

ENTERPRISE BANCORP INC /MA/

Form 10-Q

November 09, 2012

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended September 30, 2012

Commission File Number: 001-33912

Enterprise Bancorp, Inc.

(Exact name of registrant as specified in its charter)

Massachusetts

(State or other jurisdiction of  
incorporation or organization)

04-3308902

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

222 Merrimack Street, Lowell, Massachusetts

(Address of principal executive offices)

(978) 459-9000

(Registrant's telephone number, including area code)

01852

(Zip code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files)  Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition for "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

As of November 5, 2012, there were 9,634,329 shares of the issuer's common stock outstanding- Par Value \$0.01 per share



Table of Contents

ENTERPRISE BANCORP, INC.  
INDEX

|   | Page Number |
|---|-------------|
| <u>Cover Page</u>   | <u>1</u>    |
| <u>Index</u>  | <u>2</u>    |
| <u>PART I - FINANCIAL INFORMATION</u>   |             |
| <u>Item 1 Financial Statements</u>  | <u>3</u>    |
| <u>Consolidated Balance Sheets – September 30, 2012 and December 31, 2011</u>                                   | <u>3</u>    |
| <u>Consolidated Statements of Income -Three and nine months ended September 30, 2012 and 2011</u>               | <u>4</u>    |
| <u>Consolidated Statements of Comprehensive Income -Three and nine months ended September 30, 2012 and 2011</u> | <u>5</u>    |
| <u>Consolidated Statement of Changes in Stockholders' Equity - Nine months ended September 30, 2012</u>         | <u>6</u>    |
| <u>Consolidated Statements of Cash Flows - Nine months ended September 30, 2012 and 2011</u>                    | <u>7</u>    |
| <u>Notes to Unaudited Consolidated Financial Statements</u>   | <u>8</u>    |
| <u>Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations</u>             | <u>33</u>   |
| <u>Item 3 Quantitative and Qualitative Disclosures About Market Risk</u>  | <u>56</u>   |
| <u>Item 4 Controls and Procedures</u>   | <u>57</u>   |
| <u>PART II - OTHER INFORMATION</u>  |             |
| <u>Item 1 Legal Proceedings</u>   | <u>58</u>   |
| <u>Item 1A Risk Factors</u>   | <u>58</u>   |
| <u>Item 2 Unregistered Sales of Equity Securities and Use of Proceeds</u>                                       | <u>58</u>   |
| <u>Item 3 Defaults Upon Senior Securities</u>   | <u>58</u>   |
| <u>Item 4 Mine Safety Disclosures</u>   | <u>58</u>   |
| <u>Item 5 Other Information</u>   | <u>58</u>   |
| <u>Item 6 Exhibits</u>  | <u>59</u>   |
| <u>Signature page</u>   | <u>60</u>   |

Table of Contents

## PART I-FINANCIAL INFORMATION

Item 1 - Financial Statements  
ENTERPRISE BANCORP, INC.  
Consolidated Balance Sheets

| (Dollars in thousands)   | September 30,<br>2012<br>(unaudited) | December 31,<br>2011 |
|--|--------------------------------------|----------------------|
| Assets   |                                      |                      |
| Cash and cash equivalents:   |                                      |                      |
| Cash and due from banks  | \$50,978                             | \$30,231             |
| Interest-earning deposits  | 25,413                               | 6,785                |
| Fed funds sold   | 5,879                                | 2,115                |
| Total cash and cash equivalents  | 82,270                               | 39,131               |
| Investment securities at fair value  | 191,696                              | 140,405              |
| Federal Home Loan Bank Stock   | 4,260                                | 4,740                |
| Loans, less allowance for loan losses of \$23,930 at September 30, 2012 and \$23,160 at December 31, 2011, respectively  | 1,280,123                            | 1,227,329            |
| Premises and equipment   | 27,267                               | 27,310               |
| Accrued interest receivable  | 5,830                                | 5,821                |
| Deferred income taxes, net   | 12,132                               | 12,411               |
| Bank-owned life insurance  | 15,321                               | 14,937               |
| Prepaid income taxes   | 719                                  | 287                  |
| Prepaid expenses and other assets  | 12,273                               | 11,136               |
| Goodwill   | 5,656                                | 5,656                |
| Total assets   | \$1,637,547                          | \$1,489,163          |
| Liabilities and Stockholders' Equity   |                                      |                      |
| Liabilities  |                                      |                      |
| Deposits   | \$1,470,426                          | \$1,333,158          |
| Borrowed funds   | 2,994                                | 4,494                |
| Junior subordinated debentures   | 10,825                               | 10,825               |
| Accrued expenses and other liabilities   | 16,444                               | 12,487               |
| Accrued interest payable   | 323                                  | 751                  |
| Total liabilities  | \$1,501,012                          | \$1,361,715          |
| Commitments and Contingencies  |                                      |                      |
| Stockholders' Equity   |                                      |                      |
| Preferred stock, \$0.01 par value per share; 1,000,000 shares authorized; no shares issued   | —                                    | —                    |
| Common stock \$0.01 par value per share; 20,000,000 shares authorized; 9,632,904 and 9,472,748 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively | 96                                   | 95                   |
| Additional paid-in-capital   | 47,304                               | 45,158               |
| Retained earnings  | 84,985                               | 78,999               |
| Accumulated other comprehensive income   | 4,150                                | 3,196                |
| Total stockholders' equity   | \$136,535                            | \$127,448            |
| Total liabilities and stockholders' equity   | \$1,637,547                          | \$1,489,163          |

See the accompanying notes to the unaudited consolidated financial statements.

Table of Contents

ENTERPRISE BANCORP, INC.  
 Consolidated Statements of Income  
 (unaudited)

| (Dollars in thousands, except per share data)       | Three months ended    |           | Nine months ended     |           |
|---|-----------------------|-----------|-----------------------|-----------|
|   | September 30,<br>2012 | 2011      | September 30,<br>2012 | 2011      |
| Interest and dividend income:                       |                       |           |                       |           |
| Loans   | \$16,324              | \$16,078  | 48,510                | 46,915    |
| Investment securities                               | 833                   | 824       | 2,467                 | 2,679     |
| Other interest-earning assets                       | 25                    | 11        | 68                    | 49        |
| Total interest and dividend income                  | 17,182                | 16,913    | 51,045                | 49,643    |
| Interest expense:                                   |                       |           |                       |           |
| Deposits  | 1,228                 | 1,858     | 4,133                 | 5,676     |
| Borrowed funds                                      | 12                    | 22        | 41                    | 66        |
| Junior subordinated debentures                      | 294                   | 294       | 883                   | 883       |
| Total interest expense                              | 1,534                 | 2,174     | 5,057                 | 6,625     |
| Net interest income                                 | 15,648                | 14,739    | 45,988                | 43,018    |
| Provision for loan losses                           | 800                   | 1,840     | 2,150                 | 3,954     |
| Net interest income after provision for loan losses | 14,848                | 12,899    | 43,838                | 39,064    |
| Non-interest income:                                |                       |           |                       |           |
| Investment advisory fees                            | 925                   | 919       | 2,880                 | 2,844     |
| Deposit service fees                                | 1,153                 | 1,157     | 3,281                 | 3,313     |
| Income on bank-owned life insurance                 | 122                   | 132       | 384                   | 409       |
| Net gains on sales of investment securities         | 38                    | 486       | 197                   | 747       |
| Gains on sales of loans                             | 211                   | 119       | 669                   | 403       |
| Other income  | 536                   | 397       | 1,500                 | 1,275     |
| Total non-interest income                           | 2,985                 | 3,210     | 8,911                 | 8,991     |
| Non-interest expense:                               |                       |           |                       |           |
| Salaries and employee benefits                      | 8,190                 | 7,177     | 23,534                | 21,275    |
| Occupancy and equipment expenses                    | 1,400                 | 1,346     | 4,244                 | 4,147     |
| Technology and telecommunications expenses          | 1,122                 | 959       | 3,198                 | 2,893     |
| Advertising and public relations expenses           | 408                   | 471       | 1,694                 | 1,717     |
| Deposit insurance premiums                          | 283                   | 276       | 843                   | 1,049     |
| Audit, legal and other professional fees            | 336                   | 331       | 1,306                 | 1,003     |
| Supplies and postage expenses                       | 232                   | 212       | 659                   | 636       |
| Investment advisory and custodial expenses          | 110                   | 97        | 319                   | 327       |
| Other operating expenses                            | 929                   | 979       | 3,003                 | 3,050     |
| Total non-interest expense                          | 13,010                | 11,848    | 38,800                | 36,097    |
| Income before income taxes                          | 4,823                 | 4,261     | 13,949                | 11,958    |
| Provision for income taxes                          | 1,760                 | 1,324     | 4,808                 | 3,872     |
| Net income  | \$3,063               | \$2,937   | \$9,141               | \$8,086   |
| Basic earnings per share                            | \$0.32                | \$0.31    | \$0.96                | \$0.86    |
| Diluted earnings per share                          | \$0.32                | \$0.31    | \$0.95                | \$0.86    |
| Basic weighted average common shares outstanding    | 9,613,386             | 9,429,360 | 9,567,294             | 9,383,678 |
| Diluted weighted average common shares outstanding  | 9,692,290             | 9,463,664 | 9,639,122             | 9,435,506 |

See the accompanying notes to the unaudited consolidated financial statements.



Table of Contents

ENTERPRISE BANCORP, INC.  
 Consolidated Statements of Comprehensive Income  
 (Unaudited)

| (Dollars in thousands)  | Three months ended |         | Nine months ended |         |
|---|--------------------|---------|-------------------|---------|
|   | September 30,      |         | September 30,     |         |
|   | 2012               | 2011    | 2012              | 2011    |
| Net income  | \$3,063            | \$2,937 | \$9,141           | \$8,086 |
| Other comprehensive income, net of taxes:                               |                    |         |                   |         |
| Gross unrealized holding gains on investments arising during the period | 861                | (51     | ) 1,677           | 1,933   |
| Income tax expense  | (307               | ) 14    | (594              | ) (697  |
| Net unrealized holding gains, net of tax                                | 554                | (37     | ) 1,083           | 1,236   |
| Less: Reclassification adjustment for net gains included in net income  |                    |         |                   |         |
| Net realized gains on sales of securities during the period             | 38                 | 486     | 197               | 747     |
| Income tax expense  | (12                | ) (170  | ) (68             | ) (264  |
| Reclassification adjustment for gains realized, net of tax              | 26                 | 316     | 129               | 483     |
| Total other comprehensive income  | 528                | (353    | ) 954             | 753     |
| Comprehensive income  | \$3,591            | \$2,584 | \$10,095          | \$8,839 |



Table of Contents

## ENTERPRISE BANCORP, INC.

Consolidated Statement of Changes in Stockholders' Equity  
(Unaudited)

| (Dollars in thousands)                                  | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Total<br>Stockholders'<br>Equity |
|---|-----------------|----------------------------------|----------------------|---|----------------------------------|
| Balance at December 31, 2011                            | \$95            | \$45,158                         | \$78,999             | \$ 3,196  | \$127,448                        |
| Net income  |                 |                                  | 9,141                |   | 9,141                            |
| Other comprehensive income, net                         |                 |                                  |                      | 954   | 954                              |
| Tax benefit from exercise of stock options              |                 | 1                                |                      |   | 1                                |
| Common stock dividend paid (\$0.33 per share)           |                 |                                  | (3,155 )             |   | (3,155 )                         |
| Common stock issued under dividend<br>reinvestment plan | —               | 956                              |                      |   | 956                              |
| Stock-based compensation                                | 1               | 978                              |                      |   | 979                              |
| Stock options exercised                                 | —               | 211                              |                      |   | 211                              |
| Balance at September 30, 2012                           | \$96            | \$47,304                         | \$84,985             | \$ 4,150  | \$136,535                        |

See the accompanying notes to the unaudited consolidated financial statements.

Table of Contents

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

|   | Nine months ended<br>September 30, |          |
|---|------------------------------------|----------|
|   | 2012                               | 2011     |
| (Dollars in thousands)  |                                    |          |
| Cash flows from operating activities:   |                                    |          |
| Net income  | \$9,141                            | \$8,086  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                    |          |
| Provision for loan losses   | 2,150                              | 3,954    |
| Depreciation and amortization   | 3,291                              | 3,081    |
| Stock-based compensation expense  | 956                                | 796      |
| Mortgage loans originated for sale  | (35,041)                           | (19,338) |
| Proceeds from mortgage loans sold   | 35,085                             | 22,549   |
| Net gains on sales of loans   | (669)                              | (403)    |
| Net gains on sales of OREO  | (45)                               | —        |
| Net gains on sales of investments   | (197)                              | (747)    |
| Income on bank-owned life insurance, net of costs                                 | (384)                              | (404)    |
| Changes in:   |                                    |          |
| Accrued interest receivable   | (9)                                | 114      |
| Prepaid expenses and other assets   | (1,807)                            | 423      |
| Deferred income taxes   | (245)                              | (1,524)  |
| Accrued expenses and other liabilities  | (1,568)                            | 327      |
| Accrued interest payable  | (428)                              | (548)    |
| Net cash provided by operating activities   | 10,230                             | 16,366   |
| Cash flows from investing activities:   |                                    |          |
| Proceeds from sales of investment securities available for sale                   | 3,240                              | 10,935   |
| Proceeds from FHLB capital stock repurchase                                       | 480                                | —        |
| Proceeds from maturities, calls and pay-downs of investment securities            | 22,332                             | 39,000   |
| Purchase of investment securities   | (70,115)                           | (33,611) |
| Net increase in loans   | (54,719)                           | (90,645) |
| Additions to premises and equipment, net  | (2,730)                            | (3,796)  |
| Proceeds from OREO sales and payments   | 885                                | 325      |
| Purchase of Oreo  | (245)                              | —        |
| Net cash used in investing activities   | (100,872)                          | (77,792) |
| Cash flows from financing activities:   |                                    |          |
| Net increase in deposits  | 137,268                            | 101,417  |
| Net decrease in borrowed funds  | (1,500)                            | (11,047) |
| Cash dividends paid   | (3,155)                            | (2,953)  |
| Proceeds from issuance of common stock  | 956                                | 942      |
| Proceeds from the exercise of stock options                                       | 211                                | 239      |
| Tax benefit from the exercise of stock option                                     | 1                                  | 4        |
| Net cash provided by financing activities   | 133,781                            | 88,602   |
| Net increase in cash and cash equivalents   | 43,139                             | 27,176   |
| Cash and cash equivalents at beginning of period                                  | 39,131                             | 55,006   |
| Cash and cash equivalents at end of period  | \$82,270                           | \$82,182 |

Edgar Filing: ENTERPRISE BANCORP INC /MA/ - Form 10-Q

Supplemental financial data:

|                             |         |         |
|-----------------------------|---------|---------|
| Cash Paid For: Interest     | \$5,485 | \$7,173 |
| Cash Paid For: Income Taxes | 5,485   | 5,391   |

Supplemental schedule of non-cash investing activity:

|   |       |       |
|---|-------|-------|
| Purchase of investment securities not yet settled | 5,548 | 1,463 |
| Transfer from loans to other real estate owned    | 400   | 825   |

See accompanying notes to the unaudited consolidated financial statements.

7

---

Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements

(1) Organization of Holding Company and Basis of Presentation

The accompanying unaudited consolidated financial statements and these notes should be read in conjunction with the Company's December 31, 2011 audited consolidated financial statements and notes thereto contained in the Company's 2011 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 15, 2012. Interim results are not necessarily indicative of results to be expected for the entire year.

The Company has not changed its reporting policies from those disclosed in its 2011 Annual Report on Form 10-K. The consolidated interim financial statements of Enterprise Bancorp, Inc. (the "Company" or "Enterprise") include the accounts of the Company and its wholly owned subsidiary, Enterprise Bank and Trust Company (the "Bank"). The Bank is a Massachusetts trust company organized in 1989. Substantially all of the Company's operations are conducted through the Bank.

The Bank's subsidiaries include Enterprise Insurance Services, LLC and Enterprise Investment Services, LLC, organized under the laws of the Commonwealth of Massachusetts for the purposes of engaging in insurance sales activities and offering non-deposit investment products and services, respectively. In addition, the Bank has subsidiaries incorporated in the Commonwealth of Massachusetts and classified as security corporations in accordance with applicable Massachusetts General Laws. These subsidiaries are: Enterprise Security Corporation; Enterprise Security Corporation II; and Enterprise Security Corporation III, which hold various types of qualifying securities. The security corporations are limited to conducting securities investment activities that the Bank itself would be allowed to conduct under applicable laws.

The Company has 19 full service branches serving the Merrimack Valley and North Central regions of Massachusetts and Southern New Hampshire. The Company has also obtained the necessary regulatory approvals for its new branches in Tyngsboro and Lawrence, Massachusetts with the Tyngsboro office opening in November 2012 and the planned opening of Lawrence office in the first quarter of 2013. Through the Bank and its subsidiaries, the Company offers a range of commercial and consumer loan products, deposit and cash management products, investment advisory and wealth management, and insurance services. The services offered through the Bank and subsidiaries are managed as one strategic unit and represent the Company's only reportable operating segment.

Pursuant to the Accounting Standards Codification ("ASC") Topic 810 "Consolidation of Variable Interest Entities," issued by the Financial Accounting Standards Board (originally issued as Financial Interpretation No. 46R) in December 2003, the Company carries Junior Subordinated Debentures as a liability on its consolidated financial statements, along with the related interest expense. The debentures were issued by a statutory business trust (the "Trust") created by the Company in March 2000 under the laws of Delaware, and the trust preferred securities issued by the Trust, and the related non-interest expense, are excluded from the Company's consolidated financial statements.

The Federal Deposit Insurance Corporation (the "FDIC") and the Massachusetts Commissioner of Banks (the "Commissioner") have regulatory authority over the Bank. The Bank is also subject to certain regulatory requirements of the Board of Governors of the Federal Reserve System (the "Federal Reserve Board") and, with respect to its New Hampshire branch operations, the New Hampshire Banking Department. The business and operations of the Company are subject to the regulatory oversight of the Federal Reserve Board. The Commissioner also retains supervisory jurisdiction over the Company.

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP") for interim financial information and the instructions for

Form 10-Q through the rules and interpretive releases of the SEC under federal securities law. In the opinion of management, the accompanying unaudited consolidated financial statements reflect all necessary adjustments consisting of normal recurring accruals for a fair presentation. All significant intercompany balances and transactions have been eliminated in the accompanying unaudited consolidated financial statements.

Certain previous year amounts in the unaudited consolidated financial statements and accompanying footnotes have been reclassified to conform to the current year's presentation.

Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

(2)Critical Accounting Estimates

The Company has not changed its significant accounting policies from those disclosed in its 2011 Annual Report filed on Form 10-K.

In preparing the consolidated financial statements in conformity with GAAP, management is required to exercise judgment in determining many of the methodologies, assumptions and estimates to be utilized. These estimates and assumptions affect the reported amounts of assets and liabilities as of the balance sheet date and revenues and expenses for the period then ended. As future events and their effects cannot be determined with precision, actual results could differ significantly from these estimates should the assumptions and estimates used change over time due to changes in circumstances. Changes in those estimates resulting from continuing changes in the economic environment and other factors will be reflected in the financial statements and results of operations in future periods.

As discussed in the Company's 2011 Annual Report on Form 10-K, the three most significant areas in which management applies critical assumptions and estimates that are particularly susceptible to change relate to the determination of the allowance for loan losses, impairment review of investment securities and the impairment review of goodwill. Refer to note 1, "Summary of Significant Accounting Policies," to the Company's consolidated financial statements included in the Company's 2011 Annual Report on Form 10-K for significant accounting policies.

(3)Recent Accounting Pronouncements

In December 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. ASU 2011-11 requires an entity to disclose information about offsetting and related arrangements to enable users of financial statements to understand the effect of those arrangements on its financial position, and to allow investors to better compare financial statements prepared under GAAP with financial statements prepared under International Financial Reporting Standards ("IFRS"). The new standards are effective for annual periods beginning January 1, 2013, and interim periods within those annual periods. Retrospective application is required. The Company will implement the provisions of ASU 2011-11 as of January 1, 2013. As this ASU primarily deals with disclosure requirements and the Company has no material netting arrangements, this adoption is not expected to have a material impact on the Company's financial statements.

Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

## (4) Investments

The amortized cost and carrying values of investment securities at the dates specified are summarized as follows:

| (Dollars in thousands)   | September 30, 2012 |                  |                   | Fair Value |
|--|--------------------|------------------|-------------------|------------|
|  | Amortized cost     | Unrealized gains | Unrealized losses |            |
| Federal agency obligations <sup>(1)</sup>                      | \$75,319           | \$421            | \$1               | \$75,739   |
| Federal agency mortgage backed securities (MBS) <sup>(1)</sup> | 47,267             | 1,433            | —                 | 48,700     |
| Municipal securities   | 53,432             | 3,141            | 22                | 56,551     |
| Corporate bonds  | 648                | 8                | —                 | 656        |
| Certificates of deposit <sup>(2)</sup>                         | 500                | —                | —                 | 500        |
| Total fixed income securities                                  | 177,166            | 5,003            | 23                | 182,146    |
| Equity investments   | 8,075              | 1,535            | 60                | 9,550      |
| Total available for sale securities, at fair value             | \$185,241          | \$6,538          | \$83              | \$191,696  |

  

| (Dollars in thousands)   | December 31, 2011 |                  |                   | Fair Value |
|--|-------------------|------------------|-------------------|------------|
|  | Amortized cost    | Unrealized gains | Unrealized losses |            |
| Federal agency obligations <sup>(1)</sup>                      | \$40,206          | \$191            | \$—               | \$40,397   |
| Federal agency mortgage backed securities (MBS) <sup>(1)</sup> | 38,275            | 1,416            | 3                 | 39,688     |
| Municipal securities   | 48,393            | 2,821            | 5                 | 51,209     |
| Certificates of deposit <sup>(2)</sup>                         | 2,149             | —                | 2                 | 2,147      |
| Total fixed income securities                                  | 129,023           | 4,428            | 10                | 133,441    |
| Equity investments   | 6,405             | 804              | 245               | 6,964      |
| Total available for sale securities, at fair value             | \$135,428         | \$5,232          | \$255             | \$140,405  |

These categories may include investments issued or guaranteed by government sponsored enterprises such as Fannie Mae (FNMA), Freddie Mac (FHLMC), Ginnie Mae (GNMA), Federal Farm Credit Bank, or one of several Federal Home Loan Banks. All agency MBS/Collateralized Mortgage Obligations ("CMOs") investments owned by the Company are backed by residential mortgages.

(2) Certificates of Deposits ("CD") represent term deposits issued by banks that are subject to FDIC insurance and purchased on the open market.

Included in the carrying amount of federal agency MBS category were CMOs totaling \$25.8 million and \$21.8 million at September 30, 2012 and December 31, 2011, respectively.

In 2012, the Company's internal investment policy was expanded to allow the purchase of corporate bonds within certain guidelines outlined in the policy. At September 30, 2012, the Company held \$656 thousand in these types of authorized investments.

Net unrealized appreciation and depreciation on investments available for sale, net of applicable income taxes, are reflected as a component of accumulated other comprehensive income.

The net unrealized gain or loss in the Company's fixed income portfolio fluctuates as market interest rates rise and fall. Due to the fixed rate nature of this portfolio, as market rates fall, the value of the portfolio rises, and as market rates rise, the value of the portfolio declines. The unrealized gains or losses on fixed income investments will also decline as the securities approach maturity. Unrealized gains or losses will be recognized in the statements of income if the securities are sold. However, if an unrealized loss on the fixed income portfolio is deemed to be other-than-temporary, the credit loss portion is charged to earnings and the non-credit portion is recognized in accumulated other comprehensive income.



Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

The net unrealized gain or loss on equity securities will fluctuate based on changes in the market value of the funds and individual securities held in the portfolio. Unrealized gains or losses will be recognized in the statements of income if the securities are sold. However, if an unrealized loss on an equity security is deemed to be other-than-temporary prior to a sale, the loss is charged to earnings.

The following paragraphs outline the investment categories within the portfolio with investments in an unrealized loss position at September 30, 2012.

As of September 30, 2012, the unrealized losses on the federal agency obligations were limited to one individual security, which was attributed to market interest rate volatility.

As of September 30, 2012, the unrealized losses on the Company's municipal securities were related to eight obligations and were attributed to market interest rate volatility and not a fundamental deterioration in the issuers. The Company does not consider these investments to be other-than-temporarily impaired at September 30, 2012 based on management's assessment of these investments including a review of market pricing and ongoing credit evaluations. In addition, the Company does not intend to, and it is more likely than not that it will not be required to, sell these investments prior to a market price recovery or maturity.

At September 30, 2012, the equity portfolio consisted primarily of investments in a diversified group of mutual funds, with a small portion of the portfolio (approximately 13%) invested in exchange traded funds or individual common stock of entities in the financial services industry. At September 30, 2012, the Company had six investments with total unrealized losses of \$60 thousand, which were short term in nature or which management believes there is no impairment of the underlying security. Management regularly reviews the portfolio for securities with unrealized losses that are other-than-temporarily impaired. Management's assessment includes evaluating whether any equity security or fund exhibits fundamental deterioration and whether it is unlikely that the security or fund will completely recover its unrealized loss within a reasonable time period. In determining the amount of the other-than-temporary impairment charge, management considers the severity of the declines and the uncertainty of recovery in the short-term for these equities. Based upon this review, the Company did not consider those equity funds to be other-than-temporarily impaired at September 30, 2012.

During the nine months ended September 30, 2012 and 2011, the Company did not record any fair value impairment charges on its investments.

Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

The contractual maturity distribution at September 30, 2012 of total fixed income investments, excluding CDs which mature in less than a year, is as follows:

|                            | Within One Year |            | After One, But Within Five Years |            | After Five, But within Ten Years |            | After Ten Years |            |
|----------------------------|-----------------|------------|----------------------------------|------------|----------------------------------|------------|-----------------|------------|
|                            | Amortized Cost  | Fair Value | Amortized Cost                   | Fair Value | Amortized Cost                   | Fair Value | Amortized Cost  | Fair Value |
| Federal agency obligations | \$7,003         | \$7,024    | \$63,316                         | \$63,644   | \$5,000                          | \$5,071    | \$—             | \$—        |
| MBS                        | —               | —          | 97                               | 102        | 14,047                           | 14,560     | 33,123          | 34,038     |
| Municipal securities       | 3,216           | 3,235      | 13,717                           | 14,113     | 25,256                           | 26,759     | 11,243          | 12,444     |
| Corporate bonds            | —               | —          | 420                              | 423        | 228                              | 233        | —               | —          |
| Total Fixed Income         | \$10,219        | \$10,259   | \$77,550                         | \$78,282   | \$44,531                         | \$46,623   | \$44,366        | \$46,482   |

Scheduled contractual maturities may not reflect the actual maturities of the investments. MBS/CMOs are shown at their final maturity. However, due to prepayments and amortization the actual MBS/CMO cash flows may be faster than presented above. Similarly, included in the carrying value of fixed income investment above, primarily the municipal and federal agency obligations categories are \$51.9 million in securities which can be "called" before maturity. Actual maturity of these callable securities could be shorter if called. Management considers these factors when evaluating the net interest margin in the Company's asset-liability management program.

See Note 12, "Fair Value Measurements" below for further information regarding the Company's fair value measurements for available-for-sale securities.

From time to time the Company may pledge securities as collateral against deposit account balances of municipal deposit customers, for Federal Home Loan Bank of Boston ("FHLB") borrowing capacity and as collateral for borrowing from the Federal Reserve Bank of Boston ("FRB"). The fair value of securities pledged as collateral for these purposes was \$173.6 million at September 30, 2012.

**(5) Restricted Investments**

As a member of the FHLB, the Company is required to purchase certain levels of FHLB capital stock in association with the Company's borrowing relationship from the FHLB. This stock is classified as a restricted investment and carried at cost, which management believes approximates fair value. FHLB stock represents the only restricted investment held by the Company.

Based on management's ongoing review, the Company has not recorded any other-than-temporary impairment charges on this investment to date. However, if negative events or deterioration in the FHLB financial condition or capital levels occurs, the Company's investment in FHLB capital stock may become other-than-temporarily impaired to some degree. At September 30, 2012, the Company's investment in FHLB capital stock amounted to \$4.3 million, compared to \$4.7 million at December 31, 2011. The change reflects the FHLB's one-time repurchase of \$480 thousand of the Company's FHLB capital stock holdings in the first quarter of 2012.

Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

## (6)Loans

Major classifications of loans and loans held for sale at the periods indicated, are as follows:

| (Dollars in thousands)              | September 30,<br>2012 | December 31,<br>2011 |
|-------------------------------------|-----------------------|----------------------|
| Real estate:                        |                       |                      |
| Commercial real estate              | \$687,920             | \$650,697            |
| Commercial construction             | 120,684               | 117,398              |
| Residential mortgages               | 92,967                | 86,311               |
| Loans held for sale                 | 5,686                 | 5,061                |
| Total real estate                   | 907,257               | 859,467              |
| Commercial and industrial           | 320,278               | 310,706              |
| Home equity                         | 73,517                | 77,135               |
| Consumer                            | 4,380                 | 4,570                |
| Gross loans                         | 1,305,432             | 1,251,878            |
| Deferred loan origination fees, net | (1,379                | ) (1,389             |
| Total loans                         | 1,304,053             | 1,250,489            |
| Allowance for loan losses           | (23,930               | ) (23,160            |
| Net loans and loans held for sale   | \$1,280,123           | \$1,227,329          |

The Company manages its loan portfolio to avoid concentration by industry and loan size to minimize its credit risk exposure. In addition, the Company does not have a “sub-prime” mortgage program. However, inherent in the lending process is the risk of loss due to customer non-payment, or “credit risk.” While the Company endeavors to minimize this risk through the credit risk management function, management recognizes that loan losses will occur and that the amount of these losses will fluctuate depending on the risk characteristics of the loan portfolio and economic conditions (see Note 7, "Allowance for Loan Losses", for additional information on the Company's credit risk management).

## Loan Categories

## - Commercial loans:

Commercial real estate loans include loans secured by both owner-use and non-owner occupied real estate. These loans are typically secured by a variety of commercial and industrial property types including apartment buildings, office or mixed-use facilities, strip shopping centers, or other commercial property and are generally guaranteed by the principals of the borrower. Commercial real estate loans generally have repayment periods of approximately fifteen to twenty-five years. Variable interest rate commercial real estate loans have a variety of adjustment terms and indices, and are generally fixed for the first one to five years before periodic rate adjustments begin.

Commercial and industrial loans include seasonal revolving lines of credit, working capital loans, equipment financing (including equipment leases), and term loans. Also included in commercial and industrial loans are loans partially guaranteed by the Small Business Administration (SBA), loans under various programs issued in conjunction with the Massachusetts Development Finance Agency and other agencies. Commercial and industrial credits may be unsecured loans and lines to financially strong borrowers, secured in whole or in part by real estate unrelated to the principal purpose of the loan or secured by inventories, equipment, or receivables, and are generally guaranteed by the principals of the borrower. Variable rate loans and lines in this portfolio have interest rates that are periodically

adjusted, with loans generally having fixed initial periods of one to three years. Commercial and industrial loans have average repayment periods of one to seven years.

Commercial construction loans include the development of residential housing and condominium projects, the development of commercial and industrial use property, and loans for the purchase and improvement of raw land. These loans are secured in whole or in part by the underlying real estate collateral and are generally guaranteed by the principals of the borrowers. Construction lenders work to cultivate long-term relationships with established developers. The Company limits the amount of financing provided to any single developer for the construction of properties built on a speculative basis. Funds for

Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

construction projects are disbursed as pre-specified stages of construction are completed. Regular site inspections are performed, either by experienced construction lenders on staff or by independent outside inspection companies, at each construction phase, prior to advancing additional funds. Commercial construction loans generally are variable rate loans and lines with interest rates that are periodically adjusted and generally have terms of one to three years.

From time to time, the Company participates with other banks in the financing of certain commercial projects. In some cases, the Company may act as the lead lender, originating and servicing the loans, but participating out a portion of the funding to other banks. In other cases, the Company may participate in loans originated by other institutions. In each case, the participating bank funds a percentage of the loan commitment and takes on the related risk. In each case in which the Company participates in a loan, the rights and obligations of each participating bank are divided proportionately among the participating banks in an amount equal to their share of ownership and with equal priority among all banks. The balances participated out to other institutions are not carried as assets on the Company's financial statements. Loans originated by other banks in which the Company is the participating institution are carried in the loan portfolio at the Company's pro rata share of ownership. The Company performs an independent credit analysis of each commitment and a review of the participating institution prior to participation in the loan. Loans originated by other banks in which the Company is the participating institution amounted to \$25.8 million at September 30, 2012 and \$33.0 million at December 31, 2011.

Standby letters of credit are conditional commitments issued by the Company to guarantee the financial obligation or performance by a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. If the letter of credit is drawn upon, a loan is created for the customer, generally a commercial loan, with the same criteria associated with similar commercial loans.

- Residential loans:

Enterprise originates conventional mortgage loans on one-to-four family residential properties. These properties may serve as the borrower's primary residence, vacation homes, or investment properties. Loan to value limits vary, generally from 80% for adjustable rate and multi-family, owner occupied properties, up to 97% for fixed rate loans on single family, owner occupied properties, with mortgage insurance coverage required for loan-to-value ratios greater than 80% based on program parameters. In addition, financing is provided for the construction of owner occupied primary residences. Residential mortgage loans may have terms of up to 30 years at either fixed or adjustable rates of interest. Fixed and adjustable rate residential mortgage loans are generally originated using secondary market underwriting and documentation standards.

Depending on the current interest rate environment, management projections of future interest rates and the overall asset-liability management program of the Company, management may elect to sell those fixed and adjustable rate residential mortgage loans which are eligible for sale in the secondary market, or hold some or all of this residential loan production for the Company's portfolio. Mortgage loans are generally not pooled for sale, but instead sold on an individual basis. The Company may retain or sell the servicing when selling the loans. All loans sold are currently sold without recourse, subject to an early payment default period covering the first four payments for certain loan sales.

- Home equity loans and lines of credit:

Home equity loans are originated for one-to-four family residential properties with maximum original loan to value ratios generally up to 80% of the assessed or appraised value of the property securing the loan. Home equity loan payments consist of monthly principal and interest based on amortization ranging from three to fifteen years. The

rates may also be fixed for three to fifteen years.

The Company originates home equity lines of credit for one-to-four family residential properties with maximum original loan to value ratios generally up to 80% of the appraised value of the property securing the loan. Home equity lines generally have interest rates that adjust monthly based on changes in the Prime Rate as published in the Wall Street Journal, although minimum rates may be applicable. Some home equity line rates may be fixed for a period of time and then adjusted monthly thereafter. The payment schedule for home equity lines for the first ten years of the lines are interest only payments. Generally at the end of ten years, the line is frozen to future advances, and principal plus interest payments are collected over a fifteen-year amortization schedule.

Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

**- Consumer loans:**

Consumer loans primarily consist of secured or unsecured personal loans and overdraft protection lines on checking accounts extended to individual customers. Overdrawn deposit accounts are reclassified as loan balances.

## Loans serviced for others

At September 30, 2012 and December 31, 2011, the Company was servicing residential mortgage loans owned by investors amounting to \$23.1 million and \$24.4 million, respectively. Additionally, the Company was servicing commercial loans participated out to various other institutions amounting to \$51.4 million and \$43.0 million at September 30, 2012 and December 31, 2011, respectively. See the discussion above for further information regarding commercial participations.

## Loans serving as collateral

Loans designated as qualified collateral and pledged to the FHLB for borrowing capacity are summarized below:

| (Dollars in thousands)      | September 30,<br>2012 | December 31,<br>2011 |
|-----------------------------|-----------------------|----------------------|
| Commercial real estate      | \$227,981             | \$204,158            |
| Residential mortgages       | 69,619                | 67,344               |
| Home equity                 | 18,900                | 19,835               |
| Total loans pledged to FHLB | \$316,500             | \$291,337            |

The increase since December 31, 2011 reflects the pledge of additional commercial real estate loans during the period, especially in order to provide additional borrowing capacity as part of the Company's ongoing liquidity management.

**(7) Allowance for Loan Loss**

## Credit Quality Indicators

Management believes that the loan portfolio has experienced a level of modest credit stabilization compared to the 2011 periods, as indicated by the improving statistics related to migration of adversely classified, past due and non-accrual loans, impaired loans and the level of OREO properties held as of September 30, 2012. Given the size and commercial mix of the Company's loan portfolio, management considers the current statistics to be reflective of the lagging effect that the regional economic environment has had on the local commercial markets and its impact on the credit profile of such a portfolio.

However, despite prudent loan underwriting and ongoing credit risk management, adverse changes within the Company's market area or further deterioration in the local, regional or national economic conditions could negatively impact the portfolio's credit risk profile and the Company's asset quality in the future.

**- Adversely Classified Loans**

The Company's loan risk rating system classifies loans depending on risk of loss characteristics. The classifications range from "substantially risk free" for the highest quality loans and loans that are secured by cash collateral, to the more severe adverse classifications of "substandard," "doubtful" and "loss" based on criteria established under banking

regulations.

Loans classified as substandard include those loans characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. These loans are inadequately protected by the sound net worth and paying capacity of the borrower; repayment has become increasingly reliant on collateral liquidation or reliance on guaranties; credit weaknesses are well-defined; borrower cash flow is insufficient to meet required debt service specified in loan terms and to meet other obligations, such as trade debt and tax payments.

Loans classified as doubtful have all the weaknesses inherent in a substandard rated loan with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The probability of loss is extremely high, but because of certain important and reasonably specific pending factors which may work to the advantage and strengthening of the loan, its classification as an estimated loss

15

---



Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

is deferred until more exact status may be determined.

Loans classified as loss are generally considered uncollectible at present, although long term recovery of part or all of loan proceeds may be possible. These “loss” loans would require a specific loss reserve or charge-off.

Adversely classified loans may be accruing or in non-accrual status and may be additionally designated as impaired or restructured, or some combination thereof. Loans which are evaluated to be of weaker credit quality are reviewed on a more frequent basis by management.

The following tables present the credit risk profile by internally assigned risk rating category at the periods indicated.

| (Dollars in thousands)    | September 30, 2012   |          |      |               |             |
|---------------------------|----------------------|----------|------|---------------|-------------|
|                           | Adversely Classified |          |      | Not Adversely |             |
|                           | Substandard          | Doubtful | Loss | Classified    | Gross Loans |
| Commercial real estate    | \$21,889             | \$—      | \$—  | \$666,031     | \$687,920   |
| Commercial and industrial | 6,336                | 2,445    | 2    | 311,495       | 320,278     |
| Commercial construction   | 3,052                | —        | —    | 117,632       | 120,684     |
| Residential               | 1,513                | —        | —    | 91,454        | 92,967      |
| Home equity               | 576                  | —        | —    | 72,941        | 73,517      |
| Consumer                  | 36                   | 1        | 1    | 4,342         | 4,380       |
| Loans held for sale       | —                    | —        | —    | 5,686         | 5,686       |
| Total gross loans         | \$33,402             | \$2,446  | \$3  | \$1,269,581   | \$1,305,432 |

| (Dollars in thousands)    | December 31, 2011    |          |      |               |             |
|---------------------------|----------------------|----------|------|---------------|-------------|
|                           | Adversely Classified |          |      | Not Adversely |             |
|                           | Substandard          | Doubtful | Loss | Classified    | Gross Loans |
| Commercial real estate    | \$23,676             | \$—      | \$—  | \$627,021     | \$650,697   |
| Commercial and industrial | 6,963                | 2,073    | —    | 301,670       | 310,706     |
| Commercial construction   | 3,221                | —        | —    | 114,177       | 117,398     |
| Residential               | 1,251                | —        | —    | 85,060        | 86,311      |
| Home equity               | 595                  | —        | —    | 76,540        | 77,135      |
| Consumer                  | 6                    | 3        | —    | 4,561         | 4,570       |
| Loans held for sale       | —                    | —        | —    | 5,061         | 5,061       |
| Total gross loans         | \$35,712             | \$2,076  | \$—  | \$1,214,090   | \$1,251,878 |

The decrease in adversely classified loans since the prior period was due primarily to paydowns on several commercial relationships, upgraded commercial loans and charge-offs, partially offset by additional credit downgrades during the period.

**- Past Due and Non-Accrual Loans**

Loans on which the accrual of interest has been discontinued are designated as non-accrual loans. Accrual of interest on loans is generally discontinued when a loan becomes contractually past due, with respect to interest or principal, by 90 days, or when reasonable doubt exists as to the full and timely collection of interest or principal. When a loan is placed on non-accrual status, all interest previously accrued but not collected is reversed against current period interest income. Interest accruals are resumed on such loans only when payments are brought current and have remained current for a period of 180 days and when, in the judgment of management, the collectability of both principal and interest is reasonably assured. Interest payments received on loans in a non-accrual status are generally applied to

principal on the books of the Company.

16

---

Table of Contents

## ENTERPRISE BANCORP, INC.

## Notes to the Unaudited Consolidated Financial Statements (continued)

The following tables present age analysis of past due loans as of the dates indicated.

Balance at September 30, 2012

| (Dollars in thousands)    | Loans<br>30-59 Days<br>Past Due | Loans<br>60-89 Days<br>Past Due | Loans 90 or<br>More Days<br>Past Due (non-<br>accrual) | Total Past<br>Due Loans | Current Loans | Gross<br>Loans |
|---------------------------|---------------------------------|---------------------------------|--|-------------------------|---------------|----------------|
| Commercial real estate    | \$1,465                         | \$1,100                         | \$12,655   | \$15,220                | \$672,700     | \$687,920      |
| Commercial and industrial | 650                             | 296                             | 8,378  | 9,324                   | 310,954       | 320,278        |
| Commercial construction   | —                               | —                               | 809  | 809                     | 119,875       | 120,684        |
| Residential               | 401                             | 394                             | 1,119  | 1,914                   | 91,053        | 92,967         |
| Home equity               | 273                             | —                               | 348  | 621                     | 72,896        | 73,517         |
| Consumer                  | 29                              | 6                               | 2  | 37                      | 4,343         | 4,380          |
| Loans held for sale       | —                               | —                               | —  | —                       | 5,686         | 5,686          |
| Total gross loans         | \$2,818                         | \$1,796                         | \$23,311   | \$27,925                | \$1,277,507   | \$1,305,432    |

Balance at December 31, 2011

| (Dollars in thousands)    | Loans<br>30-59 Days<br>Past Due | Loans<br>60-89 Days<br>Past Due | Loans 90 or<br>More Days<br>Past Due (non-<br>accrual) | Total Past<br>Due Loans | Current Loans | Gross Loans |
|---------------------------|---------------------------------|---------------------------------|--|-------------------------|---------------|-------------|
| Commercial real estate    | \$2,420                         | \$1,885                         | \$14,060   | \$18,365                | \$632,332     | \$650,697   |
| Commercial and industrial | 1,153                           | 699                             | 9,696  | 11,548                  | 299,158       | 310,706     |
| Commercial construction   | 171                             | —                               | 727  | 898                     | 116,500       | 117,398     |
| Residential               | 703                             | 401                             | 850  | 1,954                   | 84,357        | 86,311      |
| Home equity               | —                               | —                               | 536  | 536                     | 76,599        | 77,135      |
| Consumer                  | 7                               | 41                              | 7  | 55                      | 4,515         | 4,570       |
| Loans held for sale       | —                               | —                               | —  | —                       | 5,061         | 5,061       |
| Total gross loans         | \$4,454                         | \$3,026                         | \$25,876   | \$33,356                | \$1,218,522   | \$1,251,878 |

Total non-accrual loans amounted to \$23.3 million at September 30, 2012 and \$25.9 million December 31, 2011. Non-accrual loans which were not adversely classified amounted to \$1.5 million at September 30, 2012 and \$2.1 million at December 31, 2011. These balances primarily represented the guaranteed portions of non-performing Small Business Administration loans.

The ratio of non-accrual loans to total loans amounted to 1.79% at September 30, 2012 and 2.07% at December 31, 2011, and 2.10% at September 30, 2011.

At September 30, 2012, additional funding commitments for loans on non-accrual status totaled \$621 thousand compared to \$97 thousand at December 31, 2011. The increase reflects unadvanced funds on a commercial construction loan that was classified as non-accrual during the current year. The Company's obligation to fulfill the additional funding commitments on non-accrual loans is generally contingent on the borrower's compliance with the terms of the credit agreement, or if the borrower is not in compliance, additional funding commitments may be made at the Company's discretion.

The majority of the non-accrual loan balances were also carried as impaired loans during the periods noted, and are discussed further below.

- Impaired Loans

Impaired loans are individually significant loans for which management considers it probable that not all amounts due (principal and interest) in accordance with the original contractual terms will be collected. The majority of impaired loans are included within the non-accrual balances; however, not every loan in non-accrual status has been designated as impaired. Impaired loans include loans that have been modified in a troubled debt restructuring (TDR, see below). Management does not

Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

set any minimum delay of payments as a factor in reviewing for impaired classification. Management considers the payment status, net worth and earnings potential of the borrower, and the value and cash flow of the collateral as factors to determine if a loan will be paid in accordance with its contractual terms.

Impaired loans exclude large groups of smaller-balance homogeneous loans, such as residential mortgage loans and consumer loans, which are collectively evaluated for impairment and loans that are measured at fair value, unless the loan is amended in a TDR. Impaired loans are individually evaluated for credit loss and a specific reserve is assigned for the amount of the estimated credit loss. Refer to heading "Allowance for probable loan losses methodology" contained in Note 5 "Allowance For Loan Losses," to the Company's consolidated financial statements contained in the Company's 2011 Annual Report on Form 10-K for further discussion of management's methodology used to estimate specific reserves for impaired loans.

Total impaired loans amounted to \$36.3 million and \$38.3 million, at September 30, 2012 and December 31, 2011, respectively. Total accruing impaired loans amounted to \$13.7 million and \$13.2 million at September 30, 2012 and December 31, 2011, respectively, while non-accrual impaired loans amounted to \$22.5 million and \$25.1 million as of September 30, 2012 and December 31, 2011, respectively. The decrease was primarily due to the changes discussed above under Adversely Classified loans.

The following tables set forth the recorded investment in impaired loans and the related specific allowance allocated as of the dated indicated.

## Balance at September 30, 2012

| (Dollars in thousands)    | Unpaid contractual principal balance | Total recorded investment in impaired loans | Recorded investment with no allowance | Recorded investment with allowance | Related allowance |
|---------------------------|--------------------------------------|---|---------------------------------------|------------------------------------|-------------------|
| Commercial real estate    | \$ 24,601                            | \$22,920                                    | \$ 19,677                             | \$3,243                            | \$817             |
| Commercial and industrial | 10,945                               | 9,372                                       | 4,642                                 | 4,730                              | 2,613             |
| Commercial construction   | 3,090                                | 2,998                                       | 1,000                                 | 1,998                              | 728               |
| Residential               | 1,038                                | 895   | 396                                   | 499                                | 93                |
| Home equity               | 50                                   | 50  | —                                     | 50                                 | 50                |
| Consumer                  | 15                                   | 15  | —                                     | 15                                 | 15                |
| Total                     | \$ 39,739                            | \$36,250                                    | \$25,715                              | \$10,535                           | \$4,316           |

## Balance at December 31, 2011

| (Dollars in thousands)    | Unpaid contractual principal balance | Total recorded investment in impaired loans | Recorded investment with no allowance | Recorded investment with allowance | Related allowance |
|---------------------------|--------------------------------------|---|---------------------------------------|------------------------------------|-------------------|
| Commercial real estate    | \$ 26,052                            | \$24,580                                    | \$20,792                              | \$3,788                            | \$973             |
| Commercial and industrial | 12,439                               | 10,633                                      | 4,105                                 | 6,528                              | 2,651             |
| Commercial construction   | 2,482                                | 2,407                                       | 229                                   | 2,178                              | 629               |
| Residential               | 655                                  | 624   | 286                                   | 338                                | 125               |
| Home equity               | 50                                   | 50  | —                                     | 50                                 | 50                |
| Consumer                  | 17                                   | 17  | —                                     | 17                                 | 17                |
| Total                     | \$41,695                             | \$38,311                                    | \$25,412                              | \$12,899                           | \$4,445           |



Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

The following table presents the average recorded investment in impaired loans and the related interest recognized during the three month periods indicated.

| (Dollars in thousands)    | Three Months Ended<br>September 30, 2012 |                               | Three Months Ended<br>September 30, 2011 |                               |
|---------------------------|--|-------------------------------|--|-------------------------------|
|                           | Average recorded<br>investment           | Interest income<br>recognized | Average recorded<br>investment           | Interest income<br>recognized |
| Commercial real estate    | \$22,952                                 | \$127                         | \$22,991                                 | \$130                         |
| Commercial and industrial | 9,613                                    | 19                            | 9,837                                    | 18                            |
| Commercial construction   | 2,438                                    | 24                            | 3,755                                    | 20                            |
| Residential               | 836                                      | 3                             | 661                                      | 1                             |
| Home equity               | 50                                       | —                             | —  | —                             |
| Consumer                  | 15                                       | —                             | 19                                       | 1                             |
| Total                     | \$35,904                                 | \$173                         | \$37,263                                 | \$170                         |

The following table presents the average recorded investment in impaired loans and the related interest recognized during the nine month periods indicated.

| (Dollars in thousands)    | Nine Months Ended<br>September 30, 2012 |                               | Nine Months Ended<br>September 30, 2011 |                               |
|---------------------------|---|-------------------------------|---|-------------------------------|
|                           | Average recorded<br>investment          | Interest income<br>recognized | Average recorded<br>investment          | Interest income<br>recognized |
| Commercial real estate    | \$23,853                                | \$437                         | \$28,407                                | \$574                         |
| Commercial and industrial | 10,028                                  | 105                           | 9,668                                   | 47                            |
| Commercial construction   | 2,195                                   | 41                            | 4,055                                   | 64                            |
| Residential               | 758                                     | 8                             | 602                                     | 2                             |
| Home equity               | 50                                      | —                             | —                                       | 1                             |
| Consumer                  | 17                                      | 1                             | 19                                      | 2                             |
| Total                     | \$36,901                                | \$592                         | \$42,751                                | \$690                         |

**- Troubled Debt Restructures**

Loans are designated as a TDR when, as part of an agreement to modify the original contractual terms of the loan, the Bank grants a concession on the terms, that would not otherwise be considered, as a result of financial difficulties of the borrower. Typically, such concessions may consist of a reduction in interest rate to a below market rate, taking into account the credit quality of the note, or a deferment or reduction of payments, principal or interest, which materially alters the Bank's position or significantly extends the note's maturity date, such that the present value of cash flows to be received is materially less than those contractually established at the loan's origination. All loans that are modified are reviewed by the Company to identify if a TDR has occurred.

Restructured loans are included in the impaired loan category and as such, these loans are individually evaluated and a specific reserve is assigned for the amount of the estimated credit loss. Refer to heading "Allowance for probable loan losses methodology" contained in Note 5 "Allowance For Loan Losses," to the Company's consolidated financial statements contained in the Company's 2011 Annual Report on Form 10-K, for further discussion of management's methodology used to estimate specific reserves for impaired loans.

Total TDR loans, included in the impaired loan figures above as of September 30, 2012 and December 31, 2011 were \$23.7 million and \$25.5 million, respectively.

TDR loans on accrual status amounted to \$13.2 million and \$12.4 million at September 30, 2012 and December 31, 2011, respectively. TDR loans included in non-performing loans amounted to \$10.5 million and \$13.0 million at September 30, 2012 and December 31, 2011, respectively.



Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

The following tables present certain information regarding loan modifications classified as troubled debt restructures during the periods presented.

Troubled debt restructure agreements entered into during the period indicated.

| (Dollars in thousands)    | Three months ended September 30, 2012 |  |   |
|---------------------------|---------------------------------------|--|---|
|                           | Number of restructurings              | Pre-modification outstanding recorded investment | Post-modification outstanding recorded investment |
| Commercial real estate    | —                                     | \$ —   | \$ —  |
| Commercial and industrial | —                                     | —  | —   |
| Commercial construction   | 2                                     | 716  | 716   |
| Residential               | 1                                     | 259  | 259   |
| Home equity               | —                                     | —  | —   |
| Consumer                  | —                                     | —  | —   |
| Total                     | 3                                     | \$ 975   | \$ 975  |

Troubled debt restructures that subsequently defaulted.

There were no loans modified as troubled debt restructuring within the previous twelve months for which there was a payment default during the three months ended September 30, 2012.

Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

Troubled debt restructure agreements entered into during the period indicated.

| (Dollars in thousands)    | Nine months ended September 30, 2012 |  |   |
|---------------------------|--------------------------------------|--|---|
|                           | Number of restructurings             | Pre-modification outstanding recorded investment | Post-modification outstanding recorded investment |
| Commercial real estate    | —                                    | \$ —   | \$ —  |
| Commercial and industrial | 5                                    | 115  | 113   |
| Commercial construction   | 2                                    | 716  | 716   |
| Residential               | 2                                    | 388  | 386   |
| Home equity               | —                                    | —  | —   |
| Consumer                  | —                                    | —  | —   |
| Total                     | 9                                    | \$ 1,219   | \$ 1,215  |

Troubled debt restructures that subsequently defaulted during the period indicated.<sup>(1)</sup>

| (Dollars in thousands)    | Nine months ended September 30, 2012 |   |
|---------------------------|--------------------------------------|---|
|                           | Number of TDR's that defaulted       | Post-modification outstanding recorded investment |
| Commercial real estate    | —                                    | \$ —  |
| Commercial and industrial | 3                                    | 14  |
| Commercial construction   | —                                    | —   |
| Residential               | 1                                    | 126   |
| Home equity               | —                                    | —   |
| Consumer                  | —                                    | —   |
| Total                     | 4                                    | \$ 140  |

(1) Data represents loans modified as troubled debt restructuring within the previous twelve months for which there was a payment default during the period noted.

There were no charge-offs associated with TDRs, noted in the tables above, during the periods indicated. At September 30, 2012, specific reserves allocated to the TDRs entered into in 2012 amounted to \$92 thousand, and interest payments received on non-accruing new 2012 TDR loans which were applied to principal and not recognized as interest income amounted to \$4 thousand.

Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

Troubled debt restructure agreements entered into during the period indicated.

| (Dollars in thousands)    | Three months ended September 30, 2011 |  |   |
|---------------------------|---------------------------------------|--|---|
|                           | Number of restructurings              | Pre-modification outstanding recorded investment | Post-modification outstanding recorded investment |
| Commercial real estate    | 7                                     | \$ 3,296   | \$ 3,219  |
| Commercial and industrial | 4                                     | 318  | 263   |
| Commercial construction   | —                                     | —  | —   |
| Residential               | 1                                     | 138  | 136   |
| Home equity               | —                                     | —  | —   |
| Consumer                  | —                                     | —  | —   |
| Total                     | 12                                    | \$ 3,752   | \$ 3,618  |

Troubled debt restructure agreements entered into during the period indicated.

| (Dollars in thousands)    | Nine months ended September 30, 2011 |  |   |
|---------------------------|--------------------------------------|--|---|
|                           | Number of restructurings             | Pre-modification outstanding recorded investment | Post-modification outstanding recorded investment |
| Commercial real estate    | 12                                   | \$ 4,642   | \$ 4,570  |
| Commercial and industrial | 14                                   | 1,251  | 1,227   |
| Commercial construction   | 1                                    | 166  | 166   |
| Residential               | 1                                    | 138  | 136   |
| Home equity               | —                                    | —  | —   |
| Consumer                  | —                                    | —  | —   |
| Total                     | 28                                   | \$ 6,197   | \$ 6,099  |

There were no charge-offs associated with TDRs noted in the tables above during the periods indicated. At September 30, 2011, specific reserves allocated to the TDRs entered into during the 2011 period amounted to \$280 thousand and interest payments received on non-accruing 2011 TDR loans which were applied to principal and not recognized as interest income amounted to \$114 thousand for the nine months ended September 30, 2011.

## Allowance for probable loan losses methodology

On a quarterly basis, management prepares an estimate of the allowance necessary to cover estimated credit losses. The Company maintains the allowance at a level that it deems adequate to absorb all reasonably anticipated losses from specifically known and other credit risks associated with the portfolio. The Company uses a systematic methodology to measure the amount of estimated loan loss exposure inherent in the portfolio for purposes of establishing a sufficient allowance for loan losses. The methodology makes use of specific reserves, for loans individually evaluated and deemed impaired and general reserves, for larger groups of homogeneous loans, which rely on a combination of qualitative and quantitative factors that could have an impact on the credit quality of the portfolio.

There have been no material changes in the Company's underwriting practices, credit risk management system, or to the allowance assessment methodology used to estimate loan loss exposure as reported in the Company's most recent Annual Report on Form 10-K. Refer to heading "Allowance for probable loan losses methodology" contained in Note 5 "Allowance For Loan Losses," to the Company's consolidated financial statements contained in the Company's 2011 Annual Report on Form 10-K for further discussion of management's methodology used to estimate the loan loss exposure inherent in the

Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

portfolio for purposes of establishing a sufficient allowance.

## Allowance for loan loss activity

The allowance for loan losses is established through a provision for loan losses, a direct charge to earnings. Loan losses are charged against the allowance when management believes that the collectability of the loan principal is unlikely. Recoveries on loans previously charged-off are credited to the allowance.

The allowance for loan losses amounted to \$23.9 million at September 30, 2012 compared to \$23.2 million at December 31, 2011. The allowance for loan losses to total loans ratio was 1.84% at September 30, 2012 compared to 1.85% at December 31, 2011. The allowance for loan loss ratio decreased primarily as a result of the decrease in specific reserves on impaired loans and other changes discussed above under "Credit Quality Indicators." The majority of charge-offs recorded in the current year-to-date period ended September 30, 2012 had reserves specifically allocated in prior periods. Based on the foregoing, as well as management's judgment as to the existing credit risks inherent in the loan portfolio, management believes the Company's allowance for loan losses is adequate to absorb probable losses from specifically known and other credit risks associated with the portfolio as of September 30, 2012.

Changes in the allowance for loan losses by segment for the three months ended September 30, 2012, are presented below:

| (Dollars in thousands)               | Cmml Real Estate | Cmml and Industrial | Cmml Constr | Resid. Mortgage | Home Equity | Consumer | Total     |
|--------------------------------------|------------------|---------------------|-------------|-----------------|-------------|----------|-----------|
| Beginning Balance at June 30, 2012   | \$ 10,997        | \$ 7,205            | \$ 3,329    | \$ 774          | \$ 721      | \$ 100   | \$ 23,126 |
| Provision                            | 224              | 423                 | 12          | 17              | 104         | 20       | 800       |
| Recoveries                           | 15               | 35                  | —           | —               | —           | 4        | 54        |
| Less: Charge offs                    | 8                | 33                  | —           | —               | —           | 9        | 50        |
| Ending Balance at September 30, 2012 | \$ 11,228        | \$ 7,630            | \$ 3,341    | \$ 791          | \$ 825      | \$ 115   | \$ 23,930 |

Changes in the allowance for loan losses by segment for the nine months ended September 30, 2012, are presented below:

| (Dollars in thousands)                                  | Cmml Real Estate | Cmml and Industrial | Cmml Constr | Resid. Mortgage | Home Equity | Consumer | Total     |
|---|------------------|---------------------|-------------|-----------------|-------------|----------|-----------|
| Beginning Balance at December 31, 2011                  | \$ 10,855        | \$ 7,568            | \$ 3,013    | \$ 995          | \$ 615      | \$ 114   | \$ 23,160 |
| Provision   | 589              | 933                 | 426         | (22 )           | 209         | 15       | 2,150     |
| Recoveries  | 15               | 227                 | 2           | —               | 1           | 7        | 252       |
| Less: Charge offs                                       | 231              | 1,098               | 100         | 182             | —           | 21       | 1,632     |
| Ending Balance at September 30, 2012                    | \$ 11,228        | \$ 7,630            | \$ 3,341    | \$ 791          | \$ 825      | \$ 115   | \$ 23,930 |
| Ending allowance balance:                               |                  |                     |             |                 |             |          |           |
| Allotted to loans individually evaluated for impairment | \$ 817           | \$ 2,613            | \$ 728      | \$ 93           | \$ 50       | \$ 15    | \$ 4,316  |
| Allotted to loans collectively evaluated for impairment | 10,411           | 5,017               | 2,613       | 698             | 775         | 100      | \$ 19,614 |



Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

Changes in the allowance for loan losses by segment for the three months ended September 30, 2011, are presented below:

| (Dollars in thousands)               | Cmml Real Estate | Cmml and Industrial | Cmml Constr | Resid. Mortgage | Home Equity | Consumer | Total     |
|--------------------------------------|------------------|---------------------|-------------|-----------------|-------------|----------|-----------|
| Beginning Balance at June 30, 2011   | \$ 10,473        | \$ 6,041            | \$ 3,194    | \$ 903          | \$ 602      | \$ 97    | \$ 21,310 |
| Provision                            | 839              | 972                 | (49 )       | 26              | 49          | 3        | 1,840     |
| Recoveries                           | 28               | 59                  | —           | —               | —           | 3        | 90        |
| Less: Charge offs                    | 504              | 150                 | —           | —               | —           | 17       | 671       |
| Ending Balance at September 30, 2011 | \$ 10,836        | \$ 6,922            | \$ 3,145    | \$ 929          | \$ 651      | \$ 86    | \$ 22,569 |

Changes in the allowance for loan losses by segment for the nine months ended September 30, 2011, are presented below:

| (Dollars in thousands)                                  | Cmml Real Estate | Cmml and Industrial | Cmml Constr | Resid. Mortgage | Home Equity | Consumer | Total     |
|---|------------------|---------------------|-------------|-----------------|-------------|----------|-----------|
| Beginning Balance at December 31, 2010                  | \$ 9,769         | \$ 5,489            | \$ 2,609    | \$ 882          | \$ 553      | \$ 113   | \$ 19,415 |
| Provision   | 1,529            | 1,753               | 532         | 49              | 98          | (7 )     | 3,954     |
| Recoveries  | 76               | 137                 | 4           | 2               | —           | 9        | 228       |
| Less: Charge offs                                       | 538              | 457                 | —           | 4               | —           | 29       | 1,028     |
| Ending Balance at September 30, 2011                    | \$ 10,836        | \$ 6,922            | \$ 3,145    | \$ 929          | \$ 651      | \$ 86    | \$ 22,569 |
| Ending allowance balance:                               |                  |                     |             |                 |             |          |           |
| Allotted to loans individually evaluated for impairment | \$ 1,163         | \$ 2,130            | \$ 652      | \$ 175          | \$ —        | \$ 17    | \$ 4,137  |
| Allotted to loans collectively evaluated for impairment | 9,673            | 4,792               | 2,493       | 754             | 651         | 69       | \$ 18,432 |

The balances of loans as of September 30, 2012 by segment and evaluation method are summarized as follows:

| (Dollars in thousands)    | Loans individually evaluated for impairment | Loans collectively evaluated for impairment | Total Loans |
|---------------------------|---|---|-------------|
| Commercial real estate    | \$ 22,920                                   | \$ 665,000                                  | \$ 687,920  |
| Commercial and industrial | 9,372                                       | 310,906                                     | 320,278     |
| Commercial construction   | 2,998                                       | 117,686                                     | 120,684     |
| Residential               | 895   | 92,072                                      | 92,967      |
| Home equity               | 50  | 73,467                                      | 73,517      |
| Consumer                  | 15  | 4,365                                       | 4,380       |
| Loans held for sale       | —   | 5,686                                       | 5,686       |
| Deferred Fees             | —   | (1,379 )                                    | (1,379 )    |

|             |           |              |             |
|-------------|-----------|--------------|-------------|
| Total loans | \$ 36,250 | \$ 1,267,803 | \$1,304,053 |
|-------------|-----------|--------------|-------------|



Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

The balances of loans as of December 31, 2011 by segment and evaluation method are summarized as follows:

| (Dollars in thousands)    | Loans individually          |   | Total Loans  |
|---------------------------|-----------------------------|---|--------------|
|                           | evaluated for<br>impairment | Loans collectively<br>evaluated for<br>impairment |              |
| Commercial real estate    | \$ 24,580                   | \$ 626,117  | \$650,697    |
| Commercial and industrial | 10,633                      | 300,073   | 310,706      |
| Commercial construction   | 2,407                       | 114,991   | 117,398      |
| Residential               | 624                         | 85,687  | 86,311       |
| Home equity               | 50                          | 77,085  | 77,135       |
| Consumer                  | 17                          | 4,553   | 4,570        |
| Loans held for sale       | —                           | 5,061   | 5,061        |
| Deferred Fees             | —                           | (1,389  | ) (1,389     |
| Total loans               | \$ 38,311                   | \$ 1,212,178                                      | \$ 1,250,489 |

## (8) Supplemental Retirement Plan and Other Postretirement Benefit Obligations

## Supplemental Retirement Plan (SERPs)

The Company has salary continuation agreements with two of its active executive officers, and one former executive officer who currently works on a part time basis. These agreements provide for predetermined fixed-cash supplemental retirement benefits to be provided for a period of 20 years after each individual reaches a defined “benefit age.” The Company has not recognized service cost in the current or prior year as each officer had previously attained their individually defined benefit age and was fully vested under the plan.

This non-qualified plan represents a direct liability of the Company, and as such has no specific assets set aside to settle the benefit obligation. The funded status is the aggregate amount accrued, or the “Accumulated Benefit Obligation,” which is equal to the present value of the benefits to be provided to the employee or any beneficiary in exchange for the employee’s service rendered to that date. Because the Company’s benefit obligations provide for predetermined fixed-cash payments, the Company does not have any unrecognized costs to be included as a component of accumulated other comprehensive income.

Total net periodic benefit cost, which was comprised of interest cost only, was \$38 thousand and \$114 thousand for the three and nine months ended September 30, 2012, respectively, compared to \$43 thousand and \$128 thousand for the three and nine months ended September 30, 2011, respectively.

Benefits paid amounted to \$69 thousand and \$207 thousand for both the three and nine months ended September 30, 2012 and September 30, 2011, respectively. The Company anticipates accruing an additional \$37 thousand to the plan during the remainder of 2012.

## Supplemental Life Insurance

For certain senior and executive officers on whom the Company owns bank owned life insurance (“BOLI”), the Company has provided supplemental life insurance which provides a death benefit to the officer’s designated beneficiaries.

The Company has recognized a liability for future benefits associated with an endorsement split-dollar life insurance arrangement that provides a benefit to an employee that extends to postretirement periods.

This non-qualified plan represents a direct liability of the Company, and as such has no specific assets set aside to settle the benefit obligation. The funded status is the aggregate amount accrued, or the “Accumulated Postretirement Benefit Obligation,” which is the present value of the future retirement benefits associated with this arrangement.

Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

The following table illustrates the net periodic post retirement benefit cost for the supplemental life insurance plans for the periods indicated:

| (Dollars in thousands)                    | Three months ended September 30, |      | Nine months ended September 30, |      |
|---|----------------------------------|------|---------------------------------|------|
|   | 2012                             | 2011 | 2012                            | 2011 |
| Service Cost                              | \$3                              | \$4  | \$6                             | \$11 |
| Interest Cost                             | 17                               | 18   | 51                              | 54   |
| Actuarial Gain/Loss                       | —                                | —    | —                               | (19) |
| Net periodic post retirement benefit cost | \$20                             | \$22 | \$57                            | \$46 |

## (9) Stock-Based Compensation

The Company currently has three individual stock incentive plans. The Company has not changed the general terms and conditions of these plans from those disclosed in the Company's 2011 Annual Report on Form 10-K.

The Company's stock-based compensation expense includes stock option awards and restricted stock awards to officers, other employees and directors, and stock compensation in lieu of cash fees to directors. Total stock-based compensation expense was \$304 thousand and \$956 thousand for the three and nine months ended September 30, 2012, respectively, compared to \$249 thousand and \$796 thousand for the three and nine months ended September 30, 2011, respectively.

## Stock Option Awards

The Company recognized stock-based compensation expense related to stock option awards of \$65 thousand and \$190 thousand for the three and nine months ended September 30, 2012, respectively, compared to \$63 thousand and \$172 thousand for the three and nine months ended September 30, 2011, respectively.

There were a total of 67,750 and 83,075 stock option awards granted to employees during the nine months ended September 30, 2012 and 2011, respectively. Options that have been granted under the plans generally vest ratably over four years. Vested options are only exercisable while the employee remains employed with the Bank and for a limited time thereafter, and these options expire seven years from the date of grant. For these awards, under Company guidelines, upon the date of retirement, vesting of unvested options may be accelerated if an employee meets certain retirement criteria.

If a grantee's employment or other service relationship, such as service as a director, is terminated for any reason, then any stock options granted that have not vested as of the time of such termination generally must be forfeited, unless the Compensation Committee or the Board of Directors, as the case may be, waives such forfeiture requirement. In the case of retirement, under current Company guidelines, unvested stock options may be accelerated if the employee meets certain retirement criteria.

The Company utilizes the Black-Scholes option valuation model in order to determine the per share grant date fair value of option grants.

Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

The table below provides a summary of the options granted, fair value, the fair value as a percentage of the market value of the stock at the date of grant and the average assumptions used in the model for the options granted in 2012 and 2011.

|  | Nine months ended September 30, |           |   |
|--|---------------------------------|-----------|---|
|  | 2012                            | 2011      |   |
| Options granted  | 67,750                          | 83,075    |   |
| Average assumptions used in the model:                   |                                 |           |   |
| Expected volatility                                      | 50                              | % 45      | % |
| Expected dividend yield                                  | 2.88                            | % 2.91    | % |
| Expected life in years                                   | 5.5 years                       | 5.5 years |   |
| Risk-free interest rate                                  | 1.38                            | % 2.17    | % |
| Market price on date of grant                            | \$16.25                         | \$14.88   |   |
| Per share weighted average fair value                    | \$6.33                          | \$5.28    |   |
| Fair value as a percentage of market value at grant date | 39                              | % 35      | % |

Refer to note 14 “Stock-Based Compensation Plans” in the Company’s 2011 Annual Report on Form 10-K for a further description of the assumptions used in the valuation model.

**Restricted Stock Awards**

Stock-based compensation expense recognized in association with restricted stock awards amounted to \$207 thousand and \$623 thousand for the three and nine months ended September 30, 2012, respectively, compared to \$156 thousand and \$497 thousand for the three and nine months ended September 30, 2011, respectively.

During the nine months ended September 30, 2012, the Company granted 71,376 shares of common stock in the form of restricted stock awards comprised of 62,160 shares awarded to employees generally vesting over four years, 3,000 shares awarded to an executive officer vesting immediately and 6,216 shares awarded to directors vesting over two years. The weighted average grant date fair value of the restricted stock awarded was \$16.25 per share, the market value of the common stock on the grant dates. The unvested 2012 awards generally vest, in each case, in equal portions beginning on or about the first anniversary date of the award.

During the nine months ended September 30, 2011, the Company granted 64,765 shares of common stock in the form of restricted stock awards comprised of 54,475 shares awarded to employees, generally vesting over four years, 3,500 shares awarded to an executive officer vesting immediately and 6,790 shares awarded to directors vesting over two years. The weighted average grant date fair value of the restricted stock awarded was \$14.88 per share, which reflects the market value of the common stock on the grant dates. The unvested 2011 awards generally vest, in each case, in equal portions beginning on or about the first anniversary date of the award.

The restricted stock awards allow for the receipt of dividends, and the voting of all shares, whether or not vested, throughout the vesting periods.

If a grantee’s employment or other service relationship, such as service as a director, is terminated for any reason, then any shares of restricted stock granted that have not vested as of the time of such termination generally must be forfeited, unless the Compensation Committee or the Board of Directors, as the case may be, waives such forfeiture requirement. In the case of retirement, under current Company guidelines, a portion of the unvested restricted shares may be accelerated if the employee meets certain retirement criteria.

Stock in Lieu of Directors' Fees

In addition to restricted stock awards discussed above, the members of the Company's Board of Directors may opt to receive newly issued shares of the Company's common stock in lieu of cash compensation for attendance at Board and Board Committee meetings. Stock-based compensation expense related to Directors' election to receive shares of common stock in lieu of cash fees for attendance at Board and Board committee meetings amounted to \$32 thousand and \$143 thousand for the three and nine months ended September 30, 2012, respectively, compared to \$30 thousand and \$127 thousand for the three and

Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

nine months ended September 30, 2011, respectively. In January 2012, directors were issued 12,132 shares of common stock in lieu of cash fees related to the 2011 annual directors' stock-based compensation expense of \$166 thousand and a market value price of \$13.65 per share, the market value of the common stock on the measurement date, January 3, 2011.

## (10) Income Taxes

The Company uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax attributable to differences between the financial statement carrying amounts and the tax basis of assets and liabilities. The deferred tax assets and liabilities are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities will be adjusted accordingly through the provision for income taxes.

The Company's policy is to classify interest resulting from underpayment of income taxes as income tax expense in the first period the interest would begin accruing according to the provisions of the relevant tax law. The Company classifies penalties resulting from underpayment of income taxes as income tax expense in the period for which the Company claims or expects to claim an uncertain tax position or in the period in which the Company's judgment changes regarding an uncertain tax position.

The Company did not have any unrecognized tax benefits accrued as income tax liabilities or receivables or as deferred tax items at September 30, 2012. The Company's tax years beginning after December 31, 2005 are open to federal and state income tax examinations.

## (11) Earnings per share

Basic earnings per share are calculated by dividing net income by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflects the effect on weighted average shares outstanding of the number of additional shares outstanding if dilutive stock options were converted into shares of common stock using the treasury stock method.

The table below presents the increase in average shares outstanding, using the treasury stock method, for the diluted earnings per share calculation for the periods indicated:

|  | Three months ended<br>September 30, |           | Nine months ended<br>September 30, |           |
|--|-------------------------------------|-----------|------------------------------------|-----------|
|  | 2012                                | 2011      | 2012                               | 2011      |
| Basic weighted average common shares outstanding   | 9,613,386                           | 9,429,360 | 9,567,294                          | 9,383,678 |
| Dilutive shares                                    | 78,904                              | 34,304    | 71,828                             | 51,828    |
| Diluted weighted average common shares outstanding | 9,692,290                           | 9,463,664 | 9,639,122                          | 9,435,506 |

For the nine months ended September 30, 2012, there were an additional 167,534 average stock options outstanding, which were excluded from the year-to-date calculation of diluted earnings per share due to the exercise price of these options exceeding the average market price of the Company's common stock for the period. These options, which were not dilutive at that date, may potentially dilute earnings per share in the future.



Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

## (12) Fair Value Measurements

The Financial Accounting Standard Board (“FASB”) defines the fair value of an asset or liability to be the price which a seller would receive in an orderly transaction between market participants (an exit price) and also establishes a fair value hierarchy segregating fair value measurements using three levels of inputs: (Level 1) quoted market prices in active markets for identical assets or liabilities; (Level 2) significant other observable inputs, including quoted prices for similar items in active markets, quoted prices for identical or similar items in markets that are not active, inputs such as interest rates and yield curves, volatilities, prepayment speeds, credit risks and default rates which provide a reasonable basis for fair value determination or inputs derived principally from observed market data; (Level 3) significant unobservable inputs for situations in which there is little, if any, market activity for the asset or liability. Unobservable inputs must reflect reasonable assumptions that market participants would use in pricing the asset or liability, which are developed on the basis of the best information available under the circumstances.

The following tables summarize significant assets and liabilities carried at fair value and placement in the fair value hierarchy at the dates specified:

|   | September 30,<br>2012 | Fair Value Measurements using: |           |           |
|---|-----------------------|--------------------------------|-----------|-----------|
| (Dollars in thousands)                    | Fair Value            | (level 1)                      | (level 2) | (level 3) |
| Assets measured on a recurring basis:     |                       |                                |           |           |
| Fixed income securities                   | \$182,146             | \$—                            | \$182,146 | \$—       |
| Equity securities                         | 9,550                 | 9,550                          | —         | —         |
| FHLB Stock                                | 4,260                 | —                              | —         | 4,260     |
| Assets measured on a non-recurring basis: |                       |                                |           |           |
| Impaired loans (collateral dependent)     | 5,031                 | —                              | —         | 5,031     |
| Other real estate owned                   | 1,250                 | —                              | —         | 1,250     |
|   |                       |                                |           |           |
|   | December 31,<br>2011  | Fair Value Measurements using: |           |           |
| (Dollars in thousands)                    | Fair Value            | (level 1)                      | (level 2) | (level 3) |
| Assets measured on a recurring basis:     |                       |                                |           |           |
| Fixed income securities                   | \$133,441             | \$—                            | \$133,441 | \$—       |
| Equity securities                         | 6,964                 | 6,964                          | —         | —         |
| FHLB Stock                                | 4,740                 | —                              | —         | 4,740     |
| Assets measured on a non-recurring basis: |                       |                                |           |           |
| Impaired loans (collateral dependent)     | 7,418                 | —                              | —         | 7,418     |
| Other real estate owned                   | 1,445                 | —                              | —         | 1,445     |

The Company did not have cause to transfer any assets between the fair value measurement levels during the nine months ended September 30, 2012 or the year ended December 31, 2011. There were no liabilities measured at fair value on a recurring or non-recurring basis as of September 30, 2012 or December 31, 2011. There were no gains or losses due to changes in fair value, recorded in earnings for level 3 assets for the nine months ended September 30, 2012, or the year ended December 31, 2011.

All of the Company's fixed income investments and equity securities that are considered “available for sale” are carried at fair value. The fixed income category above includes federal agency obligations, federal agency MBS, municipal



securities, corporate bonds and certificates of deposits, as held at those dates. Certificates of deposit are investment securities issued by financial institutions. They are subject to FDIC insurance and trade in the open market. The Company utilizes third-party pricing vendors to provide valuations on its fixed income securities. Fair values provided by the vendors were generally determined based upon pricing matrices utilizing observable market data inputs for similar or benchmark securities in active markets and/or based on a matrix pricing methodology which employs The Bond Market Association's standard calculations for cash flow and price/yield analysis, live benchmark bond pricing and terms/condition data available from major pricing sources.

Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

Therefore, management regards the inputs and methods used by third party pricing vendors to be “Level 2 inputs and methods” as defined in the “fair value hierarchy.” The Company periodically obtains a second price from an impartial third party on fixed income securities to assess the reasonableness of prices provided by the primary independent pricing vendor.

The Company’s equity portfolio fair value is measured based on quoted market prices for the shares, therefore these securities are categorized as Level 1 within the fair value hierarchy.

Net unrealized appreciation and depreciation on investments available for sale, net of applicable income taxes, are reflected as a component of accumulated other comprehensive income.

The Bank is required to purchase FHLB stock at par value in association with advances from the FHLB; this stock is classified as a restricted investment and carried at cost which management believes approximates fair value, therefore these securities are categorized as Level 3 measures. See the discussion regarding FHLB stock in Note 5, “Restricted Investments,” above, for further information regarding the Company’s fair value assessment of FHLB capital stock.

Impaired loan balances in the table above represent those collateral dependent impaired commercial loans where management has estimated the credit loss by comparing the loan’s carrying value against the expected realizable fair value of the collateral (appraised value or internal analysis less estimated cost to sell, adjusted as necessary for changes in relevant valuation factors subsequent to the measurement date). Certain inputs used in these assessments, and possible subsequent adjustments, are not always observable, and therefore, collateral dependent impaired loans are categorized as Level 3 within the fair value hierarchy. A specific allowance is assigned to the collateral dependent impaired loan for the amount of management’s estimated credit loss. The specific allowances assigned to the collateral dependent impaired loans at September 30, 2012 amounted to \$2.4 million compared to \$2.6 million at December 31, 2011, a net decrease of \$157 thousand.

Real estate acquired by the Company through foreclosure proceedings or the acceptance of a deed in lieu of foreclosure is classified as Other Real Estate Owned (“OREO”). When property is acquired, it is generally recorded at the lesser of the loan’s remaining principal balance, net of unamortized deferred fees, or the estimated fair value of the property acquired, less estimated costs to sell. The estimated fair value is based on market appraisals and the Company’s internal analysis. Certain inputs used in appraisals or the Company’s internal analysis, are not always observable, and therefore, OREO may be categorized as Level 3 within the fair value hierarchy. The carrying values of OREO at September 30, 2012 and December 31, 2011 consisted of four properties at the end of each period. Two properties were added and two properties were sold during 2012; net gains realized on the sale of the OREO properties were \$45 thousand.

The following table presents additional quantitative information about assets measured at fair value on a recurring and non-recurring basis for which the Company utilized Level 3 inputs (significant unobservable inputs for situations in which there is little, if any, market activity for the asset or liability) to determine fair value as of September 30, 2012.

| (Dollars in thousands)                    | Fair Value | Valuation Technique   | Unobservable Input | Unobservable Input Value or Range |
|---|------------|-----------------------|--------------------|-----------------------------------|
| Assets measured on a recurring basis:     |            |                       |                    |                                   |
| FHLB Stock                                | \$4,260    | FHLB Stated Par Value | N/A                | N/A                               |
| Assets measured on a non-recurring basis: |            |                       |                    |                                   |

|                                       |         |                         |                              |          |
|---------------------------------------|---------|-------------------------|------------------------------|----------|
| Impaired loans (collateral dependent) | \$5,031 | Appraisal of collateral | Appraisal adjustments<br>(1) | 5% - 50% |
| Other real estate owned               | \$1,250 | Appraisal of collateral | Appraisal adjustments<br>(1) | 0% - 30% |

(1) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.

#### Other Guarantees and Commitments

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance by a customer to a third party. The fair value of these commitments was estimated to be the fees charged to enter into similar agreements, and accordingly these fair value measures are deemed to be FASB Level 2 measurements. In accordance with the FASB, the estimated fair values of these commitments are carried on the balance sheet as a liability and amortized to income over the life of the letters of credit, which are typically one year. The estimated fair value of these commitments carried on the balance sheet

Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

was \$5 thousand and \$27 thousand at September 30, 2012 and December 31, 2011, respectively, and were deemed immaterial.

Interest rate lock commitments related to the origination of mortgage loans that will be sold are considered derivative instruments. The Company estimates the fair value of these derivatives using the difference between the guaranteed interest rate in the commitment and the current market interest rate. To reduce the net interest rate exposure arising from its loan sale activity, the Company enters into the commitment to sell these loans at essentially the same time that the interest rate lock commitment is quoted on the origination of the loan. The commitments to sell loans are also considered derivative instruments, with estimated fair values based on changes in current market rates. These commitments represent the Company's only derivative instruments and are accounted for in accordance with FASB guidance. The fair values of the Company's derivative instruments are deemed to be FASB Level 2 measurements. At September 30, 2012 and December 31, 2011, the estimated fair value of the Company's derivative instruments was considered to be immaterial.

Estimated Fair Values of Assets and Liabilities

In addition to disclosures regarding the measurement of assets and liabilities carried at fair value on the balance sheet, the Company is also required to disclose fair value information about financial instruments for which it is practicable to estimate that value, whether or not recognized on the balance sheet. In cases where quoted fair values are not available, fair values are based upon estimates using various valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following methods and assumptions were used by the Company in estimating fair values of its financial instruments:

**Loans:** The fair value of loans was determined using discounted cash flow analysis, using interest rates currently being offered by the Company. The incremental credit risk for non-accrual loans was considered in the determination of the fair value of the loans. This method of estimating fair value does not incorporate the exit price concept of fair value.

**Commitments:** The fair values of the unused portion of lines of credit and letters of credit were estimated to be the fees currently charged to enter into similar agreements. Commitments to originate non-mortgage loans were short-term and were at current market rates and estimated to have no significant change in fair value.

**Financial liabilities:** The fair values of certificates of deposit and borrowings were estimated using discounted cash flow analysis using rates offered by the Bank, or advance rates offered by the FHLB on September 30, 2012 and December 31, 2011 for similar instruments. The fair value of junior subordinated debentures was estimated using discounted cash flow analysis using a market rate of interest at September 30, 2012 and December 31, 2011.

**Limitations:** The estimates of fair value of financial instruments were based on information available at September 30, 2012 and December 31, 2011 and are not indicative of the fair market value of those instruments as of the date of this report. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. The fair value of the Company's time deposit liabilities do not take into consideration the value of the Company's long-term relationships with depositors, which may have significant value.

Because no active market exists for a portion of the Company's financial instruments, fair value estimates were based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could

significantly affect the estimates.

Fair value estimates were based on existing on- and off-balance sheet financial instruments without an attempt to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments, including premises and equipment and foreclosed real estate.

In addition, the tax ramifications related to the realization of the unrealized appreciation and depreciation can have a significant effect on fair value estimates and have not been considered in any of the estimates. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

31

---

Table of Contents

ENTERPRISE BANCORP, INC.

Notes to the Unaudited Consolidated Financial Statements (continued)

The carrying values, estimated fair values and placement in the fair value hierarchy of the Company's financial instruments<sup>(1)</sup> for which fair value is only disclosed but not recognized on the balance sheet at the dates indicated are summarized as follows:

| (Dollars in thousands)         | September 30, 2012 |             | Fair value measurement |                |                |
|--------------------------------|--------------------|-------------|------------------------|----------------|----------------|
|                                | Carrying Amount    | Fair Value  | Level 1 inputs         | Level 2 Inputs | Level 3 Inputs |
| Financial assets:              |                    |             |                        |                |                |
| Loans, net                     | \$1,280,123        | \$1,294,503 | \$—                    | \$—            | 1,294,503      |
| Financial liabilities:         |                    |             |                        |                |                |
| Certificates of deposit        | 247,010            | 247,606     | —                      | 247,606        | —              |
| Borrowed funds                 | 2,994              | 3,016       | —                      | 3,016          | —              |
| Junior subordinated debentures | 10,825             | 12,597      | —                      | —              | 12,597         |
|                                |                    |             |                        |                |                |
| (Dollars in thousands)         | December 31, 2011  |             | Fair value measurement |                |                |
|                                | Carrying Amount    | Fair Value  | Level 1 inputs         | Level 2 Inputs | Level 3 Inputs |
| Financial assets:              |                    |             |                        |                |                |
| Loans, net                     | \$1,227,329        | \$1,235,229 | \$—                    | \$—            | \$1,235,229    |
| Financial liabilities:         |                    |             |                        |                |                |
| Certificates of deposit        | 269,695            | 270,282     | —                      | 270,282        | —              |
| Borrowed funds                 | 4,494              | 4,541       | —                      | 4,541          | —              |
| Junior subordinated debentures | 10,825             | 11,042      | —                      | —              | 11,042         |

(1) Excluded from this table are certain financial instruments that approximated their fair value, as they were short-term in nature or payable on demand. These include cash and cash equivalents, accrued interest receivable, non-term deposit accounts, and accrued interest payable. The respective carrying values of these instruments would all be considered to be classified within Level 1 of their fair value hierarchy.

## Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations

Management's discussion and analysis should be read in conjunction with the Company's (also referred to herein as "Enterprise," "us," "we" or "our") consolidated financial statements and notes thereto contained in this report and the Company's 2011 Annual Report on Form 10-K.

### Accounting Policies/Critical Accounting Estimates

As discussed in the Company's 2011 Annual Report on Form 10-K, the three most significant areas in which management applies critical assumptions and estimates that are particularly susceptible to change relate to the determination of the allowance for loan losses, impairment review of investment securities and the impairment review of goodwill. The Company has not changed its significant accounting and reporting policies from those disclosed in its 2011 Annual Report on Form 10-K.

### Special Note Regarding Forward-Looking Statements

This report contains certain "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, including statements concerning plans, objectives, future events or performance and assumptions and other statements that are other than statements of historical fact. Forward-looking statements may be identified by reference to a future period or periods or by use of forward-looking terminology such as "anticipates," "believes," "expects," "intends," "may," "plans," "pursue," "views" and similar terms or expressions. Various statements contained in Item 2 - "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Item 3 - "Quantitative and Qualitative Disclosures About Market Risk," including, but not limited to, statements related to management's views on the banking environment and the economy, competition and market expansion opportunities, the interest rate environment, credit risk and the level of future non-performing assets and charge-offs, potential asset and deposit growth, future non-interest expenditures and non-interest income growth, and borrowing capacity are forward-looking statements. The Company wishes to caution readers that such forward-looking statements reflect numerous assumptions and involve a number of risks and uncertainties that may adversely affect the Company's future results. The following important factors, among others, could cause the Company's results for subsequent periods to differ materially from those expressed in any forward-looking statement made herein: (i) changes in interest rates could negatively impact net interest income; (ii) changes in the business cycle and downturns in the local, regional or national economies, including deterioration in the local real estate market, could negatively impact credit and/or asset quality and result in credit losses and increases in the Company's allowance for loan losses; (iii) changes in consumer spending could negatively impact the Company's credit quality and financial results; (iv) increasing competition from larger regional and out-of-state banking organizations as well as non-bank providers of various financial services could adversely affect the Company's competitive position within its market area and reduce demand for the Company's products and services; (v) deterioration of securities markets could adversely affect the value or credit quality of the Company's assets and the availability of funding sources necessary to meet the Company's liquidity needs; (vi) changes in technology could adversely impact the Company's operations and increase technology-related expenditures; (vii) increases in employee compensation and benefit expenses could adversely affect the Company's financial results; (viii) changes in laws and regulations that apply to the Company's business and operations, including without limitation, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Jumpstart Our Business Startups Act (the "JOBS Act"), the notice of proposed rulemaking regarding Basel III and the additional regulations that will be forthcoming as a result thereof, could adversely affect the Company's business environment, operations and financial results; (ix) changes in accounting standards, policies and practices, as may be adopted or established by the regulatory agencies, the Financial Accounting Standards Board (the "FASB") or the Public Company Accounting Oversight Board could negatively impact the Company's financial results; (x) our ability to enter new markets successfully and capitalize on growth opportunities; (xi) future regulatory compliance costs,

including any increase caused by new regulations imposed by the Consumer Finance Protection Bureau; and (xii) some or all of the risks and uncertainties described in Item 1A of the Company's 2011 Annual Report on Form 10-K could be realized, which could have a material adverse effect on the Company's business, financial condition and results of operation. Therefore, the Company cautions readers not to place undue reliance on any such forward-looking information and statements.

## Overview

### Executive Summary

Net income amounted to \$3.1 million for the quarter ended September 30, 2012, an increase of \$126 thousand, or 4%, over the same period in the prior year. Diluted earnings per share were \$0.32 for the three months ended September 30, 2012, an increase of \$0.01, or 3%, over the same period in the prior year. Net income for the nine months ended September 30, 2012



## Table of Contents

amounted to \$9.1 million, representing an increase of \$1.1 million, or 13%, compared to the same nine month period in 2011. Diluted earnings per share were \$0.95 for the nine months ended September 30, 2012, an increase of \$0.09, or 10% compared to the same period in the prior year.

The Company's growth contributed to increases in net interest income and the level of operating expenses for both the quarter and the year-to-date periods ended September 30, 2012. In 2012, the provision for loan losses decreased compared to the 2011 periods, while non-interest income decreased mainly due to lower gains on security sales in the current year. The increases in both the quarter and year-to-date pre-tax net income were partially offset by a higher tax rate in 2012, mainly due to higher taxable income in the current year.

Strong 2012 financial results to date reflect our continued growth. Deposits and loans outstanding have increased by \$137.3 million, or 10%, and \$53.6 million, or 4%, respectively, since December 31, 2011, which are annualized growth rates of 14% and 6%, respectively. During the quarter ended September 30, 2012, deposits increased \$16.8 million and loans outstanding increased \$11.6 million. Total assets amounted to \$1.64 billion, which represented an increase of \$148.4 million, or 10%, since December 31, 2011, and \$22.5 million, or 1% since June 30, 2012. Additionally, investment assets under management increased \$73.8 million, or 15%, since December 31, 2011, and \$26.6 million, or 5%, since June 30, 2012, to \$578.9 million at September 30, 2012.

## Composition of Earnings

The Company's earnings are largely dependent on its net interest income, which is the difference between interest earned on loans and investments and the cost of funding (primarily deposits and borrowings). Net interest income expressed as a percentage of average interest earning assets is referred to as net interest margin. The Company reports net interest margin on a tax equivalent basis ("margin"). The re-pricing frequency of the Company's assets and liabilities are not identical, and therefore subject the Company to the risk of adverse changes in interest rates. This is often referred to as "interest rate risk" and is reviewed in more detail in Item 3, "Quantitative and Qualitative Disclosures About Market Risk," of this Form 10-Q.

Net interest income for the quarter ended September 30, 2012 amounted to \$15.6 million, an increase of \$909 thousand, or 6%, compared to the September 2011 quarter. Net interest income for the nine months ended September 30, 2012 amounted to \$46.0 million, an increase of \$3.0 million, or 7%, compared to the same period in 2011. The increase in net interest income was due primarily to revenue generated from loan growth which has been funded through non-interest bearing deposits, partially offset by a decrease in margin. For the three and nine months ended September 30, 2012, average loan balances increased \$84.3 million and \$95.7 million, respectively, compared to the three and nine month averages in 2011. The margin was 4.20% for the quarter ended September 30, 2012 compared to 4.32% for the quarter ended September 30, 2011. The margin was 4.31% for the quarter ended June 30, 2012. Year-to-date margins were 4.29% and 4.36% for the nine months ended September 30, 2012 and 2011, respectively. Consistent with industry trends, the 2012 margin continues to trend downward, as the yield on interest earning assets has declined faster than the rate on cost of funds, which is approaching a floor.

The provision for loan losses amounted to \$800 thousand for the three months ended September 30, 2012 compared to \$1.8 million for the same period in 2011. For the nine months ended September 30, 2012 and 2011, the provision for loan losses amounted to \$2.2 million and \$4.0 million, respectively. The decrease in the provision reflects modest credit stabilization within the loan portfolio compared to the 2011 periods. In making the provision to the allowance for loan losses, management takes into consideration the level of loan growth, adversely classified and non-performing loans, specific reserves for impaired loans, net charge-offs, and the estimated impact of current economic conditions on credit quality. The level of loan growth for the nine months ended September 30, 2012 was \$53.6 million, compared to \$86.2 million during the same period in 2011. The balance of the allowance for loan

losses allocated to impaired loans amounted to \$4.3 million at September 30, 2012, compared to \$4.1 million at September 30, 2011. Total non-performing assets as a percentage of total assets were 1.50% at September 30, 2012, compared to 1.81% at September 30, 2011. For the year-to-date period ended September 30, 2012, the Company recorded net charge-offs of \$1.4 million, the majority of which had reserves specifically allocated in prior periods. For the same period in 2011, net charge-offs were \$800 thousand. Management continues to closely monitor the non-performing assets, charge-offs and necessary allowance levels, including specific reserves. The allowance for loan losses to total loans ratio was 1.84% at September 30, 2012, compared to 1.85% at December 31, 2011 and 1.84% at September 30, 2011.

For further information regarding loan quality statistics and the allowance for loan losses, see the sections below under the heading "Financial Condition" titled "Asset Quality" and "Allowance for Loan Losses."

## Table of Contents

Non-interest income for the three months ended September 30, 2012 amounted to \$3.0 million, a decrease of \$225 thousand, or 7%, compared to the third quarter of 2011. Non-interest income for the nine months ended September 30, 2012 amounted to \$8.9 million a decrease of \$80 thousand, or 1%, compared to the 2011 year-to-date period. A decrease in gains on securities sales impacted both the quarter and year-to-date results, partially offset by an increase in gains on loan sales and higher "other income" in the current year. The increase in other income is primarily due to increases in insurance commissions in both the quarter and year-to-date periods.

Non-interest expense for the three months ended September 30, 2012 amounted to \$13.0 million, an increase of \$1.2 million, or 10%, compared to the same period in the prior year. For the nine months ended September 30, 2012, non-interest expense amounted to \$38.8 million, an increase of \$2.7 million, or 7%, compared to the same period in the prior year. Increases in salaries and benefits and technology expenses from the Company's strategic growth initiatives including branch growth, impacted both the quarter and the year-to-date periods. The year-to-date expenses were also impacted primarily by increases in legal and other professional services and occupancy expenses, partially offset by a reduction in FDIC insurance expenses.

## Sources and Uses of Funds

The Company's primary sources of funds are deposits, Federal Home Loan Bank ("FHLB") borrowings, current earnings and proceeds from the sales, maturities and pay-downs on loans and investment securities. The Company may also from time to time utilize brokered deposits and overnight borrowings from correspondent banks as additional funding sources. These funds are used to originate loans, purchase investment securities, conduct operations, expand the branch network, and pay dividends to shareholders.

Total assets amounted to \$1.64 billion at September 30, 2012, increases of \$148.4 million, or 10%, since December 31, 2011 and \$22.5 million, or 1%, since June 30, 2012. The Company's core asset strategy is to grow loans, primarily high quality commercial loans. Total loans increased \$53.6 million, or 4%, since December 31, 2011 and amounted to \$1.30 billion, or 80% of total assets, at September 30, 2012. Since June 30, 2012, total loans have increased \$11.6 million, or 1%. Total commercial loans amounted to \$1.13 billion, or 86% of gross loans, which was consistent with the composition at December 31, 2011.

The investment portfolio is the other key component of earning assets and is primarily used to invest excess funds, provide liquidity and to manage the Company's asset-liability position. Total investments increased \$51.3 million since December 31, 2011 and amounted to \$191.7 million at September 30, 2012, representing 12% of total assets, compared to 9% at December 31, 2011.

Since December 31, 2011, cash and cash equivalents have increased \$43.1 million, primarily due to deposit growth exceeding loan and investment growth.

Management's preferred strategy for funding asset growth is to grow low cost deposits (comprised of demand deposit accounts, interest and business checking accounts and traditional savings accounts). Asset growth in excess of low cost deposits is typically funded through higher cost deposits (comprised of money market accounts, commercial tiered rate savings or "investment savings" accounts and certificates of deposit), wholesale funding (brokered deposits and borrowed funds), and investment portfolio cash flow.

At September 30, 2012, deposits amounted to \$1.47 billion, an increase of \$137.3 million, or 10%, from December 31, 2011 balances and \$16.8 million, or 1%, since June 30, 2012. This increase since December 31, 2011 was primarily due to increases in checking account balances of \$90.2 million, or 19%, specifically non-interest bearing accounts, and savings and money market account balances of \$69.7 million, or 12%, partially offset by a

decrease of \$22.7 million in CDs. Management believes that the deposit growth is primarily attributed to a general inflow of funds into the deposit marketplace due to economic uncertainties and low returns on other investment options available to deposit customers, as well as customers seeking an alternative to larger regional and national banks.

Wholesale funding remained at low levels and amounted to \$3.0 million at September 30, 2012, compared to \$4.5 million at December 31, 2011. At both September 30, 2012 and December 31, 2011, wholesale funding was comprised of FHLB term borrowings.

#### Opportunities and Risks

While the current economic environment continues to present significant challenges for all companies, management also

## Table of Contents

believes that it has created opportunities for growth and customer acquisition. Strategically, our focus remains on organic growth and market expansion, while planning for our future by investing in our branch network, technology, progressive product capabilities, our communities and most importantly, in our people.

The Company's ability to achieve its long-term growth and market share objectives will depend upon the Company's continued success in differentiating itself in the market place. We believe that the Company has built a reputation within its market area based on consistently superior customer service and support for the local communities, differentiating itself through its people, who function as trusted advisors to clients. The Company's professionals are committed to upholding the Company's core values, including significant community involvement, which has led to a strong network with local business and community leaders. Management believes the Enterprise business model of providing a full range of diversified financial products, services and the latest technology, creates opportunities for the Company to be the leading provider of banking and investment advisory and wealth management services in its growing market area. These services are delivered by experienced local banking professionals who possess strong technical skills, have developed in-depth knowledge of our markets and have earned a trusted reputation within the community.

Enterprise faces strong competition to generate loans, attract deposits, and to grow its insurance business and investment advisory assets. National and larger regional banks have a local presence in the Company's market area. These established larger banks, as well as recent larger entrants into the local market area, have certain competitive advantages, including the ability to make larger loans to a single borrower than is possible for the Company, and greater financial resources. Numerous local savings banks, commercial banks, cooperative banks and credit unions also compete in the Company's market area. The expanded commercial lending capabilities of credit unions and the shift to commercial lending by traditional savings banks allow them to compete for the Company's targeted commercial customers. In addition, the non-taxable status of credit unions allows them certain advantages as compared to taxable institutions such as Enterprise. Competition for loans, deposit and cash management services, investment advisory assets, and insurance services also comes from other businesses that provide financial services, including consumer finance companies, mortgage brokers, private lenders, insurance companies, securities brokerage firms, institutional mutual funds, registered investment advisors, non-bank electronic delivery channels and internet based banks.

Notwithstanding the competition discussed above, management believes that customers continue to migrate from larger, national and regional banks to local, stable community banks, choosing to do business with local professional bankers who can offer them the flexibility, responsiveness and personalized service that a community bank such as Enterprise provides. Management views the Company's customer service culture, investments in the communities we serve, and diverse financial product offerings and delivery channels as key elements in positioning Enterprise to take advantage of these market opportunities created by the current challenging banking landscape.

The Company also seeks to increase deposit share, through continuous reviews of deposit product offerings and delivery options with targeted marketing strategies, including its online banking and mobile delivery capabilities. In addition, Enterprise carefully plans expansion into neighboring markets and new branch development. In February 2012, the Company opened its 19th branch office in the town of Pelham, New Hampshire. The Company has also obtained the necessary regulatory approvals for its new branches in Tyngsboro and Lawrence, Massachusetts. The Tyngsboro office will open in November 2012 and the Lawrence office is expected to open in the first quarter of 2013.

Management believes that Enterprise is also well equipped to capitalize on market potential to grow both the commercial and residential loan portfolios through strong business development efforts, while utilizing a disciplined and consistent lending approach and credit review practices, which have served to provide quality asset growth over varying economic cycles during the Company's twenty-three year history. The Company has a skilled lending sales

force with a broad breadth of business knowledge and depth of lending experience to draw upon, supported by a highly qualified and experienced commercial credit review function.

Management continues to undertake significant strategic initiatives, including investments in employee training and development, marketing and public relations, technology and electronic product delivery, branch expansion and ongoing improvements and renovations to existing customer service locations and operations facilities. The current industry consolidation also provides management the opportunity to recruit experienced banking professionals with market knowledge who compliment the Enterprise sales and service culture. While management recognizes that such investments increase expenses in the short-term, Enterprise believes that such initiatives are an investment in the long-term growth and earnings of the Company and are reflective of the opportunities in the current marketplace for community banks such as Enterprise.

Any possible deterioration of the current economic environment could weaken the local New England economy and have adverse repercussions on local industries leading to increased unemployment and foreclosures, further deterioration of local

## Table of Contents

commercial real estate values, or other unforeseen consequences, which could have a severe negative impact on the Company's financial condition, capital position, liquidity, and performance. In addition, the loan portfolio consists primarily of commercial real estate, commercial and industrial, and construction loans. These types of loans are typically larger and are generally viewed as having more risk of default than owner occupied residential real estate loans or consumer loans. The underlying commercial real estate values, customer cash flow and payment expectations and, in the case of commercial construction loans, the actual costs necessary to complete a construction project, can be more easily influenced by adverse conditions in the local or national economy, the real estate market, or the related industries. Any significant deterioration in the commercial loan portfolio or underlying collateral values due to a continuation or worsening of the current economic environment could have a material adverse effect on the Company's financial condition and results of operations. The risk of loss due to customers' non-payment of loans or lines of credit is called "credit risk." Credit risk management is reviewed below in this Item 2 under the headings "Credit Risk," "Asset Quality" and "Allowance for Loan Losses."

The value of the investment portfolio as a whole, or individual securities held, including restricted FHLB capital stock, could be negatively impacted by any renewed volatility in the financial markets or in credit markets, which could possibly result in the recognition of additional other-than-temporary-impairment ("OTTI") charges in the future.

The re-pricing frequency of interest earning assets and liabilities are not identical, and therefore subject the Company to the risk of adverse changes in interest rates. This is often referred to as "interest rate risk" and is reviewed in more detail under the heading Item 3, "Quantitative and Qualitative Disclosures About Market Risk," below.

Liquidity management is the coordination of activities so that cash needs are anticipated and met, readily and efficiently. Liquidity management is reviewed further below in this Item 2 under the heading "Liquidity."

Federal banking agencies require the Company and the Bank to meet minimum capital requirements. At September 30, 2012, the Company was categorized as "well capitalized"; however future unanticipated charges against capital could impact that regulatory capital designation. Moreover, in June 2012, U.S. banking regulators released notices of proposed rulemaking that would revise and replace the agencies' current regulatory capital requirements to align with the Basel III international capital standards and to implement certain changes required by the Dodd-Frank Act. The proposal is generally expected to require all U.S. banking organizations, including community banks, such as Enterprise Bank, to hold higher amounts of capital, especially common equity, against their risk-weighted assets.

For information regarding the capital requirements applicable to the Company and the Bank and their respective capital levels at September 30, 2012, and the recently released notices of proposed rule making see the section entitled "Capital Resources" contained in this Item 2 below.

In addition, any further changes in government regulation or oversight, including the implementation by the federal regulatory agencies of the various requirements contained in the Dodd-Frank Act and the proposed rules under Basel III could affect the Company in substantial and unpredictable ways, including, but not limited to, subjecting the Company to additional operating, governance and compliance costs, additional capital requirements, or potential loss of revenue due to the impact of an enhanced regulatory structure on the banking industry. Although several significant aspects of the Dodd-Frank Act expressly apply only to larger, "systemically significant" institutions, they may have the potential to influence the Company's business decisions, while other parts of the legislation apply either directly, or potentially indirectly, to activities of community banks, such as Enterprise.

The full extent of the regulatory impact resulting from the Dodd-Frank Act is still not known, as the various federal regulatory agencies continue to implement new regulations and the Government Accounting Office and other federal agencies continue to complete their studies regarding various financial services industry issues that were raised during the legislative process.

Additionally, certain provisions of the Dodd-Frank Act impact FDIC deposit insurance rates and assessment methodology. For further information see the discussion under the heading "FDIC Deposit Insurance Assessment" below.

Management has processes in place for the monitoring and management of compliance risk. Compliance risk includes the threat of fines, civil money penalties, lawsuits and restricted growth opportunities resulting from violations and/or non-conformance with laws, rules, regulations, prescribed practices, internal policies and procedures, or ethical standards.

The Company maintains a Compliance Management Program (CMP) designed to meet regulatory and legislative requirements. The CMP provides for tracking and implementing regulatory changes, monitoring the effectiveness of policies and procedures, conducting compliance risk assessments, and educating employees in matters relating to regulatory compliance. The Audit Committee of the Board of Directors oversees the effectiveness of the CMP.



## Table of Contents

Operational risk includes the threat of loss from inadequate or failed internal processes, people, systems or external events, due to, among other things: fraud or error; the inability to deliver products or services; failure to maintain a competitive position; lack of information or physical security; or violations of ethical standards. Controls to manage operational risk include, but are not limited to, technology administration, information security, vendor management and business continuity planning.

The Company's technology administration includes policies and guidelines for the design, procurement, installation, management and acceptable use of hardware, software and network devices. The Company has implemented layered security approaches for all delivery channels that allow employees, customers, or vendors access as required to the Company's information and technology systems. This strategy includes internal and third party risk assessments, due diligence on vendors, and project and change management practices. These standards are designed to provide risk based oversight, coordinate and communicate ideas, and to prioritize and manage technology projects in a manner consistent with corporate objectives.

Management utilizes a combination of third party information security assessments, key technologies and ongoing internal evaluations to provide a level of protection of non-public personal information and to continually monitor and attempt to safeguard information on its operating systems and those of third party service providers. The Company contracts with outside parties to perform a broad scope of both internal and external information security assessments on the Company's systems on a regular basis. These third parties conduct penetration testing and vulnerability scans to test the network configuration and security controls, and assess internal practices aimed at protecting the Company's operating systems. In addition, an outside service provider monitors usage patterns and identifies unusual activity on bank issued debit/ATM cards. The Company also utilizes firewall technology and a combination of software and third-party monitoring to detect intrusion, guard against unauthorized access, and continuously scan for computer viruses on the Company's information systems.

The Company may enter into third-party relationships by outsourcing certain operational functions or by using third parties to provide certain products and services to the Bank's customers. Management is responsible for assessing that the activities conducted through third-party relationships are conducted in a safe and sound manner and in accordance with applicable laws and regulations, just as if the activity was performed by the Company itself. The Company has a third-party vendor management program in order to identify and rate the risks arising from conducting activities through third party relationships. These risks may include operational risk and the failure to deliver a particular product or service; non-compliance with applicable laws and regulations; loss of non-public personal information; vendor business decisions that are inconsistent with the Company's strategic goals; or damage to the Company's reputation; among others. The Company's risk-based vendor management program is designed to provide a mechanism to enable management to determine what risk, if any, a particular vendor exposes the Company to, and to mitigate that risk by properly performing initial and ongoing due diligence when selecting or maintaining a relationship with significant third-party providers.

The Company's Business Continuity Plan consists of the information and procedures required to attempt a rapid recovery from an occurrence that would disable the Company's operations for an extended period. The plan addresses issues and concerns regarding the loss of personnel, loss of information and/or loss of access to information under various scenarios including the following: the inability of staff or customers to travel to or to access bank offices, the serious threat of widespread public health or safety concerns, and the physical destruction or damage of facilities, infrastructure or systems. The plan, which is reviewed annually, establishes responsibility for assessing a disruption of business, contains alternative strategies for the continuance of critical business functions during an emergency situation, assigns responsibility for restoring services, and sets priorities by which critical services will be restored. A bank-owned and maintained secondary off-site data center provides the Company more control and auxiliary network processing capabilities. Any contingency plan, however well designed and operated, is based in part on certain

assumptions and can provide only reasonable, not absolute, assurances that the objectives of the plan will be met as the assumptions used change over time or due to changes in circumstances and events.

In addition to the risks discussed above, numerous other factors that could adversely affect the Company's reputation, its future results of operations and financial condition are addressed in Item 1A, "Risk Factors," included in the Company's 2011 Annual Report on Form 10-K. This Opportunities and Risks discussion should be read in conjunction with Item 1A of the 2011 Annual Report.

#### Financial Condition

Total assets increased \$148.4 million, or 10%, since December 31, 2011, to \$1.64 billion at September 30, 2012. The balance sheet composition and changes since December 31, 2011 are discussed below.

#### Cash and cash equivalents

Table of Contents

Cash and cash equivalents is comprised of cash on hand and cash items due from banks, interest-earning deposits (deposit accounts, money market, and money market mutual funds accounts) and fed funds sold. As of September 30, 2012, cash and cash equivalents amounted to 5% of total assets, compared to 3% of total assets, at December 31, 2011. Balances in cash and cash equivalents will fluctuate primarily due to the timing of net deposit flows, borrowing and loan inflows and outflows, investment purchases and maturities, calls and sales proceeds, and the immediate liquidity needs of the Company.

## Investments

At September 30, 2012, the carrying value of the investment portfolio amounted to \$191.7 million, an increase of \$51.3 million, or 37%, compared to December 31, 2011. The increase in investments in the current year is primarily due to excess funds from deposits exceeding loan growth.

The following table summarizes investments at the dates indicated:

| (Dollars in thousands)   | September 30,<br>2012 |         | December 31,<br>2011 |         | September 30,<br>2011 |         |  |  |
|--|-----------------------|---------|----------------------|---------|-----------------------|---------|--|--|
|  | Amount                | Percent | Amount               | Percent | Amount                | Percent |  |  |
| Federal agency obligations <sup>(1)</sup>                      | \$75,739              | 39.5 %  | \$40,397             | 28.8 %  | \$37,727              | 29.3 %  |  |  |
| Federal agency mortgage backed securities (MBS) <sup>(1)</sup> | 48,700                | 25.4 %  | 39,688               | 28.2 %  | 37,429                | 29.0 %  |  |  |
| Municipal securities   | 56,551                | 29.5 %  | 51,209               | 36.5 %  | 48,031                | 37.3 %  |  |  |
| Corporate bonds  | 656                   | 0.3 %   | —                    | — %     | —                     | — %     |  |  |
| Certificates of deposits <sup>(2)</sup>                        | 500                   | 0.3 %   | 2,147                | 1.5 %   | —                     | — %     |  |  |
| Total fixed income securities                                  | 182,146               | 95.0 %  | 133,441              | 95.0 %  | 123,187               | 95.6 %  |  |  |
| Equity investments   | 9,550                 | 5.0 %   | 6,964                | 5.0 %   | 5,735                 | 4.4 %   |  |  |
| Total available for sale investments at fair value             | \$191,696             | 100.0 % | \$140,405            | 100.0 % | \$128,922             | 100.0 % |  |  |

These categories may include investments issued or guaranteed by government sponsored enterprises such as Fannie Mae (FNMA), Freddie Mac (FHLMC), Ginnie Mae (GNMA), Federal Farm Credit Bank, or one of several  
(1) Federal Home Loan Banks. All agency MBS/CMO investments owned by the Company are backed by residential mortgages.

(2) Certificates of Deposits ("CD") represent term deposits issued by banks that are subject to FDIC insurance and purchased on the open market.

Included in the federal agency MBS categories above were CMOs totaling \$25.8 million, \$21.8 million, and \$23.0 million at September 30, 2012, December 31, 2011, and September 30, 2011, respectively.

During the nine months ended September 30, 2012, the total principal pay downs, calls and maturities amounted to \$22.3 million. In addition, during the period, the Company purchased \$75.7 million in securities, and sold investment securities with an amortized cost of approximately \$3.0 million realizing gains on sales of \$197 thousand.

Net unrealized gains on the investment portfolio amounted to \$6.5 million at September 30, 2012 compared to \$5.0 million at December 31, 2011 and \$4.3 million at September 30, 2011. The level of net unrealized gains in the portfolio at September 30, 2012, primarily resulted from the low interest rate environment on fixed income securities. See Note 4, "Investment Securities," and Note 12, "Fair Value Measurements," to the Company's unaudited consolidated financial statements contained in Item 1 above for further information regarding the Company's unrealized gain and losses on debt and equity securities, including information about investments in an unrealized loss position for which

an other-than-temporary impairment has or has not been recognized, and investments pledged as collateral, as well as the Company's fair value measurements for available-for-sale securities.

#### Federal Home Loan Bank Stock

The Company is required to purchase stock of the FHLB in association with advances from the FHLB; this stock is classified as a restricted investment and carried at cost, which management believes approximates fair value. The carrying amount of FHLB stock was \$4.3 million at September 30, 2012, compared to \$4.7 million at December 31, 2011 and September 30, 2011. See Note 5, "Restricted Investments," to the Company's unaudited consolidated financial statements contained in Item 1 above

Table of Contents

for further information regarding the Company's investment in FHLB.

## Loans

Total loans represented 80% of total assets as of September 30, 2012, compared to 84% at December 31, 2011. Total loans increased \$53.6 million, or 4%, compared to December 31, 2011, and \$74.5 million, or 6%, since September 30, 2011. The mix of loans within the portfolio remained relatively unchanged with commercial loans amounting to approximately 86% of gross loans, reflecting the Bank's goal of selectively developing relationships with strong, credit-worthy commercial customers.

The following table sets forth the loan balances by certain loan categories at the dates indicated and the percentage of each category to gross loans.

| (Dollars in thousands)    | September 30, 2012 |         | December 31, 2011 |         | September 30, 2011 |         |   |  |
|---------------------------|--------------------|---------|-------------------|---------|--------------------|---------|---|--|
|                           | Amount             | Percent | Amount            | Percent | Amount             | Percent |   |  |
| Commercial real estate    | \$687,920          | 52.7    | % \$650,697       | 51.9    | % \$634,229        | 51.5    | % |  |
| Commercial and industrial | 320,278            | 24.5    | % 310,706         | 24.8    | % 305,015          | 24.8    | % |  |
| Commercial construction   | 120,684            | 9.3     | % 117,398         | 9.4     | % 120,753          | 9.8     | % |  |
| Total commercial loans    | 1,128,882          | 86.5    | % 1,078,801       | 86.1    | % 1,059,997        | 86.1    | % |  |
| Residential mortgages     | 92,967             | 7.1     | % 86,311          | 6.9     | % 86,398           | 7.0     | % |  |
| Home equity               | 73,517             | 5.6     | % 77,135          | 6.2     | % 77,478           | 6.3     | % |  |
| Consumer                  | 4,380              | 0.3     | % 4,570           | 0.4     | % 3,541            | 0.3     | % |  |
| Loans held for sale       | 5,686              | 0.5     | % 5,061           | 0.4     | % 3,600            | 0.3     | % |  |
| Gross loans               | 1,305,432          | 100.0   | % 1,251,878       | 100.0   | % 1,231,014        | 100.0   | % |  |
| Deferred fees, net        | (1,379 )           |         | (1,389 )          |         | (1,456 )           |         |   |  |
| Total loans               | 1,304,053          |         | 1,250,489         |         | 1,229,558          |         |   |  |
| Allowance for loan losses | (23,930 )          |         | (23,160 )         |         | (22,569 )          |         |   |  |
| Net loans                 | \$1,280,123        |         | \$1,227,329       |         | \$1,206,989        |         |   |  |

Commercial real estate loans increased \$37.2 million, or 6%, as of September 30, 2012, compared to December 31, 2011, and increased 8% compared to September 30, 2011. Commercial real estate loans are typically secured by apartment buildings, office or mixed-use facilities, strip shopping centers or other commercial or industrial property.

Commercial and industrial loans increased by \$9.6 million, or 3%, since December 31, 2011, and increased 5% as compared to September 30, 2011. These loans include seasonal revolving lines of credit, working capital loans, equipment financing (including equipment leases), and term loans. Also included in commercial and industrial loans are loans under various U.S. Small Business Administration programs.

Commercial construction loans increased by \$3.3 million, or 3%, since December 31, 2011, however they were relatively flat compared to September 30, 2011. Commercial construction loans include the development of residential housing and condominium projects, the development of commercial and industrial use property and loans for the purchase and improvement of raw land.

Residential mortgages (including residential construction loans), home equity mortgages and consumer loans combined represented approximately 13% of the total loan portfolio at September 30, 2012 and December 31, 2011. These loans increased by \$2.8 million, or 2%, since December 31, 2011 and increased by \$3.4 million, or 2%, since September 30, 2011. The increase since the prior year was primarily within the residential mortgage portfolio.

During the nine months ended September 30, 2012, the Company originated \$35.0 million in residential loans designated for sale, compared to \$19.3 million for the same period in the prior year. During the 2012 period, loans sold amounted to \$34.4 million compared to \$22.1 million in the 2011 period. These loan sales generated gains on sales of \$669 thousand and \$403 thousand for the 2012 and 2011 periods, respectively.

At September 30, 2012, commercial loan balances participated out to various banks amounted to \$51.4 million, compared to \$43.0 million at December 31, 2011, and \$38.0 million at September 30, 2011. These balances participated out to other

## Table of Contents

institutions are not carried as assets on the Company's financial statements. Loans originated by other banks in which the Company is the participating institution are carried at the pro-rata share of ownership and amounted to \$25.8 million, \$33.0 million and \$35.4 million at September 30, 2012, December 31, 2011, and September 30, 2011, respectively. In each case, the participating bank funds a percentage of the loan commitment and takes on the related risk. In each case in which the Company participates in a loan, the rights and obligations of each participating bank are divided proportionately among the participating banks in an amount equal to their share of ownership and with equal priority among all banks.

## Credit Risk

The Company manages its loan portfolio to avoid concentration by industry and loan size to minimize its credit risk exposure. In addition, the Company does not have a "sub-prime" mortgage program. However, inherent in the lending process is the risk of loss due to customer non-payment, or "credit risk." The Company's commercial lending focus may entail significant additional risks compared to long term financing on existing, owner-occupied residential real estate. These types of loans are typically larger and are generally viewed as having more risk of default than owner-occupied residential real estate loans or consumer loans. The underlying commercial real estate values, customer cash flow and payment expectations and, in the case of commercial construction loans, the actual costs necessary to complete a construction project, can be more easily influenced by adverse conditions in the local or national economy, the real estate market, or the related industries. As such, an extended downturn in the national or local economy or real estate markets, among other factors, could have a material impact on the borrowers' ability to repay outstanding loans and on the value of the collateral securing these loans. While the Company endeavors to minimize this risk through the credit risk management function, management recognizes that loan losses will occur and that the amount of these losses will fluctuate depending on the risk characteristics of the loan portfolio and economic conditions.

The credit risk management function focuses on a wide variety of factors, including, among others, current and expected economic conditions, the real estate market, the financial condition of borrowers, the ability of borrowers to adapt to changing conditions or circumstances affecting their business and the continuity of borrowers' management teams. Early detection of credit issues is critical to minimize credit losses. Accordingly, management regularly monitors these factors, among others, through ongoing credit reviews by the Credit Department, an external loan review service, reviews by members of senior management and the Loan Committee of the Board of Directors. This review includes the assessment of internal credit quality indicators such as the risk classification of loans, adversely classified loans, past due and non-accrual loans, impaired and restructured loans, and the level of foreclosure activity.

The Company's loan risk rating system classifies loans depending on risk of loss characteristics. The classifications range from "substantially risk free" for the highest quality loans and loans that are secured by cash collateral, to the more severe adverse classifications of "substandard," "doubtful" and "loss" based on criteria established under banking regulations. Loans classified as substandard include those characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Loans classified as doubtful have all the weaknesses inherent in a substandard rated loan with the added characteristic that the weaknesses make collection or full payment from liquidation, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Loans classified as "loss" are generally considered uncollectible at present, although long term recovery of part or all of loan proceeds may be possible. These "loss" loans would require a specific loss reserve or charge-off. Adversely classified loans may be accruing or in non-accrual status and may be additionally designated as restructured and/or impaired, or some combination thereof. Loans which are evaluated to be of weaker credit quality are reviewed on a more frequent basis by management.

Loans on which the accrual of interest has been discontinued are designated as non-accrual loans. Accrual of interest on loans is generally discontinued when a loan becomes contractually past due, with respect to interest or principal, by ninety days, or when reasonable doubt exists as to the full and timely collection of interest or principal. When a loan is placed on non-accrual status, all interest previously accrued but not collected is reversed against current period interest income. Interest accruals are resumed on such loans only when payments are brought current and have remained current for a period of one hundred eighty days or when, in the judgment of management, the collectability of both principal and interest is reasonably assured. Interest payments received on loans in a non-accrual status are generally applied to principal on the books of the Company.

Impaired loans are individually significant loans for which management considers it probable that not all amounts due (principal and interest) in accordance with original contractual terms will be collected. The majority of impaired loans are included within the non-accrual balances; however, not every loan in non-accrual status has been designated as impaired. Impaired loans include loans that have been modified in a troubled debt restructure ("TDR"). Impaired loans exclude large groups of smaller-balance homogeneous loans, such as residential mortgage loans and consumer loans, which are collectively



## Table of Contents

evaluated for impairment and loans that are measured at fair value, unless the loan is amended in a TDR.

Management does not set any minimum delay of payments as a factor in reviewing for impaired classification. Management considers the payment status, net worth and earnings potential of the borrower, and the value and cash flow of the collateral as factors to determine if a loan will be paid in accordance with its contractual terms.

When a loan is deemed to be impaired, management estimates the credit loss by comparing the loan's carrying value against either 1) the present value of the expected future cash flows discounted at the loan's effective interest rate; 2) the loan's observable market price; or 3) the expected realizable fair value of the collateral, in the case of collateral dependent loans. A specific allowance is assigned to the impaired loan for the amount of estimated credit loss. Impaired loans are charged off, in whole or in part, when management believes that the recorded investment in the loan is uncollectible.

Loans are designated as a TDR when, as part of an agreement to modify the original contractual terms of the loan, the Bank grants a concession on the terms, that would not otherwise be considered, as a result of financial difficulties of the borrower. Typically, such concessions consist of a reduction in interest rate to a below market rate, taking into account the credit quality of the note, or a deferment or reduction of payments (principal or interest), which materially alters the Bank's position or significantly extends the note's maturity date, such that the present value of cash flows to be received is materially less than those contractually established at the loan's origination. All loans that are modified are reviewed by the Company to identify if a TDR has occurred. TDR loans are included in the impaired loan category.

Real estate acquired by the Company through foreclosure proceedings or the acceptance of a deed in lieu of foreclosure is classified as OREO. When property is acquired, it is generally recorded at the lesser of the loan's remaining principal balance, net of any unamortized deferred fees, or the estimated fair value of the property acquired, less estimated costs to sell. Any loan balance in excess of the estimated realizable fair value on the date of transfer is charged to the allowance for loan losses on that date. All costs incurred thereafter in maintaining the property, as well as subsequent declines in fair value are charged to non-interest expense.

Non-performing assets are comprised of non-accrual loans, deposit account overdrafts that are more than 90 days past due and OREO. The designation of a loan or other asset as non-performing does not necessarily indicate that loan principal and interest will ultimately be uncollectible. However, management recognizes the greater risk characteristics of these assets and therefore considers the potential risk of loss on assets included in this category in evaluating the adequacy of the allowance for loan losses. Despite prudent loan underwriting, adverse changes within the Company's market area, or deterioration in local, regional or national economic conditions, could negatively impact the Company's level of non-performing assets in the future.

### Asset Quality

At September 30, 2012, the Company had adversely classified loans (loans carrying "substandard," "doubtful" or "loss" classifications) amounting to \$35.9 million, compared to \$37.8 million at December 31, 2011. There were \$3 thousand of loans classified as "Loss" at September 30, 2012 and none at December 31, 2011. The decrease in adversely classified loans since the prior period was due primarily to paydowns on several commercial relationships, upgraded commercial loans and charge-offs, partially offset by additional credit downgrades during the period.

Adversely classified loans which were performing but possessed potential weaknesses and, as a result, could ultimately become non-performing loans amounted to \$14.0 million at both September 30, 2012 and December 31, 2011. The remaining balances of adversely classified loans were non-accrual loans, amounting to \$21.9 million and \$23.8 million at September 30, 2012 and December 31, 2011, respectively. Non-accrual loans which were not

adversely classified amounted to \$1.5 million and \$2.1 million at September 30, 2012 and December 31, 2011, respectively, and primarily represented the guaranteed portions of non-performing Small Business Administration loans.

Table of Contents

The following table sets forth information regarding non-performing assets, restructured loans and delinquent loans 60-89 days past due as to interest or principal, held by the Company at the dates indicated:

| (Dollars in thousands)                          | September 30,<br>2012 | December 31,<br>2011 | September 30,<br>2011 |   |
|---|-----------------------|----------------------|-----------------------|---|
| Commercial real estate                          | \$12,655              | \$14,060             | \$13,291              |   |
| Commercial and industrial                       | 8,378                 | 9,696                | 9,254                 |   |
| Commercial construction                         | 809                   | 727                  | 2,107                 |   |
| Residential                                     | 1,119                 | 850                  | 997                   |   |
| Home equity                                     | 348                   | 536                  | 141                   |   |
| Consumer  | 2                     | 6                    | 6                     |   |
| Total non-accrual loans                         | 23,311                | 25,875               | 25,796                |   |
| Overdrafts > 90 days past due                   | —                     | 1                    | —                     |   |
| Total non-performing loans                      | 23,311                | 25,876               | 25,796                |   |
| Other real estate owned (“OREO”)                | 1,250                 | 1,445                | 1,325                 |   |
| Total non-performing assets                     | \$24,561              | \$27,321             | \$27,121              |   |
| Total Loans                                     | \$1,304,053           | \$1,250,489          | \$1,229,558           |   |
| Accruing restructured loans not included above  | \$13,206              | \$12,442             | \$12,629              |   |
| Delinquent loans 60 — 89 day past due           | \$1,796               | \$3,026              | \$2,633               |   |
| Non-performing loans to total loans             | 1.79                  | % 2.07               | % 2.10                | % |
| Non-performing assets to total assets           | 1.50                  | % 1.83               | % 1.81                | % |
| Loans 60-89 days past due to total loans        | 0.14                  | % 0.24               | % 0.21                | % |
| Adversely classified loans to total loans       | 2.75                  | % 3.02               | % 3.09                | % |
| Allowance for loan losses                       | \$23,930              | \$23,160             | \$22,569              |   |
| Allowance for loan losses: Non-performing loans | 102.66                | % 89.50              | % 87.49               | % |
| Allowance for loan losses: Total loans          | 1.84                  | % 1.85               | % 1.84                | % |

Management believes that the loan portfolio has experienced a level of modest credit stabilization compared to the 2011 periods, as indicated by the improving statistics related to migration of adversely classified, past due and non-accrual loans, impaired loans and the level of OREO properties held as of September 30, 2012. Given the size and commercial mix of the Company's loan portfolio, management considers the current statistics to be reflective of the lagging effect that the regional economic environment has had on the local commercial markets and its impact on the credit profile of such a portfolio.

However, despite prudent loan underwriting and ongoing credit risk management, adverse changes within the Company's market area or further deterioration in the local, regional or national economic conditions could negatively impact the portfolio's credit risk profile and the Company's assets quality in the future.

Total impaired loans amounted to \$36.3 million and \$38.3 million at September 30, 2012 and December 31, 2011, respectively. Total accruing impaired loans amounted to \$13.7 million and \$13.2 million at September 30, 2012 and December 31, 2011, respectively, while non-accrual impaired loans amounted to \$22.5 million and \$25.1 million as of September 30, 2012 and December 31, 2011, respectively. The overall decrease in impaired loans was primarily due to paydowns on several commercial relationships, upgraded commercial loans and charge-offs, partially offset by additional credit downgrades during the period.

In management's opinion the majority of impaired loan balances at September 30, 2012 and December 31, 2011 were supported by expected future cash flows or, for those collateral dependent loans, the net realizable value of the underlying collateral. Based on management's assessment at September 30, 2012, impaired loans totaling \$25.7 million required no specific reserves and impaired loans totaling \$10.5 million required specific reserve allocations of

\$4.3 million. At December 31, 2011, impaired loans totaling \$25.4 million required no specific reserves and impaired loans totaling \$12.9 million required specific reserve allocations of \$4.4 million. Management closely monitors these relationships for collateral or credit deterioration.

Total TDR loans, included in the impaired loan figures above as of September 30, 2012 and December 31, 2011 were \$23.7

43

---

## Table of Contents

million and \$25.5 million, respectively. The decline is primarily due to the impaired loan activity discussed above. TDR loans on accrual status amounted to \$13.2 million and \$12.4 million at September 30, 2012 and December 31, 2011, respectively. TDR loans included in non-performing loans amounted to \$10.5 million and \$13.0 million at September 30, 2012 and December 31, 2011, respectively. The Company continues to work with commercial relationships and enters into loan modifications to the extent deemed to be necessary or appropriate while attempting to achieve the best mutual outcome given the current economic environment.

The carrying value of OREO at September 30, 2012 was \$1.3 million and consisted of four properties; two properties were added and two properties were sold during the 2012 period; there were \$45 thousand in net gains realized on the sale of these OREO properties. The carry value of OREO at December 31, 2011 and September 30, 2011 was \$1.4 million and \$1.3 million respectively. During the nine months ended September 30, 2011, one property was sold; there were no gains or losses on the OREO sale.

### Allowance for Loan Losses

On a quarterly basis, management prepares an estimate of the allowance necessary to cover estimated credit losses. The allowance for loan losses is an estimate of probable credit risk inherent in the loan portfolio as of the specified balance sheet dates. The Company maintains the allowance at a level that it deems adequate to absorb all reasonably anticipated losses from specifically known and other credit risks associated with the portfolio.

In making its assessment on the adequacy of the allowance, management considers several quantitative and qualitative factors that could have an effect on the credit quality of the portfolio including individual assessment of larger and high risk credits, delinquency trends and the level of non-performing loans, net charge-offs, the growth and composition of the loan portfolio, expansion in geographic market area, the strength of the local and national economy, and comparison to industry peers, among other factors. Except for loans specifically identified as impaired, as discussed above, the estimate is a two-tiered approach that allocates loan loss reserves to "adversely classified" loans by credit rating and to non-classified loans by credit type. The general loss allocations take into account the historic loss experience as well as the quantitative and qualitative factors identified above. The allowance for loan losses is established through a provision for loan losses, a direct charge to earnings. Loan losses are charged against the allowance when management believes that the collectability of the loan principal is unlikely. Recoveries on loans previously charged off are credited to the allowance.

Management closely monitors the credit quality of individual delinquent and non-performing relationships, industry concentrations, the local and regional real estate market and current economic conditions. The level of delinquent and non-performing assets is largely a function of economic conditions and the overall banking environment. Despite prudent loan underwriting, adverse changes within the Company's market area, or further deterioration in the local, regional or national economic conditions could negatively impact the Company's level of non-performing assets in the future.

The allowance for loan losses to total loans ratio was 1.84% at September 30, 2012 compared to 1.85% at December 31, 2011. The allowance for loan loss ratio decreased primarily as a result of the decrease in specific reserves on impaired loans and other changes discussed above under "Credit Risk" and "Asset Quality." The majority of charge-offs recorded in the current year-to-date period ended September 30, 2012 had reserves specifically allocated in prior periods. Based on the foregoing, as well as management's judgment as to the existing credit risks inherent in the loan portfolio, management believes the Company's allowance for loan losses is adequate to absorb probable losses from specifically known and other credit risks associated with the portfolio as of September 30, 2012.



Table of Contents

The following table summarizes the activity in the allowance for loan losses for the periods indicated:

| (Dollars in thousands)                                      | Nine months ended September |          |   |
|---|-----------------------------|----------|---|
|   | 30,<br>2012                 | 2011     |   |
| Balance at beginning of year                                | \$23,160                    | \$19,415 |   |
| Provision charged to operations                             | 2,150                       | 3,954    |   |
| Recoveries on charged-off loans:                            |                             |          |   |
| Commercial real estate                                      | 15                          | 76       |   |
| Commercial and industrial                                   | 227                         | 137      |   |
| Commercial construction                                     | 2                           | 4        |   |
| Residential   | —                           | 2        |   |
| Home equity   | 1                           | —        |   |
| Consumer  | 7                           | 9        |   |
| Total recoveries  | 252                         | 228      |   |
| Charged-off loans   |                             |          |   |
| Commercial real estate                                      | 231                         | 538      |   |
| Commercial and industrial                                   | 1,098                       | 457      |   |
| Commercial construction                                     | 100                         | —        |   |
| Residential   | 182                         | 4        |   |
| Home equity   | —                           | —        |   |
| Consumer  | 21                          | 29       |   |
| Total Charged off   | 1,632                       | 1,028    |   |
| Net loans charged-off                                       | (1,380                      | ) (800   | ) |
| Ending Balance  | \$23,930                    | \$22,569 |   |
| Annualized net loans charged-off: Average loans outstanding | 0.15                        | % 0.09   | % |

The allowance reflects management's estimate of loan loss reserves necessary to support the level of credit risk inherent in the portfolio during the period. Refer to "Credit Risk," "Asset Quality" and "Allowance for Loan Losses" contained in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," included in the Company's 2011 Annual Report on Form 10-K for additional information regarding the Company's credit risk management process and allowance for loan losses.

#### FDIC Deposit Insurance Assessment

The Company's deposit accounts are insured by the FDIC's Deposit Insurance Fund (the "DIF") up to the maximum amount provided by law. In order to restore the DIF reserves, the FDIC required all insured institutions to make a one-time prepayment, on December 30, 2009, of estimated insurance assessments for 2010, 2011 and 2012 based on the then current assessment methodology. At September 30, 2012, the Company carried the remaining balance of its prepaid assessment totaling approximately \$2.1 million as a prepaid asset on its balance sheet.

The FDIC has redefined its deposit insurance premium assessment base to be an institution's average consolidated total assets minus average tangible equity, as required by the Dodd-Frank Act, and revised its deposit insurance assessment rate schedule in light of this change to the assessment base. The revised rate schedule and other revisions to the assessment rules became effective on April 1, 2011 and have resulted in a decrease in the Company's deposit insurance expense. The FDIC retains the ability to impose additional special assessments or implement future changes to the

assessment rate, payment schedules or pursuant various aspects of the Dodd-Frank Act.



Table of Contents

## Deposits

Total deposits increased \$137.3 million, or 10%, compared to December 31, 2011, and increased \$124.9 million, or 9%, since September 30, 2011.

The following table sets forth the deposit balances by certain categories at the dates indicated and the percentage of each category to total deposits.

| (Dollars in thousands)               | September 30, 2012 |         | December 31, 2011 |         | September 30, 2011 |         |   |  |
|--------------------------------------|--------------------|---------|-------------------|---------|--------------------|---------|---|--|
|                                      | Amount             | Percent | Amount            | Percent | Amount             | Percent |   |  |
| Non-interest bearing demand deposits | \$375,924          | 25.6    | % \$309,930       | 23.3    | % \$277,886        | 20.6    | % |  |
| Interest bearing checking            | 189,963            | 12.9    | % 165,718         | 12.4    | % 178,799          | 13.3    | % |  |
| Total checking                       | 565,887            | 38.5    | % 475,648         | 35.7    | % 456,685          | 33.9    | % |  |
| Savings                              | 166,874            | 11.3    | % 141,289         | 10.6    | % 147,704          | 11.0    | % |  |
| Money markets                        | 490,655            | 33.4    | % 446,526         | 33.5    | % 465,922          | 34.6    | % |  |
| Total savings/money markets          | 657,529            | 44.7    | % 587,815         | 44.1    | % 613,626          | 45.6    | % |  |
| Certificates of deposit              | 247,010            | 16.8    | % 269,695         | 20.2    | % 275,177          | 20.5    | % |  |
| Total deposits                       | \$1,470,426        | 100.0   | % \$1,333,158     | 100.0   | % \$1,345,488      | 100.0   | % |  |

Deposit growth was noted across all non-term deposit products, primarily non-interest bearing accounts, which increased \$66.0 million, or 21%, since December 31, 2011. The deposit growth is primarily attributed to a general inflow of funds into the deposit marketplace due to economic uncertainties and low returns on other investment options available to deposit customers as well as customers seeking an alternative to larger regional and national banks.

The Company had no brokered deposits at September 30, 2012, December 31, 2011, or September 30, 2011.

## Borrowed Funds

Borrowed funds consisted of FHLB borrowings of \$3.0 million at September 30, 2012, compared to \$4.5 million at both December 31, 2011 and September 30, 2011, respectively.

Borrowed funds decreased \$1.5 million since December 31, 2011. Outstanding FHLB borrowing balances at September 30, 2012, December 31, 2011 and September 30, 2011 represented term advances, linked to outstanding commercial loans, under various community investment programs of the FHLB.

At September 30, 2012, the Bank had the capacity to borrow additional funds from the FHLB of up to approximately \$203.1 million and capacity to borrow from the FRB Discount window of approximately \$52.9 million.

The Company also had \$10.8 million of outstanding junior subordinated debentures at September 30, 2012, December 31, 2011 and September 30, 2011, respectively, in addition to the borrowed funds noted above.

## Liquidity

Liquidity is the ability to meet cash needs arising from, among other things, fluctuations in loans, investments, deposits and borrowings. Liquidity management is the coordination of activities so that cash needs are anticipated and met readily and efficiently. The Company's liquidity policies are set and monitored by the Company's Asset-Liability

Committee of the Board of Directors. The Company's asset-liability objectives are to engage in sound balance sheet management strategies, maintain liquidity, provide and enhance access to a diverse and stable source of funds, provide competitively priced and attractive products to customers and conduct funding at a low cost relative to current market conditions. Funds gathered are used to support current commitments, to fund earning asset growth, and to take advantage of selected leverage opportunities.

The Company's liquidity is maintained by projecting cash needs, balancing maturing assets with maturing liabilities, monitoring various liquidity ratios, monitoring deposit flows, maintaining cash flow within the investment portfolio, and maintaining wholesale funding resources.

Table of Contents

The Company's wholesale funding sources primarily include borrowing capacity in the brokered deposit markets, at the FHLB, through the FRB Discount Window, and through fed fund purchase arrangements with correspondent banks. The Company's primary borrowing source is the FHLB, but the Company may choose to borrow from other established business partners.

From time to time, management may also utilize brokered deposits or purchase securities sold under agreements to repurchase ("repurchase agreements") as cost effective alternative wholesale funding sources for continued loan growth. Brokered deposits may be comprised of money market deposits placed into overnight brokered deposits and CDs placed into selected term deposits via nationwide networks in increments that are covered by FDIC insurance.

Management believes that the Company has adequate liquidity to meet its obligations. However, if, as a result of general economic conditions or other events these sources of external funding become restricted or are eliminated, the Company may not be able to raise adequate funds or may incur substantially higher funding costs or operating restrictions in order to raise the necessary funds to support the Company's operations and growth.

The Company currently funds earning assets primarily with deposits, FHLB borrowings, and earnings. The Company has in the past also issued junior subordinated debentures, utilized brokered deposits and other wholesale funding sources, and offered shares of the Company's common stock for sale to the general public, as most recently with the December 2009 offerings, in order to increase its liquidity.

Capital Resources

The Company believes its current capital is adequate to support ongoing operations. As of September 30, 2012, both the Company and the Bank qualify as "well capitalized" under applicable regulations of the Federal Reserve Board and the FDIC. To be categorized as "well capitalized," the Company and the Bank must maintain minimum Total Capital and Tier 1 Capital ratios of 10% and 6% respectively, and, in the case of the Bank, to qualify as "well capitalized," it must also maintain a leverage capital ratio (Tier 1 capital to average assets) of at least 5%.

The Company's actual capital amounts and ratios are presented as of September 30, 2012 in the table below. The Bank's capital amounts and ratios do not differ materially from the amounts and ratios presented for the Company.

| (Dollars in thousands)                   | Actual     |       | Minimum Capital<br>for Capital Adequacy<br>Purposes |       |              | Minimum Capital<br>To Be<br>Well Capitalized |    |  |
|--|------------|-------|---|-------|--------------|--|----|--|
|  | Amount     | Ratio | Amount  | Ratio | Amount       | Ratio  |    |  |
| Total Capital (to risk weighted assets)  | \$ 154,124 | 11.57 | % \$ 106,563  | 8.00  | % \$ 133,204 | 10.00  | %  |  |
| Tier 1 Capital (to risk weighted assets) | \$ 136,721 | 10.26 | % \$ 53,282   | 4.00  | % \$ 79,923  | 6.00   | %  |  |
| Tier 1 Capital (to average assets)       | \$ 136,721 | 8.58  | % \$ 63,774   | 4.00  | % \$ 79,718  | 5.00   | %* |  |

\* This requirement is reflected in the table merely for informational purposes with respect to the Bank, and does not apply to the Company.

The Company maintains a dividend reinvestment plan (the "DRP"). The DRP enables stockholders, at their discretion, to elect to reinvest cash dividends paid on their shares of the Company's common stock by purchasing additional shares of common stock from the Company at a purchase price equal to fair market value. Shareholders utilized the DRP to invest \$956 thousand of the \$3.2 million in cash dividends paid through September 30, 2012, into 61,557 shares of the Company's common stock.

As previously announced on October 16, 2012, the Company declared a quarterly dividend of \$0.11 per share to be paid on December 3, 2012 to shareholders of record as of November 12, 2012. The quarterly dividend represents a 4.8% increase over the 2011 dividend rate.

On June 7, 2012, the U.S. banking agencies requested comment on three proposed rules that, taken together, would establish an integrated regulatory capital framework implementing the Basel III regulatory capital reforms in the United States. As proposed, the U.S. implementation of Basel III would lead to significantly higher capital requirements and more restrictive leverage and liquidity ratios than those currently in place. If adopted as proposed, these new capital requirements would be phased in over time. Additionally, the U.S. implementation of Basel III proposes that, for banking organizations with less than \$15 billion in assets, the ability to treat trust preferred securities as Tier 1 capital would be phased out over a ten-year period. The comment period on these regulatory capital proposals recently ended on October 22, 2012 and the proposals could change significantly before finalization. The potential ultimate impact of the U.S. implementation of the proposed new capital and liquidity standards

Table of Contents

on the Company and the Bank is currently being reviewed. At this point we cannot determine the ultimate effect that any final regulations, if enacted, would have upon our earnings or financial position. In addition, important questions remain as to how the numerous capital and liquidity mandates of the Dodd-Frank Act will be integrated with the requirements of Basel III.

## Investment Assets Under Management

The Company provides a wide range of investment advisory and management services, including brokerage, trust, and investment management (together, “investment advisory services”). The market values of these components are affected by fluctuations in the financial markets.

Also included in the investment assets under management total are customers’ commercial sweep arrangements that are invested in third party money market mutual funds.

The following table sets forth the fair market value of investment assets under management by certain categories at the dates indicated.

| (Dollars in thousands)                      | September 30,<br>2012 | December 31,<br>2011 | September 30,<br>2011 |
|---|-----------------------|----------------------|-----------------------|
| Investment advisory and management services | \$465,415             | \$389,569            | \$364,205             |
| Brokerage and management services           | 108,744               | 108,190              | 100,929               |
| Total investment advisory assets            | 574,159               | 497,759              | 465,134               |
| Commercial sweep accounts                   | 4,759                 | 7,404                | 5,456                 |
| Investment assets under management          | \$578,918             | \$505,163            | \$470,590             |

Investment assets under management increased \$73.8 million, or 15%, since December 31, 2011 and \$108.3 million, or 23%, since September 30, 2011. The increase is attributable primarily to asset growth from new business and from market value appreciation.

Total assets under management, which includes total assets, investment assets under management, and loans serviced for others amounted to \$2.29 billion at September 30, 2012, \$2.06 billion at December 31, 2011, and \$2.03 billion at September 30, 2011.

## Results of Operations

## Three Months Ended September 30, 2012 vs. Three Months Ended September 30, 2011

Unless otherwise indicated, the reported results are for the three months ended September 30, 2012 with the “comparable period,” and “prior period” being the three months ended September 30, 2011. Average yields are presented on a tax equivalent basis.

The Company’s third quarter 2012 net income amounted to \$3.1 million compared to \$2.9 million for the same period in 2011, an increase of 4%. Diluted earnings per common share were \$0.32 and \$0.31 for the three months ended September 30, 2012 and September 30, 2011, respectively, an increase of 3%.

The Company's growth contributed to increases in net interest income and the level of operating expenses for the quarter ended September 30, 2012. In 2012, the provision for loan losses decreased compared to the 2011 periods, while non-interest income decreased mainly due to lower gains on security sales in the current year. The increase in the quarter pre-tax net income was partially offset by a higher tax rate in 2012, mainly due to higher taxable income in the current year.

#### Net Interest Income

The Company's net interest income for the quarter ended September 30, 2012 amounted to \$15.6 million, compared to \$14.7 million for the quarter ended September 30, 2011, an increase of \$909 thousand, or 6%. The increase in net interest income over the comparable period was primarily due to revenue generated from loan growth which has been funded through non-interest bearing deposits, partially offset by a decrease in tax equivalent net interest margin ("margin").

#### Net Interest Margin

The Company's margin was 4.20% for the three months ended September 30, 2012 compared to 4.31% and 4.39% for the

48

---

Table of Contents

quarters ended June 30, 2012 and December 31, 2011, respectively. For the quarter ended September 30, 2011, margin was 4.32%. Consistent with industry trends, the 2012 margin continues to trend downward, as the yield on interest earning assets has declined faster than the rate on cost of funds, which is approaching a floor. The margin was also impacted by an increase in lower yielding investments as a percent of interest earning assets in 2012 compared to the same period in 2011. This margin compression was partially offset by an increase in the average balance of non-interest bearing demand deposits.

## Rate / Volume Analysis

The following table sets forth the extent to which changes in interest rates and changes in the average balances of interest-earning assets and interest-bearing liabilities have affected interest income and expense during the three months ended September 30, 2012 compared to the three months ended September 30, 2011. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to: (1) volume (change in average portfolio balance multiplied by prior period average rate); (2) interest rate (change in average interest rate multiplied by prior period average balance); and (3) rate and volume (the remaining difference).

| (Dollars in thousands)   | Net<br>Change | Increase (decrease) due to |         |                 |
|--|---------------|----------------------------|---------|-----------------|
|  |               | Volume                     | Rate    | Rate/<br>Volume |
| Interest Income  |               |                            |         |                 |
| Loans  | \$246         | \$1,151                    | \$(795) | \$(110)         |
| Investments (1)  | 23            | 287                        | (180)   | (84)            |
| Total interest earnings assets                                 | 269           | 1,438                      | (975)   | (194)           |
| Interest Expense   |               |                            |         |                 |
| Int chkg, savings and money market                             | (352)         | ) 59                       | (394)   | ) (17)          |
| Certificates of deposit  | (278)         | ) (67)                     | ) (227) | ) 16            |
| Borrowed funds   | (10)          | ) (8)                      | ) (2)   | ) —             |
| Junior subordinated debentures                                 | —             | —                          | —       | —               |
| Total interest-bearing deposits, borrowed funds and debentures | (640)         | ) (16)                     | ) (623) | ) (1)           |
| Change in net interest income                                  | \$909         | \$1,454                    | \$(352) | \$(193)         |

(1) Investments include investment securities, dividends on FHLB stock, interest-earning deposits and fed funds.

Table of Contents

The following table presents the Company's average balance sheet, net interest income and average rates for the three months ended September 30, 2012 and 2011.

## AVERAGE BALANCES, INTEREST AND AVERAGE YIELDS

| (Dollars in thousands)                        | Three Months Ended<br>September 30, 2012 |          |                     | Three Months Ended<br>September 30, 2011 |          |                     |   |  |
|---|--|----------|---------------------|--|----------|---------------------|---|--|
|   | Average<br>Balance                       | Interest | Average<br>Yield(1) | Average<br>Balance                       | Interest | Average<br>Yield(1) |   |  |
| Assets:                                       |  |          |                     |  |          |                     |   |  |
| Loans (2)                                     | \$1,291,818                              | \$16,324 | 5.08                | % \$1,207,488                            | \$16,078 | 5.34                | % |  |
| Investments (3)                               | 229,292                                  | 858      | 1.91                | % 179,510                                | 835      | 2.31                | % |  |
| Total interest earnings assets                | 1,521,110                                | 17,182   | 4.61                | % 1,386,998                              | 16,913   | 4.95                | % |  |
| Other assets                                  | 88,129                                   |          |                     | 81,317                                   |          |                     |   |  |
| Total assets                                  | \$1,609,239                              |          |                     | \$1,468,315                              |          |                     |   |  |
| Liabilities and stockholders' equity:         |  |          |                     |  |          |                     |   |  |
| Int chkg, savings and money market            | \$828,263                                | 673      | 0.32                | % \$783,410                              | 1,025    | 0.52                | % |  |
| Certificates of deposit                       | 251,581                                  | 555      | 0.88                | % 273,792                                | 833      | 1.21                | % |  |
| Borrowed funds                                | 2,964                                    | 12       | 1.69                | % 4,689                                  | 22       | 1.81                | % |  |
| Junior subordinated debentures                | 10,825                                   | 294      | 10.88               | % 10,825                                 | 294      | 10.88               | % |  |
| Total interest-bearing funding                | 1,093,633                                | 1,534    | 0.56                | % 1,072,716                              | 2,174    | 0.80                | % |  |
| Net interest rate spread                      |  |          | 4.05                | %  |          | 4.15                | % |  |
| Demand deposits                               | 370,647                                  | —        |                     | 262,247                                  | —        |                     |   |  |
| Total deposits, borrowed funds and debentures | 1,464,280                                | 1,534    | 0.42                | % 1,334,963                              | 2,174    | 0.65                | % |  |
| Other liabilities                             | 9,885                                    |          |                     | 10,036                                   |          |                     |   |  |
| Total liabilities                             | 1,474,165                                |          |                     | 1,344,999                                |          |                     |   |  |
| Stockholders' equity                          | 135,074                                  |          |                     | 123,316                                  |          |                     |   |  |
| Total liabilities and stockholders' equity    | \$1,609,239                              |          |                     | \$1,468,315                              |          |                     |   |  |
| Net interest income                           |  | \$15,648 |                     |  | \$14,739 |                     |   |  |
| Net interest margin (tax equivalent)          |  |          | 4.20                | %  |          | 4.32                | % |  |

Average yields are presented on a tax equivalent basis. The tax equivalent effect associated with loans and (1) investments, which was not included in the interest amount above, was \$414 thousand and \$359 thousand for the quarters ended September 30, 2012 and September 30, 2011, respectively.

(2) Average loans include non-accrual loans and are net of average deferred loan fees.

(3) Average investments are presented at amortized cost and include investment securities, interest-earning deposits, fed funds sold and FHLB stock.

## Interest and Dividend Income



For the third quarter of 2012, total interest and dividend income amounted to \$17.2 million, an increase of \$269 thousand, or 2%, compared to the prior period. The increase resulted primarily from an increase of \$134.1 million, or 10%, in the average balance of interest earning assets for the quarter ended September 30, 2012 compared to the third quarter of 2011, primarily in loans, partially offset by a 34 basis point decline in the yield on interest earning assets due primarily to the lower interest rate environment during the period.

## Table of Contents

Interest income on loans, which accounts for the majority of interest income, amounted to \$16.3 million for the quarter ended September 30, 2012, an increase of \$246 thousand, or 2%, over the comparable period, due primarily to loan growth, partially offset by a decline in loan yields. The average loan balances increased \$84.3 million, or 7%, for the three months ended September 30, 2012 compared to the same period in 2011, while the average yield on loans declined 26 basis points compared to the prior period and amounted to 5.08% for the three months ended September 30, 2012.

Total investment income, which represents the remainder of interest income, amounted to \$858 thousand for the three months ended September 30, 2012, an increase of \$23 thousand, or 3%, compared to the prior period. The increase resulted from an increase of \$49.8 million, or 28%, in the average balance of investments for the third quarter of 2012 compared to the third quarter of 2011. The increase was partially offset by the impact of a 40 basis point decrease in the average yield on investment securities and fed funds sold as investments that were purchased had lower yields than investments that were sold, matured, or were called during the period. In 2012, investment purchases have been primarily in lower yielding, shorter term investments such as Federal Agency Obligations.

### Interest Expense

For the three months ended September 30, 2012, total interest expense amounted to \$1.5 million, a decrease of \$640 thousand, or 29%, compared to the prior period. The decrease resulted primarily from a 23 basis point decrease in the average cost of funding, due primarily to the reduction in deposit market interest rates over the period.

Interest expense on interest checking, savings and money market accounts amounted to \$673 thousand for the quarter ended September 30, 2012, a decrease of \$352 thousand, or 34%, compared to the same quarter in the prior period. The decrease primarily resulted from a decrease of 20 basis points in the average cost of these accounts to 0.32%, partially offset by an increase in average balances of \$44.9 million, or 6%, for the three months ended September 30, 2012 compared to the same period in 2011. Average balance increases were noted primarily in money market accounts.

Interest expense on CDs decreased \$278 thousand, or 33%, compared to the prior period and amounted to \$555 thousand for the three months ended September 30, 2012. The decrease was primarily due to a decline in market rates since the comparable period and the repricing of term CDs. The average cost of CDs decreased 33 basis points to 0.88%, for the three months ended September 30, 2012, and average balances of these CDs decreased \$22.2 million, or 8%, compared to the quarter ended September 30, 2011. The Company did not have any brokered CDs in the third quarter of 2012 or 2011.

Interest expense on borrowed funds, consisting primarily of FHLB borrowings, amounted to \$12 thousand for the third quarter of 2012, a decrease of \$10 thousand, or 45%, over the same period last year. The decrease was primarily attributed to the reduction in average balances of approximately \$1.7 million, or 37%, for the quarter ended September 30, 2012 compared to the same period in 2011.

The interest expense and average rate on junior subordinated debentures remained the same at \$294 thousand and 10.88% for both the three months ended September 30, 2012 and September 30, 2011.

For the three months ended September 30, 2012, the average balance of non-interest bearing demand deposits increased \$108.4 million, or 41%, as compared to the same period in 2011. Non-interest bearing demand deposits are an important component of the Company's core funding strategy. This non-interest bearing funding source represented 26% and 20% of total average deposit balances for the three months ended September 30, 2012 and 2011, respectively.

### Provision for Loan Loss

The provision for loan losses amounted to \$800 thousand for three months ended September 30, 2012 a decrease of \$1.0 million compared to the same period last year. The provision made to the allowance for loan losses takes into consideration the level of loan growth, adversely classified and non-performing loans, specific reserves for impaired loans, net charge-offs, and the estimated impact of current economic conditions on credit quality. For further discussion regarding the provision for loan losses and management's assessment of the adequacy of the allowance for loan losses see "Credit Risk," "Asset Quality" and "Allowance for Loan Losses" under "Financial Condition" in this Item 2 above and "Credit Risk," "Asset Quality" and "Allowance for Loan Losses" in the Financial Condition section of Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's 2011 Annual Report on Form 10-K.

There have been no material changes to the Company's underwriting practices or to the allowance for loan loss methodology used to estimate loan loss exposure as reported in the Company's Annual Report on Form 10-K for the year ended December 31, 2011. The provision for loan losses is a significant factor in the Company's operating results.

## Table of Contents

### Non-Interest Income

Non-interest income for the three months ended September 30, 2012 amounted to \$3.0 million, a decrease of \$225 thousand, or 7%, as compared to the three months ended September 30, 2011. The significant changes are discussed below.

Net gains on security sales for the three months ended September 30, 2012 decreased \$448 thousand, or 92%, compared to the comparable period in 2011. Investment sales are typically driven by market or strategic opportunities.

Gains on loan sales increased \$92 thousand, or 77%, to \$211 thousand for the three months ended September 30, 2012 primarily due to a higher volume of residential loan sales in the current year.

Other income increased \$139 thousand, or 35%, primarily due to increases in insurance commissions as a result of new business.

### Non-Interest Expense

Non-interest expense for the three months ended September 30, 2012 amounted to \$13.0 million, an increase of \$1.2 million, or 10%, compared to the same period in 2011. The significant changes are discussed below.

Salaries and employee benefits increased \$1.0 million, or 14%. The increase is primarily due to an increase in personnel costs necessary to support the Company's strategic growth initiatives, including annual salary adjustments, branch growth and incentives since the prior period.

Technology and telecommunications expenses increased \$163 thousand, or 17%, primarily as a result of investments to improve our service capabilities, support the Company's growth and enhance business continuity and network infrastructure.

Other expense decreased \$50 thousand, or 5%, primarily due to a decrease in OREO carry costs and workout loan expense, partially offset by an increase in expenses for outsourced services.

### Income Tax Expense

Income tax expense increased \$436 thousand, or 33%, due to higher taxable income in the current year.

### Results of Operations

#### Nine Months Ended September 30, 2012 vs. Nine Months Ended September 30, 2011

Unless otherwise indicated, the reported results are for the nine months ended September 30, 2012 with the "comparable period", "prior year" and "prior period" being the nine months ended September 30, 2011. Average yields are presented on a tax equivalent basis.

The Company's year-to-date 2012 net income amounted to \$9.1 million compared to \$8.1 million for the same period in 2011, an increase of \$1.1 million, or 13%. Diluted earnings per common share were \$0.95 for the nine months ended September 30, 2012 compared to \$0.86 for the comparable 2011 period, an increase of 10%.

The Company's growth contributed to increases in net interest income and the level of operating expenses for the year-to-date period ended September 30, 2012. In 2012, the provision for loan losses decreased compared to the 2011 period, while non-interest income decreased mainly due to lower gains on security sales in the current year. The increase in year-to-date pre-tax net income was partially offset by a higher tax rate in 2012, mainly due to higher taxable income in the current year.

#### Net Interest Income

The Company's net interest income for the nine months ended September 30, 2012 was \$46.0 million compared to \$43.0 million for the nine months ended September 30, 2011, an increase of \$3.0 million, or 7%. The increase in net interest income over the comparable year period was primarily due to revenue generated from loan growth, funded through non-interest bearing accounts, partially offset by a decrease in tax equivalent net interest margin.

Table of Contents

## Net Interest Margin

The Company's margin was 4.29% for the nine months ended September 30, 2012, compared to 4.36% in the comparable 2011 period. As previously noted, consistent with industry trends, the 2012 margin continues to trend downward, as the yield on interest earning assets has declined faster than the rate on cost of funds, which is approaching a floor. The margin was also impacted by an increase in lower yielding investments as a percent of interest earning assets in 2012 compared to the same period in 2011. This margin compression was partially offset by an increase in the average balance of non-interest bearing demand deposits.

## Rate / Volume Analysis

The following table sets forth the extent to which changes in interest rates and changes in the average balances of interest-earning assets and interest-bearing liabilities have affected interest income and expense during the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to: (1) volume (change in average portfolio balance multiplied by prior period average rate); (2) interest rate (change in average interest rate multiplied by prior period average balance); and (3) rate and volume (the remaining difference).

| (Dollars in thousands)   | Net<br>Change | Increase (decrease) due to |           |                 |
|--|---------------|----------------------------|-----------|-----------------|
|  |               | Volume                     | Rate      | Rate/<br>Volume |
| Interest Income  |               |                            |           |                 |
| Loans  | \$1,595       | \$3,884                    | \$(2,109) | \$(180)         |
| Investments (1)  | (193)         | ) 429                      | (499)     | ) (123)         |
| Total interest earnings assets                                 | 1,402         | 4,313                      | (2,608)   | ) (303)         |
| Interest Expense   |               |                            |           |                 |
| Int chkg, savings and money market                             | (881)         | ) 111                      | (924)     | ) (68)          |
| Certificates of deposit  | (662)         | ) (154)                    | ) (539)   | ) 31            |
| Borrowed funds   | (25)          | ) (22)                     | ) (5)     | ) 2             |
| Junior subordinated debentures                                 | —             | —                          | —         | —               |
| Total interest-bearing deposits, borrowed funds and debentures | (1,568)       | ) (65)                     | ) (1,468) | ) (35)          |
| Change in net interest income                                  | \$2,970       | \$4,378                    | \$(1,140) | \$(268)         |

(1) Investments include investment securities, FHLB stock and short-term investments.

Table of Contents

The following table presents the Company's average balance sheet, net interest income and average rates for the nine months ended September 30, 2012 and 2011.

## AVERAGE BALANCES, INTEREST AND AVERAGE YIELDS

| (Dollars in thousands)                        | Nine months ended September 30, 2012 |          |                  | Nine months ended September 30, 2011 |          |                  |   |
|---|--------------------------------------|----------|------------------|--------------------------------------|----------|------------------|---|
|   | Average Balance                      | Interest | Average Yield(1) | Average Balance                      | Interest | Average Yield(1) |   |
| Assets:                                       |                                      |          |                  |                                      |          |                  |   |
| Loans (2)                                     | \$1,267,935                          | \$48,510 | 5.17             | % \$1,172,217                        | \$46,915 | 5.40             | % |
| Investments (3)                               | 202,274                              | 2,535    | 2.13             | % 179,390                            | 2,728    | 2.51             | % |
| Total interest earnings assets                | 1,470,209                            | 51,045   | 4.75             | % 1,351,607                          | 49,643   | 5.02             | % |
| Other assets                                  | 86,956                               |          |                  | 80,255                               |          |                  |   |
| Total assets                                  | \$1,557,165                          |          |                  | \$1,431,862                          |          |                  |   |
| Liabilities and stockholders' equity:         |                                      |          |                  |                                      |          |                  |   |
| Int chkg, savings and money market            | \$799,681                            | 2,204    | 0.37             | % \$771,760                          | 3,085    | 0.53             | % |
| Certificates of deposit                       | 260,105                              | 1,929    | 0.99             | % 276,582                            | 2,591    | 1.25             | % |
| Borrowed funds                                | 3,382                                | 41       | 1.63             | % 5,474                              | 66       | 1.60             | % |
| Junior subordinated debentures                | 10,825                               | 883      | 10.88            | % 10,825                             | 883      | 10.88            | % |
| Total interest-bearing funding                | 1,073,993                            | 5,057    | 0.63             | % 1,064,641                          | 6,625    | 0.83             | % |
| Net interest rate spread                      |                                      |          | 4.12             | %                                    |          | 4.19             | % |
| Demand deposits                               | 340,999                              | —        |                  | 236,839                              | —        |                  |   |
| Total deposits, borrowed funds and debentures | 1,414,992                            | 5,057    | 0.48             | % 1,301,480                          | 6,625    | 0.68             | % |
| Other liabilities                             | 10,108                               |          |                  | 9,795                                |          |                  |   |
| Total liabilities                             | 1,425,100                            |          |                  | 1,311,275                            |          |                  |   |
| Stockholders' equity                          | 132,065                              |          |                  | 120,587                              |          |                  |   |
| Total liabilities and stockholders' equity    | \$1,557,165                          |          |                  | \$1,431,862                          |          |                  |   |
| Net interest income                           |                                      | \$45,988 |                  |                                      | \$43,018 |                  |   |
| Net interest margin (tax equivalent)          |                                      |          | 4.29             | %                                    |          | 4.36             | % |

Average yields are presented on a tax equivalent basis. The tax equivalent effect associated with loans and (1) investments, which was not included in the interest amount above, was \$1.2 million and \$1.1 million for the periods ended September 30, 2012 and September 30, 2011 respectively.

(2) Average loans include non-accrual loans and are net of average deferred loan fees.

(3) Average investment balances are presented at average amortized cost and include investment securities, interest-earning assets, fed funds sold, and FHLB stock.

## Interest and Dividend Income

Total interest and dividend income amounted to \$51.0 million for the nine months ended September 30, 2012, an increase of \$1.4 million, or 3%, compared to the prior period. The increase resulted primarily from an increase of \$118.6 million, or 9%, in the average balance of interest earning assets, partially offset by a 27 basis point decline in the yield on interest earning assets due to the lower interest rate environment during the period.

Interest income on loans, which accounts for the majority of interest income, amounted to \$48.5 million, an increase of \$1.6 million, or 3%, over the comparable period, due primarily to loan growth, partially offset by a decline in loan yields. The average loan balances increased \$95.7 million, or 8%, compared to the prior period, while the average yield on loans declined 23 basis points since the same period and amounted to 5.17% for the nine months ended September 30, 2012.



## Table of Contents

Total investment income, which represents the remainder of interest income, amounted to \$2.5 million for the nine months ended September 30, 2012, a decrease of \$193 thousand, or 7%, compared to the prior period. The decrease resulted primarily from the impact of a 38 basis point decrease in the average yield on investment securities and fed funds sold, as investments that were purchased had lower yields than investments that were sold, matured, or were called during the period. In 2012, investment purchases have been primarily in lower yielding, shorter term investments such as Federal Agency Obligations. This decrease in interest income was partially offset by a \$22.9 million, or 13%, increase in the average balances of investments over the comparable period.

### Interest Expense

For the nine months ended September 30, 2012, total interest expense amounted to \$5.1 million, a decrease of \$1.6 million, or 24%, compared to the prior period. The decrease resulted primarily from a 20 basis point decrease in the average cost of funding due to the reduction in deposit market interest rates over the period.

Interest expense on interest checking, savings and money market accounts amounted to \$2.2 million for the nine months ended September 30, 2012, a decrease of \$881 thousand, or 29%, over the same period in the prior year, resulting primarily from a decrease in the average cost of these accounts, partially offset by an increase in average balances. The average cost of these accounts decreased 16 basis points to 0.37%, while the average balances increased \$27.9 million, or 4%, compared to the prior period. Average balance increases were noted primarily in money market accounts.

Interest expense on CDs decreased \$662 thousand, or 26%, compared to the prior period and amounted to \$1.9 million for the nine months ended September 30, 2012. The decrease was primarily due to a decline in rates over the comparable period and to a lesser extent, the decline in the average balance of CDs, which decreased \$16.5 million, or 6%, compared to the previous period in 2011. As a result of market rate decreases and the repricing of term CDs, the average cost of CDs decreased 26 basis points, to 0.99%, for the nine month period ended September 30, 2012. The Company did not have any brokered CD balances in the nine months ended September 30, 2012 or 2011.

Interest expense on borrowed funds, consisting primarily of FHLB borrowings, amounted to \$41 thousand, a decrease of \$25 thousand, or 38%, compared to the same period last year. The decrease was primarily attributed to the reduction in average balances of approximately \$2.1 million, or 38%, compared to the prior period.

The interest expense and average rate on junior subordinated debentures remained the same at \$883 thousand and 10.88% for both the nine months ended September 30, 2012 and September 30, 2011.

For the nine months ended September 30, 2012, the average balance of non-interest bearing demand deposits, increased \$104.2 million, or 44%, as compared to the same period in 2011. Non-interest bearing demand deposits are an important component of the Company's core funding strategy. This non-interest bearing funding represented 24% and 18% of total average deposit balances for the nine months ended September 30, 2012 and 2011, respectively.

### Provision for Loan Loss

The provision for loan losses amounted to \$2.2 million for the nine months ended September 30, 2012, a decrease of \$1.8 million compared to the same period last year. The provision made to the allowance for loan losses takes into consideration the level of loan growth, adversely classified and non-performing loans, specific reserves for impaired loans, net charge-offs, and the estimated impact of current economic conditions on credit quality. For further discussion regarding the provision for loan losses and management's assessment of the adequacy of the allowance for loan losses see "Credit Risk," "Asset Quality" and "Allowance for Loan Losses" under "Financial Condition" in this Item 2 above and "Credit Risk," "Asset Quality" and "Allowance for Loan Losses" in the Financial Condition section of

Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's 2011 Annual Report on Form 10-K.

There have been no material changes to the Company's underwriting practices or to the allowance for loan loss methodology used to estimate loan loss exposure as reported in the Company's Annual Report on Form 10-K for the year ended December 31, 2011. The provision for loan losses is a significant factor in the Company's operating results.

#### Non-Interest Income

Non-interest income for the nine months ended September 30, 2012 amounted to \$8.9 million, a decrease of \$80 thousand, or 1%, as compared to the nine months ended September 30, 2011. The significant changes are discussed below.

## Table of Contents

Net gains on security sales for the nine months ended September 30, 2012 decreased \$550 thousand, or 74%, compared to the prior year. Investment sales are typically driven by market or strategic opportunities.

Net gain on loan sales increased \$266 thousand, or 66%, for the nine months ended September 30, 2012 when compared to the same period in 2011, primarily due to a higher volume of residential loan sales in the current year.

The increase in other income of \$225 thousand, or 18%, is primarily due to increases in insurance commissions, loan fees and net gains on OREO sales.

### Non-Interest Expense

Non-interest expense for the nine months ended September 30, 2012 amounted to \$38.8 million, an increase of \$2.7 million, or 7%, compared to the same period in 2011. The significant changes are discussed below.

Salaries and employee benefits increased \$2.3 million, or 11%. The increase was primarily due to the personnel and benefit costs necessary to support the Company's strategic growth initiatives including annual salary adjustments, new branches, incentives, and an increase in health insurance rates since the prior period.

Occupancy and equipment expenses increased \$97 thousand, or 2%, primarily due to branch expansion and investments in facilities.

Technology and telecommunications expense increased \$305 thousand, or 11%, primarily as a result of investments to improve our service capabilities, support the Company's growth and enhance business continuity and network infrastructure.

For the nine months ended September 30, 2012, deposit insurance premiums decreased \$206 thousand, or 20%, resulting from changes made by the FDIC (effective April 1, 2011) in their deposit insurance assessment methodology in order to put more of the insurance fund burden on higher risk institutions.

Audit, legal, and other professional fees increased \$303 thousand, or 30%, primarily due to increases in legal expenses and consulting costs including process improvement reviews in 2012.

Other non-interest expense decreased \$47 thousand, or 2%, due to decreases in OREO carry costs and workout loan expenses and outsourced services, partially offset by increases in training expense and ATM rebates.

### Tax Expense

Tax expense increased \$936 thousand, or 24%, mainly due to higher taxable income in the current year.

## Item 3 - Quantitative and Qualitative Disclosures About Market Risk

The Company's primary market risk is interest rate risk. Oversight of interest rate risk management is centered on the Asset-Liability Committee ("ALCO"). ALCO is comprised of five outside directors of the Company and three executive officers of the Company, who are also members of the Board of Directors. In addition, several directors who are not on ALCO rotate in on a regular basis. Annually, ALCO reviews and approves the Company's asset-liability management policy, which provides management with guidelines for controlling interest rate risk, as measured through net interest income sensitivity to changes in interest rates, within certain tolerance levels. ALCO also establishes and monitors guidelines for the Company's liquidity and capital ratios.

The Company's asset-liability management strategies and guidelines are reviewed on a periodic basis by management and presented and discussed with ALCO on at least a quarterly basis. These strategies and guidelines are revised based on changes in interest rate levels, general economic conditions, competition in the marketplace, the current interest rate risk position of the Company, anticipated growth and other factors.

One of the principal factors in maintaining planned levels of net interest income is the ability to design effective strategies to manage the impact of interest rate changes on future net interest income. Quarterly, management completes a net interest income sensitivity analysis, which is presented to the committee. This analysis includes a simulation of the Company's net interest income under various interest rate scenarios. Variations in the interest rate environment affect numerous factors,

## Table of Contents

including prepayment speeds, reinvestment rates, maturities of investments (due to call provisions), and interest rates on various asset and liability accounts.

The Company can be subject to net interest margin (“margin”) compression depending on the economic environment and the shape of the yield curve. Under the Company’s current balance sheet position, the Company’s margin generally performs slightly better over time in a rising rate environment, while it generally decreases in a declining rate environment and when the yield curve is flattening or inverted.

Under a flattening yield curve scenario, margin compression occurs as the spread between the cost of funding and the yield on interest earning assets narrows. Under this scenario the degree of margin compression is highly dependent on the Company’s ability to fund asset growth through lower cost deposits. However, if the curve is flattening, while short-term rates are rising, the adverse impact on margin may be somewhat delayed, as increases in the Prime Rate will initially result in the Company’s asset yields re-pricing more quickly than funding costs.

Under an inverted yield curve situation, shorter-term rates exceed longer-term rates, and the impact on margin is similar but more adverse than the flat curve scenario. Again, however, the extent of the impact on margin is highly dependent on the Company’s balance sheet mix.

In a declining rate environment, margin compression will eventually occur as the yield on interest earning assets decreases more rapidly than decreases in funding costs. The primary causes would be the impact of interest rate decreases (including decreases in the Prime Rate) on adjustable rate loans and the fact that decreases in deposit rates may be limited or lag decreases in the Prime Rate.

Net interest margin in 2012 continues to trend downward as the yield on interest earning assets has declined faster than the rate on cost of funds, which is approaching a floor. Additional margin compression may occur if loans continue to re-price downward while the cost of deposits remains at the same level.

There have been no material changes in the results of the Company’s net interest income sensitivity analysis as reported in the Company’s Annual Report on Form 10-K for the year ended December 31, 2011. At September 30, 2012, management continues to consider the Company’s primary interest rate risk exposure to be margin compression that may result from changes in interest rates and/or changes in the mix of the Company’s balance sheet components. This would include the mix of fixed versus variable rate loans and investments on the asset side, and higher cost versus lower cost deposits and overnight borrowings versus term borrowings and certificates of deposit on the liability side.

## Item 4 - Controls and Procedures

### Evaluation of Disclosure Controls and Procedures

The Company maintains a set of disclosure controls and procedures and internal controls designed to ensure that the information required to be disclosed in reports that it files or submits to the United States Securities and Exchange Commission (the “SEC”) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms.

The Company carried out an evaluation as of the end of the period covered by this report under the supervision and with the participation of the Company’s management, including its principal executive officer and principal financial officer, of the effectiveness of the design and operation of the Company’s disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(b). Based upon that evaluation, the Company’s principal executive officer and principal financial officer concluded that the Company’s disclosure controls and procedures are effective as of September 30, 2012.

Changes in Internal Control over Financial Reporting

There has been no change in the Company's internal control over financial reporting that has occurred during the Company's most recent fiscal quarter (i.e., the three months ended September 30, 2012) that has materially affected, or is reasonably likely to materially affect, such internal controls.

Table of Contents

PART II - OTHER INFORMATION

Item 1 - Legal Proceedings

There are no material pending legal proceedings to which the Company or its subsidiaries are a party or to which any of its property is subject, other than ordinary routine litigation incidental to the business of the Company. After review with legal counsel, management does not believe resolution of any present litigation will have a material adverse effect on the consolidated financial condition or results of operations of the Company.

Item 1A - Risk Factors

Management believes that there have been no material changes in the Company's risk factors as reported in the Annual Report on Form 10-K for the year ended December 31, 2011.

Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds

The Company has not sold any equity securities that were not registered under the Securities Act of 1933, as amended, during the three months ended September 30, 2012. Neither the Company nor any "affiliated purchaser" (as defined in the SEC's Rule 10b-18(a)(3)) has repurchased any of the Company's outstanding shares, nor caused any such shares to be repurchased on its behalf, during the three months ended September 30, 2012.

Item 3 - Defaults upon Senior Securities

Not Applicable

Item 4 - Mine Safety Disclosures

Not Applicable

Item 5 - Other Information

Not Applicable

Table of Contents

Item 6 - Exhibits

EXHIBIT INDEX

---

Exhibit No. Description

31.1\*Certification of Principal Executive Officer under Securities Exchange Act Rule 13a-14(a)

31.2\*Certification of Principal Financial Officer under Securities Exchange Act Rule 13a-14(a)

32\* Certification of Principal Executive Officer and Principal Financial Officer under 18 U.S.C. § 1350 Furnished Pursuant to Securities Exchange Act Rule 13a-14(b)

The following materials from Enterprise Bancorp, Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2012 were formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Balance Sheets as of September 30, 2012 and December 31, 2011, (ii) Consolidated Statements of Income for the three and nine months ended September 30, 2012 and 2011, (iii) Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2012 and 2011, (iv) Consolidated Statements of Changes in Equity for the nine months ended September 30, 2012, (v) Consolidated Statements of Cash Flows for the nine months ended September 30, 2012 and 2011 and (vi) Notes to Unaudited Consolidated Financial Statements. (Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purpose of Section 11 or 12 of the Securities Act of 1933, as amended, or Section 18 of the Exchange Act and otherwise are not subjected to liability under these sections.)

---

\*Filed herewith

59

---



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.

ENTERPRISE BANCORP, INC.

DATE: November 9, 2012

By: /s/ James A. Marcotte  
James A. Marcotte  
Executive Vice President,  
Chief Financial Officer and Treasurer  
(Principal Financial Officer)