

LAKELAND BANCORP INC  
Form 10-Q  
August 08, 2017  
Table of Contents

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 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 June 30, 2017

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 000-17820

LAKELAND BANCORP, INC.

(Exact name of registrant as specified in its charter)

New Jersey

22-2953275

(State or other jurisdiction of  
incorporation or organization)

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

250 Oak Ridge Road, Oak Ridge, New Jersey

07438

(Address of principal executive offices)

(Zip Code)

(973) 697-2000

(Registrant's telephone number, including area code)

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

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

As of July 31, 2017, there were 47,352,725 outstanding shares of Common Stock, no par value.

**Table of Contents**

LAKELAND BANCORP, INC.

Form 10-Q Index

|                                      | PAGE  |
|--------------------------------------|---|
| <u>Part I. Financial Information</u> |   |
| Item 1.                              | <u>Financial Statements:</u>  |
|                                      | <u>Consolidated Balance Sheets as of June 30, 2017 (unaudited) and December 31, 2016</u>                                      |
|                                      | 3   |
|                                      | <u>Consolidated Statements of Income for the Three and Six Months Ended June 30, 2017 and 2016 (unaudited)</u>                |
|                                      | 4   |
|                                      | <u>Consolidated Statements of Comprehensive Income for the Three and Six Months Ended June 30, 2017 and 2016 (unaudited)</u>  |
|                                      | 5   |
|                                      | <u>Consolidated Statements of Changes in Stockholders' Equity for the Six Months Ended June 30, 2017 and 2016 (unaudited)</u> |
|                                      | 6   |
|                                      | <u>Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2017 and 2016 (unaudited)</u>                      |
|                                      | 7   |
|                                      | <u>Notes to Consolidated Financial Statements</u>   |
|                                      | 9   |
| Item 2.                              | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                                  |
|                                      | 40  |
| Item 3.                              | <u>Quantitative and Qualitative Disclosures About Market Risk</u>   |
|                                      | 54  |
| Item 4.                              | <u>Controls and Procedures</u>  |
|                                      | 56  |
| <u>Part II. Other Information</u>    |   |
| Item 1.                              | <u>Legal Proceedings</u>  |
|                                      | 57  |
| Item 1A.                             | <u>Risk Factors</u>   |
|                                      | 57  |
| Item 2.                              | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>  |
|                                      | 57  |
| Item 3.                              | <u>Defaults Upon Senior Securities</u>  |
|                                      | 57  |
| Item 4.                              | <u>Mine Safety Disclosures</u>  |
|                                      | 57  |
| Item 5.                              | <u>Other Information</u>  |
|                                      | 57  |
| Item 6.                              | <u>Exhibits</u>   |
|                                      | 57  |
|                                      | <u>Signatures</u>   |
|                                      | 58  |

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****Lakeland Bancorp, Inc. and Subsidiaries****CONSOLIDATED BALANCE SHEETS**

|   | June 30,<br>2017<br>(unaudited) | December 31, 2016   |
|---|---------------------------------|---------------------|
|   | (dollars in thousands)          |                     |
| <b>ASSETS</b>   |                                 |                     |
| Cash  | \$ 169,109                      | \$ 169,149          |
| Interest-bearing deposits due from banks  | 16,573                          | 6,652               |
| Total cash and cash equivalents   | 185,682                         | 175,801             |
| Investment securities available for sale, at fair value   | 673,164                         | 606,704             |
| Investment securities held to maturity; fair value of \$138,619 at June 30, 2017 and \$146,990 at December 31, 2016 | 138,468                         | 147,614             |
| Federal Home Loan Bank and other membership bank stock, at cost   | 18,899                          | 15,099              |
| Loans, net of deferred costs (fees)   | 4,050,731                       | 3,870,598           |
| Less: allowance for loan and lease losses   | 32,823                          | 31,245              |
| Net loans   | 4,017,908                       | 3,839,353           |
| Loans held for sale   | 877                             | 1,742               |
| Premises and equipment, net   | 50,411                          | 52,236              |
| Accrued interest receivable   | 13,192                          | 12,557              |
| Goodwill  | 136,433                         | 135,747             |
| Other identifiable intangible assets  | 2,631                           | 3,344               |
| Bank owned life insurance   | 89,339                          | 72,384              |
| Other assets  | 35,183                          | 30,550              |
| <b>TOTAL ASSETS</b>   | <b>\$ 5,362,187</b>             | <b>\$ 5,093,131</b> |
| <b>LIABILITIES</b>  |                                 |                     |
| Deposits:   |                                 |                     |
| Noninterest-bearing   | \$ 978,668                      | \$ 927,270          |
| Savings and interest-bearing transaction accounts   | 2,682,291                       | 2,620,657           |
| Time deposits \$250 thousand and under  | 408,228                         | 404,680             |
| Time deposits over \$250 thousand   | 158,017                         | 140,228             |
| Total deposits  | 4,227,204                       | 4,092,835           |
| Federal funds purchased and securities sold under agreements to repurchase  | 118,487                         | 56,354              |
| Other borrowings  | 312,251                         | 260,866             |

Edgar Filing: LAKELAND BANCORP INC - Form 10-Q

|   |                     |                     |
|---|---------------------|---------------------|
| Subordinated debentures   | 104,842             | 104,784             |
| Other liabilities   | 31,858              | 28,248              |
| <b>TOTAL LIABILITIES</b>  | <b>4,794,642</b>    | <b>4,543,087</b>    |
| <b>STOCKHOLDERS EQUITY</b>  |                     |                     |
| Common stock, no par value; authorized shares, 70,000,000; issued<br>47,352,725 shares at June 30, 2017 and 47,222,914 shares at December 31,<br>2016 | 511,967             | 510,861             |
| Retained earnings   | 54,969              | 38,590              |
| Accumulated other comprehensive income  | 609                 | 593                 |
| <b>TOTAL STOCKHOLDERS EQUITY</b>  | <b>567,545</b>      | <b>550,044</b>      |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>  | <b>\$ 5,362,187</b> | <b>\$ 5,093,131</b> |

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

**Table of Contents****Lakeland Bancorp, Inc. and Subsidiaries****CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)**

|  | For the Three Months Ended June 30,   |               | For the Six Months Ended June 30, |               |
|--|---------------------------------------|---------------|-----------------------------------|---------------|
|  | 2017                                  | 2016          | 2017                              | 2016          |
|  | (in thousands, except per share data) |               |                                   |               |
| <b>INTEREST INCOME</b>   |                                       |               |                                   |               |
| Loans, leases and fees   | \$ 42,740                             | \$ 35,800     | \$ 83,151                         | \$ 69,921     |
| Federal funds sold and interest-bearing deposits with banks                | 132                                   | 124           | 408                               | 199           |
| Taxable investment securities and other                                    | 3,818                                 | 2,696         | 7,417                             | 5,658         |
| Tax-exempt investment securities   | 522                                   | 417           | 1,032                             | 830           |
| <b>TOTAL INTEREST INCOME</b>   | <b>47,212</b>                         | <b>39,037</b> | <b>92,008</b>                     | <b>76,608</b> |
| <b>INTEREST EXPENSE</b>  |                                       |               |                                   |               |
| Deposits   | 3,784                                 | 2,404         | 7,118                             | 4,609         |
| Federal funds purchased and securities sold under agreements to repurchase | 98                                    | 9             | 108                               | 47            |
| Other borrowings   | 1,909                                 | 1,522         | 4,038                             | 3,000         |
| <b>TOTAL INTEREST EXPENSE</b>  | <b>5,791</b>                          | <b>3,935</b>  | <b>11,264</b>                     | <b>7,656</b>  |
| <b>NET INTEREST INCOME</b>   | <b>41,421</b>                         | <b>35,102</b> | <b>80,744</b>                     | <b>68,952</b> |
| Provision for loan and lease losses  | 1,827                                 | 1,010         | 3,045                             | 2,085         |
| <b>NET INTEREST INCOME AFTER PROVISION FOR LOAN AND LEASE LOSSES</b>       | <b>39,594</b>                         | <b>34,092</b> | <b>77,699</b>                     | <b>66,867</b> |
| <b>NONINTEREST INCOME</b>  |                                       |               |                                   |               |
| Service charges on deposit accounts  | 2,674                                 | 2,523         | 5,129                             | 4,965         |
| Commissions and fees   | 1,135                                 | 1,099         | 2,291                             | 2,078         |
| Gains (losses) on sales of investment securities                           | (15)                                  |               | 2,524                             | 370           |
| Gains on sales of loans  | 471                                   | 425           | 869                               | 845           |
| Income on bank owned life insurance  | 500                                   | 414           | 926                               | 822           |
| Other income   | 1,346                                 | 424           | 2,466                             | 672           |
| <b>TOTAL NONINTEREST INCOME</b>  | <b>6,111</b>                          | <b>4,885</b>  | <b>14,205</b>                     | <b>9,752</b>  |
| <b>NONINTEREST EXPENSE</b>   |                                       |               |                                   |               |
| Salaries and employee benefits   | 15,096                                | 13,091        | 30,513                            | 27,176        |
| Net occupancy expense  | 2,507                                 | 2,341         | 5,343                             | 5,029         |
| Furniture and equipment  | 1,996                                 | 2,082         | 4,093                             | 4,028         |
| Stationery, supplies and postage   | 572                                   | 416           | 1,015                             | 859           |
| Marketing expense  | 508                                   | 385           | 909                               | 694           |
| FDIC insurance expense   | 425                                   | 681           | 743                               | 1,271         |

Edgar Filing: LAKELAND BANCORP INC - Form 10-Q

|  |                  |                  |                  |                  |
|--|------------------|------------------|------------------|------------------|
| Data processing expense  | 502              | 459              | 1,055            | 979              |
| Telecommunications expense                                       | 372              | 386              | 776              | 810              |
| ATM and debit card expense                                       | 517              | 383              | 958              | 729              |
| Expenses on other real estate owned and other repossessed assets | 4                | 26               | 41               | 65               |
| Long-term debt prepayment fee                                    |                  |                  | 2,828            |                  |
| Merger related expenses  |                  | 685              |                  | 2,406            |
| Core deposit intangible amortization                             | 190              | 164              | 385              | 331              |
| Other expenses   | 2,677            | 2,616            | 5,177            | 4,762            |
| <b>TOTAL NONINTEREST EXPENSE</b>                                 | <b>25,366</b>    | <b>23,715</b>    | <b>53,836</b>    | <b>49,139</b>    |
| Income before income tax expense                                 | 20,339           | 15,262           | 38,068           | 27,480           |
| Income tax expense   | 6,969            | 5,132            | 12,386           | 9,242            |
| <b>NET INCOME</b>  | <b>\$ 13,370</b> | <b>\$ 10,130</b> | <b>\$ 25,682</b> | <b>\$ 18,238</b> |
| <b>PER SHARE OF COMMON STOCK</b>                                 |                  |                  |                  |                  |
| Basic earnings   | \$ 0.28          | \$ 0.24          | \$ 0.54          | \$ 0.44          |
| Diluted earnings   | \$ 0.28          | \$ 0.24          | \$ 0.53          | \$ 0.44          |
| Dividends  | \$ 0.100         | \$ 0.095         | \$ 0.195         | \$ 0.180         |

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

Table of Contents**Lakeland Bancorp, Inc. and Subsidiaries**

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

|  | For the Three Months Ended June 30, |           | For the Six Months Ended June 30, |           |
|--|-------------------------------------|-----------|-----------------------------------|-----------|
|  | 2017                                | 2016      | 2017                              | 2016      |
|  | (in thousands)                      |           | (in thousands)                    |           |
| NET INCOME   | \$ 13,370                           | \$ 10,130 | \$ 25,682                         | \$ 18,238 |
| OTHER COMPREHENSIVE INCOME (LOSS),<br>NET OF TAX:                        |                                     |           |                                   |           |
| Unrealized gains on securities available for sale                        | 1,029                               | 1,697     | 1,763                             | 5,854     |
| Reclassification for securities losses (gains) included<br>in net income | 9                                   |           | (1,640)                           | (233)     |
| Unrealized losses on derivatives   | (121)                               | (126)     | (107)                             | (126)     |
| Change in pension liability, net   |                                     | 6         |                                   | 44        |
| Other comprehensive income   | 917                                 | 1,577     | 16                                | 5,539     |
| TOTAL COMPREHENSIVE INCOME   | \$ 14,287                           | \$ 11,707 | \$ 25,698                         | \$ 23,777 |

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



Table of Contents**Lakeland Bancorp, Inc. and Subsidiaries**

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (UNAUDITED)

For the Six Months Ended June 30, 2017 and 2016

|   | Common<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Total      |
|---|-----------------|----------------------|---|------------|
|   | (in thousands)  |                      |   |            |
| At January 1, 2016                        | \$ 386,287      | \$ 13,079            | \$ 1,150  | \$ 400,516 |
| Net income                                |                 | 18,238               |   | 18,238     |
| Other comprehensive income, net of tax    |                 |                      | 5,539   | 5,539      |
| Stock based compensation                  | 1,107           |                      |   | 1,107      |
| Issuance of stock for Pascack acquisition | 37,221          |                      |   | 37,221     |
| Retirement of restricted stock            | (206)           |                      |   | (206)      |
| Cash dividends, common stock              |                 | (7,481)              |   | (7,481)    |
| At June 30, 2016                          | \$ 424,409      | \$ 23,836            | \$ 6,689  | \$ 454,934 |
| At January 1, 2017                        | \$ 510,861      | \$ 38,590            | \$ 593  | \$ 550,044 |
| Net income                                |                 | 25,682               |   | 25,682     |
| Other comprehensive income, net of tax    |                 |                      | 16  | 16         |
| Stock based compensation                  | 1,566           |                      |   | 1,566      |
| Exercise of stock options                 | 313             |                      |   | 313        |
| Retirement of restricted stock            | (773)           |                      |   | (773)      |
| Cash dividends, common stock              |                 | (9,303)              |   | (9,303)    |
| At June 30, 2017                          | \$ 511,967      | \$ 54,969            | \$ 609  | \$ 567,545 |

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

**Table of Contents****Lakeland Bancorp, Inc. and Subsidiaries****CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

|   | For the Six Months Ended June 30, |                  |
|---|-----------------------------------|------------------|
|   | 2017                              | 2016             |
|   | (in thousands)                    |                  |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                                   |                  |
| Net income  | \$ 25,682                         | \$ 18,238        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                   |                  |
| Net amortization of premiums, discounts and deferred loan fees and costs          | 2,413                             | 1,794            |
| Depreciation and amortization   | 2,080                             | 1,847            |
| Amortization of intangible assets   | 385                               | 331              |
| Provision for loan and lease losses   | 3,045                             | 2,085            |
| Loans originated for sale   | (27,197)                          | (38,408)         |
| Proceeds from sales of loans held for sale  | 28,931                            | 34,023           |
| Gains on sales of securities  | (2,524)                           | (370)            |
| Gains on sales of loans held for sale   | (869)                             | (845)            |
| Gains on other real estate and other repossessed assets                           | (500)                             | (90)             |
| (Gains) losses on sales of premises and equipment                                 | (672)                             | 117              |
| Long-term debt prepayment penalty   | 2,828                             |                  |
| Stock-based compensation  | 1,566                             | 1,107            |
| Excess tax benefits   | 582                               |                  |
| Increase in other assets  | (4,672)                           | (9,176)          |
| Increase in other liabilities   | 1,988                             | 483              |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>                                  | <b>33,066</b>                     | <b>11,136</b>    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                                   |                  |
| Net cash acquired in acquisitions   |                                   | 40,942           |
| Proceeds from repayments and maturities of available for sale securities          | 43,726                            | 40,083           |
| Proceeds from repayments and maturities of held to maturity securities            | 18,624                            | 13,156           |
| Proceeds from sales of available for sale securities                              | 4,484                             | 15,654           |
| Purchase of available for sale securities   | (113,724)                         | (61,705)         |
| Purchase of held to maturity securities   | (9,754)                           | (22,778)         |
| Purchase of bank owned life insurance   | (16,000)                          |                  |
| Proceeds from redemptions of Federal Home Loan Bank stock                         | 3,477                             | 1,757            |
| Purchases of Federal Home Loan Bank stock   | (7,278)                           | (504)            |
| Net increase in loans and leases  | (186,328)                         | (170,698)        |
| Proceeds from sales of other real estate and repossessed assets                   | 3,583                             | 758              |
| Proceeds from dispositions and sales of premises and equipment                    | 1,262                             | 11               |
| Purchases of premises and equipment   | (1,324)                           | (1,648)          |
| <b>NET CASH USED IN INVESTING ACTIVITIES</b>                                      | <b>(259,252)</b>                  | <b>(144,972)</b> |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                                   |                  |

Edgar Filing: LAKELAND BANCORP INC - Form 10-Q

|   |                   |                   |
|---|-------------------|-------------------|
| Net increase in deposits  | 134,719           | 237,564           |
| Increase (decrease) in federal funds purchased and securities sold under agreements to repurchase | 62,133            | (27,572)          |
| Proceeds from other borrowings  | 164,036           | 4,921             |
| Repayments of other borrowings  | (115,058)         | (39,000)          |
| Exercise of stock options   | 313               |                   |
| Retirement of restricted stock  | (773)             | (206)             |
| Dividends paid  | (9,303)           | (7,481)           |
| <b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>  | <b>236,067</b>    | <b>168,226</b>    |
| Net increase in cash and cash equivalents   | 9,881             | 34,390            |
| Cash and cash equivalents, beginning of period  | 175,801           | 118,493           |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>   | <b>\$ 185,682</b> | <b>\$ 152,883</b> |

**Table of Contents**

|   | For the Six Months Ended June 30, |                  |
|---|-----------------------------------|------------------|
|   | 2017                              | 2016             |
|   | (in thousands)                    |                  |
| <b>Supplemental schedule of non-cash investing and financing activities:</b>                    |                                   |                  |
| Cash paid during the period for income taxes  | \$ 11,703                         | \$ 10,682        |
| Cash paid during the period for interest  | 11,310                            | 7,501            |
| Transfer of loans and leases into other repossessed assets and other real estate owned          | 3,425                             | 1,280            |
| <b>Acquisition of Pascack:</b>  |                                   |                  |
| <b>Non-cash assets acquired:</b>  |                                   |                  |
| Federal Home Loan Bank stock  |                                   | 2,962            |
| Investment securities held for maturity   |                                   | 3,925            |
| Loans, including loans held for sale  |                                   | 319,575          |
| Goodwill and other intangible assets, net   |                                   | 16,825           |
| Other assets  |                                   | 21,110           |
| <b>Total non-cash assets acquired</b>   |                                   | <b>364,397</b>   |
| <b>Liabilities assumed:</b>   |                                   |                  |
| Deposits  |                                   | (304,466)        |
| Other borrowings  |                                   | (57,308)         |
| Other liabilities   |                                   | (6,344)          |
| <b>Total liabilities assumed</b>  |                                   | <b>(368,118)</b> |
| Common stock issued and fair value of stock options converted to Lakeland Bancorp stock options |                                   | 37,221           |

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

---

**Table of Contents**

**Lakeland Bancorp, Inc. and Subsidiaries**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 SIGNIFICANT ACCOUNTING POLICIES

*Basis of Presentation.*

This quarterly report presents the consolidated financial statements of Lakeland Bancorp, Inc. and its subsidiaries, including Lakeland Bank ( Lakeland ) and the Bank's wholly owned subsidiaries (collectively, the Company ). The accounting and reporting policies of the Company conform with accounting principles generally accepted in the United States of America ( U.S. GAAP ) and predominant practices within the banking industry. The Company's unaudited interim financial statements reflect all adjustments, such as normal recurring accruals that are, in the opinion of management, necessary for the fair presentation of the results of the interim periods. The results of operations for the six months ended June 30, 2017 do not necessarily indicate the results that the Company will achieve for all of 2017.

Certain information and footnote disclosures required under U.S. GAAP have been condensed or omitted, as permitted by rules and regulations of the Securities and Exchange Commission. These unaudited interim financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes that are presented in the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

NOTE 2 ACQUISITIONS

*Harmony Bank*

On July 1, 2016, the Company completed its acquisition of Harmony Bank ( Harmony ), a bank with three branches located in Ocean County, NJ. Effective upon the opening of business on July 1, 2016, Harmony was merged into Lakeland Bank. This merger allows the Company to expand its presence to Ocean County. The merger agreement provided that shareholders of Harmony would receive 1.25 shares of the Company common stock for each share of Harmony Bank common stock that they owned at the effective time of the merger. The Company issued an aggregate of 3,201,109 shares of its common stock in the merger. Outstanding Harmony stock options were paid out in cash at the difference between \$14.31 (Lakeland's closing stock price on July 1, 2016 of \$11.45 multiplied by 1.25) and the average strike price of \$9.07 for a total cash payment of \$869,000.

During the second quarter of 2017, the Company revised the estimate of the fair value of the acquired assets as of the acquisition date. This adjustment related to the fair market value of certain loans and the valuation of core deposit intangible which resulted in an increase of \$685,000 to goodwill.

The acquisition was accounted for under the acquisition method of accounting. Accordingly, the assets acquired and liabilities assumed in the acquisition were recorded at their estimated fair values based on management's best estimates using information available at the date of the acquisition, including the use of a third party valuation specialist. The fair values are preliminary estimates and subject to adjustment for up to one year after the closing date of the acquisition. The following table summarizes the estimated fair value of the acquired assets and liabilities assumed at the date of acquisition for Harmony, net of cash consideration paid.



**Table of Contents**

|  | On July 1,<br>2016<br>(in thousands) |
|--|--------------------------------------|
| Cash and cash equivalents                    | \$ 27,809                            |
| Securities available for sale                | 7,474                                |
| Securities held to maturity                  | 6,885                                |
| Federal Home Loan Bank stock                 | 780                                  |
| Loans  | 259,985                              |
| Premises and equipment                       | 3,125                                |
| Goodwill                                     | 11,147                               |
| Identifiable intangible assets               | 1,088                                |
| Accrued interest receivable and other assets | 8,146                                |
| <br>Total assets acquired                    | <br>326,439                          |
| Deposits                                     | (278,060)                            |
| Other borrowings                             | (9,314)                              |
| Other liabilities                            | (2,411)                              |
| <br>Total liabilities assumed                | <br>(289,785)                        |
| <br>Net assets acquired                      | <br>\$ 36,654                        |

Loans acquired in the Harmony acquisition were recorded at fair value, and there was no carryover related allowance for loan and lease losses. The fair values of loans acquired from Harmony were estimated using cash flow projections based on the remaining maturity and repricing terms. Cash flows were adjusted for estimated future credit losses and the rate of prepayments. Projected cash flows were then discounted to present value using a risk-adjusted market rate for similar loans.

The following is a summary of the loans accounted for in accordance with ASC 310-30 that were acquired in the Harmony acquisition as of the closing date.

|  | Acquired<br>Credit<br>Impaired<br>Loans<br>(in thousands) |
|--|---|
| Contractually required principal and interest at acquisition                       | \$ 1,264  |
| Contractual cash flows not expected to be collected<br>(non-accretable difference) | 398   |
| Expected cash flows at acquisition   | 866   |
| Interest component of expected cash flows (accretable<br>difference)               | 97  |
| <br>Fair value of acquired loans   | <br>\$ 769  |

The core deposit intangible totaled \$691,000 and is being amortized over its estimated useful life of approximately 10 years using an accelerated method. The goodwill will be evaluated annually for impairment. The goodwill is not deductible for tax purposes.

The fair values of deposit liabilities with no stated maturities such as checking, money market and savings accounts, were assumed to equal the carrying amounts since these deposits are payable on demand. The fair values of certificates of deposits and IRAs represent the present value of contractual cash flows discounted at market rates for similar certificates of deposit.



**Table of Contents***Pascack Bancorp*

On January 7, 2016, the Company completed its acquisition of Pascack Bancorp, Inc. ( *Pascack* ), a bank holding company headquartered in Waldwick, New Jersey. *Pascack* was the parent of *Pascack Community Bank* which operated 8 branches in Bergen and Essex Counties in New Jersey. This acquisition enabled the Company to broaden its presence in Bergen and Essex counties. Effective as of the close of business on January 7, 2016, *Pascack* merged into the Company, and *Pascack Community Bank* merged into *Lakeland Bank*. The merger agreement provided that the shareholders of *Pascack* would receive, at their election, for each outstanding share of *Pascack* common stock that they own at the effective time of the merger, either 0.9576 shares of *Lakeland Bancorp* common stock or \$11.35 in cash, subject to proration as described in the merger agreement, so that 90% of the aggregate merger consideration was shares of *Lakeland Bancorp* common stock and 10% was cash. *Lakeland Bancorp* issued 3,314,284 shares of its common stock in the merger and paid approximately \$4.5 million in cash including the cash paid in connection with the cancellation of *Pascack* stock options. Outstanding *Pascack* stock options were paid out in cash at the difference between \$11.35 and an average strike price of \$7.37 for a total cash payment of \$122,000.

The acquisition was accounted for under the acquisition method of accounting. Accordingly, the assets acquired and liabilities assumed in the acquisition were recorded at their estimated fair values based on management's best estimates using information available at the date of the acquisition, including the use of a third party valuation specialist. The following table summarizes the estimated fair value of the acquired assets and liabilities assumed at the date of acquisition for *Pascack*, net of cash consideration paid.

|  | On January 7,<br>2016<br>(in thousands) |
|--|---|
| Cash and cash equivalents                    | \$ 40,942                               |
| Securities held to maturity                  | 3,925                                   |
| Federal Home Loan Bank stock                 | 2,962                                   |
| Loans  | 319,575                                 |
| Premises and equipment                       | 14,438                                  |
| Goodwill                                     | 15,311                                  |
| Identifiable intangible assets               | 1,514                                   |
| Accrued interest receivable and other assets | 6,672                                   |
| <b>Total assets acquired</b>                 | <b>405,339</b>                          |
| Deposits                                     | (304,466)                               |
| Other borrowings                             | (57,308)                                |
| Other liabilities                            | (6,344)                                 |
| <b>Total liabilities assumed</b>             | <b>(368,118)</b>                        |
| <b>Net assets acquired</b>                   | <b>\$ 37,221</b>                        |

Loans acquired in the *Pascack* acquisition were recorded at fair value, and there was no carryover related allowance for loan and lease losses. The fair values of loans acquired from *Pascack* were estimated using cash flow projections based on the remaining maturity and repricing terms. Cash flows were adjusted for estimated future credit losses and

the rate of prepayments. Projected cash flows were then discounted to present value using a risk-adjusted market rate for similar loans.

The following is a summary of the loans accounted for in accordance with ASC 310-30 that were acquired in the Pascack acquisition as of the closing date.

**Table of Contents**

|  | Acquired<br>Credit<br>Impaired<br>Loans<br>(in thousands) |
|--|---|
| Contractually required principal and interest at acquisition                       | \$ 4,932  |
| Contractual cash flows not expected to be collected<br>(non-accretable difference) | 4,030   |
| Expected cash flows at acquisition   | 902   |
| Interest component of expected cash flows (accretable<br>difference)               | 85  |
| Fair value of acquired loans   | \$ 817  |

The core deposit intangible totaled \$1.5 million and is being amortized over its estimated useful life of approximately 10 years using an accelerated method. The goodwill will be evaluated annually for impairment. The goodwill is not deductible for tax purposes.

The fair values of deposit liabilities with no stated maturities such as checking, money market and savings accounts, were assumed to equal the carrying amounts since these deposits are payable on demand. The fair values of certificates of deposits and IRAs represent the present value of contractual cash flows discounted at market rates for similar certificates of deposit.

Direct costs related to the Pascaack and Harmony acquisitions were expensed as incurred. During the six months ended June 30, 2016, the Company incurred \$2.4 million of merger and acquisition integration-related expenses, which have been separately stated in the Company's consolidated statements of income.

**Table of Contents**

## NOTE 3 EARNINGS PER SHARE

The following schedule shows the Company's earnings per share calculations for the periods presented:

|  | For the Three Months Ended June 30,   |           | For the Six Months Ended June 30, |           |
|--|---------------------------------------|-----------|-----------------------------------|-----------|
|  | 2017                                  | 2016      | 2017                              | 2016      |
|  | (in thousands, except per share data) |           |                                   |           |
| Net income available to common shareholders                    | \$ 13,370                             | \$ 10,130 | \$ 25,682                         | \$ 18,238 |
| Less: earnings allocated to participating securities           | 119                                   | 106       | 239                               | 162       |
| Net income allocated to common shareholders                    | \$ 13,251                             | \$ 10,024 | \$ 25,443                         | \$ 18,076 |
| Weighted average number of common shares outstanding - basic   | 47,465                                | 41,238    | 47,410                            | 41,084    |
| Share-based plans  | 209                                   | 168       | 236                               | 161       |
| Weighted average number of common shares outstanding - diluted | 47,674                                | 41,406    | 47,646                            | 41,245    |
| Basic earnings per share                                       | \$ 0.28                               | \$ 0.24   | \$ 0.54                           | \$ 0.44   |
| Diluted earnings per share                                     | \$ 0.28                               | \$ 0.24   | \$ 0.53                           | \$ 0.44   |

There were no antidilutive options to purchase common stock excluded from the computation for the three and six months ended June 30, 2017 and 2016.

**Table of Contents**

## NOTE 4 INVESTMENT SECURITIES

|  | June 30, 2017  |  |   | Fair Value | December 31, 2016 |  |   | Fair Value |
|--|----------------|--|---|------------|-------------------|--|---|------------|
|  | Amortized Cost | Gross Unrealized Gains<br>(in thousands) | Gross Unrealized Losses<br>(in thousands) |            | Amortized Cost    | Gross Unrealized Gains<br>(in thousands) | Gross Unrealized Losses<br>(in thousands) |            |
| <b>AVAILABLE FOR SALE</b>                        |                |  |   |            |                   |  |   |            |
| U.S. Treasury and U.S. government agencies       | \$ 143,077     | \$ 244                                   | \$ (877)                                  | \$ 142,444 | \$ 118,537        | \$ 102                                   | \$ (1,280)                                | \$ 117,359 |
| Mortgage-backed securities, residential          | 445,829        | 1,255                                    | (3,541)                                   | 443,543    | 406,851           | 1,174                                    | (4,487)                                   | 403,538    |
| Mortgage-backed securities, multifamily          | 10,162         | 60                                       | (23)                                      | 10,199     | 10,192            | 30                                       | (35)                                      | 10,187     |
| Obligations of states and political subdivisions | 53,798         | 768                                      | (292)                                     | 54,274     | 48,868            | 391                                      | (933)                                     | 48,326     |
| Debt securities                                  | 5,000          | 95                                       |   | 5,095      | 5,350             | 63                                       | (1)                                       | 5,412      |
| Equity securities                                | 15,385         | 2,620                                    | (396)                                     | 17,609     | 17,314            | 5,000                                    | (432)                                     | 21,882     |
|  | \$ 673,251     | \$ 5,042                                 | \$ (5,129)                                | \$ 673,164 | \$ 607,112        | \$ 6,760                                 | \$ (7,168)                                | \$ 606,704 |

|  | June 30, 2017  |  |   | Fair Value | December 31, 2016 |  |   | Fair Value |
|--|----------------|--|---|------------|-------------------|--|---|------------|
|  | Amortized Cost | Gross Unrealized Gains<br>(in thousands) | Gross Unrealized Losses<br>(in thousands) |            | Amortized Cost    | Gross Unrealized Gains<br>(in thousands) | Gross Unrealized Losses<br>(in thousands) |            |
| <b>HELD TO MATURITY</b>                          |                |  |   |            |                   |  |   |            |
| U.S. government agencies                         | \$ 33,484      | \$ 193                                   | \$ (283)                                  | \$ 33,394  | \$ 33,553         | \$ 144                                   | \$ (430)                                  | \$ 33,267  |
| Mortgage-backed securities, residential          | 38,262         | 298                                      | (524)                                     | 38,036     | 38,706            | 369                                      | (598)                                     | 38,477     |
| Mortgage-backed securities, multifamily          | 2,008          |  | (17)                                      | 1,991      | 2,059             |  | (44)                                      | 2,015      |
| Obligations of states and political subdivisions | 62,706         | 585                                      | (135)                                     | 63,156     | 71,284            | 269                                      | (385)                                     | 71,168     |
| Debt securities                                  | 2,008          | 34                                       |   | 2,042      | 2,012             | 51                                       |   | 2,063      |
|  | \$ 138,468     | \$ 1,110                                 | \$ (959)                                  | \$ 138,619 | \$ 147,614        | \$ 833                                   | \$ (1,457)                                | \$ 146,990 |

**Table of Contents**

The following table shows investment securities by stated maturity. Securities backed by mortgages have expected maturities that differ from contractual maturities because borrowers have the right to call or prepay, and are, therefore, classified separately with no specific maturity date (in thousands):

| June 30, 2017                          | Available for Sale |            | Held to Maturity |            |
|--|--------------------|------------|------------------|------------|
|  | Amortized Cost     | Fair Value | Amortized Cost   | Fair Value |
| Due in one year or less                | \$ 2,605           | \$ 2,623   | \$ 29,499        | \$ 29,503  |
| Due after one year through five years  | 107,942            | 108,341    | 35,641           | 35,904     |
| Due after five years through ten years | 66,678             | 66,174     | 28,621           | 28,721     |
| Due after ten years                    | 24,650             | 24,675     | 4,437            | 4,464      |
|  | 201,875            | 201,813    | 98,198           | 98,592     |
| Mortgage-backed securities             | 455,991            | 453,742    | 40,270           | 40,027     |
| Equity securities                      | 15,385             | 17,609     |                  |            |
| Total securities                       | \$ 673,251         | \$ 673,164 | \$ 138,468       | \$ 138,619 |

The following table shows proceeds from sales of securities and gross gains on sales of securities for the periods indicated (in thousands):

|                      | For the Three Months Ended June 30, |      | For the Six Months Ended June 30, |           |
|----------------------|-------------------------------------|------|-----------------------------------|-----------|
|                      | 2017                                | 2016 | 2017                              | 2016      |
| Sale proceeds        | \$                                  | \$   | \$ 4,499                          | \$ 15,654 |
| Gross gains (losses) | (15)                                |      | 2,524                             | 370       |

There were no other-than-temporary impairments during the six months ended June 30, 2017 or 2016.

Gains or losses on sales of investment securities are based on the net proceeds and the adjusted carrying amount of the securities sold using the specific identification method.

Securities with a carrying value of approximately \$502.5 million and \$443.4 million at June 30, 2017 and December 31, 2016, respectively, were pledged to secure public deposits and for other purposes required by applicable laws and regulations.

The following table indicates the length of time individual securities have been in a continuous unrealized loss position for the periods presented:

**Table of Contents**

| June 30, 2017                                    | Less Than 12 Months |                     | 12 Months or Longer |                     | Number of Securities | Total                |                   |                   |
|--|---------------------|---------------------|---------------------|---------------------|----------------------|----------------------|-------------------|-------------------|
|  | Fair Value          | Unrealized Losses   | Fair Value          | Unrealized Losses   |                      | Fair Value           | Unrealized Losses |                   |
| (dollars in thousands)                           |                     |                     |                     |                     |                      |                      |                   |                   |
| <b>AVAILABLE FOR SALE</b>                        |                     |                     |                     |                     |                      |                      |                   |                   |
| U.S. government agencies                         | \$ 67,712           | \$ 653              | \$ 4,786            | \$ 224              | 15                   | \$ 72,498            | \$ 877            |                   |
| Mortgage-backed securities, residential          | 270,813             | 3,099               | 17,938              | 442                 | 85                   | 288,751              | 3,541             |                   |
| Mortgage-backed securities, multifamily          | 5,159               | 23                  |                     |                     | 1                    | 5,159                | 23                |                   |
| Obligations of states and political subdivisions | 17,616              | 275                 | 877                 | 17                  | 32                   | 18,493               | 292               |                   |
| Equity securities                                |                     |                     | 9,602               | 396                 | 2                    | 9,602                | 396               |                   |
|  | \$ 361,300          | \$ 4,050            | \$ 33,203           | \$ 1,079            | 135                  | \$ 394,503           | \$ 5,129          |                   |
| <b>HELD TO MATURITY</b>                          |                     |                     |                     |                     |                      |                      |                   |                   |
| U.S. government agencies                         | \$ 12,215           | \$ 283              | \$                  | \$                  | 2                    | \$ 12,215            | \$ 283            |                   |
| Mortgage-backed securities, residential          | 26,661              | 411                 | 2,191               | 113                 | 17                   | 28,852               | 524               |                   |
| Mortgage-backed securities, multifamily          | 846                 | 13                  | 1,047               | 4                   | 2                    | 1,893                | 17                |                   |
| Obligations of states and political subdivisions | 29,283              | 135                 |                     |                     | 17                   | 29,283               | 135               |                   |
|  | \$ 69,005           | \$ 842              | \$ 3,238            | \$ 117              | 38                   | \$ 72,243            | \$ 959            |                   |
| <b>December 31, 2016</b>                         |                     |                     |                     |                     |                      |                      |                   |                   |
|  |                     | Less Than 12 Months |                     | 12 Months or Longer |                      | Total                |                   |                   |
|  |                     | Fair Value          | Unrealized Losses   | Fair Value          | Unrealized Losses    | Number of Securities | Fair Value        | Unrealized Losses |
| (dollars in thousands)                           |                     |                     |                     |                     |                      |                      |                   |                   |
| <b>AVAILABLE FOR SALE</b>                        |                     |                     |                     |                     |                      |                      |                   |                   |
| U.S. Treasury and U.S. government agencies       | \$ 94,153           | \$ 1,280            | \$                  | \$                  | 18                   | \$ 94,153            | \$ 1,280          |                   |
| Mortgage-backed securities, residential          | 292,873             | 4,078               | 15,453              | 409                 | 91                   | 308,326              | 4,487             |                   |
| Mortgage-backed securities, multifamily          | 5,178               | 35                  |                     |                     | 1                    | 5,178                | 35                |                   |
| Obligations of states and political subdivisions | 29,904              | 933                 |                     |                     | 54                   | 29,904               | 933               |                   |
| Other debt securities                            | 350                 | 1                   |                     |                     | 1                    | 350                  | 1                 |                   |
| Equity securities                                | 6,030               | 94                  | 4,720               | 338                 | 2                    | 10,750               | 432               |                   |
|  | \$ 428,488          | \$ 6,421            | \$ 20,173           | \$ 747              | 167                  | \$ 448,661           | \$ 7,168          |                   |
| <b>HELD TO MATURITY</b>                          |                     |                     |                     |                     |                      |                      |                   |                   |
| U.S. government agencies                         | \$ 17,147           | \$ 430              | \$                  | \$                  | 3                    | \$ 17,147            | \$ 430            |                   |

Edgar Filing: LAKELAND BANCORP INC - Form 10-Q

|   |           |          |          |       |    |           |          |
|---|-----------|----------|----------|-------|----|-----------|----------|
| Mortgage-backed securities,<br>residential          | 27,909    | 535      | 1,061    | 63    | 15 | 28,970    | 598      |
| Mortgage-backed securities,<br>multifamily          | 2,015     | 44       |          |       | 2  | 2,015     | 44       |
| Obligations of states and political<br>subdivisions | 50,302    | 384      | 401      | 1     | 43 | 50,703    | 385      |
|   | \$ 97,373 | \$ 1,393 | \$ 1,462 | \$ 64 | 63 | \$ 98,835 | \$ 1,457 |



**Table of Contents**

Management has evaluated the securities in the above table and has concluded that none of the securities are other-than-temporarily impaired. The fair values being below cost is due to interest rate movements and is deemed temporary. All investment securities are evaluated on a periodic basis to identify any factors that would require a further analysis. In evaluating the Company's securities, management considers the following items:

- The Company's ability and intent to hold the securities, including an evaluation of the need to sell the security to meet certain liquidity measures, or whether the Company has sufficient levels of cash to hold the identified security in order to recover the entire amortized cost of the security;
- The financial condition of the underlying issuer;
- The credit ratings of the underlying issuer and if any changes in the credit rating have occurred;
- The length of time the security's fair value has been less than amortized cost; and
- Adverse conditions related to the security or its issuer if the issuer has failed to make scheduled payments or other factors.

If the above factors indicate that an additional analysis is required, management will perform and consider the results of a discounted cash flow analysis.

As of June 30, 2017, the equity securities include investments in other financial institutions for market appreciation purposes. These equities had a purchase price of \$2.1 million and a market value of \$4.7 million as of June 30, 2017.

As of June 30, 2017, the equity securities also included \$12.9 million in investment funds that do not have a quoted market price, but use net asset value per share or its equivalent to measure fair value.

The investment funds include \$9.6 million that are invested in government guaranteed loans, mortgage-backed securities, small business loans and other instruments supporting affordable housing and economic development. The Company may redeem these funds at the net asset value calculated at the end of the current business day less any unpaid management fees. As of June 30, 2017, the amortized cost of these securities was \$10.0 million and the fair value was \$9.6 million. There are no restrictions on redemptions for the holdings in these investments other than the notice required by the fund manager. There are no unfunded commitments related to these investments.

The investment funds also include \$3.3 million that are primarily invested in community development loans that are guaranteed by the Small Business Administration (SBA). Because the funds are primarily guaranteed by the federal government there are minimal changes in market value between accounting periods. These funds can be redeemed with 60 days notice at the net asset value less unpaid management fees with the approval of the fund manager. As of June 30, 2017, the net amortized cost equaled the market value of the investment. There are no unfunded commitments related to these investments.

**NOTE 5 LOANS, LEASES AND OTHER REAL ESTATE**

The following sets forth the composition of the Company's loan and lease portfolio:

|                                    | June 30, 2017  | December 31, 2016 |
|------------------------------------|----------------|-------------------|
|                                    | (in thousands) |                   |
| Commercial, secured by real estate | \$ 2,725,418   | \$ 2,556,601      |
| Commercial, industrial and other   | 352,977        | 350,228           |

Edgar Filing: LAKELAND BANCORP INC - Form 10-Q

|   |                     |                     |
|---|---------------------|---------------------|
| Leases  | 70,295              | 67,016              |
| Real estate - residential mortgage            | 337,765             | 349,581             |
| Real estate - construction                    | 230,178             | 211,109             |
| Home equity and consumer                      | 337,643             | 339,360             |
| <b>Total loans and leases</b>                 | <b>4,054,276</b>    | <b>3,873,895</b>    |
| Less: deferred fees                           | (3,545)             | (3,297)             |
| <b>Loans and leases, net of deferred fees</b> | <b>\$ 4,050,731</b> | <b>\$ 3,870,598</b> |

At June 30, 2017 and December 31, 2016, home equity and consumer loans included overdraft deposit balances of \$763,000 and \$364,000, respectively. At June 30, 2017 and December 31, 2016, the Company had \$1.1 billion and \$942.0 million, respectively, in loans pledged for actual and potential borrowings at the Federal Home Loan Bank of New York( FHLB ).

**Table of Contents***Purchased Credit Impaired Loans*

The carrying value of loans acquired in the Pascack acquisition and accounted for in accordance with ASC Subtopic 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality, was \$214,000 at June 30, 2017, which was \$603,000 less than the balance at the time of acquisition on January 7, 2016. In first quarter 2017, one of the Pascack purchased credit impaired ( PCI ) loans totaling \$127,000 experienced further credit deterioration and was fully charged off. In the second quarter of 2017, a loan with a net value of \$218,000 was fully paid off. The carrying value of loans acquired in the Harmony acquisition was \$528,000 at June 30, 2017 which was \$241,000 less than the balance at acquisition date on July 1, 2016. In the second quarter of 2017, a loan with a net value of \$247,000 was fully paid off.

The following table presents changes in the accretable yield for PCI loans:

|  | For the Three Months Ended |               | For the Six Months Ended |               |
|--|----------------------------|---------------|--------------------------|---------------|
|  | June 30, 2017              | June 30, 2016 | June 30, 2017            | June 30, 2016 |
|  | (in thousands)             |               | (in thousands)           |               |
| Balance, beginning of period                   | \$ 180                     | \$ 69         | \$ 145                   | \$ 85         |
| Acquisitions                                   |                            |               |                          |               |
| Accretion                                      | (47)                       | (15)          | (98)                     | (31)          |
| Net reclassification non-accretable difference |                            | 11            | 86                       | 11            |
| Balance, end of period                         | \$ 133                     | \$ 65         | \$ 133                   | \$ 65         |

*Non-Performing Assets and Past Due Loans*

The following schedule sets forth certain information regarding the Company's non-performing assets and its accruing troubled debt restructurings, excluding PCI loans:

|  | June 30,<br>2017 | December 31,<br>2016 |
|--|------------------|----------------------|
|  | (in thousands)   |                      |
| Commercial, secured by real estate             | \$ 8,768         | \$ 10,413            |
| Commercial, industrial and other               | 378              | 167                  |
| Leases, including leases held for sale         | 81               | 153                  |
| Real estate - residential mortgage             | 3,857            | 6,048                |
| Real estate - construction                     | 1,472            | 1,472                |
| Home equity and consumer                       | 1,689            | 2,151                |
| Total non-accrual loans and leases             | \$ 16,245        | \$ 20,404            |
| Other real estate and other repossessed assets | 1,415            | 1,072                |
| <b>TOTAL NON-PERFORMING ASSETS</b>             | <b>\$ 17,660</b> | <b>\$ 21,476</b>     |

Edgar Filing: LAKELAND BANCORP INC - Form 10-Q

|  |           |    |       |
|--|-----------|----|-------|
| Troubled debt restructurings, still accruing | \$ 11,697 | \$ | 8,802 |
|--|-----------|----|-------|

Non-accrual loans included \$2.1 million and \$2.4 million of troubled debt restructurings at June 30, 2017 and December 31, 2016, respectively. At June 30, 2017 and December 31, 2016, the Company had \$3.1 million and \$3.7 million respectively in residential mortgages and consumer home equity loans that were in the process of foreclosure.

An age analysis of past due loans, segregated by class of loans as of June 30, 2017 and December 31, 2016, is as follows:

**Table of Contents**

|                                    | 30-59 Days<br>Past<br>Due | 60-89 Days<br>Past Due | Greater<br>Than<br>89 Days<br>Past Due | Total<br>Past Due<br>(in thousands) | Current      | Total<br>Loans<br>and Leases | Recorded<br>Investment<br>than 89 Days and<br>Still<br>Accruing |
|------------------------------------|---------------------------|------------------------|--|-------------------------------------|--------------|------------------------------|---|
| <b>June 30, 2017</b>               |                           |                        |  |                                     |              |                              |   |
| Commercial, secured by real estate | \$ 3,258                  | \$ 600                 | \$ 8,388                               | \$ 12,246                           | \$ 2,713,172 | \$ 2,725,418                 | \$  |
| Commercial, industrial and other   | 491                       |                        | 301                                    | 792                                 | 352,185      | 352,977                      |   |
| Leases                             | 303                       | 113                    | 81                                     | 497                                 | 69,798       | 70,295                       |   |
| Real estate - residential mortgage | 985                       | 636                    | 3,295                                  | 4,916                               | 332,849      | 337,765                      |   |
| Real estate - construction         |                           |                        | 1,472                                  | 1,472                               | 228,706      | 230,178                      |   |
| Home equity and consumer           | 1,148                     | 148                    | 1,292                                  | 2,588                               | 335,055      | 337,643                      | 20  |
|                                    | \$ 6,185                  | \$ 1,497               | \$ 14,829                              | \$ 22,511                           | \$ 4,031,765 | \$ 4,054,276                 | \$ 20   |
| <b>December 31, 2016</b>           |                           |                        |  |                                     |              |                              |   |
| Commercial, secured by real estate | \$ 6,082                  | \$ 1,234               | \$ 9,313                               | \$ 16,629                           | \$ 2,539,972 | \$ 2,556,601                 | \$  |
| Commercial, industrial and other   | 1,193                     | 213                    | 42                                     | 1,448                               | 348,780      | 350,228                      |   |
| Leases                             | 132                       | 78                     | 153                                    | 363                                 | 66,653       | 67,016                       |   |
| Real estate - residential mortgage | 2,990                     | 1,057                  | 5,330                                  | 9,377                               | 340,204      | 349,581                      |   |
| Real estate - construction         | 3,409                     |                        | 1,472                                  | 4,881                               | 206,228      | 211,109                      |   |
| Home equity and consumer           | 1,260                     | 129                    | 2,049                                  | 3,438                               | 335,922      | 339,360                      | 10  |
|                                    | \$ 15,066                 | \$ 2,711               | \$ 18,359                              | \$ 36,136                           | \$ 3,837,759 | \$ 3,873,895                 | \$ 10   |

*Impaired Loans*

The Company defines impaired loans as all non-accrual loans and leases with recorded investments of \$500,000 or greater. Impaired loans also include all loans that have been modified in troubled debt restructurings. Impaired loans as of June 30, 2017 and December 31, 2016 are as follows:

**Table of Contents**

| June 30, 2017                            | Recorded<br>Investment<br>in<br>Impaired Loans | Contractual<br>Unpaid<br>Principal<br>Balance | Specific<br>Allowance<br>(in thousands) | Average<br>Investment<br>in<br>Impaired Loans | Interest<br>Income<br>Recognized |
|--|--|---|---|---|----------------------------------|
| <b>Loans without specific allowance:</b> |  |   |   |   |                                  |
| Commercial, secured by real estate       | \$ 14,806                                      | \$ 15,180                                     | \$                                      | \$ 13,909                                     | \$ 148                           |
| Commercial, industrial and other         | 568  | 568   |   | 568   | 11                               |
| Real estate - residential mortgage       | 970  | 987   |   | 903   | 8                                |
| Real estate - construction               | 1,472  | 1,472   |   | 1,472   |                                  |
| <b>Home equity and consumer</b>          |  |   |   |   |                                  |
| <b>Loans with specific allowance:</b>    |  |   |   |   |                                  |
| Commercial, secured by real estate       | 5,022  | 5,342   | 276                                     | 4,913   | 117                              |
| Commercial, industrial and other         | 431  | 431   | 14                                      | 402   | 9                                |
| Real estate - residential mortgage       | 1,005  | 1,134   | 34                                      | 1,015   | 15                               |
| <b>Real estate - construction</b>        |  |   |   |   |                                  |
| Home equity and consumer                 | 1,148  | 1,175   | 99                                      | 1,150   | 28                               |
| <b>Total:</b>                            |  |   |   |   |                                  |
| Commercial, secured by real estate       | \$ 19,828                                      | \$ 20,522                                     | \$ 276                                  | \$ 18,822                                     | \$ 265                           |
| Commercial, industrial and other         | 999  | 999   | 14                                      | 970   | 20                               |
| Real estate - residential mortgage       | 1,975  | 2,121   | 34                                      | 1,918   | 23                               |
| Real estate - construction               | 1,472  | 1,472   |   | 1,472   |                                  |
| Home equity and consumer                 | 1,148  | 1,175   | 99                                      | 1,150   | 28                               |
|  | \$ 25,422                                      | \$ 26,289                                     | \$ 423                                  | \$ 24,332                                     | \$ 336                           |

**Table of Contents**

| December 31, 2016                        | Recorded<br>Investment in<br>Impaired Loans | Contractual<br>Unpaid<br>Principal<br>Balance | Specific<br>Allowance<br>(in thousands) | Average<br>Investment in<br>Impaired Loans | Interest<br>Income<br>Recognized |
|--|---|---|---|--|----------------------------------|
| <b>Loans without specific allowance:</b> |   |   |   |  |                                  |
| Commercial, secured by real estate       | \$ 12,764                                   | \$ 13,195                                     | \$                                      | \$ 13,631                                  | \$ 229                           |
| Commercial, industrial and other         | 603   | 603   |   | 1,109                                      | 24                               |
| <b>Leases</b>                            |   |   |   |  |                                  |
| Real estate - residential mortgage       | 1,880                                       | 3,146   |   | 2,430                                      | 16                               |
| Real estate - construction               | 1,471                                       | 1,471   |   | 12   |                                  |
| Home equity and consumer                 | 139   | 139   |   | 388  |                                  |
| <b>Loans with specific allowance:</b>    |   |   |   |  |                                  |
| Commercial, secured by real estate       | 5,860                                       | 6,142   | 392                                     | 6,549                                      | 273                              |
| Commercial, industrial and other         | 349   | 349   | 12                                      | 360  | 17                               |
| <b>Leases</b>                            |   |   |   |  |                                  |
| Real estate - residential mortgage       | 1,031                                       | 1,100   | 31                                      | 1,011                                      | 30                               |
| Real estate - construction               |   |   |   |  |                                  |
| Home equity and consumer                 | 1,188                                       | 1,211   | 94                                      | 1,184                                      | 59                               |
| <b>Total:</b>                            |   |   |   |  |                                  |
| Commercial, secured by real estate       | \$ 18,624                                   | \$ 19,337                                     | \$ 392                                  | \$ 20,180                                  | \$ 502                           |
| Commercial, industrial and other         | 952   | 952   | 12                                      | 1,469                                      | 41                               |
| <b>Leases</b>                            |   |   |   |  |                                  |
| Real estate - residential mortgage       | 2,911                                       | 4,246   | 31                                      | 3,441                                      | 46                               |
| Real estate - construction               | 1,471                                       | 1,471   |   | 12   |                                  |
| Home equity and consumer                 | 1,327                                       | 1,350   | 94                                      | 1,572                                      | 59                               |
|  | \$ 25,285                                   | \$ 27,356                                     | \$ 529                                  | \$ 26,675                                  | \$ 648                           |

Interest income recognized on impaired loans was \$336,000 for each of the six months ended June 30, 2017 and 2016, respectively. Interest that would have been accrued on impaired loans during the first six months of 2017 and 2016 had the loans been performing under original terms would have been \$813,000 and \$828,000, respectively.

*Credit Quality Indicators*

The class of loans is determined by internal risk rating. Management closely and continually monitors the quality of its loans and leases and assesses the quantitative and qualitative risks arising from the credit quality of its loans and leases. Lakeland assigns a credit risk rating to all commercial loans and loan commitments. The credit risk rating system has been developed by management to provide a methodology to be used by loan officers, department heads and senior management in identifying various levels of credit risk that exist within Lakeland's commercial loan portfolios. The risk rating system assists senior management in evaluating Lakeland's commercial loan portfolio, analyzing trends, and determining the proper level of required reserves to be recommended to the Board. In assigning risk ratings, management considers, among other things, a borrower's debt service coverage, earnings strength, loan to value ratios, industry conditions and economic conditions. Management categorizes commercial loans and commitments into a one (1) to nine (9) numerical structure with rating 1 being the strongest





**Table of Contents**

rating and rating 9 being the weakest. Ratings 1 through 5W are considered "Pass" ratings.

The following table shows the Company's commercial loan portfolio as of June 30, 2017 and December 31, 2016, by the risk ratings discussed above (in thousands):

| June 30, 2017                         | Commercial,<br>Secured by<br>Real Estate | Commercial,<br>Industrial<br>and Other | Real Estate -<br>Construction |
|---------------------------------------|--|--|-------------------------------|
| <b>RISK RATING</b>                    |  |  |                               |
| 1                                     | \$                                       | \$ 448                                 | \$                            |
| 2                                     |  | 29,901                                 |                               |
| 3                                     | 84,407                                   | 35,124                                 |                               |
| 4                                     | 821,819                                  | 129,845                                | 8,800                         |
| 5                                     | 1,700,154                                | 131,751                                | 218,054                       |
| 5W - Watch                            | 58,427                                   | 11,047                                 | 698                           |
| 6 - Other assets especially mentioned | 31,163                                   | 9,474                                  |                               |
| 7 - Substandard                       | 29,448                                   | 5,387                                  | 2,626                         |
| 8 - Doubtful                          |  |  |                               |
| 9 - Loss                              |  |  |                               |
| <b>Total</b>                          | <b>\$ 2,725,418</b>                      | <b>\$ 352,977</b>                      | <b>\$ 230,178</b>             |
| <br>                                  |  |  |                               |
| December 31, 2016                     | Commercial,<br>Secured by<br>Real Estate | Commercial,<br>Industrial<br>and Other | Real Estate -<br>Construction |
| <b>RISK RATING</b>                    |  |  |                               |
| 1                                     | \$                                       | \$ 1,449                               | \$                            |
| 2                                     |  | 26,743                                 |                               |
| 3                                     | 82,102                                   | 36,644                                 |                               |
| 4                                     | 729,281                                  | 135,702                                | 28,177                        |
| 5                                     | 1,615,331                                | 129,366                                | 175,595                       |
| 5W - Watch                            | 68,372                                   | 6,395                                  | 1,223                         |
| 6 - Other assets especially mentioned | 33,015                                   | 5,242                                  |                               |
| 7 - Substandard                       | 28,500                                   | 8,687                                  | 6,114                         |
| 8 - Doubtful                          |  |  |                               |
| 9 - Loss                              |  |  |                               |
| <b>Total</b>                          | <b>\$ 2,556,601</b>                      | <b>\$ 350,228</b>                      | <b>\$ 211,109</b>             |

The risk rating tables above do not include residential mortgage loans, consumer loans, or leases because they are evaluated on their payment status.

*Allowance for Loan and Lease Losses*

The following table details activity in the allowance for loan and lease losses by portfolio segment for the three and six months ended June 30, 2017 and 2016:

**Table of Contents**

| Three Months Ended June 30, 2017 | Commercial,<br>Secured by<br>Real Estate | Commercial,<br>Industrial<br>and Other | Leases | Real Estate-<br>Residential<br>Mortgage | Real Estate-<br>Construction | Home<br>Equity and<br>Consumer | Total     |
|----------------------------------|--|--|--------|---|------------------------------|--------------------------------|-----------|
|                                  | (in thousands)                           |  |        |   |                              |                                |           |
| Beginning Balance                | \$ 22,083                                | \$ 1,792                               | \$ 502 | \$ 1,825                                | \$ 2,378                     | \$ 3,010                       | \$ 31,590 |
| Charge-offs                      | (83)                                     | (71)                                   | (120)  | (169)                                   |                              | (427)                          | (870)     |
| Recoveries                       | 145                                      | 27                                     | 28     |   | 5                            | 71                             | 276       |
| Provision                        | 1,199                                    | (60)                                   | 119    | 98                                      | 213                          | 258                            | 1,827     |
| Ending Balance                   | \$ 23,344                                | \$ 1,688                               | \$ 529 | \$ 1,754                                | \$ 2,596                     | \$ 2,912                       | \$ 32,823 |

| Three Months Ended June 30, 2016 | Commercial,<br>Secured by<br>Real Estate | Commercial,<br>Industrial<br>and Other | Leases | Real Estate-<br>Residential<br>Mortgage | Real Estate-<br>Construction | Home<br>Equity and<br>Consumer | Total     |
|----------------------------------|--|--|--------|---|------------------------------|--------------------------------|-----------|
|                                  | (in thousands)                           |  |        |   |                              |                                |           |
| Beginning Balance                | \$ 20,077                                | \$ 2,597                               | \$ 588 | \$ 2,266                                | \$ 1,504                     | \$ 3,521                       | \$ 30,553 |
| Charge-offs                      | (139)                                    | (171)                                  | (205)  | (213)                                   |                              | (317)                          | (1,045)   |
| Recoveries                       | 26                                       | 34                                     | 21     | 1                                       |                              | 67                             | 149       |
| Provision                        | 395                                      | (248)                                  | 220    | 110                                     | 284                          | 249                            | 1,010     |
| Ending Balance                   | \$ 20,359                                | \$ 2,212                               | \$ 624 | \$ 2,164                                | \$ 1,788                     | \$ 3,520                       | \$ 30,667 |

| Six Months Ended June 30, 2017 | Commercial,<br>Secured by<br>Real Estate | Commercial,<br>Industrial<br>and Other | Leases | Real Estate-<br>Residential<br>Mortgage | Real Estate-<br>Construction | Home<br>Equity and<br>Consumer | Total     |
|--------------------------------|--|--|--------|---|------------------------------|--------------------------------|-----------|
|                                | (in thousands)                           |  |        |   |                              |                                |           |
| Beginning Balance              | \$ 21,223                                | \$ 1,723                               | \$ 548 | \$ 1,964                                | \$ 2,352                     | \$ 3,435                       | \$ 31,245 |
| Charge-offs                    | (303)                                    | (234)                                  | (163)  | (310)                                   | (609)                        | (611)                          | (2,230)   |
| Recoveries                     | 364                                      | 122                                    | 32     |   | 20                           | 225                            | 763       |
| Provision                      | 2,060                                    | 77                                     | 112    | 100                                     | 833                          | (137)                          | 3,045     |
| Ending Balance                 | \$ 23,344                                | \$ 1,688                               | \$ 529 | \$ 1,754                                | \$ 2,596                     | \$ 2,912                       | \$ 32,823 |

| Six Months Ended June 30, 2016 | Commercial,<br>Secured by<br>Real Estate | Commercial,<br>Industrial<br>and Other | Leases | Real Estate-<br>Residential<br>Mortgage | Real Estate-<br>Construction | Home<br>Equity and<br>Consumer | Total     |
|--------------------------------|--|--|--------|---|------------------------------|--------------------------------|-----------|
|                                | (in thousands)                           |  |        |   |                              |                                |           |
| Beginning Balance              | \$ 20,223                                | \$ 2,637                               | \$ 460 | \$ 2,588                                | \$ 1,591                     | \$ 3,375                       | \$ 30,874 |
| Charge-offs                    | (274)                                    | (796)                                  | (275)  | (306)                                   |                              | (937)                          | (2,588)   |
| Recoveries                     | 81                                       | 76                                     | 22     | 4                                       |                              | 113                            | 296       |
| Provision                      | 329                                      | 295                                    | 417    | (122)                                   | 197                          | 969                            | 2,085     |
| Ending Balance                 | \$ 20,359                                | \$ 2,212                               | \$ 624 | \$ 2,164                                | \$ 1,788                     | \$ 3,520                       | \$ 30,667 |



**Table of Contents**

Loans receivable summarized by portfolio segment and impairment method are as follows:

|   | Commercial,<br>Secured by<br>Real Estate | Commercial,<br>Industrial<br>and Other | Leases    | Real Estate-<br>Residential<br>Mortgage<br>(in thousands) | Real<br>Estate-<br>Construction | Home<br>Equity and<br>Consumer | Total        |
|---|--|--|-----------|---|---------------------------------|--------------------------------|--------------|
| <b>June 30, 2017</b>  |  |  |           |   |                                 |                                |              |
| Ending Balance:<br>Individually evaluated<br>for impairment           | \$ 19,828                                | \$ 999                                 | \$        | \$ 1,975  | \$ 1,472                        | \$ 1,148                       | \$ 25,422    |
| Ending Balance:<br>Collectively evaluated<br>for impairment           | 2,704,863                                | 351,971                                | 70,295    | 335,790   | 228,706                         | 336,487                        | 4,028,112    |
| Ending Balance: Loans<br>acquired with<br>deteriorated credit quality | 727                                      | 7                                      |           |   |                                 | 8                              | 742          |
| Ending Balance (1)  | \$ 2,725,418                             | \$ 352,977                             | \$ 70,295 | \$ 337,765  | \$ 230,178                      | \$ 337,643                     | \$ 4,054,276 |
|   |  |  |           |   |                                 |                                |              |
|   | Commercial,<br>Secured by<br>Real Estate | Commercial,<br>Industrial<br>and Other | Leases    | Real Estate-<br>Residential<br>Mortgage<br>(in thousands) | Real<br>Estate-<br>Construction | Home<br>Equity and<br>Consumer | Total        |
| <b>December 31, 2016</b>  |  |  |           |   |                                 |                                |              |
| Ending Balance:<br>Individually evaluated<br>for impairment           | \$ 18,624                                | \$ 952                                 | \$        | \$ 2,911  | \$ 1,471                        | \$ 1,327                       | \$ 25,285    |
| Ending Balance:<br>Collectively evaluated<br>for impairment           | 2,536,858                                | 349,001                                | 67,016    | 346,670   | 209,638                         | 338,019                        | 3,847,202    |
| Ending balance: Loans<br>acquired with<br>deteriorated credit quality | 1,119                                    | 275                                    |           |   |                                 | 14                             | 1,408        |
| Ending Balance (1)  | \$ 2,556,601                             | \$ 350,228                             | \$ 67,016 | \$ 349,581  | \$ 211,109                      | \$ 339,360                     | \$ 3,873,895 |

(1) Excludes deferred fees

**Table of Contents**

The allowance for loan and lease losses is summarized by portfolio segment and impairment classification as follows:

|   | Commercial<br>Secured<br>by<br>Real<br>Estate | Commercial,<br>Industrial<br>and<br>Other | Leases | Real Estate-<br>Residential<br>Mortgage | Real<br>Estate-<br>Construction | Home<br>Equity and<br>Consumer | Total     |
|---|---|---|--------|---|---------------------------------|--------------------------------|-----------|
| <u>June 30, 2017</u>                                  |   |   |        |   |                                 |                                |           |
| Ending Balance: Individually evaluated for impairment | \$ 276  | \$ 14                                     | \$     | \$ 34                                   | \$                              | \$ 99                          | \$ 423    |
| Ending Balance: Collectively evaluated for impairment | 23,068  | 1,674                                     | 529    | 1,720                                   | 2,596                           | 2,813                          | 32,400    |
| Ending Balance  | \$ 23,344                                     | \$ 1,688                                  | \$ 529 | \$ 1,754                                | \$ 2,596                        | \$ 2,912                       | \$ 32,823 |

|   | Commercial<br>Secured<br>by<br>Real Estate | Commercial,<br>Industrial<br>and<br>Other | Leases | Real Estate-<br>Residential<br>Mortgage | Real<br>Estate-<br>Construction | Home<br>Equity and<br>Consumer | Total     |
|---|--|---|--------|---|---------------------------------|--------------------------------|-----------|
| <u>December 31, 2016</u>                              |  |   |        |   |                                 |                                |           |
| Ending Balance: Individually evaluated for impairment | \$ 392                                     | \$ 12                                     | \$     | \$ 31                                   | \$                              | \$ 94                          | \$ 529    |
| Ending Balance: Collectively evaluated for impairment | 20,831                                     | 1,711                                     | 548    | 1,933                                   | 2,352                           | 3,341                          | 30,716    |
| Ending Balance  | \$ 21,223                                  | \$ 1,723                                  | \$ 548 | \$ 1,964                                | \$ 2,352                        | \$ 3,435                       | \$ 31,245 |

Lakeland also maintains a reserve for unfunded lending commitments which is included in other liabilities. This reserve was \$2.5 million for each of the periods ended June 30, 2017 and December 31, 2016. The Company analyzes the adequacy of the reserve for unfunded lending commitments quarterly.

*Troubled Debt Restructurings*

Loans are classified as troubled debt restructured loans in cases where borrowers experience financial difficulties and Lakeland makes certain concessionary modifications to contractual terms. Restructured loans typically involve a modification of terms such as a reduction of the stated interest rate, a moratorium of principal payments and/or an extension of the maturity date at a stated interest rate lower than the current market rate of a new loan with similar risk. The Company considers the potential losses on these loans as well as the remainder of its impaired loans while considering the adequacy of the allowance for loan and lease losses.

The following table summarizes loans that have been restructured during the three and six months ended June 30, 2017 and 2016:



**Table of Contents**

|                                    | For the Three Months Ended<br>June 30, 2017                   |                        |  | For the Three Months Ended<br>June 30, 2016                   |                        |  |
|------------------------------------|---|------------------------|--|---|------------------------|--|
|                                    | Pre-<br>Modification<br>Outstanding<br>Number of<br>Contracts | Recorded<br>Investment | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment | Pre-<br>Modification<br>Outstanding<br>Number of<br>Contracts | Recorded<br>Investment | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment |
| Commercial, secured by real estate | 2   | \$ 159                 | \$ 159   |   | \$                     | \$   |
| Commercial, industrial and other   | 2   | 124                    | 124  |   |                        |  |
|                                    | 4   | \$ 283                 | \$ 283   |   | \$                     | \$   |

|                                    | For the Six Months Ended<br>June 30, 2017                     |                        |  | For the Six Months Ended<br>June 30, 2016                     |                        |  |
|------------------------------------|---|------------------------|--|---|------------------------|--|
|                                    | Pre-<br>Modification<br>Outstanding<br>Number of<br>Contracts | Recorded<br>Investment | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment | Pre-<br>Modification<br>Outstanding<br>Number of<br>Contracts | Recorded<br>Investment | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment |
| Commercial, secured by real estate | 4   | \$ 3,038               | \$ 3,038   |   | \$                     | \$   |
| Commercial, industrial and other   | 2   | 124                    | 124  |   |                        |  |
| Home equity and consumer           |   |                        |  | 3   | 285                    | 285  |
|                                    | 6   | \$ 3,162               | \$ 3,162   | \$ 3  | \$ 285                 | \$ 285   |

The following table summarizes as of June 30, 2017 and 2016, loans that were restructured within the previous twelve months that have subsequently defaulted:

|                                    | June 30, 2017          |                        | June 30, 2016          |                        |
|------------------------------------|------------------------|------------------------|------------------------|------------------------|
|                                    | Number of<br>Contracts | Recorded<br>Investment | Number of<br>Contracts | Recorded<br>Investment |
| Real estate - residential mortgage | 1                      | \$ 254                 |                        | \$                     |
| Home equity and consumer           |                        |                        | 1                      | 162                    |
|                                    | 1                      | \$ 254                 | 1                      | \$ 162                 |

*Other Real Estate and Other Repossessed Assets*

At June 30, 2017, the Company had other real estate owned and other repossessed assets of \$1.4 million and \$28,000,





**Table of Contents**

respectively. At December 31, 2016, the Company had other real estate owned and other repossessed assets of \$1.1 million and \$9,000, respectively. Included in other real estate owned was residential property acquired as a result of foreclosure proceedings totaling \$1.1 million that the Company held at each of the periods ended June 30, 2017 and December 31, 2016.

**NOTE 6 DERIVATIVES**

Lakeland is a party to interest rate derivatives that are not designated as hedging instruments. Under a program, Lakeland executes interest rate swaps with commercial lending customers to facilitate their respective risk management strategies. These interest rate swaps with customers are simultaneously offset by interest rate swaps that Lakeland executes with a third party, such that Lakeland minimizes its net risk exposure resulting from such transactions. Because the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings. The changes in the fair value of the swaps offset each other, except for the credit risk of the counterparties, which is determined by taking into consideration the risk rating, probability of default and loss given default for all counterparties. Lakeland had \$7.5 million in available for sale securities pledged for collateral on its interest rate swaps with the financial institution at each of June 30, 2017 and December 31, 2016.

In June 2016, the Company entered into two cash flow hedges in order to hedge the variable cash outflows associated with its subordinated debentures. The notional value of these hedges was \$30.0 million. The Company's objectives in using the cash flow hedge are to add stability to interest expense and to manage its exposure to interest rate movements. The Company used interest rate swaps designated as cash flow hedges which involved the receipt of variable amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount. In these particular hedges the Company is paying a third party an average of 1.10% in exchange for a payment at 3 month LIBOR. The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges are recorded in accumulated other comprehensive income and are subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During the six months ended June 30, 2017, the Company did not record any hedge ineffectiveness. The Company recognized \$4,000 of accumulated other comprehensive income that was reclassified into interest expense for the first six months of 2017.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest payments are made on the Company's debt. During the next twelve months, the Company estimates that \$60,000 will be reclassified as a decrease to interest expense should the rate environment remain the same.

The following table presents summary information regarding these derivatives for the periods presented (dollars in thousands):

| June 30, 2017                           | Notional Amount | Average Maturity (Years) | Weighted Average Fixed Rate | Weighted Average Variable Rate | Fair Value |
|---|-----------------|--------------------------|-----------------------------|--------------------------------|------------|
| <b>Classified in Other Assets:</b>      |                 |                          |                             |                                |            |
| 3rd Party interest rate swaps           | \$ 87,852       | 9.4                      | 3.78%                       | 1 Mo. LIBOR + 2.12             | \$ 2,989   |
| Customer interest rate swaps            | 98,651          | 11.3                     | 4.64%                       | 1 Mo. LIBOR + 2.19             | 2,522      |
| Interest rate swap (cash flow hedge)    | 30,000          | 4.0                      | 1.10%                       | 3 Mo. LIBOR                    | 868        |
| <b>Classified in Other Liabilities:</b> |                 |                          |                             |                                |            |

Edgar Filing: LAKELAND BANCORP INC - Form 10-Q

|                               |           |      |       |                    |            |
|-------------------------------|-----------|------|-------|--------------------|------------|
| Customer interest rate swaps  | \$ 87,852 | 9.4  | 3.78% | 1 Mo. LIBOR + 2.12 | \$ (2,989) |
| 3rd Party interest rate swaps | 98,651    | 11.3 | 4.64% | 1 Mo. LIBOR + 2.19 | (2,522)    |

| December 31, 2016                    | Notional Amount | Weighted Average         |            |                                | Fair Value |
|--------------------------------------|-----------------|--------------------------|------------|--------------------------------|------------|
|                                      |                 | Average Maturity (Years) | Fixed Rate | Weighted Average Variable Rate |            |
| Customer interest rate swaps         | \$ 129,252      | 10.9                     | 4.03%      | 1 Mo. LIBOR + 2.10             | \$ (2,345) |
| 3rd party interest rate swaps        | (129,252)       | 10.9                     | 4.03%      | 1 Mo. LIBOR + 2.10             | 2,345      |
| Interest rate swap (cash flow hedge) | 30,000          | 4.5                      | 1.10%      | 3 Mo. LIBOR                    | 1,033      |

**Table of Contents****NOTE 7 GOODWILL AND INTANGIBLE ASSETS**

The Company had goodwill of \$136.4 million and \$135.7 million for the periods ended June 30, 2017 and December 31, 2016, respectively. The Company reviews its goodwill and intangible assets annually, on November 30, or more frequently if conditions warrant, for impairment. In testing goodwill for impairment, the Company compares the estimated fair value of its reporting unit to its carrying amount, including goodwill. The Company has determined that it has one reporting unit, Community Banking.

The Company had core deposit intangible of \$2.6 million and \$3.3 million for the periods ended June 30, 2017 and December 31, 2016, respectively. The estimated future amortization expense for the remainder of 2017 and for each of the succeeding five years ended December 31 is as follows (dollars in thousands):

| <u>For the Year Ended</u> |        |
|---------------------------|--------|
| 2017                      | \$ 268 |
| 2018                      | 594    |
| 2019                      | 504    |
| 2020                      | 415    |
| 2021                      | 326    |
| 2022                      | 236    |

**NOTE 8 BORROWINGS***Repurchase Agreements*

At June 30, 2017, the Company had federal funds purchased and securities sold under agreements to repurchase of \$91.6 million and \$26.9 million respectively. The securities sold under agreements to repurchase are overnight sweep arrangement accounts with our customers. The Company also had \$20.0 million in long-term securities sold under agreements to repurchase included in other borrowings which mature within 1 year. As of June 30, 2017, the Company had \$54.9 million in mortgage backed securities pledged for its securities sold under agreements to repurchase.

At times the market values of securities collateralizing our securities sold under agreements to repurchase may decline due to changes in interest rates and may necessitate our lenders to issue a margin call which requires Lakeland to pledge additional collateral to meet that margin call.

*Prepayment of Borrowings*

In the first quarter of 2017, the Company repaid an aggregate of \$20.0 million in long-term securities sold under agreements to repurchase and recorded \$2.2 million in long-term debt prepayment fees. The Company also repaid an aggregate of \$34.0 million in borrowings from the Federal Home Loan Bank of New York and recorded \$638,000 in long-term debt prepayment fees.

**NOTE 9 SHARE-BASED COMPENSATION**

The Company grants restricted stock, restricted stock units ( RSUs ) and stock options under the 2009 Equity Compensation Program. Share-based compensation expense of \$1.6 million and \$1.1 million was recognized for the six months ended June 30, 2017 and 2016, respectively. As of June 30, 2017, there was unrecognized compensation

cost of \$149,000 related to unvested restricted stock that is expected to be recognized over a weighted average period of approximately 0.59 years. Unrecognized compensation expense related to RSUs was approximately \$2.21 million as of June 30, 2017, and that cost is expected to be recognized over a period of 1.53 years. There was no unrecognized compensation expense related to unvested stock options as of June 30, 2017.

In the first six months of 2017, the Company granted 13,176 shares of restricted stock to non-employee directors at a grant date fair value of \$18.20 per share under the 2009 Equity Compensation Program. The restricted stock vests one year from the date it was granted. Compensation expense on this restricted stock is expected to be \$240,000 over a one year period. In the first six months of 2016, the Company granted 23,952 shares of restricted stock to non-employee directors at a grant date fair value of \$10.02 per share under the 2009 Equity Compensation Program. The restricted stock vested one year from the date it was granted. Compensation expense on this restricted stock was \$240,000 over a one year period.

**Table of Contents**

The following is a summary of the Company's restricted stock activity during the six months ended June 30, 2017:

|                                   | Number of<br>Shares | Weighted<br>Average<br>Price |
|-----------------------------------|---------------------|------------------------------|
| Outstanding, January 1, 2017      | 42,875              | \$ 9.72                      |
| Granted                           | 13,176              | 18.20                        |
| Vested                            | (32,901)            | 9.79                         |
| Forfeited                         | (48)                | 9.39                         |
| <b>Outstanding, June 30, 2017</b> | <b>23,102</b>       | <b>\$ 14.46</b>              |

In the first six months of 2017, the Company granted 117,673 RSUs to certain officers at a weighted average grant date fair value of \$19.96 per share under the Company's 2009 Equity Compensation Program. These units vest within a range of two to three years. A portion of these RSUs will vest subject to certain performance conditions in the restricted stock unit agreement. There are also certain provisions in the compensation program which state that if a recipient of the RSUs reaches a certain age and years of service, the person has effectively earned a portion of the RSUs at that time. Compensation expense on the restricted stock units issued in the first half of 2017 is expected to average approximately \$783,000 per year over a three year period. In the first six months of 2016, the Company granted 150,226 RSUs at a weighted average grant date fair value of \$10.06 per share under the Company's 2009 Equity Compensation Program. Compensation expense on these restricted stock units is expected to average approximately \$504,000 per year over a three year period.

The following is a summary of the Company's RSU activity during the six months ended June 30, 2017:

|                                   | Number of<br>Shares | Weighted<br>Average<br>Price |
|-----------------------------------|---------------------|------------------------------|
| Outstanding, January 1, 2017      | 302,344             | \$ 10.76                     |
| Granted                           | 117,673             | 19.96                        |
| Vested                            | (148,584)           | 13.01                        |
| Forfeited                         | (8,995)             | 12.58                        |
| <b>Outstanding, June 30, 2017</b> | <b>262,438</b>      | <b>\$ 13.55</b>              |

There were no grants of stock options in the first six months of 2017 or 2016. Option activity under the Company's stock option plans is as follows:

**Table of Contents**

|                                      | Number of<br>Shares | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term<br>(in years) | Aggregate<br>Intrinsic<br>Value |
|--------------------------------------|---------------------|--|---|---------------------------------|
| Outstanding, January 1, 2017         | 135,250             | \$ 8.79                                  | 4.18  | \$ 1,450,533                    |
| Granted                              |                     |  |   |                                 |
| Exercised                            | (31,769)            | 9.84                                     |   |                                 |
| Forfeited                            |                     |  |   |                                 |
| Expired                              |                     |  |   |                                 |
| Outstanding, June 30, 2017           | 103,481             | \$ 8.47                                  | 4.78  | \$ 1,076,479                    |
| Options exercisable at June 30, 2017 | 103,481             | \$ 8.47                                  | 4.78  | \$ 1,076,479                    |

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading day of period and the exercise price, multiplied by the number of in-the-money options).

There were 31,769 stock options exercised during the first six months of 2017. The aggregate intrinsic value of stock options exercised during the six months ended June 30, 2017 was \$318,000. Exercise of stock options during the first six months of 2017 resulted in cash receipts of \$313,000.

**NOTE 10 COMPREHENSIVE INCOME**

The components of other comprehensive income (loss) are as follows:

**Table of Contents**

| For the quarter ended:   | June 30, 2017                          |  |  | June 30, 2016                          |  |  |
|--|--|--|--|--|--|--|
|  | Before<br>Tax Amount<br>(in thousands) | Tax Benefit<br>(Expense)<br>(in thousands) | Net of<br>Tax Amount<br>(in thousands) | Before<br>Tax Amount<br>(in thousands) | Tax Benefit<br>(Expense)<br>(in thousands) | Net of<br>Tax Amount<br>(in thousands) |
| Net unrealized gains (losses) on available for sale securities       |  |  |  |  |  |  |
| Net unrealized holding gains arising during period                   | \$ 1,661                               | \$ (632)                                   | \$ 1,029                               | \$ 2,684                               | \$ (987)                                   | \$ 1,697                               |
| Reclassification adjustment for net losses arising during the period | 15                                     | (6)  | 9                                      |  |  |  |
| Net unrealized gains   | 1,676                                  | (638)                                      | 1,038                                  | 2,684                                  | (987)                                      | 1,697                                  |
| Unrealized losses on derivatives                                     | (186)                                  | 65   | (121)                                  | (193)                                  | 67   | (126)                                  |
| Change in minimum pension liability                                  |  |  |  | 8                                      | (2)  | 6                                      |
| Other comprehensive income, net                                      | \$ 1,490                               | \$ (573)                                   | \$ 917                                 | \$ 2,499                               | \$ (922)                                   | \$ 1,577                               |
|  |  |  |  |  |  |  |
| For the six months ended:  | Before<br>Tax Amount<br>(in thousands) | Tax Benefit<br>(Expense)<br>(in thousands) | Net of<br>Tax Amount<br>(in thousands) | Before<br>Tax Amount<br>(in thousands) | Tax Benefit<br>(Expense)<br>(in thousands) | Net of<br>Tax Amount<br>(in thousands) |
| Net unrealized gains on available for sale securities                |  |  |  |  |  |  |
| Net unrealized holding gains arising during period                   | \$ 2,845                               | \$ (1,082)                                 | \$ 1,763                               | \$ 9,247                               | \$ (3,393)                                 | \$ 5,854                               |
| Reclassification adjustment for net gains arising during the period  | (2,524)                                | 884  | (1,640)                                | (370)                                  | 137  | (233)                                  |
| Net unrealized gains   | 321                                    | (198)                                      | 123                                    | 8,877                                  | (3,256)                                    | 5,621                                  |
| Unrealized losses on derivatives                                     | (165)                                  | 58   | (107)                                  | (193)                                  | 67   | (126)                                  |
| Change in minimum pension liability                                  |  |  |  | 72                                     | (28)                                       | 44                                     |
| Other comprehensive income, net                                      | \$ 156                                 | \$ (140)                                   | \$ 16                                  | \$ 8,756                               | \$ (3,217)                                 | \$ 5,539                               |

The following table shows the changes in the balances of each of the components of other comprehensive income for the periods presented, net of tax (in thousands):



**Table of Contents**

|  | For the Three Months Ended June 30, 2017 |             |               |          | For the Three Months Ended June 30, 2016 |             |               |          |
|--|--|-------------|---------------|----------|--|-------------|---------------|----------|
|  | Unrealized                               |             |               |          | Unrealized Gains                         |             |               |          |
|  | Gains (Losses) on                        |             |               |          | on                                       |             |               |          |
|  | Available for Sale                       |             |               |          | Available for Sale                       |             |               |          |
|  | Securities                               | Derivatives | Pension Items | Total    | Securities                               | Derivatives | Pension Items | Total    |
| Beginning balance  | \$ (1,032)                               | \$ 686      | \$ 38         | \$ (308) | \$ 5,078                                 | \$          | \$ 34         | \$ 5,112 |
| Other comprehensive income before classifications                | 1,029                                    | (121)       |               | 908      | 1,697                                    | (126)       | 6             | 1,577    |
| Amounts reclassified from accumulated other comprehensive income | 9  |             |               | 9        |  |             |               |          |
| Net current period other comprehensive income (loss)             | 1,038                                    | (121)       |               | 917      | 1,697                                    | (126)       | 6             | 1,577    |
| Ending balance   | \$ 6                                     | \$ 565      | \$ 38         | \$ 609   | \$ 6,775                                 | (126)       | \$ 40         | \$ 6,689 |

|  | For the Six Months Ended June 30, 2017 |             |               |         | For the Six Months Ended June 30, 2016 |             |               |          |
|--|--|-------------|---------------|---------|--|-------------|---------------|----------|
|  | Unrealized                             |             |               |         | Unrealized                             |             |               |          |
|  | Gains (Losses) on                      |             |               |         | Gains on                               |             |               |          |
|  | Available for Sale                     |             |               |         | Available for Sale                     |             |               |          |
|  | Securities                             | Derivatives | Pension Items | Total   | Securities                             | Derivatives | Pension Items | Total    |
| Beginning balance  | \$ (117)                               | \$ 672      | \$ 38         | \$ 593  | \$ 1,154                               | \$          | \$ (4)        | \$ 1,150 |
| Other comprehensive income before classifications                | 1,763                                  | (107)       |               | 1,656   | 5,854                                  | (126)       | 44            | 5,772    |
| Amounts reclassified from accumulated other comprehensive income | (1,640)                                |             |               | (1,640) | (233)                                  |             |               | (233)    |
| Net current period other comprehensive income                    | 123                                    | (107)       |               | 16      | 5,621                                  | (126)       | 44            | 5,539    |
| Ending balance   | \$ 6                                   | \$ 565      | \$ 38         | \$ 609  | \$ 6,775                               | (126)       | \$ 40         | \$ 6,689 |

## NOTE 11 ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENT

*Fair Value Measurement*

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for an asset or liability in an orderly transaction between market participants at the measurement date. U.S. GAAP establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels giving the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest level priority to unobservable inputs (level 3 measurements). The following describes the three levels of fair value hierarchy:

Level 1 unadjusted quoted prices in active markets for identical assets or liabilities; includes U.S. Treasury Notes, and other U.S. Government Agency securities that actively trade in over-the-counter markets; equity securities and mutual funds that actively trade in over-the-counter markets.

Level 2 quoted prices for similar assets or liabilities in active markets; or quoted prices for identical or similar assets or liabilities in markets that are not active; or inputs other than quoted prices that are observable for the asset or liability including yield curves, volatilities, and prepayment speeds.

**Table of Contents**

Level 3 unobservable inputs for the asset or liability that reflect the Company's own assumptions about assumptions that market participants would use in the pricing of the asset or liability and that are consequently not based on market activity but upon particular valuation techniques.

The Company's assets that are measured at fair value on a recurring basis are its available for sale investment securities. The Company obtains fair values on its securities using information from a third party servicer. If quoted prices for securities are available in an active market, those securities are classified as Level 1 securities. The Company has U.S. Treasury Notes and certain equity securities that are classified as Level 1 securities. Level 2 securities were primarily comprised of U.S. Agency bonds, residential mortgage-backed securities, obligations of state and political subdivisions and corporate securities. Fair values were estimated primarily by obtaining quoted prices for similar assets in active markets or through the use of pricing models supported with market data information. Standard inputs include benchmark yields, reported trades, issuer spreads, bids and offers. On a quarterly basis, the Company reviews the pricing information received from the Company's third party pricing service. This review includes a comparison to non-binding third-party quotes.

The fair values of derivatives are based on valuation models from a third party using current market terms (including interest rates and fees), the remaining terms of the agreements and the credit worthiness of the counter party as of the measurement date (Level 2).

The following table sets forth the Company's financial assets that were accounted for at fair value on a recurring basis as of the periods presented by level within the fair value hierarchy. During the six months ended June 30, 2017, the Company did not make any transfers between any levels within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement:

**Table of Contents**

|  | Quoted Prices in<br>Active Markets<br>for Identical<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total<br>Fair Value<br>(in thousands) |
|--|---|---|--|---------------------------------------|
| <b>June 30, 2017</b>                             |   |   |  |                                       |
| Assets:  |   |   |  |                                       |
| Investment securities, available for sale        |   |   |  |                                       |
| U.S. Treasury and government agencies            | \$ 5,696  | \$ 136,748  | \$   | \$ 142,444                            |
| Mortgage-backed securities                       |   | 453,742   |  | 453,742                               |
| Obligations of states and political subdivisions |   | 54,274  |  | 54,274                                |
| Other debt securities                            |   | 5,095   |  | 5,095                                 |
| Equity securities                                | 4,722   | 12,887  |  | 17,609                                |
| <b>Total securities available for sale</b>       | <b>10,418</b>   | <b>662,746</b>  |  | <b>673,164</b>                        |
| Derivative assets                                |   | 6,379   |  | 6,379                                 |
| <b>Total Assets</b>                              | <b>\$ 10,418</b>  | <b>\$ 669,125</b>   | <b>\$</b>  | <b>\$ 679,543</b>                     |
| Liabilities:                                     |   |   |  |                                       |
| Derivative liabilities                           | \$  | \$ 5,511  | \$   | \$ 5,511                              |
| <b>Total Liabilities</b>                         | <b>\$</b>   | <b>\$ 5,511</b>   | <b>\$</b>  | <b>\$ 5,511</b>                       |
| <b>December 31, 2016</b>                         |   |   |  |                                       |
| Assets:  |   |   |  |                                       |
| Investment securities, available for sale        |   |   |  |                                       |
| U.S. Treasury and government agencies            | \$ 5,931  | \$ 111,428  | \$   | \$ 117,359                            |
| Mortgage-backed securities                       |   | 413,725   |  | 413,725                               |
| Obligations of states and political subdivisions |   | 48,326  |  | 48,326                                |
| Other debt securities                            |   | 5,412   |  | 5,412                                 |
| Equity securities                                | 7,748   | 14,134  |  | 21,882                                |
| <b>Total securities available for sale</b>       | <b>13,679</b>   | <b>593,025</b>  |  | <b>606,704</b>                        |
| Derivative assets                                |   | 3,378   |  | 3,378                                 |
| <b>Total Assets</b>                              | <b>\$ 13,679</b>  | <b>\$ 596,403</b>   | <b>\$</b>  | <b>\$ 610,082</b>                     |

Liabilities:

|                        |    |          |    |          |
|------------------------|----|----------|----|----------|
| Derivative liabilities | \$ | \$ 2,345 | \$ | \$ 2,345 |
| Total Liabilities      | \$ | \$ 2,345 | \$ | \$ 2,345 |

**Table of Contents**

The following table sets forth the Company's assets subject to fair value adjustments (impairment) on a non-recurring basis. Assets are classified in their entirety based on the lowest level of input that is significant to the fair value measurement:

|  | (Level 1)      | (Level 2) | (Level 3) | Total Fair Value |
|--|----------------|-----------|-----------|------------------|
|  | (in thousands) |           |           |                  |
| <b>June 30, 2017</b>                                 |                |           |           |                  |
| Assets:  |                |           |           |                  |
| Impaired loans and leases                            | \$             | \$        | \$ 25,422 | \$ 25,422        |
| Loans held for sale                                  |                | 877       |           | 877              |
| Other real estate owned and other repossessed assets |                |           | 1,415     | 1,415            |
| <b>December 31, 2016</b>                             |                |           |           |                  |
| Assets:  |                |           |           |                  |
| Impaired loans and leases                            | \$             | \$        | \$ 25,285 | \$ 25,285        |
| Loans held for sale                                  |                | 1,742     |           | 1,742            |
| Other real estate owned and other repossessed assets |                |           | 1,072     | 1,072            |

Impaired loans are evaluated and valued at the time the loan is identified as impaired at the lower of cost or market value of the underlying collateral. Because most of Lakeland's impaired loans are collateral dependent, fair value is generally measured based on the value of the collateral, less estimated costs to sell, securing these loans and leases and is classified at a level 3 in the fair value hierarchy. Collateral may be real estate, accounts receivable, inventory, equipment and/or other business assets. The value of real estate is assessed based on appraisals by qualified third party licensed appraisers. The appraisers may use the sales comparison approach, the cost approach or the income approach to value the collateral using discount rates (with ranges of 5-11%) or capitalization rates (with ranges of 5-10%) to evaluate the property. The value of the equipment may be determined by an appraiser, if significant, inquiry through a recognized valuation resource, or by the value on the borrower's financial statements. Field examiner reviews on business assets may be conducted based on the loan exposure and reliance on this type of collateral. Appraised and reported values may be adjusted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and client's business. Loans that are not collateral dependent are evaluated based on a discounted cash flow method. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above.

The Company has a held for sale loan portfolio that consists of residential mortgages that are being sold in the secondary market. The Company records these mortgages at the lower of cost or market value. Fair value is generally determined by the value of purchase commitments.

Other real estate owned (OREO) and other repossessed assets, representing property acquired through foreclosure, are recorded at fair value less estimated disposal costs of the acquired property on the date of acquisition and thereafter re-measured and carried at lower of cost or fair market value. Fair value on other real estate owned is based on the appraised value of the collateral using the sales comparison approach or the income approach with discount rates or capitalization rates similar to those used in impaired loan valuation. The fair value of other repossessed assets is estimated by inquiry through recognized valuation resources.

Changes in the assumptions or methodologies used to estimate fair values may materially affect the estimated amounts. Changes in economic conditions, locally or nationally, could impact the value of the estimated amounts of impaired loans, OREO and other repossessed assets.

*Fair Value of Certain Financial Instruments*

Estimated fair values have been determined by the Company using the best available data and an estimation methodology suitable for each category of financial instruments. There may not be reasonable comparability between institutions due to the wide range of permitted assumptions and methodologies in the absence of active markets. This lack of uniformity gives rise to a high degree of subjectivity in estimating financial instrument fair values.

The estimation methodologies used, the estimated fair values, and recorded book balances at June 30, 2017 and

**Table of Contents**

December 31, 2016 are outlined below.

This summary, as well as the table below, excludes financial assets and liabilities for which carrying value approximates fair value. For financial assets, these include cash and cash equivalents. For financial liabilities, these include noninterest-bearing demand deposits, savings and interest-bearing transaction accounts and federal funds sold and securities sold under agreements to repurchase. The estimated fair value of demand, savings and interest-bearing transaction accounts is the amount payable on demand at the reporting date. Carrying value is used because there is no stated maturity on these accounts, and the customer has the ability to withdraw the funds immediately. Also excluded from this summary and the following table are those financial instruments recorded at fair value on a recurring basis, as previously described.

The fair value of investment securities held to maturity was measured using information from the same third-party servicer used for investment securities available for sale using the same methodologies discussed above. Investment securities held to maturity includes \$27.5 million in short-term municipal bond anticipation notes and \$1.0 million in subordinated debt that are non-rated and do not have an active secondary market or information readily available on standard financial systems. As a result, the securities are classified as Level 3 securities. Management performs a credit analysis before investing in these securities.

FHLB stock is an equity interest that can be sold to the issuing FHLB, to other Federal Home Loan Banks, or to other member banks at its par value. Because ownership of these securities is restricted, they do not have a readily determinable fair value. As such, the Company's FHLB stock is recorded at cost or par value and is evaluated for impairment each reporting period by considering the ultimate recoverability of the investment rather than temporary declines in value. The Company's evaluation primarily includes an evaluation of liquidity, capitalization, operating performance, commitments, and regulatory or legislative events.

The net loan portfolio at June 30, 2017 and December 31, 2016 has been valued using a present value discounted cash flow where market prices are not available. The discount rate used in these calculations is the estimated current market rate adjusted for credit risk. The valuation of the Company's loan portfolio is consistent with accounting guidance but does not fully incorporate the exit price approach.

For fixed maturity certificates of deposit, fair value is estimated based on the present value of discounted cash flows using the rates currently offered for deposits of similar remaining maturities. The carrying amount of accrued interest payable approximates its fair value.

The fair value of long-term debt is based upon the discounted value of contractual cash flows. The Company estimates the discount rate using the rates currently offered for similar borrowing arrangements. The fair value of subordinated debentures is based on bid/ask prices from brokers for similar types of instruments.

The fair values of commitments to extend credit and standby letters of credit are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of guarantees and letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. The fair value of commitments to extend credit and standby letters of credit are deemed immaterial.





**Table of Contents**

The following table presents the carrying values, fair values and placement in the fair value hierarchy of the Company's financial instruments as of June 30, 2017 and December 31, 2016:

|   | Carrying Value | Fair Value | Quoted Prices in Significant Active Markets for Identical Assets (Level 1)<br>(in thousands) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|----------------|------------|--|-----------------------------------|---|
| <b>June 30, 2017</b>                                    |                |            |  |                                   |   |
| Financial Assets:                                       |                |            |  |                                   |   |
| Investment securities held to maturity                  | \$ 138,468     | \$ 138,619 | \$   | \$ 110,139                        | \$ 28,480                                 |
| Federal Home Loan Bank and other membership bank stocks | 18,899         | 18,899     |  | 18,899                            |   |
| Loans and leases, net                                   | 4,017,908      | 4,019,534  |  |                                   | 4,019,534                                 |
| Financial Liabilities:                                  |                |            |  |                                   |   |
| Certificates of deposit                                 | 566,245        | 564,084    |  | 564,084                           |   |
| Other borrowings  | 312,251        | 312,136    |  | 312,136                           |   |
| Subordinated debentures                                 | 104,842        | 95,588     |  |                                   | 95,588                                    |
| <b>December 31, 2016</b>                                |                |            |  |                                   |   |
| Financial Assets:                                       |                |            |  |                                   |   |
| Investment securities held to maturity                  | \$ 147,614     | \$ 146,990 | \$   | \$ 111,403                        | \$ 35,587                                 |
| Federal Home Loan Bank and other membership bank stocks | 15,099         | 15,099     |  | 15,099                            |   |
| Loans and leases, net                                   | 3,839,353      | 3,832,465  |  |                                   | 3,832,465                                 |
| Financial Liabilities:                                  |                |            |  |                                   |   |
| Certificates of deposit                                 | 544,908        | 543,399    |  | 543,399                           |   |
| Other borrowings  | 260,866        | 264,586    |  | 264,586                           |   |
| Subordinated debentures                                 | 104,784        | 94,476     |  |                                   | 94,476                                    |

**NOTE 12 RECENT ACCOUNTING PRONOUNCEMENTS**

In May 2017, the Financial Accounting Standards Board ( FASB ) issued an update which provides clarity and reduces diversity in practice when accounting for the modification of terms and conditions for share-based payment awards. Previous accounting guidance did not distinguish between modifications which were substantive from modifications that were merely administrative. The accounting standards update requires entities to account for the effects of a modification unless the following three conditions are met: the fair value of the modified award is the same as the fair value of the original award immediately before the original award is modified; the vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the original award is modified; and the classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the original award is modified. This update will be effective for annual and interim periods beginning after December 15, 2017. The adoption of this update is not expected to have a material impact on the Company's financial statements.

In March 2017, the FASB issued an update which shortens the amortization period for certain callable debt securities held at a premium to the earliest call date. Under current GAAP, entities amortize the premium as an adjustment of yield over the contractual life of the instrument even if the holder is certain that the call will be exercised. As a result, upon the exercise of a

**Table of Contents**

call on a callable debt security held at a premium, the unamortized premium is recorded as a loss in earnings. The update shortens the amortization period for certain callable debt securities held at a premium and requires the premium be amortized to the earliest call date. This update will be effective for annual and interim periods beginning after December 15, 2018. Entities are required to apply the amendments on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The adoption of this update is not expected to have a material impact on the Company's financial statements.

In March 2017, the FASB issued an update which improves the presentation of net periodic pension cost and net periodic postretirement benefit cost in a company's income statement. The amendment requires that an employer report the service cost component in the same line items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. The amendment is effective for annual and interim periods beginning after December 15, 2017. The adoption of this update is not expected to have a material impact on the Company's financial statements.

In January 2017, the FASB issued an update to simplify the test for goodwill impairment. This amendment eliminates Step 2 from the goodwill impairment test. The annual, or interim, goodwill impairment test is performed by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value. This update will be effective for the Company's financial statements for fiscal years beginning after December 15, 2019. The adoption of this update is not expected to have a material impact on the Company's financial statements.

In January 2017, the FASB issued an update that clarifies the definition of a business as it pertains to business combinations. This amendment affects all companies and other reporting organizations that must determine whether they have sold or acquired a business. This update will be effective for the Company's financial statements for fiscal years beginning after December 15, 2017. The adoption of this update is not expected to have a material impact on the Company's financial statements.

In September 2016, the FASB issued an accounting standards update to address diversity in presentation in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. This update will be effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2017. The adoption of this update is not expected to have a material impact on the Company's financial statements.

In June 2016, the FASB issued an accounting standards update pertaining to the measurement of credit losses on financial instruments. This update requires the measurement of all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. This update is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. This update will be effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2019. The Company is currently evaluating its existing systems and data to support the new standard as well as assessing the impact that the guidance will have on the Company's consolidated financial statements.

In March 2016, the FASB issued an accounting standards update to simplify employee share-based payment accounting. The areas for simplification in this update involve several aspects of the accounting for employee share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The standard specifically requires excess tax benefits and tax deficiencies to be recorded in the income statement when awards vest or are settled. The Company adopted this

accounting standards update in the first quarter of 2017. As a result, during the first six months of 2017, the Company recorded \$582,000 in excess tax benefits in the income statement. The Company elected to continue its existing practice of estimating the number of awards that will be forfeited. The Company elected to apply the cash flow classification guidance prospectively, and therefore, prior periods have not been adjusted.

In March 2016, the FASB issued an accounting standards update that requires that embedded derivatives be separated from the host contract and accounted for separately as derivatives if certain criteria are met, including the clearly and closely related criterion. The amendments in this update clarify the requirements for assessing whether contingent call or put options that can accelerate the payment of principal on debt instruments are clearly and closely related to their debt hosts. The Company adopted this accounting standards update in the first quarter of 2017. The adoption of this update did not have a material impact on the Company's financial statements.

**Table of Contents**

In February 2016, FASB issued accounting guidance that requires all lessees to recognize a lease liability and a right-of-use asset, measured at the present value of the future minimum lease payments, at the lease commencement date. Lessor accounting remains largely unchanged under the new guidance. The guidance is effective for fiscal years beginning after December 15, 2018, including interim reporting periods within that reporting period, with early adoption permitted. A modified retrospective approach must be applied for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The Company is currently assessing the impact of the new guidance on its consolidated financial statements. The Company expects to recognize a right-of-use asset and a lease liability for its operating lease commitments.

In January 2016, the FASB issued an accounting standards update intended to improve the recognition and measurement of financial instruments. Specifically, the accounting standards update requires all equity instruments, with the exception of those that are accounted for under the equity method of accounting, to be measured at fair value with changes in the fair value recognized through net income. Additionally, public business entities are required to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. The amendments in this update also require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. This amendment is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. The adoption of this update is not expected to have a material impact on the Company's financial statements.

In May 2014, the FASB issued an accounting standards update that clarifies the principles for recognizing revenue. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to a customer in an amount that reflects the consideration to which the entity expects to be entitled in exchange for these goods or services. To achieve that core principle, an entity should apply the following steps: (i) identify the contract(s) with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations in the contract; and (v) recognize revenue when (or as) the entity satisfies a performance obligation. In 2016, the FASB issued further implementation guidance regarding revenue recognition. This additional guidance included clarification on certain principal versus agent considerations within the implementation of the guidance as well as clarification related to identifying performance obligations and licensing. The guidance along with its updates is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. The Company is still evaluating the potential impact on the Company's financial statements. In evaluating this standard, management has determined that the majority of revenue earned by the Company is from revenue streams not included in the scope of this standard and therefore management does not expect the new revenue recognition guidance to have a material impact on its consolidated financial statements.

**Table of Contents**

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

This section should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations included in the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

**Statements Regarding Forward Looking Information**

The information disclosed in this document includes various forward-looking statements that are made in reliance upon the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 with respect to credit quality (including delinquency trends and the allowance for loan and lease losses), corporate objectives, and other financial and business matters. The words anticipates, projects, intends, estimates, expects, believes, plans, may, could, and other similar expressions are intended to identify such forward-looking statements. The Company cautions that these forward-looking statements are necessarily speculative and speak only as of the date made, and are subject to numerous assumptions, risks and uncertainties, all of which may change over time. Actual results could differ materially from such forward-looking statements.

In addition to the risk factors disclosed elsewhere in this document, the following factors, among others, could cause the Company's actual results to differ materially and adversely from such forward-looking statements: changes in the financial services industry and the U.S. and global capital markets, changes in economic conditions nationally, regionally and in the Company's markets, the nature and timing of actions of the Federal Reserve Board and other regulators, the nature and timing of legislation affecting the financial services industry, government intervention in the U.S. financial system, changes in levels of market interest rates, pricing pressures on loan and deposit products, credit risks of Lakeland's lending and leasing activities, customers' acceptance of Lakeland's products and services, and competition.

The above-listed risk factors are not necessarily exhaustive, particularly as to possible future events, and new risk factors may emerge from time to time. Certain events may occur that could cause the Company's actual results to be materially different than those described in the Company's periodic filings with the Securities and Exchange Commission. Any statements made by the Company that are not historical facts should be considered to be forward-looking statements. The Company is not obligated to update and does not undertake to update any of its forward-looking statements made herein.

**Critical Accounting Policies, Judgments and Estimates**

The accounting and reporting policies of the Company and its subsidiaries conform to accounting principles generally accepted in the United States of America and predominant practices within the banking industry. The consolidated financial statements include the accounts of the Company, Lakeland, Lakeland NJ Investment Corp., Lakeland Investment Corp., Lakeland Equity, Inc. and Lakeland Preferred Equity, Inc. All intercompany balances and transactions have been eliminated.

The preparation of financial statements 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 financial statements. These estimates and assumptions also affect reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates. There have been no material changes in the Company's critical accounting policies, judgments and estimates, including assumptions or estimation techniques utilized, as compared to those disclosed in the Company's most recent Annual Report on Form 10-K.

*Management Overview*

The quarter and six months ended June 30, 2017 represented a period of continued growth for the Company. As discussed in this Management's Discussion and Analysis:

Net income for the second quarter of 2017 of \$13.4 million compared to \$10.1 million for the same period in 2016. Diluted earnings per share of \$0.28 represents a 17% increase over \$0.24 for the same period in 2016.

For the second quarter of 2017, annualized return on average assets was 1.02%, annualized return on average common equity was 9.49%, and annualized return on average tangible common equity was 12.58% compared



---

**Table of Contents**

to 0.93%, 9.04%, and 12.63%, respectively, for the second quarter of 2016.

Net income for the first six months of 2017 was \$25.7 million, or \$0.53 per diluted share, compared to \$18.2 million, or \$0.44 per diluted share, for the same period in 2016. Excluding the after-tax impact of \$1.7 million in merger related expenses, net income for the first six months of 2016 was \$20.0 million, or \$0.48 per diluted share.

The annualized return on average assets for the six months ended June 30, 2017 was 1.00%, the annualized return on average common equity was 9.26%, and the annualized return on average tangible common equity was 12.31% compared to 0.85%, 8.23% and 11.53%, respectively, for the same period in 2016.

Commercial loans grew \$190.6 million, or 6% during the first six months of 2017, while total loans grew \$180.4 million, or 5%, to \$4.05 billion during the same time period.

Net interest margin ( NIM ) was 3.41% in the second quarter of 2017 compared to 3.33% in the prior quarter and 3.27% in the quarter ended December 31, 2016. The NIM increase from the linked quarter was primarily due to loan yields increasing five basis points coupled with an additional two basis points in loan prepayment fees, partially offset by rising deposit costs.

Noninterest bearing deposits increased \$51.4 million from December 31, 2016 to June 30, 2017, or 6%, to \$978.7 million.

The efficiency ratio of 52.6% in the second quarter of 2017 decreased from 56.3% for the same period in 2016.

**Comparison of Operating Results for the Three Months Ended June 30, 2017 and 2016**

*Net Income*

Net income was \$13.4 million, or \$0.28 per diluted share, for the second quarter of 2017 compared to net income of \$10.1 million, or \$0.24 per diluted share, for the second quarter of 2016. Excluding the impact of merger related expenses, net income would have been \$10.7 million, or \$0.26 per diluted share, for the second quarter of 2016. Net interest income of \$41.4 million for the second quarter of 2017 increased \$6.3 million from the second quarter of 2016 due primarily to a \$8.2 million increase in interest income, partially offset by an increase of \$1.9 million in interest expense. The increase in interest income reflects an increase in interest-earning assets resulting from the Harmony acquisition, from organic growth and from an increase in rates caused by the recent increases in the federal funds rate and prime rate.

*Net Interest Income*

Net interest income is the difference between interest income on earning assets and the cost of funds supporting those assets. The Company's net interest income is determined by: (i) the volume of interest-earning assets that it holds and

the yields that it earns on those assets, and (ii) the volume of interest-bearing liabilities that it has assumed and the rates that it pays on those liabilities.

Net interest income on a tax equivalent basis for the second quarter of 2017 was \$41.7 million, compared to \$35.3 million for the second quarter of 2016. The net interest margin decreased from 3.47% in the second quarter of 2016 to 3.41% in the second quarter of 2017 primarily as a result of a 13 basis point increase in the cost of interest-bearing liabilities, partially offset by a 3 basis point increase in the yield on interest-earning assets. The increase in the cost of interest-bearing liabilities was due primarily to an increase in the cost of borrowings resulting from the subordinated debt issuance in the third quarter of 2016 as well as a higher cost of deposits. The decrease in net interest margin was somewhat mitigated by an increase in interest income earned on free funds (interest-earning assets funded by noninterest-bearing liabilities) resulting from an increase in average noninterest-bearing deposits of \$153.5 million. The components of net interest income will be discussed in greater detail below.

The following table reflects the components of the Company's net interest income, setting forth for the periods presented, (1) average assets, liabilities and stockholders' equity, (2) interest income earned on interest-earning assets and interest expense paid on interest-bearing liabilities, (3) average yields earned on interest-earning assets and average rates paid on interest-bearing liabilities, (4) the Company's net interest spread (i.e., the average yield on interest-earning assets less the average cost of

**Table of Contents**

interest-bearing liabilities) and (5) the Company's net interest margin. Rates are computed on a tax equivalent basis using a tax rate of 35%.

|   | For the Three Months Ended,<br>June 30, 2017 |                                |   | For the Three Months Ended,<br>June 30, 2016 |                                |                                     |
|---|--|--------------------------------|---|--|--------------------------------|-------------------------------------|
|   | Average<br>Balance                           | Interest<br>Income/<br>Expense | Average<br>Rates<br>Earned/<br>Paid<br>(dollars in thousands) | Average<br>Balance                           | Interest<br>Income/<br>Expense | Average<br>Rates<br>Earned/<br>Paid |
| <b>ASSETS</b>                                     |  |                                |   |  |                                |                                     |
| Interest-earning assets:                          |  |                                |   |  |                                |                                     |
| Loans and leases (1)                              | \$ 4,011,325                                 | \$ 42,740                      | 4.27%   | \$ 3,412,503                                 | \$ 35,800                      | 4.22%                               |
| Taxable investment securities and other           | 724,675                                      | 3,818                          | 2.11%   | 493,688                                      | 2,696                          | 2.18%                               |
| Tax-exempt securities                             | 112,400                                      | 803                            | 2.86%   | 81,518                                       | 642                            | 3.15%                               |
| Federal funds sold (2)                            | 59,088                                       | 132                            | 0.89%   | 106,866                                      | 124                            | 0.46%                               |
| <b>Total interest-earning assets</b>              | <b>4,907,488</b>                             | <b>47,493</b>                  | <b>3.88%</b>  | <b>4,094,575</b>                             | <b>39,262</b>                  | <b>3.85%</b>                        |
| Noninterest-earning assets:                       |  |                                |   |  |                                |                                     |
| Allowance for loan and lease losses               | (32,234)                                     |                                |   | (30,898)                                     |                                |                                     |
| Other assets                                      | 365,901                                      |                                |   | 339,912                                      |                                |                                     |
| <b>TOTAL ASSETS</b>                               | <b>\$ 5,241,155</b>                          |                                |   | <b>\$ 4,403,589</b>                          |                                |                                     |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>       |  |                                |   |  |                                |                                     |
| Interest-bearing liabilities:                     |  |                                |   |  |                                |                                     |
| Savings accounts                                  | \$ 492,991                                   | \$ 71                          | 0.06%   | \$ 485,580                                   | \$ 64                          | 0.05%                               |
| Interest-bearing transaction accounts             | 2,295,256                                    | 2,513                          | 0.44%   | 1,775,129                                    | 1,376                          | 0.31%                               |
| Time deposits                                     | 559,665                                      | 1,200                          | 0.86%   | 487,169                                      | 964                            | 0.79%                               |
| Borrowings  | 344,833                                      | 2,007                          | 2.30%   | 377,937                                      | 1,531                          | 1.62%                               |
| <b>Total interest-bearing liabilities</b>         | <b>3,692,745</b>                             | <b>5,791</b>                   | <b>0.63%</b>  | <b>3,125,815</b>                             | <b>3,935</b>                   | <b>0.50%</b>                        |
| Noninterest-bearing liabilities:                  |  |                                |   |  |                                |                                     |
| Demand deposits                                   | 954,966                                      |                                |   | 801,488                                      |                                |                                     |
| Other liabilities                                 | 28,233                                       |                                |   | 25,480                                       |                                |                                     |
| Stockholders' equity                              | 565,211                                      |                                |   | 450,806                                      |                                |                                     |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b> | <b>\$ 5,241,155</b>                          |                                |   | <b>\$ 4,403,589</b>                          |                                |                                     |
| Net interest income/spread                        |  | 41,702                         | 3.25%   |  | 35,327                         | 3.35%                               |
| Tax equivalent basis adjustment                   |  | 281                            |   |  | 225                            |                                     |

|                         |           |           |
|-------------------------|-----------|-----------|
| NET INTEREST INCOME     | \$ 41,421 | \$ 35,102 |
| Net interest margin (3) | 3.41%     | 3.47%     |

- (1) Includes non-accrual loans, the effect of which is to reduce the yield earned on loans, and deferred loan fees.
- (2) Includes interest-bearing cash accounts.
- (3) Net interest income divided by interest-earning assets.

Interest income on a tax equivalent basis increased from \$39.3 million in the second quarter of 2016 to \$47.5 million in the second quarter of 2017, an increase of \$8.2 million, or 21%. The increase in interest income was primarily a result of the Harmony acquisition as well as organic growth in loans, as average loans and leases increased \$598.8 million compared to the second quarter of 2016. The yield on average loans and leases at 4.27% in the second quarter of 2017 was 5 basis points higher than the second quarter of 2016. The yield on average taxable and tax-exempt investment securities decreased by 7 and 29 basis points, respectively, compared to the second quarter of 2016. The reduction in the yield on taxable investment securities resulted from the receipt of \$101,000 in income from calls on U.S. government agency securities in the second quarter of 2016. The reduction in yields on tax-exempt investment securities was due primarily to maturing securities at higher rates and new purchases of shorter term securities at lower rates.

Total interest expense of \$5.8 million in the second quarter of 2017 was \$1.9 million greater than the \$3.9 million reported for the same period in 2016. The cost of average interest-bearing liabilities increased from 0.50% in the second quarter of 2016 to 0.63% in the second quarter of 2017. The increase in the cost of interest-bearing liabilities was due primarily to an

---

**Table of Contents**

increase in the cost of borrowings, higher costing deposits acquired in the Harmony acquisition as well as an increasingly competitive market for deposits resulting from a higher interest rate environment. The 68 basis point increase in the cost of borrowings was due primarily to the \$75.0 million issuance of subordinated debt in September 2016 bearing a rate of 5.125%. The prepayment of FHLB borrowings and term repurchase agreements mitigated the impact of the subordinated debt. The cost of interest-bearing liabilities was impacted by an increase in the cost of interest-bearing transaction accounts and time deposits which increased by 13 basis points and 7 basis points, respectively.

*Provision for Loan and Lease Losses*

In determining the provision for loan and lease losses, management considers national and local economic conditions; trends in the portfolio including orientation to specific loan types or industries; experience, ability and depth of lending management in relation to the complexity of the portfolio; adequacy and adherence to policies, procedures and practices; levels and trends in delinquencies, impaired loans and charge-offs; and the results of independent third party loan review.

In the second quarter of 2017, a \$1.8 million provision for loan and lease losses was recorded, which was \$817,000 higher than the provision for the same period last year. The higher provision resulted from growth in commercial real estate loans. The Company charged off \$870,000 and recovered \$276,000 in the second quarter of 2017 compared to \$1.0 million and \$149,000, respectively, in the second quarter of 2016. For more information regarding the determination of the provision, see *Risk Elements* below.

*Noninterest Income*

Noninterest income at \$6.1 million in the second quarter of 2017 increased by \$1.2 million compared to \$4.9 million in the second quarter of 2016. Service charges on deposit accounts of \$2.7 million in the second quarter of 2017 increased \$151,000 compared to the same period last year, due primarily to changes in the fee structure on deposit accounts. Gains on sales of loans totaling \$471,000 for the second quarter of 2017 increased 11% compared to the same period in 2016 due primarily to increased gains on sales of SBA loans. Income on bank owned life insurance of \$500,000 in the second quarter of 2017 increased \$86,000 or 21% compared to the second quarter of 2016 due primarily to the addition of new policies. Other income at \$1.3 million in the second quarter of 2017 was \$922,000 higher than the same period in 2016 due primarily to an \$118,000 increase in gains on sales of other real estate owned, a \$324,000 gain on the payoff of an acquired loan and \$337,000 in the gain on the sale of a former branch.

*Noninterest Expense*

Noninterest expense in the second quarter of 2017 totaled \$25.4 million, which was \$1.7 million greater than the \$23.7 million reported for the second quarter of 2016. Salaries and employee benefits expense of \$15.1 million, increased \$2.0 million from the same period last year, primarily due to the addition of Harmony employees during the second half of 2016 and year-over-year increases in employee salary and benefit costs. Net occupancy expense increased \$166,000, compared to the second quarter of 2016, due primarily to the addition of the Harmony branches. Stationary, supplies and postage increased \$156,000 compared to the second quarter of 2016 due primarily to consumer deposit mailings during the second quarter of 2017. Marketing expense of \$508,000 in the second quarter of 2017 increased \$123,000 compared to the same period last year due primarily to advertising related to the opening of the new branch in New York as well as new marketing efforts directed at the Ocean county region. FDIC insurance expense of \$425,000 in the second quarter of 2017 decreased \$256,000 compared to the same period last year, due primarily to the decreased non-performing loans and increased capital levels. ATM and debit card expense of \$517,000 increased \$134,000 due primarily to increased volume in debit card transactions as well as one-time charges

due to a change in platform. During the second quarter of 2016, the Company incurred \$685,000 in merger related expenses compared to none during the same period this year. The Company's efficiency ratio, a non-GAAP financial measure, was 52.6% in the second quarter of 2017, compared to 56.3% for the same period last year. The decrease in this ratio reflects a 19% increase in revenue as well as the realization of cost savings from the Pascack and Harmony acquisitions, and the closure of seven branches in 2016. The Company uses this ratio because it believes that the ratio provides a good comparison of period-to-period performance and because the ratio is widely accepted in the banking industry. The following table shows the calculation of the efficiency ratio for the periods presented:

**Table of Contents**

|   | For the Three Months Ended June 30, |           |
|---|-------------------------------------|-----------|
|   | 2017                                | 2016      |
|   | (dollars in thousands)              |           |
| <b>Calculation of Efficiency Ratio</b>            |                                     |           |
| Total noninterest expense                         | \$ 25,366                           | \$ 23,715 |
| Amortization of core deposit intangibles          | (190)                               | (164)     |
| Merger related expenses                           |                                     | (685)     |
| Provision for unfunded lending commitments        |                                     | (230)     |
| Noninterest expense, as adjusted                  | \$ 25,176                           | \$ 22,636 |
| Net interest income                               | \$ 41,421                           | \$ 35,102 |
| Noninterest income                                | 6,111                               | 4,885     |
| Total revenue                                     | 47,532                              | 39,987    |
| Tax-equivalent adjustment on municipal securities | 281                                 | 225       |
| Losses on sales of investment securities          | 15                                  |           |
| Total revenue, as adjusted                        | \$ 47,828                           | \$ 40,212 |
| Efficiency ratio                                  | 52.6%                               | 56.3%     |

*Income Tax Expense*

The effective tax rate in the second quarter of 2017 was 34.3% compared to 33.6% during the same period last year primarily as a result of a decrease in tax advantaged items as a percent of pretax income.

**Comparison of Operating Results for the Six Months Ended June 30, 2017 and 2016***Net Income*

Net income was \$25.7 million, or \$0.53 per diluted share, for the first half of 2017 compared to net income of \$18.2 million, or \$0.44 per diluted share, for the first half of 2016. Excluding the impact of merger related expenses, net income would have been \$20.0 million, or \$0.48 per diluted share, for the first half of 2016. Net interest income of \$80.7 million for the first half of 2017 increased \$11.8 million from the first half of 2016 due primarily to a \$15.4 million increase in interest income, partially offset by an increase of \$3.6 million in interest expense. The increase in interest income reflects an increase in interest-earning assets resulting from the Harmony acquisition, organic growth and an increase in market rates.

*Net Interest Income*

Net interest income on a tax equivalent basis for the first six months of 2017 was \$81.3 million, compared to \$69.4 million for the first six months of 2016. The net interest margin decreased from 3.48% in the first half of 2016 to 3.37% in the first half of 2017 primarily as a result of a 12 basis point increase in the cost of interest-bearing liabilities as well as a 3 basis point decrease in the yield on earning assets. The increase in the cost of interest-bearing liabilities was due primarily to an increase in the cost of borrowings resulting from the subordinated debt issuance in the third quarter of 2016 as well as a moderately higher cost of deposits. The decrease in yield on interest-earning assets was due primarily to a 17 and 45 basis point decrease in yield on taxable and tax-exempt securities,

respectively. The reduction in yields on investment securities was due primarily to maturing securities at higher rates and new purchases at lower rates. The decrease in net interest margin was somewhat mitigated by an increase in interest income earned on free funds (interest-earning assets funded by noninterest-bearing liabilities) resulting from an increase in average noninterest-bearing deposits of \$157.6 million. The components of net interest income will be discussed in greater detail below.



**Table of Contents**

The following table reflects the components of the Company's net interest income, setting forth for the periods presented, (1) average assets, liabilities and stockholders' equity, (2) interest income earned on interest-earning assets and interest expense paid on interest-bearing liabilities, (3) average yields earned on interest-earning assets and average rates paid on interest-bearing liabilities, (4) the Company's net interest spread (i.e., the average yield on interest-earning assets less the average cost of interest-bearing liabilities) and (5) the Company's net interest margin. Rates are computed on a tax equivalent basis using a tax rate of 35%.

|   | For the Six Months Ended,<br>June 30, 2017 |                                |   | For the Six Months Ended,<br>June 30, 2016 |                                |                                     |
|---|--|--------------------------------|---|--|--------------------------------|-------------------------------------|
|   | Average<br>Balance                         | Interest<br>Income/<br>Expense | Average<br>Rates<br>Earned/<br>Paid<br>(dollars in thousands) | Average<br>Balance                         | Interest<br>Income/<br>Expense | Average<br>Rates<br>Earned/<br>Paid |
| <b>ASSETS</b>                                     |  |                                |   |  |                                |                                     |
| Interest-earning assets:                          |  |                                |   |  |                                |                                     |
| Loans (1)   | \$ 3,958,564                               | \$ 83,151                      | 4.24%   | \$ 3,348,421                               | \$ 69,921                      | 4.20%                               |
| Taxable investment securities and other           | 700,971                                    | 7,417                          | 2.12%   | 494,788                                    | 5,658                          | 2.29%                               |
| Tax-exempt securities                             | 112,719                                    | 1,588                          | 2.82%   | 78,106                                     | 1,277                          | 3.27%                               |
| Federal funds sold (2)                            | 94,643                                     | 408                            | 0.86%   | 92,553                                     | 199                            | 0.43%                               |
| <b>Total interest-earning assets</b>              | <b>4,866,897</b>                           | <b>92,564</b>                  | <b>3.83%</b>  | <b>4,013,868</b>                           | <b>77,055</b>                  | <b>3.86%</b>                        |
| Noninterest-earning assets:                       |  |                                |   |  |                                |                                     |
| Allowance for loan and lease losses               | (32,063)                                   |                                |   | (31,013)                                   |                                |                                     |
| Other assets                                      | 362,931                                    |                                |   | 343,175                                    |                                |                                     |
| <b>TOTAL ASSETS</b>                               | <b>\$ 5,197,765</b>                        |                                |   | <b>\$ 4,326,030</b>                        |                                |                                     |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>       |  |                                |   |  |                                |                                     |
| Interest-bearing liabilities:                     |  |                                |   |  |                                |                                     |
| Savings accounts                                  | \$ 491,890                                 | \$ 139                         | 0.06%   | \$ 480,725                                 | \$ 157                         | 0.07%                               |
| Interest-bearing transaction accounts             | 2,268,752                                  | 4,631                          | 0.41%   | 1,728,855                                  | 2,624                          | 0.31%                               |
| Time deposits                                     | 557,479                                    | 2,348                          | 0.84%   | 476,097                                    | 1,828                          | 0.77%                               |
| Borrowings  | 352,926                                    | 4,146                          | 2.34%   | 388,680                                    | 3,047                          | 1.57%                               |
| <b>Total interest-bearing liabilities</b>         | <b>3,671,047</b>                           | <b>11,264</b>                  | <b>0.62%</b>  | <b>3,074,357</b>                           | <b>7,656</b>                   | <b>0.50%</b>                        |
| Noninterest-bearing liabilities:                  |  |                                |   |  |                                |                                     |
| Demand deposits                                   | 938,460                                    |                                |   | 780,843                                    |                                |                                     |
| Other liabilities                                 | 28,730                                     |                                |   | 25,015                                     |                                |                                     |
| Stockholders' equity                              | 559,528                                    |                                |   | 445,815                                    |                                |                                     |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b> | <b>\$ 5,197,765</b>                        |                                |   | <b>\$ 4,326,030</b>                        |                                |                                     |

Edgar Filing: LAKELAND BANCORP INC - Form 10-Q

|                                 |           |       |           |       |
|---------------------------------|-----------|-------|-----------|-------|
| Net interest income/spread      | 81,300    | 3.22% | 69,399    | 3.36% |
| Tax equivalent basis adjustment | 556       |       | 447       |       |
| NET INTEREST INCOME             | \$ 80,744 |       | \$ 68,952 |       |
| Net interest margin (3)         |           | 3.37% |           | 3.48% |

(1) Includes non-accrual loans, the effect of which is to reduce the yield earned on loans, and deferred loan fees.

(2) Includes interest-bearing cash accounts.

(3) Net interest income divided by interest-earning assets.

Interest income on a tax equivalent basis increased from \$77.1 million in the first half of 2016 to \$92.6 million in the first half of 2017, an increase of \$15.5 million, or 20%. The increase in interest income was a result of the Harmony acquisition as well as organic growth in loans, as average loans and leases increased \$610.1 million compared to the first half of 2016. The yield on average loans and leases at 4.24% in the first half of 2017 was 4 basis points higher than the first half of 2016. The yield on average taxable and tax-exempt investment securities decreased by 17 and 45 basis points, respectively, compared to the first half of 2016. The reduction in the yield of taxable investment securities resulted primarily from \$358,000 in income on called U.S. government agency securities received in the first six months of 2016. As previously mentioned, the reduction in yields on tax-exempt investment securities was due primarily to maturing securities at higher rates and new purchases of shorter term securities at lower rates.

Total interest expense of \$11.3 million in the first half of 2017 was \$3.6 million greater than the \$7.7 million reported for the same period in 2016. The cost of average interest-bearing liabilities increased from 0.50% in the first half of 2016 to 0.62% in the first half of 2017. The increase in the cost of interest-bearing liabilities was due primarily to an increase in the cost of borrowings, higher costing deposits acquired in the Harmony acquisition as well as an increasingly competitive market for deposits. The 77 basis point increase in the cost of borrowings was due primarily to the \$75.0 million issuance of subordinated debt in September 2016 bearing a rate of 5.125%. Also impacting the cost of interest-bearing liabilities was an increase in the cost of interest-bearing transaction accounts and time deposits which increased by 10 basis points and 7 basis points, respectively.

---

**Table of Contents***Provision for Loan and Lease Losses*

In the first half of 2017, a \$3.0 million provision for loan and lease losses was recorded, which was \$960,000 higher than the provision for the same period last year. The higher provision resulted from commercial real estate loan growth and higher charge-offs in commercial construction loans. The Company charged off \$2.2 million and recovered \$763,000 in the first half of 2017 compared to \$2.6 million and \$296,000, respectively, in the first half of 2016. For more information regarding the determination of the provision, see Risk Elements below.

*Noninterest Income*

Noninterest income of \$14.2 million in the first half of 2017 increased by \$4.5 million compared to \$9.8 million in the first half of 2016. Included in noninterest income in the first half of 2017 was \$2.5 million in gains on sales of investment securities, which compares to \$370,000 during the same period last year. Commissions and fees at \$2.3 million in the first half of 2017 increased \$213,000 compared to the same period last year due primarily to increases in commercial loan fees and credit card related merchant service fees. Income on bank owned life insurance of \$926,000 for the first half of 2017 increased \$104,000 compared to the same period in 2016 due primarily to the addition of new policies. Other income of \$2.5 million in the first half of 2017 was \$1.8 million higher than the same period in 2016 due primarily to a \$333,000 increase in swap fee income, a \$396,000 increase in gains on sales of other real estate owned, a \$324,000 gain on the payoff of an acquired loan and \$706,000 in gains on the sale of two former branches.

*Noninterest Expense*

Noninterest expense in the first half of 2017 totaled \$53.8 million, which was \$4.7 million greater than the \$49.1 million reported for the first half of 2016. During the first half of 2017, the Company incurred \$2.8 million in long-term debt prepayment penalties, and in the first half of 2016, the Company incurred \$2.4 million in merger related expenses. Salaries and employee benefits expense of \$30.5 million, increased \$3.3 million from the same period last year, primarily due to the addition of Harmony employees during the second half of 2016 and year-over-year increases in employee salary and benefit costs. Net occupancy expense increased \$314,000 compared to the first half of 2016, due primarily to the addition of the Harmony branches. Stationary, supplies and postage increased \$156,000 compared to the first half of 2016 due primarily to the same reason discussed in the quarterly comparison. Marketing expense of \$909,000 in the first half of 2017 increased \$215,000 compared to the same period last year due to the same reasons discussed in the quarterly comparison. FDIC insurance expense of \$743,000 in the first half of 2017 decreased \$528,000 compared to the same period last year, due primarily to the same reasons discussed in the quarterly comparison. ATM and debit card expense of \$958,000 for the first half of 2017 increased \$229,000 compared to the same period in 2016 due primarily to the same reasons discussed in the quarterly comparison. Other expenses of \$5.2 million in the first half of 2017 increased \$415,000 compared to the first half of 2016 primarily due to higher correspondent, legal and audit fees. The Company's efficiency ratio, a non-GAAP financial measure, was 54.4% in the first half of 2017, compared to 58.3% for the same period last year. The decrease in this ratio reflects an 18% increase in revenue as well as the realization of cost savings from the Pascaek and Harmony acquisitions, and the closure of seven branches in 2016. The Company uses this ratio because it believes that the ratio provides a good comparison of period-to-period performance and because the ratio is widely accepted in the banking industry. The following table shows the calculation of the efficiency ratio for the periods presented:

**Table of Contents**

|   | For the Six Months Ended June 30, |           |
|---|-----------------------------------|-----------|
|   | 2017                              | 2016      |
|   | (dollars in thousands)            |           |
| <b>Calculation of Efficiency Ratio</b>            |                                   |           |
| Total noninterest expense                         | \$ 53,836                         | \$ 49,139 |
| Less:   |                                   |           |
| Amortization of core deposit intangibles          | (385)                             | (331)     |
| Long-term debt prepayment penalty                 | (2,828)                           |           |
| Merger related expenses                           |                                   | (2,406)   |
| Provision for unfunded lending commitments        |                                   | (438)     |
| Noninterest expense, as adjusted                  | \$ 50,623                         | \$ 45,964 |
| Net interest income                               | \$ 80,744                         | \$ 68,952 |
| Noninterest income                                | 14,205                            | 9,752     |
| Total revenue                                     | 94,949                            | 78,704    |
| Tax-equivalent adjustment on municipal securities | 556                               | 447       |
| Gains on sales of investment securities           | (2,524)                           | (370)     |
| Total revenue, as adjusted                        | \$ 92,981                         | \$ 78,781 |
| Efficiency ratio                                  | 54.4%                             | 58.3%     |

*Income Tax Expense*

The effective tax rate in the first half of 2017 was 32.5% compared to 33.6% during the same period last year. The decrease in the effective tax rate was due primarily to the implementation of ASU 2016-09 during the first quarter of 2017 which resulted in a \$582,000 tax benefit related to excess tax benefits from the exercise of stock options and the vesting of restricted stock and RSUs.

*Financial Condition*

The Company's total assets increased \$269.1 million from December 31, 2016, to \$5.36 billion at June 30, 2017. Total loans net of deferred fees were \$4.05 billion, an increase of \$180.1 million, or 5%, from \$3.87 billion at December 31, 2016. Total deposits were \$4.23 billion, an increase of \$134.4 million, or 3%, from December 31, 2016.

*Loans and Leases*

Gross loans and leases of \$4.05 billion at June 30, 2017 increased \$180.4 million from December 31, 2016, primarily in the commercial loans secured by real estate category which increased \$168.8 million, or 7%, during that time period. Real estate construction loans also increased \$19.1 million, or 9%, while residential mortgages decreased \$11.8 million, or 3%. The decline in residential mortgages results from a decision to sell most of the residential loans that the Company originates. For more information on the loan portfolio, see Note 5 in Notes to the Consolidated Financial Statements in this Quarterly Report on Form 10-Q.



**Table of Contents**

*Risk Elements*

Non-performing assets, excluding PCI loans, decreased from \$21.5 million at December 31, 2016 to \$17.7 million at June 30, 2017, primarily in the commercial secured by real estate and residential mortgages categories, which decreased \$1.6 million and \$2.2 million, respectively. The percentage of non-performing assets to total assets decreased from 0.42% at December 31, 2016 to 0.33% at June 30, 2017. Non-accrual loans at June 30, 2017 included two loan relationships with a balance of \$1.0 million or over, totaling \$3.6 million, and six loan relationships between \$500,000 and \$1.0 million, totaling \$4.1 million.

There were \$20,000 in loans and leases past due ninety days or more and still accruing at June 30, 2017 compared to \$10,000 at December 31, 2016. These loans primarily consist of consumer loans which are generally placed on non-accrual and reviewed for charge-off when principal and interest payments are four months in arrears unless the obligations are well-secured and in the process of collection.

On June 30, 2017, the Company had \$11.7 million in loans that were troubled debt restructurings and accruing interest income compared to \$8.8 million at December 31, 2016. Troubled debt restructurings are those loans where the Company has granted concessions to the borrower in payment terms, either in rate or in term, as a result of the financial condition of the borrower.

On June 30, 2017, the Company had \$25.4 million in impaired loans (consisting primarily of non-accrual and restructured loans and leases) compared to \$25.3 million at year-end 2016. The Company also had purchased credit impaired loans from the Pascack and Harmony acquisitions with carrying values of \$214,000 and \$528,000, respectively, at June 30, 2017. For more information on impaired loans and leases see Note 5 in Notes to the Consolidated Financial Statements of this Quarterly Report on Form 10-Q. The valuation allowance for impaired loans is based primarily on the fair value of the underlying collateral. Based on such evaluation, \$423,000 of the allowance for loan and lease losses has been allocated for impairment at June 30, 2017 compared to \$529,000 at December 31, 2016. At June 30, 2017, the Company also had \$22.8 million in loans and leases that were rated substandard that were not classified as non-performing or impaired compared to \$28.7 million at December 31, 2016.

There were no loans and leases at June 30, 2017, other than those designated non-performing, impaired or substandard, where the Company was aware of any credit conditions of any borrowers or obligors that would indicate a strong possibility of the borrowers not complying with present terms and conditions of repayment and which may result in such loans and leases being included as non-accrual, past due or renegotiated at a future date.

The following table sets forth for the periods presented, the historical relationships among the allowance for loan and lease losses, the provision for loan and lease losses, the amount of loans and leases charged-off and the amount of loan and lease recoveries:

**Table of Contents**

| (dollars in thousands)  | Six Months<br>Ended<br>June 30,<br>2017 | Six Months<br>Ended<br>June 30,<br>2016 | Year<br>Ended<br>December 31,<br>2016 |
|---|---|---|---------------------------------------|
| Balance of the allowance at the beginning of the year                   | \$ 31,245                               | \$ 30,874                               | \$ 30,874                             |
| Loans and leases charged off:   |   |   |                                       |
| Commercial, secured by real estate                                      | (303)                                   | (274)                                   | (410)                                 |
| Commercial, industrial and other  | (234)                                   | (796)                                   | (796)                                 |
| Leases  | (163)                                   | (275)                                   | (366)                                 |
| Real estate - mortgage  | (310)                                   | (306)                                   | (1,103)                               |
| Real estate - construction  | (609)                                   |   |                                       |
| Home equity and consumer  | (611)                                   | (937)                                   | (1,980)                               |
| <b>Total loans charged off</b>  | <b>(2,230)</b>                          | <b>(2,588)</b>                          | <b>(4,655)</b>                        |
| Recoveries:   |   |   |                                       |
| Commercial, secured by real estate                                      | 364                                     | 81                                      | 297                                   |
| Commercial, industrial and other  | 122                                     | 76                                      | 202                                   |
| Leases  | 32                                      | 22                                      | 31                                    |
| Real estate - mortgage  |   | 4                                       | 8                                     |
| Real estate - construction  | 20                                      |   | 18                                    |
| Home equity and consumer  | 225                                     | 113                                     | 247                                   |
| <b>Total recoveries</b>   | <b>763</b>                              | <b>296</b>                              | <b>803</b>                            |
| Net charge-offs:  | (1,467)                                 | (2,292)                                 | (3,852)                               |
| Provision for loan and lease losses                                     | 3,045                                   | 2,085                                   | 4,223                                 |
| Ending balance  | \$ 32,823                               | \$ 30,667                               | \$ 31,245                             |
| Net charge-offs as a percentage of average loans and leases outstanding | 0.07%                                   | 0.14%                                   | 0.11%                                 |
| Allowance as a percentage of total loans and leases outstanding         | 0.81%                                   | 0.89%                                   | 0.81%                                 |

The ratio of the allowance for loan and lease losses to loans and leases outstanding reflects management's evaluation of the underlying credit risk inherent in the loan portfolio. The determination of the adequacy of the allowance for loan and lease losses and periodic provisioning for estimated losses included in the consolidated financial statements is the responsibility of management and the Board of Directors. The evaluation process is undertaken on a quarterly basis.

Methodology employed for assessing the adequacy of the allowance consists of the following criteria:

The establishment of specific reserve amounts for all impaired loans and leases that have been designated as requiring attention by Lakeland.

The establishment of reserves for pools of homogeneous types of loans and leases not subject to specific review, including impaired loans under \$500,000, leases, 1 – 4 family residential mortgages, and consumer loans.

The establishment of reserve amounts for the unimpaired loans and leases in each portfolio based upon the historical average loss experience as modified by management’s assessment of the loss emergence period for these portfolios and management’s evaluation of key qualitative factors.

Consideration is given to the results of ongoing credit quality monitoring processes, the adequacy and expertise of the Company’s lending staff, underwriting policies, loss histories, delinquency trends, the cyclical nature of economic and business conditions, and capitalization rates. Since many of the Company’s loans depend on the sufficiency of collateral as a secondary means of repayment, any adverse trend in the real estate markets could affect underlying values available to protect the Company against loss.



## **Table of Contents**

The overall balance of the allowance for loan and lease losses of \$32.8 million at June 30, 2017 increased \$1.6 million, from December 31, 2016, an increase of 5%. The change in the allowance within segments of the loan portfolio reflects changes in the non-performing loan and charge-off statistics within each segment as well as the level of growth in each segment. Loan reserves are based on a combination of historical charge-off experience, estimating the appropriate loss emergence and pre-emergence periods and assigning qualitative factors based on general economic conditions and specific bank portfolio characteristics.

Non-performing loans and leases of \$16.2 million at June 30, 2017 decreased \$4.2 million from December 31, 2016. The allowance for loan and lease losses as a percent of total loans was 0.81% of total loans at both June 30, 2017 and December 31, 2016. Management believes, based on appraisals and estimated selling costs that the majority of its non-performing loans and leases are adequately secured and reserves on its non-performing loans and leases are adequate. Based upon the process employed and giving recognition to all accompanying factors related to the loan and lease portfolio, management considers the allowance for loan and lease losses to be adequate at June 30, 2017.

### *Investment Securities*

For detailed information on the composition and maturity distribution of the Company's investment securities portfolio, see Note 4 in Notes to Consolidated Financial Statements contained in this Quarterly Report on Form 10-Q. Total investment securities increased from \$754.3 million at December 31, 2016 to \$811.6 million at June 30, 2017, an increase of \$57.3 million.

### *Deposits*

Total deposits increased from \$4.09 billion at December 31, 2016 to \$4.23 billion at June 30, 2017, an increase of \$134.4 million, or 3%. Noninterest-bearing deposits, savings and interest-bearing transaction accounts and time deposits increased \$51.4 million, \$61.6 million and \$21.3 million, respectively.

### *Liquidity*

Liquidity measures whether an entity has sufficient cash flow to meet its financial obligations and commitments on a timely basis. The Company is liquid when its subsidiary bank has the cash available to meet the borrowing and cash withdrawal requirements of customers and the Company can pay for current and planned expenditures and satisfy its debt obligations.

Lakeland funds loan demand and operation expenses from several sources:

Net income. Cash provided by operating activities was \$33.1 million for the first half of 2017 compared to \$11.1 million for the same period in 2016.

Deposits. Lakeland can offer new products or change its rate structure in order to increase deposits. In the first six months of 2017, Lakeland's deposits increased \$134.4 million.

Sales of securities. At June 30, 2017 the Company had \$673.2 million in securities designated available for sale. Of these securities, \$452.6 million were pledged to secure public deposits and for

other purposes required by applicable laws and regulations.

Repayments on loans and leases can also be a source of liquidity to fund further loan growth.

Credit lines. As a member of the FHLB, Lakeland has the ability to borrow overnight based on the market value of collateral pledged. Lakeland had no overnight borrowings from the FHLB on June 30, 2017. Lakeland also has overnight federal funds lines available for it to borrow up to \$210.0 million of which \$91.6 million was outstanding at June 30, 2017. Lakeland may also borrow from the discount window of the Federal Reserve Bank of New York based on the market value of collateral pledged. Lakeland had no borrowings with the Federal Reserve Bank of New York as of June 30, 2017.

Other borrowings. Lakeland can also generate funds by utilizing long-term debt or securities sold under agreements to repurchase that would be collateralized by security or mortgage collateral. At times the market values of securities collateralizing our securities sold under agreements to repurchase may decline due to

**Table of Contents**

changes in interest rates and may necessitate our lenders to issue a margin call which requires Lakeland to pledge additional collateral to meet that margin call.

Management and the Board monitor the Company's liquidity through the Asset/Liability Committee, which monitors the Company's compliance with certain regulatory ratios and other various liquidity guidelines.

The cash flow statements for the periods presented provide an indication of the Company's sources and uses of cash, as well as an indication of the ability of the Company to maintain an adequate level of liquidity. A discussion of the cash flow statement for the six months ended June 30, 2017 follows.

Cash and cash equivalents totaling \$185.7 million on June 30, 2017 increased \$9.9 million from December 31, 2016. Operating activities provided \$33.1 million in net cash. Investing activities used \$259.3 million in net cash, primarily reflecting an increase in loans and leases and the purchase of securities. Financing activities provided \$236.1 million in net cash primarily reflecting the net increase in deposits of \$134.7 million and net proceeds from federal funds purchased and other borrowings of \$111.1 million. The Company anticipates that it will have sufficient funds available to meet its current loan commitments and deposit maturities. This constitutes a forward-looking statement under the Private Securities Litigation Reform Act of 1995.

The following table sets forth contractual obligations and other commitments representing required and potential cash outflows as of June 30, 2017. Interest on subordinated debentures and long-term borrowed funds is calculated based on current contractual interest rates.

|   | Total               | Within<br>One Year  | After One<br>But Within<br>Three Years | After Three<br>But<br>Within<br>Five Years | After<br>Five Years |
|---|---------------------|---------------------|--|--|---------------------|
| (dollars in thousands)                                    |                     |                     |  |  |                     |
| Minimum annual rentals on noncancellable operating leases | \$ 30,417           | \$ 3,129            | \$ 5,795                               | \$ 4,914                                   | \$ 16,579           |
| Benefit plan commitments                                  | 6,160               | 349                 | 838                                    | 793  | 4,180               |
| Remaining contractual maturities of time deposits         | 566,245             | 394,443             | 144,440                                | 27,353                                     | 9                   |
| Subordinated debentures                                   | 104,842             |                     |  |  | 104,842             |
| Loan commitments  | 902,606             | 620,500             | 141,408                                | 22,322                                     | 118,376             |
| Other borrowings  | 312,251             | 207,460             | 96,187                                 | 8,604                                      |                     |
| Interest on other borrowings*                             | 60,299              | 7,708               | 11,724                                 | 10,121                                     | 30,746              |
| Standby letters of credit                                 | 13,725              | 10,616              | 2,998                                  | 31   | 80                  |
| <b>Total</b>  | <b>\$ 1,996,545</b> | <b>\$ 1,244,205</b> | <b>\$ 403,390</b>                      | <b>\$ 74,138</b>                           | <b>\$ 274,812</b>   |

\* Includes interest on other borrowings and subordinated debentures at a weighted rate of 2.43%.

**Table of Contents***Capital Resources*

Total stockholders' equity increased from \$550.0 million on December 31, 2016 to \$567.5 million on June 30, 2017, an increase of \$17.5 million. Book value per common share increased to \$11.99 on June 30, 2017 from \$11.65 on December 31, 2016. Tangible book value per share increased from \$8.70 per share on December 31, 2016 to \$9.05 per share on June 30, 2017, an increase of 4%. Please see *Non-GAAP Financial Measures* below. The increase in stockholders' equity from December 31, 2016 to June 30, 2017 was primarily due to \$25.7 million of net income, partially offset by the payment of cash dividends on common stock of \$9.3 million.

The Company and Lakeland are subject to various regulatory capital requirements that are monitored by federal banking agencies. Failure to meet minimum capital requirements can lead to certain supervisory actions by regulators; any supervisory action could have a direct material adverse effect on the Company or Lakeland's financial statements. As of June 30, 2017, the Company and Lakeland met all capital adequacy requirements to which they are subject.

The final rules implementing the Basel Committee on Banking Supervision's (BCBS) capital guidelines for U.S. banks became effective for the Company on January 1, 2015, with full compliance with all of the final rules requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of June 30, 2017, the Company's capital levels remained characterized as well-capitalized under the new rules.

The capital ratios for the Company and Lakeland for the periods presented are as follows:

|   | Common Equity Tier 1 to                      |                   |                            |                   |  |                   |   |                   |
|---|--|-------------------|----------------------------|-------------------|--|-------------------|---|-------------------|
|   | Tier 1 Capital to Total Average Assets Ratio |                   | Risk-Weighted Assets Ratio |                   | Tier 1 Capital to Risk-Weighted Assets Ratio |                   | Total Capital to Risk-Weighted Assets Ratio |                   |
|   | June 30, 2017                                | December 31, 2016 | June 30, 2017              | December 31, 2016 | June 30, 2017                                | December 31, 2016 | June 30, 2017                               | December 31, 2016 |
| The Company   | 8.99%  | 9.07%             | 10.06%                     | 10.11%            | 10.77%                                       | 10.85%            | 13.32%                                      | 13.48%            |
| Lakeland Bank   | 10.01%                                       | 10.21%            | 11.98%                     | 12.21%            | 11.98%                                       | 12.21%            | 12.81%                                      | 13.03%            |
| Required capital ratios including conservation buffer | 4.00%  | 4.00%             | 5.75%                      | 5.125%            | 7.25%  | 6.625%            | 9.25%                                       | 8.625%            |
| Well capitalized institution under FDIC Regulations   | 5.00%  | 5.00%             | 6.50%                      | 6.50%             | 8.00%  | 8.00%             | 10.00%                                      | 10.00%            |

*Non-GAAP Financial Measures*

Reported amounts are presented in accordance with U.S. GAAP. The Company's management uses certain supplemental non-GAAP information in its analysis of the Company's financial results. Specifically, the Company provides measurements and ratios based on tangible equity and tangible assets. These measures are utilized by regulators and market analysts to evaluate a company's financial condition and therefore, such information is useful to investors.

The Company also provides measures based on what it believes are its operating earnings on a consistent basis, and excludes material non-routine operating items which affect the GAAP reporting of results of operations. The Company's management believes that providing this information to analysts and investors allows them to better understand and evaluate the Company's core financial results for the periods in question.

*These disclosures should not be viewed as a substitute for financial results determined in accordance with U.S. GAAP, nor are they necessarily comparable to non-GAAP performance measures which may be presented by other companies.*

**Table of Contents**

| (dollars in thousands, except per share amounts)                      | June 30,<br>2017 | December 31,<br>2016 |
|---|------------------|----------------------|
| <u>Calculation of Tangible Book Value per Common Share</u>            |                  |                      |
| Total common stockholders equity at end of period - GAAP              | \$ 567,545       | \$ 550,044           |
| Less:   |                  |                      |
| Goodwill  | 136,433          | 135,747              |
| Other identifiable intangible assets, net                             | 2,631            | 3,344                |
| Total tangible common stockholders equity at end of period - Non-GAAP | \$ 428,481       | \$ 410,953           |
| Shares outstanding at end of period                                   | 47,353           | 47,223               |
| Book value per share - GAAP   | \$ 11.99         | \$ 11.65             |
| Tangible book value per share - Non-GAAP                              | \$ 9.05          | \$ 8.70              |
| <u>Calculation of Tangible Common Equity to Tangible Assets</u>       |                  |                      |
| Total tangible common stockholders equity at end of period - Non-GAAP | \$ 428,481       | \$ 410,953           |
| Total assets at end of period   | \$ 5,362,187     | \$ 5,093,131         |
| Less:   |                  |                      |
| Goodwill  | 136,433          | 135,747              |
| Other identifiable intangible assets, net                             | 2,631            | 3,344                |
| Total tangible assets at end of period - Non-GAAP                     | \$ 5,223,123     | \$ 4,954,040         |
| Common equity to assets - GAAP  | 10.58%           | 10.80%               |
| Tangible common equity to tangible assets - Non-GAAP                  | 8.20%            | 8.30%                |

| (dollars in thousands)   | For the Three Months Ended, |                  | For the Six Months ended, |                  |
|--|-----------------------------|------------------|---------------------------|------------------|
|  | June 30,<br>2017            | June 30,<br>2016 | June 30,<br>2017          | June 30,<br>2016 |
| <u>Calculation of Return on Average Tangible Common Equity</u> |                             |                  |                           |                  |
| Net income - GAAP  | \$ 13,370                   | \$ 10,130        | \$ 25,682                 | \$ 18,238        |
| Total average common stockholders equity                       | \$ 565,211                  | \$ 450,806       | \$ 559,528                | \$ 445,815       |
| Less:  |                             |                  |                           |                  |

Edgar Filing: LAKELAND BANCORP INC - Form 10-Q

|  |            |            |            |            |
|--|------------|------------|------------|------------|
| Average goodwill   | 135,755    | 125,424    | 135,751    | 124,923    |
| Average other identifiable intangible assets, net                | 3,069      | 2,828      | 3,172      | 2,874      |
| Total average tangible common stockholders equity - Non-GAAP     | \$ 426,387 | \$ 322,554 | \$ 420,605 | \$ 318,018 |
| Return on average common stockholders equity - GAAP              | 9.49%      | 9.04%      | 9.26%      | 8.23%      |
| Return on average tangible common stockholders equity - Non-GAAP | 12.58%     | 12.63%     | 12.31%     | 11.53%     |



**Table of Contents**

|   | For the Three Months Ended               |                  | For the Six Months Ended |                  |
|---|--|------------------|--------------------------|------------------|
|   | June 30,<br>2017                         | June 30,<br>2016 | June 30,<br>2017         | June 30,<br>2016 |
|   | (in thousands, except per share amounts) |                  |                          |                  |
| <b>Reconciliation of Earnings per Share</b>                                       |  |                  |                          |                  |
| Net income - GAAP   | \$ 13,370                                | \$ 10,130        | \$ 25,682                | \$ 18,238        |
| Non-routine transactions, net of tax  |  |                  |                          |                  |
| Tax deductible merger related expenses  |  | 175              |                          | 986              |
| Non-tax deductible merger related expenses  |  | 389              |                          | 739              |
| Net effect of non-routine transactions  |  | 564              |                          | 1,725            |
| Net income available to common shareholders<br>excluding non-routine transactions | 13,370                                   | 10,694           | 25,682                   | 19,963           |
| Less: Earnings allocated to participating securities                              | (119)                                    | (106)            | (239)                    | (161)            |
|   | \$ 13,251                                | \$ 10,588        | \$ 25,443                | \$ 19,802        |
| Weighted average shares - Basic   | 47,465                                   | 41,238           | 47,410                   | 41,084           |
| Weighted average shares - Diluted   | 47,674                                   | 41,406           | 47,646                   | 41,245           |
| Basic earnings per share, GAAP  | \$ 0.28                                  | \$ 0.24          | \$ 0.54                  | \$ 0.44          |
| Diluted earnings per share, GAAP  | \$ 0.28                                  | \$ 0.24          | \$ 0.53                  | \$ 0.44          |
| Basic earnings per share, adjusted for non-routine<br>transactions                | \$ 0.28                                  | \$ 0.26          | \$ 0.54                  | \$ 0.48          |
| Diluted earnings per share, adjusted for non-routine<br>transactions              | \$ 0.28                                  | \$ 0.26          | \$ 0.53                  | \$ 0.48          |

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The Company manages interest rate risk and market risk by identifying and quantifying interest rate risk exposures using simulation analysis and economic value at risk models. Net interest income simulation considers the relative sensitivities of the balance sheet including the effects of interest rate caps on adjustable rate mortgages and the relatively stable aspects of core deposits. As such, net interest income simulation is designed to address the probability of interest rate changes and the behavioral response of the balance sheet to those changes. Market Value of Portfolio Equity represents the fair value of the net present value of assets, liabilities and off-balance-sheet items. Changes in estimates and assumptions made for interest rate sensitivity modeling could have a significant impact on projected results and conclusions. These assumptions could include prepayment rates, sensitivity of non-maturity deposits and other similar assumptions. Therefore, if our assumptions should change, this technique may not accurately reflect the impact of general interest rate movements on the Company's net interest income or net portfolio value.

The starting point (or base case) for the following table is an estimate of the following year's net interest income assuming that both interest rates and the Company's interest-sensitive assets and liabilities remain at period-end levels. The net interest income estimated for the next twelve months (the base case) is \$164.6 million. The information provided for net interest income assumes that changes in interest rates of plus 200 basis points and minus 200 basis points change gradually in equal increments (rate ramp) over the twelve month period.

| <u>Rate Ramp</u>             | Changes in Interest Rates |         |
|------------------------------|---------------------------|---------|
|                              | +200 bp                   | -200 bp |
| Asset/Liability policy limit | -5.0%                     | -5.0%   |
| June 30, 2017                | -0.7%                     | -3.1%   |
| December 31, 2016            | -0.5%                     | -2.4%   |

**Table of Contents**

The Company's review of interest rate risk also includes policy limits for net interest income changes in various rate shock scenarios. Rate shocks assume that current interest rates change immediately. The information provided for net interest income assumes fluctuations or rate shocks for changes in interest rates as shown in the table below.

| <u>Rate Shock</u>            | Changes in Interest Rates |         |         |         |
|------------------------------|---------------------------|---------|---------|---------|
|                              | +300 bp                   | +200 bp | +100 bp | -100 bp |
| Asset/Liability policy limit | -15.0%                    | -10.0%  | -5.0%   | -5.0%   |
| June 30, 2017                | 0.7%                      | 0.7%    | 0.5%    | -6.1%   |
| December 31, 2016            | 1.9%                      | 1.4%    | 0.9%    | -4.8%   |

The base case for the following table is an estimate of the Company's net portfolio value for the periods presented using current discount rates, and assuming the Company's interest-sensitive assets and liabilities remain at period-end levels. The net portfolio value at June 30, 2017 (the base case) was \$751.4 million. The information provided for the net portfolio value assumes fluctuations or rate shocks for changes in interest rates as shown in the table below. Rate shocks assume that current interest rates change immediately.

| <u>Rate Shock</u>            | Changes in Interest Rates |         |         |         |
|------------------------------|---------------------------|---------|---------|---------|
|                              | +300 bp                   | +200 bp | +100 bp | -100 bp |
| Asset/Liability policy limit | -25.0%                    | -20.0%  | -10.0%  | -10.0%  |
| June 30, 2017                | -5.9%                     | -3.6%   | -1.4%   | -0.5%   |
| December 31, 2016            | -7.5%                     | -4.9%   | -2.2%   | 0.4%    |

The information set forth in the above tables is based on significant estimates and assumptions, and constitutes a forward-looking statement under the Private Securities Litigation Reform Act of 1995. For more information regarding the Company's market risk and assumptions used in the Company's simulation models, please refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

Certain shortcomings are inherent in the methodologies used in the above interest rate risk measurements. Modeling changes in net interest income requires the making of certain assumptions regarding prepayment and deposit decay rates, which may or may not reflect the manner in which actual yields and costs respond to changes in market interest rates. While management believes such assumptions are reasonable, there can be no assurance that assumed prepayment rates and decay rates will approximate actual future loan prepayment and deposit withdrawal activity. Moreover, the net interest income table presented assumes that the composition of interest sensitive assets and liabilities existing at the beginning of a period remains constant over the period being measured and also assumes that a particular change in interest rates is reflected uniformly across the yield curve regardless of the duration to maturity or repricing of specific assets and liabilities. Accordingly, although the net interest income table provides an indication of the Company's interest rate risk exposure at a particular point in time, such measurement is not intended to and does not provide a precise forecast of the effect of changes in market interest rates on net interest income and will differ from actual results.

**Table of Contents**

**Item 4. Controls and Procedures**

(a) **Disclosure controls and procedures.** As of the end of the Company's most recently completed fiscal quarter covered by this report, the Company carried out an evaluation, with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures pursuant to Securities Exchange Act Rule 13a-15. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms and are operating in an effective manner and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

(b) **Changes in internal controls over financial reporting.** There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2017 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

There are no pending legal proceedings involving the Company or Lakeland other than those arising in the normal course of business. Management does not anticipate that the potential liability, if any, arising out of such legal proceedings will have a material effect on the financial condition or results of operations of the Company and Lakeland on a consolidated basis.

**Item 1A. Risk Factors**

There have been no material changes in risk factors from those disclosed under Item 1A, Risk Factors in the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds** Not Applicable

**Item 3. Defaults Upon Senior Securities** Not Applicable

**Item 4. Mine Safety Disclosures** Not Applicable

**Item 5. Other Information** Not Applicable

**Item 6. Exhibits**

|         |  |
|---------|--|
| 31.1    | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002                                 |
| 31.2    | Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002                                 |
| 32.1    | Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101.INS | XBRL Instance Document   |
| 101.SCH | XBRL Taxonomy Extension Schema Document  |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document   |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document  |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document   |

Table of Contents

**SIGNATURES**

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

Lakeland Bancorp, Inc.  
(Registrant)

/s/ Thomas J. Shara  
Thomas J. Shara  
President and Chief Executive Officer  
(Principal Executive Officer)

/s/ Thomas F. Splaine  
Thomas F. Splaine  
Executive Vice President and Chief Financial Officer  
(Principal Financial Officer)

Date: August 8, 2017