation allowance on OREO	-	171	234	501
Other	659	621	1,840	1,700
Total Noninterest Expense	6,485	6,246	19,583	18,495

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Income before income taxes	3,252	2,690	8,142	7,893
Income tax expense	1,363	987	3,197	2,886
Net Income	\$ 1,889	\$ 1,703	\$ 4,945	\$ 5,007
Preferred stock dividends	50	50	150	150
Net Income Available to Common Shareholders	\$ 1,839	\$ 1,653	\$ 4,795	\$ 4,857
Earnings Per Common Share				
Basic	\$ 0.40	\$ 0.55	\$ 1.03	\$ 1.61
Diluted	\$ 0.39	\$ 0.55	\$ 1.03	\$ 1.60
Cash dividends paid per common share	\$ 0.10	\$ 0.10	\$ 0.30	\$ 0.30

See notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

(dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net Income	\$ 1,889	\$ 1,703	\$ 4,945	\$ 5,007
Net unrealized holding gains (losses) arising during period, net of tax expense (benefit) of \$(23) and \$(119); \$64 and \$(541), respectively	152	(231)	319	(1,050)
Reclassification adjustment for gains included in net income, net of tax expense (benefit) of \$0 and \$0; \$(3) and \$0, respectively	-	-	(5)	-
Comprehensive Income	\$ 2,041	\$ 1,472	\$ 5,259	\$ 3,957

See notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(dollars in thousands)	Nine Months Ended September 30,	
	2014	2013
Cash Flows from Operating Activities		
Net income	\$ 4,945	\$ 5,007
Adjustments to reconcile net income to net cash provided by operating activities		
Provision for loan losses	1,151	640
Depreciation and amortization	954	965
Loans originated for resale	(9,648)	(20,904)
Proceeds from sale of loans originated for sale	9,936	21,326
Gain on sale of loans held for sale	(348)	(547)
Net gains on the sale of OREO	(60)	(215)
Gains on sales of HTM investment securities	(16)	-
Gains on sales of AFS investment securities	(8)	-
Gain on sale of asset	(7)	(11)
Net amortization of premium/discount on investment securities	245	441
Increase in OREO valuation allowance	234	501
Increase in cash surrender of bank owned life insurance	(463)	(465)
Increase in deferred income tax benefit	(378)	(128)
(Increase) Decrease in accrued interest receivable	(77)	54
Stock based compensation	147	159
Increase in deferred loan fees	166	215
Decrease in accrued expenses and other liabilities	(113)	(455)
Decrease (Increase) in other assets	2,470	(75)
Net Cash Provided by Operating Activities	9,130	6,508
Cash Flows from Investing Activities		
Purchase of AFS investment securities	(3,229)	(13,487)
Proceeds from redemption or principal payments of AFS investment securities	6,307	8,092
Purchase of HTM investment securities	(4,580)	(11,683)
Proceeds from maturities or principal payments of HTM investment securities	10,840	32,652
Net increase of FHLB and FRB stock	(843)	(117)
Purchase of bank owned life insurance policies	(7,000)	-
Loans originated or acquired	(188,276)	(182,200)
Principal collected on loans	147,577	168,063
Purchase of premises and equipment	(1,807)	(455)
Proceeds from sale of OREO	1,878	713
Proceeds from sale of HTM investment securities	3,179	-
Proceeds from sale of AFS investment securities	2,056	-
Proceeds from disposal of asset	20	11
Net Cash (Used in) Provided by Investing Activities	(33,878)	1,589

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)**(continued)**

(dollars in thousands)	Nine Months Ended September 30,	
	2014	2013
Cash Flows from Financing Activities		
Net increase (decrease) in deposits	\$ 8,525	\$ (2,983)
Proceeds from long-term debt	5,000	10,000
Payments of long-term debt	(790)	(38)
Net increase in short term borrowings	2,000	1,640
Exercise of stock options	106	125
Dividends Paid	(1,545)	(1,064)
Net change in unearned ESOP shares	-	127
Repurchase of common stock	-	(303)
Net Cash Provided by Financing Activities	13,296	7,504
(Decrease) Increase in Cash and Cash Equivalents	\$ (11,452)	\$ 15,601
Cash and Cash Equivalents - January 1	24,519	11,296
Cash and Cash Equivalents - September 30	\$ 13,067	\$ 26,897
Supplemental Disclosures of Cash Flow Information		
Cash paid during the period for		
Interest	\$ 5,066	\$ 5,857
Income taxes	\$ 2,659	\$ 3,165
Supplemental Schedule of Non-Cash Operating Activities		
Issuance of common stock for payment of compensation	\$ 182	\$ 249
Transfer from loans to OREO	\$ 1,590	\$ 1,390

See notes to Consolidated Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

NOTE 1 – BASIS OF PRESENTATION

General - The consolidated financial statements of The Community Financial Corporation (the “Company”) and its wholly owned subsidiary, Community Bank of the Chesapeake (the “Bank”), and the Bank’s wholly owned subsidiary, Community Mortgage Corporation of Tri-County, included herein are unaudited. The Bank conducts business through its main office in Waldorf, Maryland, and eleven branch offices in Waldorf, Bryans Road, Dunkirk, Leonardtown, La Plata, Charlotte Hall, Prince Frederick, Lusby, California, Maryland; and King George and Fredericksburg, Virginia. The Company opened a branch in Fredericksburg, Virginia on July 15, 2014. The Company maintains four loan production offices (“LPOs”) in La Plata, Prince Frederick and Leonardtown, Maryland; and Fredericksburg, Virginia. The Leonardtown and Fredericksburg LPOs are co-located with branches. The Bank opened its fifth LPO in Annapolis, Maryland in early October 2014.

Effective October 18, 2013, the Company changed its name from Tri-County Financial Corporation and the Bank changed its name from Community Bank of Tri-County. The new names reflect the Bank's recent expansion into the Northern Neck of Virginia. The name of the holding company changed to better align the parent company name with that of the Bank.

The consolidated financial statements reflect all adjustments consisting only of normal recurring accruals that, in the opinion of management, are necessary to present fairly the Company’s financial condition, results of operations, and cash flows for the periods presented. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. The Company believes that the disclosures are adequate to make the information presented not misleading. The balances as of December 31, 2013 have been derived from audited financial statements. There have been no significant changes to the Company’s accounting policies as disclosed in the 2013 Annual Report. The results of operations for the three and nine months ended September 30, 2014 are not necessarily indicative of the results of operations to be expected for the remainder of the year or any other period. Certain previously reported amounts have been restated to conform to the 2014 presentation.

These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the Company’s 2013 Annual Report.

In October 2013, the Company completed a stock offering and issued 1,591,300 shares of common stock at a price of \$18.75 per share resulting in net proceeds of \$27.4 million after commissions and related offering expenses.

NOTE 2 – NATURE OF BUSINESS

The Company provides a variety of financial services to individuals and businesses through its offices in Southern Maryland and King George and Fredericksburg, Virginia. Its primary deposit products are demand, savings and time deposits, and its primary lending products are commercial and residential mortgage loans, commercial loans, construction and land development loans, home equity and second mortgages and commercial equipment loans.

NOTE 3 – INCOME TAXES

The Company files a consolidated federal income tax return with its subsidiaries. Deferred tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws and when it is considered more likely than not that deferred tax assets will be realized. It is the Company's policy to recognize accrued interest and penalties related to unrecognized tax benefits as a component of tax expense. The Company's income tax returns for the past three years are subject to examinations by tax authorities, and may change upon examination.

NOTE 4 - ACCUMULATED OTHER COMPREHENSIVE GAIN (LOSS)

The following tables present the components of comprehensive gain (loss) for the three and nine months ended September 30, 2014 and 2013. The Company's comprehensive gain (loss) was solely related to securities for the three and nine months ended September 30, 2014 and 2013.

(dollars in thousands)	Three Months Ended September 30, 2014			Three Months Ended September 30, 2013		
	Before Tax	Tax Effect	Net of Tax	Before Tax	Tax Effect	Net of Tax
Net unrealized holding gains (losses) arising during period	\$ 129	\$ (23)	\$ 152	\$ (350)	\$ (119)	\$ (231)
Reclassification adjustments	-	-	-	-	-	-
Other comprehensive gain (loss)	\$ 129	\$ (23)	\$ 152	\$ (350)	\$ (119)	\$ (231)

(dollars in thousands)	Nine Months Ended September 30, 2014			Nine Months Ended September 30, 2013		
	Before Tax	Tax Effect	Net of Tax	Before Tax	Tax Effect	Net of Tax
Net unrealized holding gains (losses) arising during period	\$ 383	\$ 64	\$ 319	\$ (1,591)	\$ (541)	\$ (1,050)
Reclassification adjustments	(8)	(3)	(5)	-	-	-
Other comprehensive gain (loss)	\$ 375	\$ 61	\$ 314	\$ (1,591)	\$ (541)	\$ (1,050)

The following table presents the changes in each component of accumulated other comprehensive loss, net of tax, for the three and nine months ended September 30, 2014 and 2013.

(dollars in thousands)	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013
	Net Unrealized Gains And Losses	Net Unrealized Gains And Losses	Net Unrealized Gains And Losses	Net Unrealized Gains And Losses
Beginning of period	\$ (895)	\$ (680)	\$ (1,057)	\$ 139
Other comprehensive gain (loss) before reclassifications	152	(231)	319	(1,050)
Amounts reclassified from accumulated other comprehensive income	-	-	(5)	-

Net other comprehensive gain (loss)	152	(231)	314	(1,050)
End of period	\$ (743)	\$ (911)	\$ (743)
				\$ (911)	

NOTE 5 - EARNINGS PER SHARE (“EPS”)

Basic earnings per common share represent income available to common shareholders, divided by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate to outstanding stock options and are determined using the treasury stock method. As of September 30, 2014 and 2013, there were 87,435 and 101,549 options, respectively, which were excluded from the calculation as their effect would be anti-dilutive, because the exercise price of the options were greater than the average market price of the common shares.

Basic and diluted earnings per share have been computed based on weighted-average common and common equivalent shares outstanding as follows:

(dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net Income	\$1,889	\$1,703	\$4,945	\$5,007
Less: dividends paid and accrued on preferred stock	(50)	(50)	(150)	(150)
Net income available to common shareholders	\$1,839	\$1,653	\$4,795	\$4,857
Average number of common shares outstanding	4,652,481	2,997,401	4,648,843	3,016,793
Effect of dilutive options	17,303	24,981	16,604	25,295
Average number of shares used to calculate diluted EPS	4,669,784	3,022,382	4,665,447	3,042,088

NOTE 6 - STOCK-BASED COMPENSATION

The Company has stock-based incentive arrangements to attract and retain key personnel. In May 2005, the 2005 Equity Compensation Plan (the "Plan") was approved by shareholders, which authorizes the issuance of restricted stock, stock appreciation rights, stock units and stock options to the Board of Directors and key employees. Compensation expense for service-based awards is recognized over the vesting period. Performance-based awards are recognized based on a vesting schedule, if applicable, and the probability of achieving goals specified at the time of the grant.

Stock-based compensation expense totaled \$147,000 and \$159,000 for the nine months ended September 30, 2014 and 2013, respectively, which consisted of the vesting of grants of restricted stock and restricted stock units. Stock-based compensation for the nine months ended September 30, 2013 included director compensation of \$3,000 for stock granted in lieu of cash compensation.

All outstanding options were fully vested and the Company has not granted any stock options since 2007.

The fair value of the Company's outstanding employee stock options is estimated on the date of grant using the Black-Scholes option pricing model. The Company estimates expected market price volatility and expected term of the options based on historical data and other factors.

The exercise price for options granted is set at the discretion of the committee administering the Plan, but is not less than the market value of the shares as of the date of grant. An option's maximum term is 10 years and the options vest at the discretion of the committee.

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The following tables below summarize outstanding and exercisable options at September 30, 2014 and December 31, 2013.

(dollars in thousands, except per share amounts)	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted- Average Contractual Life Remaining In Years
Outstanding at January 1, 2014	159,517	\$ 20.12	\$ 347	
Exercised	(6,665)	15.89	34	
Outstanding at September 30, 2014	152,852	\$ 20.30	\$ 317	0.2
Exercisable at September 30, 2014	152,852	\$ 20.30	\$ 317	0.2

(dollars in thousands, except per share amounts)	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted- Average Contractual Life Remaining In Years
Outstanding at January 1, 2013	236,059	\$ 18.49	\$ 164	
Exercised	(55,672)	13.16	310	
Forfeited	(20,870)	20.27		
Outstanding at December 31, 2013	159,517	\$ 20.12	\$ 347	1.0
Exercisable at December 31, 2013	159,517	\$ 20.12	\$ 347	1.0

Options outstanding are all currently exercisable and are summarized as follows:

Shares Outstanding September 30, 2014	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price
65,417	1 years	\$ 15.89
66,224	2 years	22.29
21,211	4 years	27.70
152,852		\$ 20.30

The aggregate intrinsic value of outstanding stock options and exercisable stock options was \$317,000 and \$347,000 at September 30, 2014 and December 31, 2013, respectively. Aggregate intrinsic value represents the difference between the Company's closing stock price on the last trading day of the period, which was \$20.73 and \$20.71 per share at September 30, 2014 and December 31, 2013, respectively, and the exercise price multiplied by the number of in the money options outstanding.

The Company has outstanding restricted stock and stock units granted in accordance with the Plan. The vesting period for granted restricted stock is between three and five years. As of September 30, 2014, unrecognized stock compensation expense was \$657,000. The following tables summarize the unvested restricted stock awards and units outstanding at September 30, 2014 and December 31, 2013, respectively.

	Restricted Stock		Restricted Stock Units	
	Number of Shares	Weighted Average Grant Date Fair Value	Number of Units	Fair Value
Nonvested at January 1, 2014	16,832	\$ 17.86	4,210	\$ 20.71
Granted	33,460	21.35	-	-

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Vested	(18,153)	18.77	(2,105)	20.29
Nonvested at September 30, 2014	32,139	\$ 20.98	2,105	\$ 20.73

	Restricted Stock		Restricted Stock Units	
	Number of Shares	Weighted Average Grant Date Fair Value	Number of Units	Fair Value
Nonvested at January 1, 2013	23,569	\$ 15.64	5,211	\$ 15.98
Granted	13,656	18.00	2,105	20.71
Vested	(20,393)	18.79	(3,106)	15.98
Nonvested at December 31, 2013	16,832	\$ 17.86	4,210	\$ 20.71

NOTE 7 - GUARANTEED PREFERRED BENEFICIAL INTEREST IN JUNIOR SUBORDINATED DEBENTURES (“TRUPS”)

On June 15, 2005, Tri-County Capital Trust II (“Capital Trust II”), a Delaware business trust formed, funded and wholly owned by the Company, issued \$5.0 million of variable-rate capital securities in a private pooled transaction. The variable rate is based on the 90-day LIBOR rate plus 1.70%. The Trust used the proceeds from this issuance, along with the \$155,000 for Capital Trust II’s common securities, to purchase \$5.2 million of the Company’s junior subordinated debentures. The interest rate on the debentures and the trust preferred securities is variable and adjusts quarterly. These capital securities qualify as Tier I capital and are presented in the Consolidated Balance Sheets as “Guaranteed Preferred Beneficial Interests in Junior Subordinated Debentures.” Both the capital securities of Capital Trust II and the junior subordinated debentures are scheduled to mature on June 15, 2035, unless called by the Company.

On July 22, 2004, Tri-County Capital Trust I (“Capital Trust I”), a Delaware business trust formed, funded and wholly owned by the Company, issued \$7.0 million of variable-rate capital securities in a private pooled transaction. The variable rate is based on the 90-day LIBOR rate plus 2.60%. The Trust used the proceeds from this issuance, along with the Company’s \$217,000 capital contribution for Capital Trust I’s common securities, to purchase \$7.2 million of the Company’s junior subordinated debentures. The interest rate on the debentures and the trust preferred securities is variable and adjusts quarterly. These debentures qualify as Tier I capital and are presented in the Consolidated Balance Sheets as “Guaranteed Preferred Beneficial Interests in Junior Subordinated Debentures.” Both the capital securities of Capital Trust I and the junior subordinated debentures are scheduled to mature on July 22, 2034, unless called by the Company.

NOTE 8 - PREFERRED STOCK

Small Business Lending Fund Preferred Stock

On September 22, 2011, the Company issued 20,000 shares of the Company’s Senior Non-Cumulative Perpetual Preferred Stock, Series C (the “Series C Preferred Stock”), having a liquidation amount per share equal to \$1,000 to the Department of the Treasury for \$20.0 million under the Small Business Lending Fund program.

The Series C Preferred Stock receives non-cumulative dividends, payable quarterly. The dividend rate fluctuates quarterly during the first 10 quarters during which the Series C Preferred Stock is outstanding, based upon changes in the level of “Qualified Small Business Lending” or “QSBL” (as defined in the Purchase Agreement) by the Bank. For the second through ninth calendar quarters, the dividend rate may be adjusted to between one percent (1%) and five percent (5%) per annum, to reflect the amount of change in the Bank’s level of QSBL. If the level of the Bank’s qualified small business loans declines so that the percentage increase in QSBL as compared to the baseline level is less than 10%, then the dividend rate payable on the Series C Preferred Stock would increase. For the tenth calendar quarter through four and one half years after issuance, the dividend rate will be fixed at between one percent (1%) and seven percent (7%) based upon the increase in QSBL as compared to the baseline. After four and one half years from issuance, the dividend rate will increase to nine percent (9%). In addition, beginning on January 1, 2014, and on all Series C Preferred Stock dividend payment dates thereafter ending on April 1, 2016, if the Company had not increased its QSBL from the baseline as of the quarter ended September 30, 2013, the Company would have been required to pay to the Department of the Treasury, on each share of Series C Preferred Stock, but only out of assets legally available, a fee equal to 0.5% of the liquidation amount per share of Series C Preferred Stock. At September 30, 2013, the Company had increased its QSBL from the baseline so that the dividend rate should remain at 1% through four and one half years from issuance.

The Series C Preferred Stock is non-voting, except in limited circumstances. If the Company misses five dividend payments, whether or not consecutive, the holder of the Series C Preferred Stock will have the right, but not the obligation, to appoint a representative as an observer on the Company's Board of Directors. The Series C Preferred Stock may be redeemed at any time at the Company's option, at a redemption price of 100% of the liquidation amount plus accrued but unpaid dividends to the date of redemption for the current period, subject to regulatory approval. The Company is permitted to repay its SBLF funding in increments of 25% or \$5.0 million, subject to regulatory approval.

NOTE 9 - OTHER REAL ESTATE OWNED ("OREO")

OREO assets are presented net of valuation allowances. The Company considers OREO as classified assets for regulatory and financial reporting. An analysis of OREO activity follows.

(dollars in thousands)	Nine Months Ended September 30,		Year Ended
	2014	2013	December 31, 2013
Balance at beginning of year	\$ 6,797	\$ 6,891	\$ 6,891
Additions of underlying property	1,590	1,391	1,853
Disposals of underlying property	(1,819)	(722)	(1,346)
Valuation allowance	(234)	(501)	(601)
Balance at end of period	\$ 6,334	\$ 7,059	\$ 6,797

During the nine months ended September 30, 2014 additions to OREO consisted of three residential properties totaling \$631,000, three residential lots totaling \$319,000 and a commercial building valued at \$640,000. Additions were offset by disposals of three residential properties totaling \$813,000, two residential lots totaling \$180,000, a commercial building of \$640,000 and a commercial lot of \$186,000. During the nine months ended September 30, 2014, the Bank recognized \$60,000 in net gains on the sale of OREO with net proceeds of \$1.9 million.

During the nine months ended September 30, 2013 additions to OREO consisted of two residential properties totaling \$699,000 and six residential lots totaling \$692,000. Additions were offset by disposals of two residential properties totaling \$532,000 and two residential lots totaling \$190,000. During the nine months ended September 30, 2013, the Bank recognized \$215,000 in net gains on the sale of OREO with net proceeds of \$713,000 and net losses of \$10,000 and the recognition of \$225,000 of previously deferred gain from the sale of an OREO property that the Bank financed during 2011 that did not initially qualify for full accrual sales treatment under ASC Topic 360-20-40 "Property Plant and Equipment – Derecognition.

Valuation allowances further reduced OREO carrying values \$234,000 and \$501,000 to current appraised values for the nine months ended September 30, 2014 and 2013, respectively. OREO carrying amounts reflect management's estimate of the realizable value of these properties incorporating current appraised values, local real estate market conditions and related costs.

Expenses applicable to OREO assets include the following.

(dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Valuation allowance	\$ -	\$ 171	\$ 234	\$ 501
Operating expenses	37	41	98	105
	\$ 37	\$ 212	\$ 332	\$ 606

NOTE 10 – SECURITIES

(dollars in thousands)	September 30, 2014			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Securities available for sale (AFS)				
Asset-backed securities issued by GSEs				
Residential Mortgage Backed Securities ("MBS")	\$38	\$ 6	\$ -	\$ 44
Residential Collateralized Mortgage Obligations ("CMOs")	40,136	37	1,140	39,033
Corporate equity securities	37	3	-	40
Bond mutual funds	4,174	87	-	4,261
Total securities available for sale	\$44,385	\$ 133	\$ 1,140	\$ 43,378
Securities held to maturity (HTM)				
Asset-backed securities issued by GSEs:				
Residential MBS	\$20,171	\$ 696	\$ 92	\$ 20,775
Residential CMOs	53,587	337	745	53,179
Asset-backed securities issued by Others:				
Residential CMOs	2,343	143	109	2,377
Total debt securities held to maturity	76,101	1,176	946	76,331
U.S. government obligations	750	-	-	750
Total securities held to maturity	\$76,851	\$ 1,176	\$ 946	\$ 77,081

(dollars in thousands)	December 31, 2013			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Securities available for sale (AFS)				
Asset-backed securities issued by GSEs				
Residential MBS	\$176	\$ 17	\$ -	\$ 193
Residential CMOs	45,299	63	1,479	43,883
Corporate equity securities	37	4	-	41
Bond mutual funds	4,108	22	-	