

MID PENN BANCORP INC
Form 10-Q
May 15, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 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 1-13677

MID PENN BANCORP, INC.

(Exact Name of Registrant as Specified in its Charter)

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| | |
|---|--|
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification Number) |
| 349 Union Street | |
| Millersburg, Pennsylvania (Address of Principal Executive Offices) | 17061 (Zip Code) |

Registrant's telephone number, including area code 1.866.642.7736

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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "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

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

As of May 15, 2014, the registrant had 3,495,382 shares of common stock outstanding.

MID PENN BANCORP, INC.

FORM 10-Q

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Unless the context otherwise requires, the terms “Mid Penn”, “we”, “us”, and “our” refer to Mid Penn Bancorp, Inc. and its consolidated subsidiaries

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MID PENN BANCORP, INC. Consolidated Balance Sheets (Unaudited)

PART 1 – FINANCIAL INFORMATION

ITEM 1 – FINANCIAL STATEMENTS

| (Dollars in thousands, except share and per share data) | March 31, 2014 | December 31, 2013 |
|---|-------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$ 13,126 | \$ 7,407 |
| Interest-bearing balances with other financial institutions | 904 | 1,216 |
| Total cash and cash equivalents | 14,030 | 8,623 |
| Interest-bearing time deposits with other financial institutions | 5,323 | 7,513 |
| Available for sale investment securities | 121,409 | 122,803 |
| Loans and leases, net of unearned interest | 549,739 | 546,462 |
| Less: Allowance for loan and lease losses | (6,423) | (6,317) |
| Net loans and leases | 543,316 | 540,145 |
| Bank premises and equipment, net | 12,655 | 12,469 |
| Restricted investment in bank stocks | 3,146 | 2,969 |
| Foreclosed assets held for sale | 1,078 | 965 |
| Accrued interest receivable | 2,904 | 2,704 |
| Deferred income taxes | 2,718 | 3,235 |
| Goodwill | 1,016 | 1,016 |
| Core deposit and other intangibles, net | 245 | 249 |
| Cash surrender value of life insurance | 8,425 | 8,374 |
| Other assets | 2,211 | 2,060 |
| Total Assets | \$ 718,476 | \$ 713,125 |
| LIABILITIES & SHAREHOLDERS' EQUITY | | |
| Deposits: | | |
| Noninterest bearing demand | \$ 49,189 | \$ 48,346 |
| Interest bearing demand | 204,481 | 201,090 |
| Money Market | 193,556 | 196,736 |
| Savings | 30,465 | 29,585 |
| Time | 128,984 | 132,373 |
| Total Deposits | 606,675 | 608,130 |
| Short-term borrowings | 28,544 | 23,833 |
| Long-term debt | 23,100 | 23,145 |
| Accrued interest payable | 486 | 393 |
| Other liabilities | 4,426 | 4,708 |
| Total Liabilities | 663,231 | 660,209 |
| Shareholders' Equity: | | |
| Series B Preferred stock, par value \$1.00; liquidation value \$1,000; authorized 5,000 shares; 7% non-cumulative dividend; 5,000 shares issued and outstanding at March 31, 2014 and December 31, 2013 | 5,000 | 5,000 |

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| | | |
|---|------------|------------|
| Common stock, par value \$1.00; authorized 10,000,000 shares; 3,495,382 shares issued and outstanding at March 31, 2014 and 3,494,397 at December 31, 2013 | 3,495 | 3,494 |
| Additional paid-in capital | 29,866 | 29,853 |
| Retained earnings | 16,691 | 15,441 |
| Accumulated other comprehensive income (loss) | 193 | (872) |
| Total Shareholders' Equity | 55,245 | 52,916 |
| Total Liabilities and Shareholders' Equity | \$ 718,476 | \$ 713,125 |

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

MID PENN BANCORP, INC. Consolidated Statements of Income (Unaudited)

| (Dollars in thousands, except per share data) | Three Months | |
|---|-------------------------|----------|
| | Ended March 31, 2014 | 2013 |
| INTEREST INCOME | | |
| Interest & fees on loans and leases | \$ 6,540 | \$ 6,261 |
| Interest on interest-bearing balances | 10 | 47 |
| Interest and dividends on investment securities: | | |
| U.S. Treasury and government agencies | 277 | 100 |
| State and political subdivision obligations, tax-exempt | 519 | 483 |
| Other securities | 34 | 6 |
| Interest on federal funds sold and securities purchased under agreements to resell | - | 5 |
| Total Interest Income | 7,380 | 6,902 |
| INTEREST EXPENSE | | |
| Interest on deposits | 978 | 1,205 |
| Interest on short-term borrowings | 14 | - |
| Interest on long-term debt | 116 | 238 |
| Total Interest Expense | 1,108 | 1,443 |
| Net Interest Income | 6,272 | 5,459 |
| PROVISION FOR LOAN AND LEASE LOSSES | | |
| Net Interest Income After Provision for Loan and Lease Losses | 5,725 | 4,964 |
| NONINTEREST INCOME | | |
| Income from fiduciary activities | 158 | 139 |
| Service charges on deposits | 127 | 134 |
| Net gain on sales of investment securities | 150 | - |
| Earnings from cash surrender value of life insurance | 51 | 58 |
| Mortgage banking income | 38 | 110 |
| ATM debit card interchange income | 126 | 119 |
| Merchant services income | 67 | 87 |
| Net gain on sales of SBA loans | 51 | - |
| Other income | 126 | 203 |
| Total Noninterest Income | 894 | 850 |
| NONINTEREST EXPENSE | | |
| Salaries and employee benefits | 2,548 | 2,857 |
| Occupancy expense, net | 382 | 310 |
| Equipment expense | 301 | 316 |
| Pennsylvania Bank Shares tax expense | 99 | 128 |
| FDIC Assessment | 132 | 202 |
| Legal and professional fees | 97 | 154 |
| Director fees and benefits expense | 79 | 80 |
| Marketing and advertising expense | 48 | 43 |
| Software licensing | 237 | 181 |
| Telephone expense | 96 | 98 |

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| | | |
|---|----------|--------|
| Loss (gain) on sale/write-down of foreclosed assets | 87 | (19) |
| Intangible amortization | 7 | 7 |
| Loan collection costs | 71 | 70 |
| Other expenses | 554 | 610 |
| Total Noninterest Expense | 4,738 | 5,037 |
| INCOME BEFORE PROVISION FOR INCOME TAXES | 1,881 | 777 |
| Provision for income taxes | 370 | 92 |
| NET INCOME | 1,511 | 685 |
| Series A preferred stock dividends and discount accretion | - | 14 |
| Series B preferred stock dividends | 87 | 47 |
| NET INCOME AVAILABLE TO COMMON SHAREHOLDERS | \$ 1,424 | \$ 624 |

PER COMMON SHARE DATA:

| | | |
|---------------------------------|---------|---------|
| Basic Earnings Per Common Share | \$ 0.41 | \$ 0.18 |
| Cash Dividends | \$ 0.05 | - |

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

MID PENN BANCORP, INC.

Consolidated Statements of Comprehensive Income (Unaudited)

| (Dollars in thousands) | Three Months Ended March 31, | |
|--|---------------------------------|--------|
| | 2014 | 2013 |
| Net income | \$ 1,511 | \$ 685 |
| Other comprehensive income (loss): | | |
| Unrealized gains (losses) arising during the period on available for sale securities, net of income taxes of \$599 and (\$209), respectively | 1,162 | (405) |
| Reclassification adjustment for net gain on sales of available for sale securities included in net income, net of income taxes of (\$51) and \$0, respectively (1) (3) | (99) | - |
| Change in defined benefit plans, net of income taxes of \$1 and \$2, respectively (2) (3) | 2 | 3 |
| Total other comprehensive income (loss) | 1,065 | (402) |
| Total comprehensive income | \$ 2,576 | \$ 283 |

(1) Amounts are included in net gain on sales of investment securities on the Consolidated Statements of Income as a separate element within total noninterest income

(2) Amounts are included in the computation of net periodic benefit cost and are included in salaries and employee benefits on the Consolidated Statements of Income as a separate element within total noninterest expense

(3) Income tax amounts are included in the provision for income taxes in the Consolidated Statements of Income

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

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MID PENN BANCORP, INC. Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

FOR THE THREE MONTHS ENDED MARCH 31, 2014 AND 2013

(Dollars in thousands)

| | Preferred Stock | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive (Loss) Income | Total Shareholders' Equity |
|---|--------------------|-----------------|----------------------------------|----------------------|--|----------------------------------|
| Balance, January 1, 2014 | \$ 5,000 | \$ 3,494 | \$ 29,853 | \$ 15,441 | \$ (872) | \$ 52,916 |
| Net income | - | - | - | 1,511 | - | 1,511 |
| Total other comprehensive income, net of taxes | - | - | - | - | 1,065 | 1,065 |
| Employee Stock Purchase Plan (985 shares) | - | 1 | 13 | - | - | 14 |
| Common stock dividends | - | - | - | (174) | - | (174) |
| Series B Preferred stock dividends | - | - | - | (87) | - | (87) |
| Balance, March 31, 2014 | \$ 5,000 | \$ 3,495 | \$ 29,866 | \$ 16,691 | \$ 193 | \$ 55,245 |
| Balance, January 1, 2013 | \$ 4,880 | \$ 3,490 | \$ 29,816 | \$ 11,741 | \$ 2,293 | \$ 52,220 |
| Net income | - | - | - | 685 | - | 685 |
| Total other comprehensive loss, net of taxes | - | - | - | - | (402) | (402) |
| Employee Stock Purchase Plan (1,346 shares) | - | 1 | 14 | - | - | 15 |
| Series B Preferred stock issuance | 120 | - | - | - | - | 120 |
| Series B Preferred stock dividends | - | - | - | (47) | - | (47) |
| Amortization of warrant cost | - | - | (14) | - | - | (14) |
| Warrant repurchase | - | - | - | (58) | - | (58) |
| Balance, March 31, 2013 | \$ 5,000 | \$ 3,491 | \$ 29,816 | \$ 12,321 | \$ 1,891 | \$ 52,519 |

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

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MID PENN BANCORP, INC. Consolidated Statements of Cash Flows (Unaudited)

| (Dollars in thousands) | Three Months Ended March 31, | |
|--|---------------------------------|----------|
| | 2014 | 2013 |
| Operating Activities: | | |
| Net Income | \$ 1,511 | \$ 685 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan and lease losses | 547 | 495 |
| Depreciation | 313 | 247 |
| Amortization of intangibles | 4 | 10 |
| Net amortization of security premiums | 43 | 1,044 |
| Gain on sales of investment securities | (150) | - |
| Earnings on cash surrender value of life insurance | (51) | (58) |
| SBA loans originated for sale | (468) | - |
| Proceeds from sales of SBA loans originated for sale | 519 | - |
| Gain on sale of loans | (51) | - |
| Gain on disposal of property, plant, and equipment | - | (3) |
| Loss (gain) on sale / write-down of foreclosed assets | 87 | (19) |
| Deferred income tax benefit | (28) | (700) |
| (Increase) decrease in accrued interest receivable | (200) | 47 |
| (Increase) decrease in other assets | (152) | 409 |
| Increase in accrued interest payable | 93 | 116 |
| (Decrease) increase in other liabilities | (282) | 6,824 |
| Net Cash Provided By Operating Activities | 1,735 | 9,097 |
| Investing Activities: | | |
| Net decrease in interest-bearing time deposits with other financial institutions | 2,190 | 6,755 |
| Proceeds from the maturity of investment securities | 3,375 | 15,126 |
| Proceeds from the sale of investment securities | 7,199 | - |
| Purchases of investment securities | (7,462) | (7,995) |
| (Purchases) redemptions of restricted investment in bank stock | (177) | 306 |
| Net increase in loans and leases | (3,982) | (11,401) |
| Purchases of bank premises and equipment | (499) | (278) |
| Proceeds from sale of foreclosed assets | 64 | 381 |
| Net Cash Provided By Investing Activities | 708 | 2,894 |
| Financing Activities: | | |
| Net increase in demand deposits and savings accounts | 1,934 | 21,658 |
| Net decrease in time deposits | (3,389) | (6,934) |
| Net increase in short-term borrowings | 4,711 | - |
| Series B preferred stock dividend paid | (87) | (47) |
| Common stock dividend paid | (174) | - |
| Series B preferred stock issuance | - | 120 |
| Employee Stock Purchase Plan | 14 | 15 |
| Warrant repurchase | - | (58) |
| Long-term debt repayment | (45) | (733) |
| Net Cash Provided By Financing Activities | 2,964 | 14,021 |

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| | | |
|--|-----------|-----------|
| Net increase in cash and cash equivalents | 5,407 | 26,012 |
| Cash and cash equivalents, beginning of year | 8,623 | 15,473 |
| Cash and cash equivalents, end of year | \$ 14,030 | \$ 41,485 |

Supplemental Disclosures of Cash Flow Information:

| | | |
|-------------------|----------|----------|
| Interest paid | \$ 1,015 | \$ 1,327 |
| Income taxes paid | \$ - | \$ - |

Supplemental Noncash Disclosures:

| | | |
|---|--------|--------|
| Loan transfers to foreclosed assets held for sale | \$ 264 | \$ 291 |
|---|--------|--------|

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

MID PENN BANCORP, INC. Notes to Consolidated Financial Statements (Unaudited)

(1) Basis of Presentation

The accompanying consolidated financial statements include the accounts of Mid Penn Bancorp, Inc. and its wholly-owned subsidiaries, Mid Penn Bank (“Bank”), and the Bank’s wholly-owned subsidiary Mid Penn Insurance Services, LLC (collectively, “Mid Penn”). All material intercompany accounts and transactions have been eliminated in consolidation.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Mid Penn believes the information presented is not misleading and the disclosures are adequate. For comparative purposes, the March 31, 2013 and December 31, 2013 balances have been reclassified to conform to the 2014 presentation. Such reclassifications had no impact on net income. The results of operations for interim periods are not necessarily indicative of operating results expected for the full year. These interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in Mid Penn’s Annual Report on Form 10-K for the year ended December 31, 2013.

Mid Penn has evaluated events and transactions occurring subsequent to the balance sheet date of March 31, 2014, for items that should potentially be recognized or disclosed in these consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.

(2) Investment Securities

Securities to be held for indefinite periods, but not intended to be held to maturity, are classified as available for sale and carried at fair value. Securities held for indefinite periods include securities that management intends to use as part of its asset and liability management strategy and that may be sold in response to liquidity needs, changes in interest rates, resultant prepayment risk, and other factors related to interest rate and resultant prepayment risk changes.

Realized gains and losses on dispositions are based on the net proceeds and the amortized cost of the securities sold, using the specific identification method. Unrealized gains and losses on investment securities available for sale are based on the difference between amortized cost and fair value of each security. These gains and losses are credited or charged to other comprehensive income, whereas realized gains and losses flow through the Corporation’s consolidated statements of income.

Accounting Standards Codification (“ASC”) Topic 320, Investments – Debt and Equity Securities, clarifies the interaction of the factors that should be considered when determining whether a debt security is

other-than-temporarily impaired. For debt securities, management must assess whether (a) it has the intent to sell the security and (b) it is more likely than not that it will be required to sell the security prior to its anticipated recovery. These steps are done before assessing whether the entity will recover the cost basis of the investment.

In instances when a determination is made that other-than-temporary impairment exists but the investor does not intend to sell the debt security and it is not more likely than not that it will be required to sell the debt security prior to its anticipated recovery, this guidance changes the presentation and amount of the other-than-temporary impairment recognized in the income statement. The other-than-temporary impairment is separated into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income.

In assessing potential other-than-temporary impairment for equity securities, consideration is given to management's intent and ability to hold the securities until recovery of unrealized losses.

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MID PENN BANCORP, INC. Notes to Consolidated Financial Statements (Unaudited)

At March 31, 2014 and December 31, 2013, amortized cost, fair value, and unrealized gains and losses on investment securities are as follows:

| (Dollars in thousands) | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|---|-------------------|---------------------|----------------------|---------------|
| March 31, 2014 | | | | |
| Available for sale securities: | | | | |
| U.S. Treasury and U.S. government agencies | \$ 12,058 | \$ 528 | \$ 15 | \$ 12,571 |
| Mortgage-backed U.S. government agencies | 36,003 | 390 | 276 | 36,117 |
| State and political subdivision obligations | 71,319 | 1,187 | 1,336 | 71,170 |
| Equity securities | 1,550 | 30 | 29 | 1,551 |
| | \$ 120,930 | \$ 2,135 | \$ 1,656 | \$ 121,409 |

| (Dollars in thousands) | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|---|-------------------|---------------------|----------------------|---------------|
| December 31, 2013 | | | | |
| Available for sale securities: | | | | |
| U.S. Treasury and U.S. government agencies | \$ 12,134 | \$ 700 | \$ - | \$ 12,834 |
| Mortgage-backed U.S. government agencies | 39,481 | 349 | 438 | 39,392 |
| State and political subdivision obligations | 70,770 | 744 | 2,476 | 69,038 |
| Equity securities | 1,550 | 20 | 31 | 1,539 |
| | \$ 123,935 | \$ 1,813 | \$ 2,945 | \$ 122,803 |

Estimated fair values of debt securities are based on quoted market prices, where applicable. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments, adjusted for differences between the quoted instruments and the instruments being valued.

Investment securities having a fair value of \$114,365,000 at March 31, 2014 and \$114,600,000 at December 31, 2013, were pledged to secure public deposits and other borrowings.

Mid Penn realized gross gains of \$150,000 and \$0 on sales of securities available for sale during the three months ended March 31, 2014 and March 31, 2013. Mid Penn realized gross losses on the sale of securities available for sale of \$0 during the three months ended March 31, 2014 and March 31, 2013.

MID PENN BANCORP, INC. Notes to Consolidated Financial Statements (Unaudited)

The following table presents gross unrealized losses and fair value of investments aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at March 31, 2014 and December 31, 2013.

| (Dollars in thousands) March 31, 2014 | Number of Securities | Less Than 12 Months Fair Value | 12 Months Unrealized Losses | 12 Months or More Fair Value | Unrealized Losses | Total Fair Value | Unrealized Losses |
|--|-------------------------|--------------------------------------|-----------------------------------|------------------------------------|----------------------|------------------------|----------------------|
| Available for sale securities: | | | | | | | |
| U.S. Treasury and U.S. government agencies | 4 | \$ 4,515 | \$ 15 | \$ - | \$ - | \$ 4,515 | \$ 15 |
| Mortgage-backed U.S. government agencies | 18 | 5,757 | 45 | 8,908 | 231 | 14,665 | 276 |
| State and political subdivision obligations | 62 | 22,301 | 693 | 9,349 | 643 | 31,650 | 1,336 |
| Equity securities | 1 | - | - | 550 | 29 | 550 | 29 |
| Total temporarily impaired available for sale securities | 85 | \$ 32,573 | \$ 753 | \$ 18,807 | \$ 903 | \$ 51,380 | \$ 1,656 |

| (Dollars in thousands) December 31, 2013 | Number of Securities | Less Than 12 Months Fair Value | 12 Months Unrealized Losses | 12 Months or More Fair Value | Unrealized Losses | Total Fair Value | Unrealized Losses |
|--|-------------------------|--------------------------------------|-----------------------------------|------------------------------------|----------------------|------------------------|----------------------|
| Available for sale securities: | | | | | | | |
| Mortgage-backed U.S. government agencies | 29 | \$ 9,799 | \$ 182 | \$ 9,866 | \$ 256 | \$ 19,665 | \$ 438 |
| State and political subdivision obligations | 90 | 39,611 | 2,150 | 4,288 | 326 | 43,899 | 2,476 |
| Equity securities | 1 | - | - | 550 | 31 | 550 | 31 |
| Total temporarily impaired available for sale securities | 120 | \$ 49,410 | \$ 2,332 | \$ 14,704 | \$ 613 | \$ 64,114 | \$ 2,945 |

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis; and more frequently when economic or market concerns warrant such evaluation. Consideration is given to the length of time and the extent to which the fair value has been less than cost, and the financial condition and near term prospects of the issuer. In addition, for debt securities, the Corporation considers (a) whether management has the intent to sell the security, (b) it is more likely than not that management will be required to sell the security prior to its anticipated recovery, and (c) whether management expects to recover the entire amortized cost basis. For equity securities, management considers the intent and ability to hold securities until recovery of unrealized losses.

The majority of the investment portfolio is comprised of mortgage-backed U.S. government agencies and state and political subdivision obligations with school districts and municipal authorities throughout the U.S. For the investment securities with an unrealized loss, Mid Penn has concluded, based on its analysis, that the unrealized losses in the investments are primarily caused by the movement of interest rates, and the contractual terms of these investments do not permit the issuer to settle the securities at a price less than the par value of the investment.

At March 31, 2014, 84 debt securities and 1 equity security with unrealized losses depreciated 3.22% from their amortized cost basis. During this period, securities in an unrealized loss position for twelve months or longer totaled \$903,000 of which the majority was attributed to state and political subdivision obligations with \$643,000 in unrealized losses. At December 31, 2013, 119 debt securities and 1 equity security with unrealized losses depreciated 4.59% from their amortized cost basis. During this period, securities in an unrealized loss position for twelve months or longer totaled \$613,000 of which the majority was attributed to mortgage,-backed U.S. government agencies and state and political subdivision obligations with \$256,000 and \$326,000 in unrealized losses, respectively.

Because Mid Penn does not intend to sell these investments and it is not likely it will be required to sell these investments before a recovery of fair value, which may be maturity, Mid Penn does not consider the securities with unrealized losses to be other-than-temporarily impaired as losses relate to changes in interest rates and not erosion of credit quality.

MID PENN BANCORP, INC. Notes to Consolidated Financial Statements (Unaudited)

The table below is the maturity distribution of investment securities at amortized cost and fair value.

| (Dollars in thousands) | March 31, 2014 | |
|---------------------------------------|-------------------|---------------|
| | Amortized Cost | Fair Value |
| Due in 1 year or less | \$ 1,251 | \$ 1,298 |
| Due after 1 year but within 5 years | 12,055 | 12,733 |
| Due after 5 years but within 10 years | 32,744 | 32,914 |
| Due after 10 years | 37,327 | 36,796 |
| | 83,377 | 83,741 |
| Mortgage-backed securities | 36,003 | 36,117 |
| Equity securities | 1,550 | 1,551 |
| | \$ 120,930 | \$ 121,409 |

(3) Loans and Allowance for Loan and Lease Losses

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at their outstanding unpaid principal balances, net of an allowance for loan losses and any deferred fees or costs. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the yield (interest income) of the related loans. These amounts are generally being amortized over the contractual life of the loan. Premiums and discounts on purchased loans are amortized as adjustments to interest income using the effective yield method.

The loan portfolio is segmented into commercial and consumer loans. Commercial loans consist of the following classes: commercial and industrial, commercial real estate, commercial real estate-construction and lease financing. Consumer loans consist of the following classes: residential mortgage loans, home equity loans and other consumer loans.

For all classes of loans, the accrual of interest is discontinued when the contractual payment of principal or interest has become 90 days or more past due or management has serious doubts about further collectability of principal or interest, even though the loan is currently performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on nonaccrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against the allowance for loan and lease losses. Interest received on nonaccrual loans, including impaired loans, generally is either applied against principal or reported as interest income, according to management's judgment as to the collectability of principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time (generally six months) and the ultimate collectability of the total contractual principal and interest is no longer in doubt. The past due status of all classes of

loans receivable is determined based on contractual due dates for loan payments.

Commercial and industrial

Mid Penn originates commercial and industrial loans. Most of the Bank's commercial and industrial loans have been extended to finance local and regional businesses and include short-term loans to finance machinery and equipment purchases, inventory, and accounts receivable. Commercial loans also involve the extension of revolving credit for a combination of equipment acquisitions and working capital in expanding companies.

The maximum term for loans extended on machinery and equipment is based on the projected useful life of such machinery and equipment. Generally, the maximum term on non-mortgage lines of credit is one year. The loan-to-value ratio on such loans and lines of credit generally may not exceed 80% of the value of the collateral securing the loan. The Bank's commercial business lending policy includes credit file documentation and analysis of the borrower's character, capacity to repay the loan, the adequacy of the borrower's capital and collateral as well as an evaluation of conditions affecting the borrower. Analysis of the borrower's past, present, and future cash flows is also an important aspect of the Bank's current credit analysis. Nonetheless, such loans are believed to carry higher credit risk than more traditional investments.

Commercial and industrial loans typically are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business. As a result, the availability of funds for the repayment of commercial business loans may be substantially dependent on the success of the business itself, which, in turn, is likely to be dependent upon the general economic environment. Mid Penn's commercial and industrial loans are usually, but not always, secured by business assets and personal guarantees. However, the

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collateral securing the loans may depreciate over time, may be difficult to appraise, and may fluctuate in value based on the success of the business.

Commercial real estate and commercial real estate - construction

Commercial real estate and commercial real estate construction loans generally present a higher level of risk than loans secured by one to four family residences. This greater risk is due to several factors, including the concentration of principal in a limited number of loans and borrowers, the effect of general economic conditions on income producing properties, and the increased difficulty of evaluating and monitoring these types of loans. In addition, the repayment of loans secured by commercial real estate is typically dependent upon the successful operation of the related real estate project. If the cash flow from the project is reduced, the borrower's ability to repay the loan may be impaired.

Lease financing

Mid Penn originates leases for select commercial and state and municipal government lessees. The nature of the leased asset is often subject to rapid depreciation in salvage value over a relatively short time frame or may be of an industry specific nature, making appraisal or liquidation of the asset difficult. These factors have led the Bank to severely curtail the origination of new leases to state or municipal government agencies where default risk is extremely limited and to only the most credit-worthy commercial customers. These commercial customers are primarily leasing fleet vehicles for use in their primary line of business, mitigating some of the asset value concerns within the portfolio. Leasing has been a declining percentage of the Mid Penn's portfolio since 2006, representing 0.27% of the portfolio at March 31, 2014.

Residential mortgage

Mid Penn offers a wide array of residential mortgage loans for both permanent structures and those under construction. The Bank's residential mortgage originations are secured primarily by properties located in its primary market and surrounding areas. Residential mortgage loans have terms up to a maximum of 30 years and with loan to value ratios up to 100% of the lesser of the appraised value of the security property or the contract price. Private mortgage insurance is generally required in an amount sufficient to reduce the Bank's exposure to at or below the 85% loan to value level. Residential mortgage loans generally do not include prepayment penalties.

In underwriting residential mortgage loans, the Bank evaluates both the borrower's ability to make monthly payments and the value of the property securing the loan. Most properties securing real estate loans made by Mid Penn are appraised by independent fee appraisers. The Bank generally requires borrowers to obtain an attorney's title opinion or title insurance and fire and property insurance (including flood insurance, if necessary) in an amount not less than the

amount of the loan. Real estate loans originated by the Bank generally contain a “due on sale” clause allowing the Bank to declare the unpaid principal balance due and payable upon the sale of the security property.

The Bank underwrites residential mortgage loans to the standards established by the secondary mortgage market, i.e., Fannie Mae, Ginnie Mae, Freddie Mac, or Pennsylvania Housing Finance Agency standards, with the intention of selling the majority of residential mortgages originated into the secondary market. In the event that the facts and circumstances surrounding a residential mortgage application do not meet all underwriting conditions of the secondary mortgage market, the Bank will evaluate the failed conditions and the potential risk of holding the residential mortgage in the Bank’s portfolio rather than rejecting the loan request. In the event that the loan is held in the Bank’s portfolio, the interest rate on the residential mortgage would be increased to compensate for the added portfolio risk.

Consumer, including home equity

Mid Penn offers a variety of secured consumer loans, including home equity, automobile, and deposit secured loans. In addition, the Bank offers other secured and unsecured consumer loans. Most consumer loans are originated in Mid Penn’s primary market and surrounding areas.

The largest component of Mid Penn’s consumer loan portfolio consists of fixed rate home equity loans and variable rate home equity lines of credit. Substantially all home equity loans and lines of credit are secured by second mortgages on principal residences. The Bank will lend amounts, which, together with all prior liens, typically may be up to 85% of the appraised value of the property securing the loan. Home equity term loans may have maximum terms up to 20 years while home equity lines of credit generally have maximum terms of five years.

Consumer loan terms vary according to the type and value of collateral, length of contract and creditworthiness of the borrower. The underwriting standards employed by the Bank for consumer loans include an application, a determination of the applicant’s payment history on other debts and an assessment of ability to meet existing obligations and payments on the proposed loan. Although

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creditworthiness of the applicant is a primary consideration, the underwriting process also includes a comparison of the value of the collateral, if any, in relation to the proposed loan amount.

Consumer loans may entail greater credit risk than do residential mortgage loans, particularly in the case of consumer loans which are unsecured or are secured by rapidly depreciable assets, such as automobiles or recreational equipment. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be affected by adverse personal circumstances. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount that can be recovered on such loans.

Junior liens inherently have more credit risk by virtue of the fact that another financial institution may have a higher security position in the case of foreclosure liquidation of collateral to extinguish the debt. Generally, foreclosure actions could become more prevalent if the real estate market continues to be weak and property values deteriorate.

Allowance for Loan and Lease Losses

The allowance for credit losses consists of the allowance for loan and lease losses and the reserve for unfunded lending commitments. The allowance for loan and lease losses ("allowance") represents management's estimate of losses inherent in the loan portfolio as of the balance sheet date and is recorded as a reduction to loans. The reserve for unfunded lending commitments represents management's estimate of losses inherent in its unfunded loan commitments and is recorded in other liabilities on the consolidated balance sheet. The allowance is increased by the provision for loan and lease losses, and decreased by charge-offs, net of recoveries. Loans deemed to be uncollectible are charged against the allowance, and subsequent recoveries, if any, are credited to the allowance. All, or part, of the principal balance of loans are charged off to the allowance as soon as it is determined that the repayment of all, or part, of the principal balance is highly unlikely. Non-residential consumer loans are generally charged off no later than 120 days past due on a contractual basis, earlier in the event of bankruptcy, or if there is an amount deemed uncollectible. Because all identified losses are immediately charged off, no portion of the allowance is restricted to any individual loan or groups of loans, and the entire allowance is available to absorb any and all loan losses.

The allowance for credit losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management performs a monthly evaluation of the adequacy of the allowance. The allowance is based on Mid Penn's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as impaired. For loans that are classified as impaired, an allowance is established when the discounted cash flows, collateral value, or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers pools of loans by loan class including commercial loans not considered impaired, as well as smaller balance homogeneous loans, such as residential real estate, home equity and other consumer loans. These pools of loans are evaluated for loss exposure based upon historical loss rates for each of these categories of loans, adjusted for qualitative factors. These qualitative risk factors include changes in economic conditions, fluctuations in loan quality measures, changes in the experience of the lending staff and loan review systems, growth or changes in the mix of loans originated, and shifting industry or portfolio concentrations.

Each factor is assigned a value to reflect improving, stable or declining conditions based on management's best judgment using relevant information available at the time of the evaluation. Adjustments to the factors are supported through documentation of changes in conditions in a narrative accompanying the allowance for loan loss calculation.

Mid Penn considers a commercial loan (consisting of commercial and industrial, commercial real estate, commercial real estate-construction, and lease financing loan classes) to be impaired when it becomes 90 days or more past due and not in the process of collection. This methodology assumes the borrower cannot or will not continue to make additional payments. At that time the loan would be considered collateral dependent as the discounted cash flow ("DCF") method indicates no operating income is available for evaluating the collateral position; therefore, all impaired loans are deemed to be collateral dependent.

In addition, Mid Penn's rating system assumes any loans classified as substandard non-accrual to be impaired, and all of these loans are considered collateral dependent; therefore, all of Mid Penn's impaired loans, whether reporting a specific allocation or not, are considered collateral dependent.

Mid Penn evaluates loans for charge-off on a monthly basis. Policies that govern the recommendation for charge-off are unique to the type of loan being considered. Commercial loans rated as nonaccrual or lower will first have a collateral evaluation completed in accordance with the guidance on impaired loans. Once the collateral evaluation has been completed, a specific allocation of allowance is made based upon the results of the evaluation. In the event the loan is unsecured, the loan would have been charged-off

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at the recognition of impairment. If the loan is secured, it will undergo a 90 day waiting period to ensure the collateral shortfall identified in the evaluation is accurate and then charged down by the specific allocation. Once the charge down is taken, the remaining balance remains an impaired loan with the original terms and interest rate intact (not restructured). Commercial loans secured by real estate rated as impaired will also have an initial collateral evaluation completed in accordance with the guidance on impaired loans. An updated real estate valuation is ordered and the collateral evaluation is modified to reflect any variations in value. A specific allocation of allowance is made for any anticipated collateral shortfall and a 90 day waiting period begins to ensure the accuracy of the collateral shortfall. The loan is then charged down by the specific allocation. Once the charge down is taken, the remaining balance remains an impaired loan with the original terms and interest rate intact (not restructured). The process of charge-off for residential mortgage loans begins upon a loan becoming delinquent for 90 days and not in the process of collection. The existing appraisal is reviewed and a lien search is obtained to determine lien position and any instances of intervening liens. A new appraisal of the property will be ordered if deemed necessary by management and a collateral evaluation is completed. The loan will then be charged down to the value indicated in the evaluation. Consumer loans (including home equity loans and other consumer loans) are recommended for charge-off after reaching delinquency of 90 days and the loan is not in the process of collection. The entire balance of the consumer loan is recommended for charge-off at this point.

As noted above, Mid Penn assesses a specific allocation for commercial loans prior to charging down or charging off the loan. Once the charge down is taken, the remaining balance remains a nonperforming loan with the original terms and interest rate intact (not restructured). In addition, Mid Penn takes a preemptive step when any commercial loan becomes classified under its internal classification system. A preliminary collateral evaluation in accordance with the guidance on impaired loans is prepared using the existing collateral information in the loan file. This process allows Mid Penn to review both the credit and documentation files to determine the status of the information needed to make a collateral evaluation. This collateral evaluation is preliminary but allows Mid Penn to determine if any potential collateral shortfalls exist.

It is Mid Penn's policy to obtain updated third party valuations on all impaired loans collateralized by real estate within 30 days of the credit being classified as impaired. Prior to receipt of the updated real estate valuation Mid Penn will use any existing real estate valuation to determine any potential allowance issues; however no allowance recommendation will be made until which time Mid Penn is in receipt of the updated valuation. The credit department employs an electronic tracking system to monitor the receipt of and need for updated appraisals. To date, there have been no significant time lapses noted with the above processes.

In some instances Mid Penn is not holding real estate as collateral and is relying on business assets (personal property) for repayment. In these circumstances a collateral inspection is performed by Mid Penn personnel to determine an estimated value. The value is based on net book value, as provided by the financial statements, and discounted accordingly based on determinations made by management. Occasionally, Mid Penn will employ an outside service to provide a fair estimate of value based on auction sales or private sales. Management reviews the estimates of these third parties and discounts them accordingly based on management's judgment, if deemed necessary.

For impaired loans with no valuation allowance required, Mid Penn's practice of obtaining independent third party market valuations on the subject property within 30 days of being placed on non-accrual status sometimes indicates that the loan to value ratio is sufficient to obviate the need for a specific allocation in spite of significant deterioration in real estate values in Mid Penn's primary market area. These circumstances are determined on a case by case analysis of the impaired loans.

Mid Penn actively monitors the values of collateral on impaired loans. This monitoring may require the modification of collateral values over time or changing circumstances by some factor, either positive or negative, from the original values. All collateral values will be assessed by management at least every 18 months for possible revaluation by an independent third party.

Mid Penn does not currently, or plan in the future to, use automated valuation methodologies as a method of valuing real estate collateral.

An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, Mid Penn does not separately identify individual residential mortgage loans, home equity loans and other consumer loans for impairment disclosures, unless such loans are the subject of a troubled debt restructuring agreement.

Loans whose terms are modified are classified as troubled debt restructurings if the borrowers have been granted concessions and it is deemed that those borrowers are experiencing financial difficulty. Concessions granted under a troubled debt restructuring generally involve a temporary reduction in interest rate or an extension of a loan's stated maturity date. Non-accrual troubled debt restructurings are restored to accrual status if principal and interest payments, under the modified terms, are current for six consecutive months after modification. Loans classified as troubled debt restructurings are designated as impaired.

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The allowance calculation methodology includes further segregation of loan classes into risk rating categories. The borrower's overall financial condition, repayment sources, guarantors, and value of collateral, if appropriate, are evaluated annually for commercial loans or when credit deficiencies arise, such as delinquent loan payments. Credit quality risk ratings include regulatory classifications of special mention, substandard, doubtful, and loss. Loans criticized as special mention have potential weaknesses that deserve management's close attention. If uncorrected, the potential weaknesses may result in deterioration of the repayment prospects. Loans classified substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They include loans that are inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified doubtful have all the weaknesses inherent in loans classified substandard with the added characteristic that collection or liquidation in full, on the basis of current conditions and facts, is highly improbable. Loans classified as a loss are considered uncollectible and are charged to the allowance for loan losses. Any loans not classified as noted above are rated pass.

In addition, Federal and State regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan and lease losses and may require the Bank to recognize additions to the allowance based on their judgments about information available to them at the time of their examination, which may not be currently available to management. Based on management's comprehensive analysis of the loan portfolio, management believes the current level of the allowance for loan losses is adequate.

The classes of the loan portfolio, summarized by the aggregate pass rating and the classified ratings of special mention, substandard, and doubtful within Mid Penn's internal risk rating system as of March 31, 2014 and December 31, 2013 are as follows:

| (Dollars in thousands) | | Special | | | |
|---------------------------------------|------------|----------|-------------|----------|------------|
| March 31, 2014 | Pass | Mention | Substandard | Doubtful | Total |
| Commercial and industrial | \$ 103,644 | \$ 845 | \$ 1,544 | \$ - | \$ 106,033 |
| Commercial real estate | 281,045 | 2,587 | 12,471 | - | 296,103 |
| Commercial real estate - construction | 46,477 | 372 | - | - | 46,849 |
| Lease financing | 1,496 | - | - | - | 1,496 |
| Residential mortgage | 67,817 | 180 | 324 | - | 68,321 |
| Home equity | 26,213 | 91 | 160 | - | 26,464 |
| Consumer | 4,473 | - | - | - | 4,473 |
| | \$ 531,165 | \$ 4,075 | \$ 14,499 | \$ - | \$ 549,739 |

| (Dollars in thousands) | | Special | | | |
|------------------------|------|---------|-------------|----------|-------|
| December 31, 2013 | Pass | Mention | Substandard | Doubtful | Total |

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| | | | | | |
|---------------------------------------|------------|----------|-----------|------|------------|
| Commercial and industrial | \$ 103,330 | \$ 938 | \$ 1,576 | \$ - | \$ 105,844 |
| Commercial real estate | 277,232 | 2,771 | 12,771 | - | 292,774 |
| Commercial real estate - construction | 45,265 | 382 | - | - | 45,647 |
| Lease financing | 1,356 | - | - | - | 1,356 |
| Residential mortgage | 69,447 | 27 | 356 | - | 69,830 |
| Home equity | 26,056 | 96 | 169 | - | 26,321 |
| Consumer | 4,690 | - | - | - | 4,690 |
| | \$ 527,376 | \$ 4,214 | \$ 14,872 | \$ - | \$ 546,462 |

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Impaired loans by loan portfolio class as of March 31, 2014 and December 31, 2013 are summarized as follows:

| (Dollars in thousands) | March 31, 2014 | | | December 31, 2013 | | |
|-------------------------------------|---------------------|--------------------------|-------------------|---------------------|--------------------------|-------------------|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| With no related allowance recorded: | | | | | | |
| Commercial and industrial | \$ 195 | \$ 679 | \$ - | \$ 185 | \$ 671 | \$ - |
| Commercial real estate | 2,890 | 6,230 | - | 2,596 | 5,898 | - |
| Residential mortgage | 260 | 276 | - | 266 | 282 | - |
| Home equity | 26 | 785 | - | 27 | 792 | - |
| With an allowance recorded: | | | | | | |
| Commercial and industrial | \$ 74 | \$ 201 | \$ 66 | \$ 115 | \$ 243 | \$ 42 |
| Commercial real estate | 7,124 | 7,510 | 1,792 | 7,649 | 7,972 | 1,860 |
| Residential mortgage | - | - | - | 25 | 25 | 25 |
| Home equity | 45 | 45 | 8 | 49 | 49 | 6 |
| Total: | | | | | | |
| Commercial and industrial | \$ 269 | \$ 880 | \$ 66 | \$ 300 | \$ 914 | \$ 42 |
| Commercial real estate | 10,014 | 13,740 | 1,792 | 10,245 | 13,870 | 1,860 |
| Residential mortgage | 260 | 276 | - | 291 | 307 | 25 |
| Home equity | 71 | 830 | 8 | 76 | 841 | 6 |

Average recorded investment of impaired loans and related interest income recognized for the three months ended March 31, 2014 and March 31, 2013 are summarized as follows:

| (Dollars in thousands) | March 31, 2014 | | March 31, 2013 | |
|---------------------------------------|-----------------------------|----------------------------|-----------------------------|----------------------------|
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| With no related allowance recorded: | | | | |
| Commercial and industrial | \$ 197 | \$ - | \$ 196 | \$ - |
| Commercial real estate | 2,921 | - | 6,450 | 17 |
| Residential mortgage | 263 | - | - | - |
| Home equity | 27 | - | 123 | - |
| With an allowance recorded: | | | | |
| Commercial and industrial | \$ 74 | \$ - | \$ 206 | \$ - |
| Commercial real estate | 7,167 | - | 4,246 | - |
| Commercial real estate - construction | - | - | 54 | - |
| Residential mortgage | - | - | 86 | - |

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| | | | | |
|---------------------------------------|--------|------|--------|------|
| Home equity | 47 | - | 67 | - |
| Total: | | | | |
| Commercial and industrial | \$ 271 | \$ - | \$ 402 | \$ - |
| Commercial real estate | 10,088 | - | 10,696 | 17 |
| Commercial real estate - construction | - | - | 54 | - |
| Residential mortgage | 263 | - | 86 | - |
| Home equity | 74 | - | 190 | - |

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Non-accrual loans by loan portfolio class as of March 31, 2014 and December 31, 2013 are summarized as follows:

| | March 31, 2014 | December 31, 2013 |
|---------------------------|----------------------|----------------------|
| (Dollars in thousands) | | |
| Commercial and industrial | \$ | |