

FIRST BANCORP /NC/  
Form 10-Q  
May 12, 2014

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 March 31, 2014

Commission File Number 0-15572

**FIRST BANCORP**

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(Exact Name of Registrant as Specified in its Charter)

North Carolina  
(State or Other Jurisdiction of  
Incorporation or Organization)

56-1421916  
(I.R.S. Employer  
Identification Number)

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300 SW Broad St., Southern Pines, North Carolina 28387  
(Address of Principal Executive Offices) (Zip Code)

(Registrant's telephone number, including area code) (910) 246-2500

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 twelve 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 website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  YES  NO

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer  Smaller Reporting Company

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

The number of shares of the registrant's Common Stock outstanding on April 30, 2014 was 19,695,316.

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**FIRST BANCORP AND SUBSIDIARIES**

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**FORWARD-LOOKING STATEMENTS**

Part I of this report contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and the Private Securities Litigation Reform Act of 1995, which statements are inherently subject to risks and uncertainties. Forward-looking statements are statements that include projections, predictions, expectations or beliefs about future events or results or otherwise are not statements of historical fact. Further, forward-looking statements are intended to speak only as of the date made. Such statements are often characterized by the use of qualifying words (and their derivatives) such as “expect,” “believe,” “estimate,” “plan,” “project,” or other statements concerning our opinions or judgment about future events. Our actual results may differ materially from those anticipated in any forward-looking statements, as they will depend on many factors about which we are unsure, including many factors which are beyond our control. Factors that could influence the accuracy of such forward-looking statements include, but are not limited to, the financial success or changing strategies of our customers, our level of success in integrating acquisitions, actions of government regulators, the level of market interest rates, and general economic conditions. For additional information about factors that could affect the matters discussed in this paragraph, see the “Risk Factors” section of our 2013 Annual Report on Form 10-K.

Index**Part I. Financial Information**

## Item 1 - Financial Statements

**First Bancorp and Subsidiaries****Consolidated Balance Sheets**

|   | March 31,<br>2014 | December<br>31,<br>2013<br>(audited) | March 31,<br>2013 |
|---|-------------------|--------------------------------------|-------------------|
| <i>(\$ in thousands-unaudited)</i>  |                   |                                      |                   |
| <b>ASSETS</b>   |                   |                                      |                   |
| Cash and due from banks, noninterest-bearing                                  | \$219,779         | 83,881                               | 73,205            |
| Due from banks, interest-bearing  | 163,489           | 136,644                              | 242,890           |
| Federal funds sold  | 821               | 2,749                                | 249               |
| Total cash and cash equivalents   | 384,089           | 223,274                              | 316,344           |
| Securities available for sale   | 180,190           | 173,041                              | 170,214           |
| Securities held to maturity (fair values of \$57,192, \$56,700, and \$60,758) | 53,937            | 53,995                               | 55,649            |
| Presold mortgages in process of settlement                                    | 4,587             | 5,422                                | 4,584             |
| Loans – non-covered   | 2,256,726         | 2,252,885                            | 2,132,683         |
| Loans – covered by FDIC loss share agreement                                  | 190,551           | 210,309                              | 263,468           |
| Total loans   | 2,447,277         | 2,463,194                            | 2,396,151         |
| Allowance for loan losses – non-covered                                       | (44,706 )         | (44,263 )                            | (44,761 )         |
| Allowance for loan losses – covered   | (3,421 )          | (4,242 )                             | (5,028 )          |
| Total allowance for loan losses   | (48,127 )         | (48,505 )                            | (49,789 )         |
| Net loans   | 2,399,150         | 2,414,689                            | 2,346,362         |
| Premises and equipment  | 76,970            | 77,448                               | 77,823            |
| Accrued interest receivable   | 8,990             | 9,649                                | 9,737             |
| FDIC indemnification asset  | 35,504            | 48,622                               | 100,594           |
| Goodwill  | 65,835            | 65,835                               | 65,835            |
| Other intangible assets   | 2,640             | 2,834                                | 3,495             |
| Foreclosed real estate – non-covered  | 11,740            | 12,251                               | 20,115            |
| Foreclosed real estate – covered  | 19,504            | 24,497                               | 30,156            |
| Bank-owned life insurance   | 44,367            | 44,040                               | 28,065            |
| Other assets  | 27,320            | 29,473                               | 51,972            |
| Total assets  | \$3,314,823       | 3,185,070                            | 3,280,945         |
| <b>LIABILITIES</b>  |                   |                                      |                   |
| Deposits: Noninterest bearing checking accounts                               | \$511,612         | 482,650                              | 429,202           |
| Interest bearing checking accounts  | 550,702           | 557,413                              | 539,270           |
| Money market accounts   | 557,346           | 551,335                              | 575,766           |

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|                                    |           |           |           |
|------------------------------------|-----------|-----------|-----------|
| Savings accounts                   | 177,744   | 169,023   | 166,510   |
| Time deposits of \$100,000 or more | 584,481   | 564,527   | 649,714   |
| Other time deposits                | 404,839   | 426,071   | 497,105   |
| Total deposits                     | 2,786,724 | 2,751,019 | 2,857,567 |
| Borrowings                         | 136,394   | 46,394    | 46,394    |
| Accrued interest payable           | 758       | 879       | 1,118     |
| Other liabilities                  | 14,860    | 14,856    | 18,634    |
| Total liabilities                  | 2,938,736 | 2,813,148 | 2,923,713 |

Commitments and contingencies

SHAREHOLDERS' EQUITY

|   |             |           |           |
|---|-------------|-----------|-----------|
| Preferred stock, no par value per share. Authorized: 5,000,000 shares             |             |           |           |
| Series B issued & outstanding: 63,500, 63,500, and 63,500 shares                  | 63,500      | 63,500    | 63,500    |
| Series C, convertible, issued & outstanding: 728,706, 728,706, and 728,706 shares | 7,287       | 7,287     | 7,287     |
| Common stock, no par value per share. Authorized: 40,000,000 shares               |             |           |           |
| Issued & outstanding: 19,695,316, 19,679,659, and 19,669,302 shares               | 132,215     | 132,099   | 131,896   |
| Retained earnings   | 171,021     | 167,136   | 154,911   |
| Accumulated other comprehensive income (loss)                                     | 2,064       | 1,900     | (362)     |
| Total shareholders' equity  | 376,087     | 371,922   | 357,232   |
| Total liabilities and shareholders' equity  | \$3,314,823 | 3,185,070 | 3,280,945 |

*See accompanying notes to consolidated financial statements.*

Index**First Bancorp and Subsidiaries****Consolidated Statements of Income**

| (\$ in thousands, except share data-unaudited)             | Three Months Ended |          |
|--|--------------------|----------|
|  | March 31,<br>2014  | 2013     |
| <b>INTEREST INCOME</b>                                     |                    |          |
| Interest and fees on loans                                 | \$36,086           | 33,551   |
| Interest on investment securities:                         |                    |          |
| Taxable interest income                                    | 1,001              | 905      |
| Tax-exempt interest income                                 | 470                | 479      |
| Other, principally overnight investments                   | 119                | 154      |
| Total interest income                                      | 37,676             | 35,089   |
| <b>INTEREST EXPENSE</b>                                    |                    |          |
| Savings, checking and money market accounts                | 252                | 510      |
| Time deposits of \$100,000 or more                         | 1,183              | 1,613    |
| Other time deposits  | 456                | 789      |
| Borrowings   | 250                | 256      |
| Total interest expense                                     | 2,141              | 3,168    |
| Net interest income  | 35,535             | 31,921   |
| Provision for loan losses – non-covered                    | 3,365              | 5,771    |
| Provision for loan losses – covered                        | 210                | 5,378    |
| Total provision for loan losses                            | 3,575              | 11,149   |
| Net interest income after provision for loan losses        | 31,960             | 20,772   |
| <b>NONINTEREST INCOME</b>                                  |                    |          |
| Service charges on deposit accounts                        | 3,573              | 2,935    |
| Other service charges, commissions and fees                | 2,367              | 2,175    |
| Fees from presold mortgage loans                           | 607                | 747      |
| Commissions from sales of insurance and financial products | 594                | 399      |
| Bank-owned life insurance income                           | 327                | 208      |
| Foreclosed property gains (losses) – non-covered           | (156               | ) 758    |
| Foreclosed property gains (losses) – covered               | (2,117             | ) (4,616 |
| FDIC indemnification asset income (expense), net           | (4,916             | ) 4,897  |
| Other gains (losses)                                       | 19                 | (395     |
| Total noninterest income                                   | 298                | 7,108    |
| <b>NONINTEREST EXPENSES</b>                                |                    |          |
| Salaries   | 11,648             | 10,677   |
| Employee benefits  | 2,311              | 2,627    |
| Total personnel expense                                    | 13,959             | 13,304   |
| Net occupancy expense                                      | 1,880              | 1,674    |
| Equipment related expenses                                 | 928                | 1,088    |
| Intangibles amortization                                   | 194                | 199      |

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|   |            |            |
|---|------------|------------|
| Other operating expenses                    | 6,590      | 6,959      |
| Total noninterest expenses                  | 23,551     | 23,224     |
| Income before income taxes                  | 8,707      | 4,656      |
| Income tax expense                          | 3,031      | 1,556      |
| Net income                                  | 5,676      | 3,100      |
| Preferred stock dividends                   | (217 )     | (245 )     |
| Net income available to common shareholders | \$5,459    | 2,855      |
| Earnings per common share:                  |            |            |
| Basic                                       | \$0.28     | 0.15       |
| Diluted                                     | 0.27       | 0.14       |
| Dividends declared per common share         | \$0.08     | 0.08       |
| Weighted average common shares outstanding: |            |            |
| Basic                                       | 19,688,183 | 19,669,302 |
| Diluted                                     | 20,424,475 | 20,409,760 |

*See accompanying notes to consolidated financial statements.*



Index**First Bancorp and Subsidiaries****Consolidated Statements of Comprehensive Income**

| (\$ in thousands-unaudited)   | Three Months Ended |        |
|---|--------------------|--------|
|   | March 31,<br>2014  | 2013   |
| Net income  | \$ 5,676           | 3,100  |
| Other comprehensive income (loss):                                  |                    |        |
| Unrealized gains (losses) on securities available for sale:         |                    |        |
| Unrealized holding gains (losses) arising during the period, pretax | 303                | (308 ) |
| Tax (expense) benefit   | (118 )             | 120    |
| Postretirement Plans:   |                    |        |
| Amortization of unrecognized net actuarial (gain) loss              | (54 )              | 3      |
| Tax expense (benefit)   | 33                 | (1 )   |
| Other comprehensive income (loss)                                   | 164                | (186 ) |
| Comprehensive income  | \$ 5,840           | 2,914  |

*See accompanying notes to consolidated financial statements.*

Index**First Bancorp and Subsidiaries****Consolidated Statements of Shareholders' Equity**

| (In thousands, except per share - unaudited)      | Preferred | Common Stock |           | Retained | Accumulated   | Total    |
|---|-----------|--------------|-----------|----------|---------------|----------|
|   | Stock     | Shares       | Amount    | Earnings | Other         | Share-   |
|   |           |              |           |          | Comprehensive | holders' |
|   |           |              |           |          | Income        | Equity   |
|   |           |              |           |          | (Loss)        |          |
| Balances, January 1, 2013                         | \$70,787  | 19,669       | \$131,877 | 153,629  | (176 )        | 356,117  |
| Net income  |           |              |           | 3,100    |               | 3,100    |
| Cash dividends declared (\$0.08 per common share) |           |              |           | (1,573 ) |               | (1,573 ) |
| Preferred dividends                               |           |              |           | (245 )   |               | (245 )   |
| Stock-based compensation                          |           | —            | 19        |          |               | 19       |
| Other comprehensive income (loss)                 |           |              |           |          | (186 )        | (186 )   |
| Balances, March 31, 2013                          | \$70,787  | 19,669       | \$131,896 | 154,911  | (362 )        | 357,232  |
| Balances, January 1, 2014                         | \$70,787  | 19,680       | \$132,099 | 167,136  | 1,900         | 371,922  |
| Net income  |           |              |           | 5,676    |               | 5,676    |
| Cash dividends declared (\$0.08 per common share) |           |              |           | (1,574 ) |               | (1,574 ) |
| Preferred dividends                               |           |              |           | (217 )   |               | (217 )   |
| Stock-based compensation                          |           | 15           | 116       |          |               | 116      |
| Other comprehensive income (loss)                 |           |              |           |          | 164           | 164      |
| Balances, March 31, 2014                          | \$70,787  | 19,695       | \$132,215 | 171,021  | 2,064         | 376,087  |

*See accompanying notes to consolidated financial statements.*

Index**First Bancorp and Subsidiaries****Consolidated Statements of Cash Flows**

|  | Three Months<br>Ended<br>March 31, |               |
|--|------------------------------------|---------------|
| (\$ in thousands-unaudited)  | 2014                               | 2013          |
| <b>Cash Flows From Operating Activities</b>                                |                                    |               |
| Net income   | \$5,676                            | 3,100         |
| Reconciliation of net income to net cash provided by operating activities: |                                    |               |
| Provision for loan losses  | 3,575                              | 11,149        |
| Net security premium amortization  | 493                                | 620           |
| Purchase accounting accretion and amortization, net                        | (6,362 )                           | (3,551 )      |
| Foreclosed property losses and write-downs, net                            | 2,273                              | 3,858         |
| Other losses (gains)   | (19 )                              | 395           |
| Decrease in net deferred loan costs  | 169                                | 1             |
| Depreciation of premises and equipment                                     | 1,157                              | 1,121         |
| Stock-based compensation expense   | 23                                 | 19            |
| Amortization of intangible assets  | 194                                | 199           |
| Origination of presold mortgages in process of settlement                  | (19,110 )                          | (26,675 )     |
| Proceeds from sales of presold mortgages in process of settlement          | 20,073                             | 30,581        |
| Decrease in accrued interest receivable                                    | 659                                | 464           |
| Decrease (increase) in other assets  | 5,469                              | (3,233 )      |
| Decrease in accrued interest payable                                       | (121 )                             | (208 )        |
| Increase (decrease) in other liabilities                                   | 43                                 | (816 )        |
| Net cash provided by operating activities                                  | 14,192                             | 17,024        |
| <b>Cash Flows From Investing Activities</b>                                |                                    |               |
| Purchases of securities available for sale                                 | (13,474 )                          | (13,084 )     |
| Proceeds from maturities/issuer calls of securities available for sale     | 6,194                              | 9,359         |
| Proceeds from maturities/issuer calls of securities held to maturity       | —                                  | 350           |
| Net decrease (increase) in loans   | 13,646                             | (13,713 )     |
| Proceeds from FDIC loss share agreements                                   | 9,384                              | 6,899         |
| Proceeds from sales of foreclosed real estate                              | 7,739                              | 25,669        |
| Purchases of premises and equipment  | (783 )                             | (3,152 )      |
| Proceeds from loans held for sale  | —                                  | 30,393        |
| Net cash received in acquisition   | —                                  | 38,315        |
| Net cash provided by investing activities                                  | 22,706                             | 81,036        |
| <b>Cash Flows From Financing Activities</b>                                |                                    |               |
| Net increase (decrease) in deposits  | 35,708                             | (21,118 )     |
| Net increase in borrowings   | 90,000                             | —             |
| Cash dividends paid – common stock   | (1,574 )                           | (1,573 )      |
| Cash dividends paid – preferred stock                                      | (217 )                             | (532 )        |
| Net cash provided (used) by financing activities                           | 123,917                            | (23,223 )     |
| <b>Increase in cash and cash equivalents</b>                               | <b>160,815</b>                     | <b>74,837</b> |

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|   |           |         |
|---|-----------|---------|
| Cash and cash equivalents, beginning of period                        | 223,274   | 241,507 |
| Cash and cash equivalents, end of period                              | \$384,089 | 316,344 |
| Supplemental Disclosures of Cash Flow Information:                    |           |         |
| Cash paid during the period for:                                      |           |         |
| Interest  | \$2,262   | 3,322   |
| Income taxes  | —         | —       |
| Non-cash transactions:  |           |         |
| Unrealized gain (loss) on securities available for sale, net of taxes | 185       | (188 )  |
| Foreclosed loans transferred to other real estate                     | 4,508     | 3,354   |

*See accompanying notes to consolidated financial statements.*

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**First Bancorp and Subsidiaries**

**Notes to Consolidated Financial Statements**

*(unaudited)* For the Periods Ended March 31, 2014 and 2013

Note 1 - Basis of Presentation

In the opinion of the Company, the accompanying unaudited consolidated financial statements contain all adjustments necessary to present fairly the consolidated financial position of the Company as of March 31, 2014 and 2013 and the consolidated results of operations and consolidated cash flows for the periods ended March 31, 2014 and 2013. All such adjustments were of a normal, recurring nature. Reference is made to the 2013 Annual Report on Form 10-K filed with the SEC for a discussion of accounting policies and other relevant information with respect to the financial statements. The results of operations for the periods ended March 31, 2014 and 2013 are not necessarily indicative of the results to be expected for the full year. The Company has evaluated all subsequent events through the date the financial statements were issued.

Note 2 – Accounting Policies

Note 1 to the 2013 Annual Report on Form 10-K filed with the SEC contains a description of the accounting policies followed by the Company and discussion of recent accounting pronouncements. The following paragraphs update that information as necessary.

In July 2013, the FASB issued guidance to eliminate the diversity in practice regarding presentation of unrecognized tax benefits in the statement of financial position. Under the clarified guidance, an unrecognized tax benefit, or a portion of an unrecognized tax benefit, will be presented in the financial statements as a reduction to a deferred tax asset unless certain criteria are met. The requirements should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. The amendments became effective for the Company for reporting periods beginning after December 15, 2013 and did not have a material effect on its financial statements.

In January 2014, the FASB amended the Investments—Equity Method and Joint Ventures topic to address accounting for investments in qualified affordable housing projects. If certain conditions are met, the amendments permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects by amortizing the initial cost of the investment in proportion to the tax credits and other tax benefits

received and recognizing the net investment performance in the income statement as a component of income tax expense (benefit). If those conditions are not met, the investment should be accounted for as an equity method investment or a cost method investment in accordance with existing accounting guidance. The amendments will be effective for the Company for interim and annual reporting periods beginning after December 15, 2014 and should be applied retrospectively for all periods presented. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

In January 2014, the FASB amended the Receivables – Troubled Debt Restructurings by Creditors subtopic to address the reclassification of consumer mortgage loans collateralized by residential real estate upon foreclosure. The amendments clarify the criteria for concluding that an in substance repossession or foreclosure has occurred, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan. The amendments will be effective for the Company for interim and annual reporting periods beginning after December 15, 2014. Companies are allowed to use either a modified retrospective transition method or a prospective transition method when adopting this update. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

#### Note 3 – Reclassifications

Certain amounts reported in the period ended March 31, 2013 have been reclassified to conform to the presentation for March 31, 2014. These reclassifications had no effect on net income or shareholders' equity for the periods presented, nor did they materially impact trends in financial information.

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Note 4 – Equity-Based Compensation Plans

At March 31, 2014, the Company had the following equity-based compensation plans: the First Bancorp 2007 Equity Plan, the First Bancorp 2004 Stock Option Plan, and the First Bancorp 1994 Stock Option Plan. The Company's shareholders approved all equity-based compensation plans. The First Bancorp 2007 Equity Plan became effective upon the approval of shareholders on May 2, 2007. As of March 31, 2014, the First Bancorp 2007 Equity Plan was the only plan that had shares available for future grants.

The First Bancorp 2007 Equity Plan is intended to serve as a means to attract, retain and motivate key employees and directors and to associate the interests of the plans' participants with those of the Company and its shareholders. The First Bancorp 2007 Equity Plan allows for both grants of stock options and other types of equity-based compensation, including stock appreciation rights, restricted stock, restricted performance stock, unrestricted stock, and performance units.

Recent equity grants to employees have either had performance vesting conditions, service vesting conditions, or both. Compensation expense for these grants is recorded over the various service periods based on the estimated number of equity grants that are probable to vest. No compensation cost is recognized for grants that do not vest and any previously recognized compensation cost will be reversed. As it relates to director equity grants, the Company grants common shares, valued at approximately \$16,000 to each non-employee director (currently 12 in total) in June of each year. Compensation expense associated with these director grants is recognized on the date of grant since there are no vesting conditions.

Pursuant to an employment agreement, the Company granted the chief executive officer 75,000 non-qualified stock options and 40,000 shares of restricted stock during the third quarter of 2012. The option award and the restricted stock award will vest in full on December 31, 2014 and December 31, 2015, respectively, if the Company achieves certain earnings targets for those years, and will be forfeited if the applicable targets are not achieved. Compensation expense for this grant will be recorded over the various periods based on the estimated number of options and restricted stock that are probable to vest. If the awards do not vest, no compensation cost will be recognized and any previously recognized compensation cost will be reversed. Based on current conditions, the Company has concluded that it is not probable that these awards will vest, and thus no compensation expense has been recorded.

Based on the Company's performance in 2013, the Company granted long-term restricted shares of common stock to the chief executive officer on February 11, 2014 with a two year minimum vesting period. The total compensation expense associated with this grant was \$278,200 and the grant will fully vest on January 1, 2016. One third of this value was expensed during 2013. The Company recorded \$23,200 in compensation expense during the three months ended March 31, 2014 and expects to record \$23,200 in compensation expense each quarter thereafter until the award vests.

The Company granted long-term restricted shares of common stock to certain senior executives on February 23, 2012 with a two year minimum vesting period. The total compensation expense associated with this grant was \$58,900 and the grant fully vested on February 23, 2014. The Company recorded \$600 and \$11,200 in compensation expense related to this grant during the three months ended March, 31, 2014 and 2013, respectively.

Under the terms of the Predecessor Plans and the First Bancorp 2007 Equity Plan, options can have a term of no longer than ten years, and all options granted thus far under these plans have had a term of ten years. The Company's options provide for immediate vesting if there is a change in control (as defined in the plans).

At March 31, 2014, there were 463,102 options outstanding related to the three First Bancorp plans, with exercise prices ranging from \$9.76 to \$22.12. At March 31, 2014, there were 745,881 shares remaining available for grant under the First Bancorp 2007 Equity Plan.

The Company issues new shares of common stock when options are exercised.

The Company measures the fair value of each option award on the date of grant using the Black-Scholes option-pricing model. The Company determines the assumptions used in the Black-Scholes option pricing model as follows: the risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of the grant; the dividend yield is based on the Company's dividend yield at the time of the grant (subject to adjustment if the dividend yield on the grant date is not expected to approximate the dividend yield over the expected life of the option); the volatility factor is based on the historical volatility of the Company's stock (subject to adjustment if future volatility is reasonably expected to differ from the past); and the weighted-average expected life is based on the historical behavior of employees related to exercises, forfeitures and cancellations.



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The Company's equity grants for the three months ended March 31, 2014 were the issuance of 15,657 shares of long-term restricted stock to the chief executive officer on February 11, 2014, at a fair market value of \$17.77 per share, which was the closing price of the Company's common stock on that date.

The Company had no equity grants for the three months ended March 31, 2013.

The Company recorded total stock-based compensation expense of \$23,800 and \$19,200 for the three-month periods ended March 31, 2014 and 2013, respectively, which relates to the employee grants discussed above and is recorded as "salaries expense." Stock based compensation is reflected as an adjustment to cash flows from operating activities on the Company's Consolidated Statement of Cash Flows. The Company recognized \$9,300 and \$7,500 of income tax benefits related to stock based compensation expense in the income statement for the three months ended March 31, 2014 and 2013, respectively.

As noted above, certain of the Company's stock option grants contain terms that provide for a graded vesting schedule whereby portions of the award vest in increments over the requisite service period. The Company has elected to recognize compensation expense for awards with graded vesting schedules on a straight-line basis over the requisite service period for the entire award. Compensation expense is based on the estimated number of stock options and awards that will ultimately vest. Over the past five years, there have only been minimal amounts of forfeitures, and therefore the Company assumes that all options granted without performance conditions will become vested.

The following table presents information regarding the activity for the first three months of 2014 related to all of the Company's stock options outstanding:

|                               | Options Outstanding |                                 |   |                           |
|-------------------------------|---------------------|---------------------------------|---|---------------------------|
|                               | Number of Shares    | Weighted-Average Exercise Price | Weighted-Average Contractual Term (years) | Aggregate Intrinsic Value |
| Balance at January 1, 2014    | 463,102             | \$ 17.95                        |   |                           |
| Granted                       | —                   | —                               |   |                           |
| Exercised                     | —                   | —                               |   |                           |
| Forfeited                     | —                   | —                               |   |                           |
| Expired                       | —                   | —                               |   |                           |
| Outstanding at March 31, 2014 | 463,102             | \$ 17.95                        | 2.8                                       | \$ 1,091,000              |
| Exercisable at March 31, 2014 | 388,102             | \$ 19.54                        | 1.8                                       | \$ 391,000                |

The Company did not have any stock option exercises during the three months ended March 31, 2014 or 2013. The Company recorded no tax benefits from the exercise of nonqualified stock options during the three months ended March 31, 2014 or 2013.

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The following table presents information regarding the activity the first three months of 2014 related to the Company's outstanding restricted stock:

|  | Long-Term Restricted Stock |   |
|--|----------------------------|---|
|  | Number of<br>Units         | Weighted-Average<br>Grant-Date Fair Value |
| Nonvested at January 1, 2014           | 45,374                     | \$ 9.90                                   |
| Granted during the period              | 15,657                     | 17.77                                     |
| Vested during the period               | (5,374 )                   | 14.54                                     |
| Forfeited or expired during the period | —                          | —   |
| Nonvested at March 31, 2014            | 55,657                     | \$ 12.01                                  |

## Note 5 – Earnings Per Common Share

Basic Earnings Per Common Share is calculated by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted Earnings Per Common Share is computed by assuming the issuance of common shares for all potentially dilutive common shares outstanding during the reporting period. Currently, the Company's potentially dilutive common stock issuances relate to stock option grants under the Company's equity-based compensation plans and the Company's Series C Preferred Stock, which is convertible into common stock on a one-for-one ratio.

In computing Diluted Earnings Per Common Share, adjustments are made to the computation of Basic Earnings Per Common shares, as follows. As it relates to stock options, it is assumed that all dilutive stock options are exercised during the reporting period at their respective exercise prices, with the proceeds from the exercises used by the Company to buy back stock in the open market at the average market price in effect during the reporting period. The difference between the number of shares assumed to be exercised and the number of shares bought back is included in the calculation of dilutive securities. As it relates to the Series C Preferred Stock, it is assumed that the preferred stock was converted to common stock during the reporting period. Dividends on the preferred stock are added back to net income and the shares assumed to be converted are included in the number of shares outstanding.

If any of the potentially dilutive common stock issuances have an anti-dilutive effect, which is the case when a net loss is reported, the potentially dilutive common stock issuance is disregarded.

The following is a reconciliation of the numerators and denominators used in computing Basic and Diluted Earnings Per Common Share:

| (\$ in thousands except per share amounts)  | For the Three Months Ended March 31, 2014 |                      |                  | 2013               |                      |                  |
|---|---|----------------------|------------------|--------------------|----------------------|------------------|
|   | Income (Numerator)                        | Shares (Denominator) | Per Share Amount | Income (Numerator) | Shares (Denominator) | Per Share Amount |
| <b>Basic EPS</b>                            |   |                      |                  |                    |                      |                  |
| Net income available to common shareholders | \$5,459                                   | 19,688,183           | \$ 0.28          | \$2,855            | 19,669,302           | \$ 0.15          |
| Effect of Dilutive Securities               | 58  | 736,292              |                  | 58                 | 740,458              |                  |
| Diluted EPS per common share                | \$5,517                                   | 20,424,475           | \$ 0.27          | \$2,913            | 20,409,760           | \$ 0.14          |

For the three months ended March 31, 2014, there were 255,229 options that were antidilutive because the exercise price exceeded the average market price for the period, and thus are not included in the calculation to determine the effect of dilutive securities. Also, for the three months ended March 31, 2014, the Company excluded 75,000 options that had an exercise price below the average market price for the period, but had performance vesting requirements that the Company has concluded are not probable to vest. For the three months ended March 31, 2013, there were 351,863 options that were antidilutive because the exercise price exceeded the average market price for the period, and thus are not included in the calculation to determine the effect of dilutive securities.

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## Note 6 – Securities

The book values and approximate fair values of investment securities at March 31, 2014 and December 31, 2013 are summarized as follows:

| (\$ in thousands)                          | March 31, 2014 |            | Unrealized |          | December 31, 2013 |            | Unrealized |          |
|--|----------------|------------|------------|----------|-------------------|------------|------------|----------|
|  | Amortized Cost | Fair Value | Gains      | (Losses) | Amortized Cost    | Fair Value | Gains      | (Losses) |
| Securities available for sale:             |                |            |            |          |                   |            |            |          |
| Government-sponsored enterprise securities | \$22,435       | 22,296     | 34         | (173 )   | 18,432            | 18,245     | 32         | (219 )   |
| Mortgage-backed securities                 | 149,366        | 148,081    | 1,277      | (2,562)  | 148,646           | 147,187    | 1,415      | (2,874)  |
| Corporate bonds                            | 3,999          | 3,675      | 36         | (360 )   | 3,999             | 3,598      | 44         | (445 )   |
| Equity securities                          | 6,107          | 6,138      | 43         | (12 )    | 3,984             | 4,011      | 40         | (13 )    |
| Total available for sale                   | \$181,907      | 180,190    | 1,390      | (3,107)  | 175,061           | 173,041    | 1,531      | (3,551)  |
| Securities held to maturity:               |                |            |            |          |                   |            |            |          |
| State and local governments                | \$53,937       | 57,192     | 3,255      | —        | 53,995            | 56,700     | 2,709      | (4 )     |

Included in mortgage-backed securities at March 31, 2014 were collateralized mortgage obligations with an amortized cost of \$174,000 and a fair value of \$180,000. Included in mortgage-backed securities at December 31, 2013 were collateralized mortgage obligations with an amortized cost of \$192,000 and a fair value of \$200,000. All of the Company's mortgage-backed securities, including collateralized mortgage obligations, were issued by government-sponsored corporations.

The Company owned Federal Home Loan Bank (FHLB) stock with a cost and fair value of \$6,016,000 at March 31, 2014 and \$3,894,000 at December 31, 2013, which is included in equity securities above and serves as part of the collateral for the Company's line of credit with the FHLB. The investment in this stock is a requirement for membership in the FHLB system. Periodically the FHLB recalculates the Company's required level of holdings, and the Company either buys more stock or the FHLB redeems a portion of the stock at cost.

The following table presents information regarding securities with unrealized losses at March 31, 2014:

| (\$ in thousands) | Securities in an    | Securities in an    | Total |
|-------------------|---------------------|---------------------|-------|
|                   | Unrealized          | Unrealized          |       |
|                   | Loss Position for   | Loss Position for   |       |
|                   | Less than 12 Months | More than 12 Months |       |
|                   | Fair Value          | Fair Value          |       |

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|  |           | Unrealized<br>Losses |        | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
|--|-----------|----------------------|--------|----------------------|---------------|----------------------|
| Government-sponsored enterprise securities | \$ 12,262 | 173                  | —      | —                    | 12,262        | 173                  |
| Mortgage-backed securities                 | 62,049    | 1,175                | 24,496 | 1,387                | 86,545        | 2,562                |
| Corporate bonds                            | —         | —                    | 640    | 360                  | 640           | 360                  |
| Equity securities                          | —         | —                    | 22     | 12                   | 22            | 12                   |
| State and local governments                | —         | —                    | —      | —                    | —             | —                    |
| Total temporarily impaired securities      | \$ 74,311 | 1,348                | 25,158 | 1,759                | 99,469        | 3,107                |

The following table presents information regarding securities with unrealized losses at December 31, 2013:

| (\$ in thousands)                          | Securities in an<br>Unrealized<br>Loss Position for<br>Less than 12 Months |                      | Securities in an<br>Unrealized<br>Loss Position for<br>More than 12 Months |                      | Total         |                      |
|--|--|----------------------|--|----------------------|---------------|----------------------|
|  | Fair Value   | Unrealized<br>Losses | Fair Value   | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| Government-sponsored enterprise securities | \$ 12,212  | 219                  | —  | —                    | 12,212        | 219                  |
| Mortgage-backed securities                 | 64,937   | 1,675                | 17,979   | 1,199                | 82,916        | 2,874                |
| Corporate bonds                            | —  | —                    | 555  | 445                  | 555           | 445                  |
| Equity securities                          | —  | —                    | 22   | 13                   | 22            | 13                   |
| State and local governments                | 992  | 4                    | —  | —                    | 992           | 4                    |
| Total temporarily impaired securities      | \$ 78,141  | 1,898                | 18,556   | 1,657                | 96,697        | 3,555                |

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In the above tables, all of the non-equity securities that were in an unrealized loss position at March 31, 2014 and December 31, 2013 are bonds that the Company has determined are in a loss position due to interest rate factors, the overall economic downturn in the financial sector, and the broader economy in general. The Company has evaluated the collectability of each of these bonds and has concluded that there is no other-than-temporary impairment. The Company does not intend to sell these securities, and it is more likely than not that the Company will not be required to sell these securities before recovery of the amortized cost. The Company has also concluded that each of the equity securities in an unrealized loss position at March 31, 2014 and December 31, 2013 was in such a position due to temporary fluctuations in the market prices of the securities. The Company's policy is to record an impairment charge for any of these equity securities that remains in an unrealized loss position for twelve consecutive months unless the amount is insignificant.

The aggregate carrying amount of cost-method investments was \$6,016,000 and \$3,894,000 at March 31, 2014 and December 31, 2013, respectively, which was the FHLB stock discussed above. The Company determined that none of its cost-method investments were impaired at either period end.

The book values and approximate fair values of investment securities at March 31, 2014, by contractual maturity, are summarized in the table below. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (\$ in thousands)                         | Securities Available<br>for Sale |               | Securities Held<br>to Maturity |               |
|---|----------------------------------|---------------|--------------------------------|---------------|
|   | Amortized<br>Cost                | Fair<br>Value | Amortized<br>Cost              | Fair<br>Value |
| Debt securities                           |                                  |               |                                |               |
| Due within one year                       | \$—                              | —             | —                              | —             |
| Due after one year but within five years  | 21,499                           | 21,413        | 7,481                          | 8,074         |
| Due after five years but within ten years | 3,935                            | 3,918         | 37,579                         | 39,791        |
| Due after ten years                       | 1,000                            | 640           | 8,877                          | 9,327         |
| Mortgage-backed securities                | 149,366                          | 148,081       | —                              | —             |
| Total debt securities                     | 175,800                          | 174,052       | 53,937                         | 57,192        |
| Equity securities                         | 6,107                            | 6,138         | —                              | —             |
| Total securities                          | \$181,907                        | 180,190       | 53,937                         | 57,192        |

At March 31, 2014 and December 31, 2013 investment securities with carrying values of \$82,120,000 and \$79,838,000, respectively, were pledged as collateral for public deposits.

The Company recorded no gains or losses on securities during the three month periods ended March 31, 2014 or 2013.

Note 7 – Loans and Asset Quality Information

The loans and foreclosed real estate that were acquired in FDIC-assisted transactions are covered by loss share agreements between the FDIC and the Company's banking subsidiary, First Bank, which afford First Bank significant loss protection - see Note 2 to the financial statements included in the Company's 2011 Annual Report on Form 10-K for detailed information regarding these transactions. Because of the loss protection provided by the FDIC, the risk of the loans and foreclosed real estate that are covered by loss share agreements are significantly different from those assets not covered under the loss share agreements. Accordingly, the Company presents separately loans subject to the loss share agreements as "covered loans" in the information below and loans that are not subject to the loss share agreements as "non-covered loans."



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The following is a summary of the major categories of total loans outstanding:

| (\$ in thousands)   | March 31, 2014 |            | December 31, 2013 |            | March 31, 2013 |            |
|---|----------------|------------|-------------------|------------|----------------|------------|
|   | Amount         | Percentage | Amount            | Percentage | Amount         | Percentage |
| All loans (non-covered and covered):                              |                |            |                   |            |                |            |
| Commercial, financial, and agricultural                           | \$ 170,209     | 7%         | \$ 168,469        | 7%         | \$ 162,074     | 7%         |
| Real estate – construction, land development & other land loans   | 296,141        | 12%        | 305,246           | 12%        | 293,918        | 12%        |
| Real estate – mortgage – residential (1-4 family) first mortgages | 829,671        | 34%        | 838,862           | 34%        | 831,467        | 35%        |
| Real estate – mortgage – home equity loans / lines of credit      | 229,167        | 9%         | 227,907           | 9%         | 236,222        | 10%        |
| Real estate – mortgage – commercial and other                     | 857,327        | 35%        | 855,249           | 35%        | 803,875        | 33%        |
| Installment loans to individuals                                  | 64,003         | 3%         | 66,533            | 3%         | 67,272         | 3%         |
| Subtotal  | 2,446,518      | 100%       | 2,462,266         | 100%       | 2,394,828      | 100%       |
| Unamortized net deferred loan costs                               | 759            |            | 928               |            | 1,323          |            |
| Total loans   | \$2,447,277    |            | \$2,463,194       |            | \$2,396,151    |            |

As of March 31, 2014, December 31, 2013 and March 31, 2013, net loans include unamortized premiums of \$49,000, \$98,000, and \$368,000, respectively, related to acquired loans.

The following is a summary of the major categories of non-covered loans outstanding:

| (\$ in thousands)   | March 31, 2014 |            | December 31, 2013 |            | March 31, 2013 |            |
|---|----------------|------------|-------------------|------------|----------------|------------|
|   | Amount         | Percentage | Amount            | Percentage | Amount         | Percentage |
| Non-covered loans:  |                |            |                   |            |                |            |
| Commercial, financial, and agricultural                           | \$ 167,443     | 7%         | \$ 164,195        | 7%         | \$ 157,235     | 7%         |
| Real estate – construction, land development & other land loans   | 269,216        | 12%        | 273,412           | 12%        | 253,275        | 12%        |
| Real estate – mortgage – residential (1-4 family) first mortgages | 729,080        | 32%        | 730,712           | 32%        | 700,429        | 33%        |
| Real estate – mortgage – home equity loans / lines of credit      | 215,128        | 10%        | 213,016           | 10%        | 217,567        | 10%        |
| Real estate – mortgage – commercial and other                     | 811,612        | 36%        | 804,621           | 36%        | 736,314        | 35%        |
| Installment loans to individuals                                  | 63,488         | 3%         | 66,001            | 3%         | 66,540         | 3%         |
| Subtotal  | 2,255,967      | 100%       | 2,251,957         | 100%       | 2,131,360      | 100%       |
| Unamortized net deferred loan costs                               | 759            |            | 928               |            | 1,323          |            |
| Total non-covered loans   | \$2,256,726    |            | \$2,252,885       |            | \$2,132,683    |            |

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The carrying amount of the covered loans at March 31, 2014 consisted of impaired and nonimpaired purchased loans (as determined on the date of acquisition), as follows:

| (\$ in thousands)   | Impaired  |  | Nonimpaired  |   | Total<br>Covered<br>Loans –<br>Carrying<br>Value | Total<br>Covered<br>Loans –<br>Unpaid<br>Principal<br>Balance |
|---|---|--|--|---|--|---|
|   | Impaired<br>Purchased<br>Loans –<br>Carrying<br>Value | Impaired<br>Purchased<br>Loans –<br>Unpaid<br>Principal<br>Balance | Nonimpaired<br>Purchased<br>Loans –<br>Carrying<br>Value | Nonimpaired<br>Purchased<br>Loans –<br>Unpaid<br>Principal<br>Balance |  |   |
| Covered loans:  |   |  |  |   |  |   |
| Commercial, financial, and agricultural                           | \$72  | 133  | 2,694  | 4,435   | 2,766  | 4,568   |
| Real estate – construction, land development & other land loans   | 329   | 555  | 26,596   | 36,520  | 26,925   | 37,075  |
| Real estate – mortgage – residential (1-4 family) first mortgages | 480   | 1,336  | 100,111  | 117,875   | 100,591  | 119,211   |
| Real estate – mortgage – home equity loans / lines of credit      | 13  | 20   | 14,026   | 16,923  | 14,039   | 16,943  |
| Real estate – mortgage – commercial and other                     | 2,394   | 4,147  | 43,321   | 55,179  | 45,715   | 59,326  |
| Installment loans to individuals                                  | —   | —  | 515  | 518   | 515  | 518   |
| Total   | \$3,288   | 6,191  | 187,263  | 231,450   | 190,551  | 237,641   |

The carrying amount of the covered loans at December 31, 2013 consisted of impaired and nonimpaired purchased loans (as determined on the date of the acquisition), as follows:

| (\$ in thousands)   | Impaired  |  | Nonimpaired  |   | Total<br>Covered<br>Loans –<br>Carrying<br>Value | Total<br>Covered<br>Loans –<br>Unpaid<br>Principal<br>Balance |
|---|---|--|--|---|--|---|
|   | Impaired<br>Purchased<br>Loans –<br>Carrying<br>Value | Impaired<br>Purchased<br>Loans –<br>Unpaid<br>Principal<br>Balance | Nonimpaired<br>Purchased<br>Loans –<br>Carrying<br>Value | Nonimpaired<br>Purchased<br>Loans –<br>Unpaid<br>Principal<br>Balance |  |   |
| Covered loans:  |   |  |  |   |  |   |
| Commercial, financial, and agricultural                           | \$75  | 136  | 4,199  | 5,268   | 4,274  | 5,404   |
| Real estate – construction, land development & other land loans   | 325   | 564  | 31,509   | 47,792  | 31,834   | 48,356  |
| Real estate – mortgage – residential (1-4 family) first mortgages | 575   | 1,500  | 107,575  | 126,882   | 108,150  | 128,382   |
| Real estate – mortgage – home equity loans / lines of credit      | 14  | 21   | 14,877   | 18,318  | 14,891   | 18,339  |
| Real estate – mortgage – commercial and other                     | 2,153   | 4,042  | 48,475   | 62,630  | 50,628   | 66,672  |
| Installment loans to individuals                                  | —   | —  | 532  | 607   | 532  | 607   |
| Total   | \$3,142   | 6,263  | 207,167  | 261,497   | 210,309  | 267,760   |

The following table presents information regarding covered purchased nonimpaired loans since December 31, 2012. The amounts include principal only and do not reflect accrued interest as of the date of the acquisition or beyond.

(\$ in thousands)

|   |           |
|---|-----------|
| Carrying amount of nonimpaired covered loans at December 31, 2012 | \$277,489 |
| Principal repayments  | (63,588 ) |
| Transfers to foreclosed real estate                               | (13,977 ) |
| Loan charge-offs  | (12,957 ) |
| Accretion of loan discount  | 20,200    |
| Carrying amount of nonimpaired covered loans at December 31, 2013 | 207,167   |
| Principal repayments  | (21,393 ) |
| Transfers to foreclosed real estate                               | (1,971 )  |
| Loan charge-offs  | (2,948 )  |
| Accretion of loan discount  | 6,408     |
| Carrying amount of nonimpaired covered loans at March 31, 2014    | \$187,263 |

As reflected in the table above, the Company accreted \$6,408,000 of the loan discount on purchased nonimpaired loans into interest income during the first quarter of 2014. As of March 31, 2014, there was remaining loan discount of \$26,461,000 related to purchased accruing loans. If these loans continue to be repaid by the borrowers, the Company will accrete the remaining loan discount into interest income over the estimated lives of the respective loans. In such circumstances, a corresponding entry to reduce the indemnification asset will be recorded amounting to 80% of the loan discount accretion, which reduces noninterest income. At March 31, 2014, the Company also had \$4,779,000 of loan discount related to purchased nonperforming loans. It is not expected that a significant amount of this discount will be accreted, as it represents estimated losses on these loans.

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The following table presents information regarding all purchased impaired loans since December 31, 2012, all of which are covered loans. The Company has applied the cost recovery method to all purchased impaired loans at their respective acquisition dates due to the uncertainty as to the timing of expected cash flows, as reflected in the following table.

(\$ in thousands)

|                                    | Contractual<br>Principal<br>Receivable | Fair Market<br>Value<br>Adjustment –<br>Write Down<br>(Nonaccretable<br>Difference) | Carrying<br>Amount |
|------------------------------------|--|---|--------------------|
| <b>Purchased Impaired Loans</b>    |  |   |                    |
| Balance at December 31, 2012       | 8,815                                  | 3,990   | 4,825              |
| Change due to payments received    | (301 )                                 | (31 )   | (270 )             |
| Transfer to foreclosed real estate | (2,100 )                               | (784 )  | (1,316 )           |
| Change due to loan charge-off      | (150 )                                 | (54 )   | (96 )              |
| Other                              | (1 )                                   | —   | (1 )               |
| Balance at December 31, 2013       | \$ 6,263                               | 3,121   | 3,142              |
| Change due to payments received    | (269 )                                 | (103 )  | (166 )             |
| Other                              | 197                                    | (115 )  | 312                |
| Balance at March 31, 2014          | \$ 6,191                               | 2,903   | 3,288              |

Because of the uncertainty of the expected cash flows, the Company is accounting for each purchased impaired loan under the cost recovery method, in which all cash payments are applied to principal. Thus, there is no accretable yield associated with the above loans. During the first quarter of 2014 and 2013, the Company received \$179,000 and \$0, respectively, in payments that exceeded the initial carrying amount of the purchased impaired loans, which is included in the loan discount accretion amount discussed previously.

Nonperforming assets are defined as nonaccrual loans, restructured loans, loans past due 90 or more days and still accruing interest, nonperforming loans held for sale, and foreclosed real estate. Nonperforming assets are summarized as follows:

| <b>ASSET QUALITY DATA</b> (\$ in thousands) | March 31,<br>2014 | December 31,<br>2013 | March 31,<br>2013 |
|---|-------------------|----------------------|-------------------|
| Non-covered nonperforming assets            |                   |                      |                   |
| Nonaccrual loans                            | \$ 44,129         | \$ 41,938            | \$ 38,917         |
| Restructured loans - accruing               | 26,335            | 27,776               | 24,378            |

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|  |            |            |            |
|--|------------|------------|------------|
| Accruing loans > 90 days past due      | —          | —          | —          |
| Total non-covered nonperforming loans  | 70,464     | 69,714     | 63,295     |
| Foreclosed real estate                 | 11,740     | 12,251     | 20,115     |
| Total non-covered nonperforming assets | \$ 82,204  | \$ 81,965  | \$ 83,410  |
| <br>Covered nonperforming assets       |            |            |            |
| Nonaccrual loans (1)                   | \$ 31,986  | \$ 37,217  | \$ 51,221  |
| Restructured loans - accruing          | 7,429      | 8,909      | 10,582     |
| Accruing loans > 90 days past due      | —          | —          | —          |
| Total covered nonperforming loans      | 39,415     | 46,126     | 61,803     |
| Foreclosed real estate                 | 19,504     | 24,497     | 30,156     |
| Total covered nonperforming assets     | \$ 58,919  | \$ 70,623  | \$ 91,959  |
| <br>Total nonperforming assets         | \$ 141,123 | \$ 152,588 | \$ 175,369 |

(1) At March 31, 2014, December 31, 2013, and March 31, 2013, the contractual balance of the nonaccrual loans covered by FDIC loss share agreements was \$49.3 million, \$60.4 million, and \$94.8 million, respectively.

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The remaining tables in this note present information derived from the Company's allowance for loan loss model. Relevant accounting guidance requires certain disclosures to be disaggregated based on how the Company develops its allowance for loan losses and manages its credit exposure. This model combines loan types in a different manner than the tables previously presented.

The following table presents the Company's nonaccrual loans as of March 31, 2014.

| (\$ in thousands)   | Non-covered | Covered | Total  |
|---|-------------|---------|--------|
| Commercial, financial, and agricultural:                        |             |         |        |
| Commercial – unsecured  | \$ 281      | 113     | 394    |
| Commercial – secured  | 4,037       | 111     | 4,148  |
| Secured by inventory and accounts receivable                    | 963         | 175     | 1,138  |
| Real estate – construction, land development & other land loans | 8,550       | 11,026  | 19,576 |
| Real estate – residential, farmland and multi-family            | 18,648      | 9,843   | 28,491 |
| Real estate – home equity lines of credit                       | 2,295       | 351     | 2,646  |
| Real estate – commercial  | 8,885       | 10,367  | 19,252 |
| Consumer  | 470         | —       | 470    |
| Total   | \$ 44,129   | 31,986  | 76,115 |

The following table presents the Company's nonaccrual loans as of December 31, 2013.

| (\$ in thousands)   | Non-covered | Covered | Total  |
|---|-------------|---------|--------|
| Commercial, financial, and agricultural:                        |             |         |        |
| Commercial – unsecured  | \$ 222      | 38      | 260    |
| Commercial – secured  | 2,662       | 114     | 2,776  |
| Secured by inventory and accounts receivable                    | 545         | 782     | 1,327  |
| Real estate – construction, land development & other land loans | 8,055       | 13,502  | 21,557 |
| Real estate – residential, farmland and multi-family            | 17,814      | 12,344  | 30,158 |
| Real estate – home equity lines of credit                       | 2,200       | 335     | 2,535  |
| Real estate – commercial  | 10,115      | 10,099  | 20,214 |
| Consumer  | 325         | 3       | 328    |
| Total   | \$ 41,938   | 37,217  | 79,155 |



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The following table presents an analysis of the payment status of the Company's loans as of March 31, 2014.

| (\$ in thousands)   | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | Nonaccrual<br>Loans | Current   | Total<br>Loans<br>Receivable |
|---|------------------------------|------------------------------|---------------------|-----------|------------------------------|
| Non-covered loans   |                              |                              |                     |           |                              |
| Commercial, financial, and agricultural:                        |                              |                              |                     |           |                              |
| Commercial - unsecured  | \$218                        | 59                           | 281                 | 34,338    | 34,896                       |
| Commercial - secured  | 1,478                        | 257                          | 4,037               | 122,958   | 128,730                      |
| Secured by inventory and accounts receivable                    | 198                          | —                            | 963                 | 19,681    | 20,842                       |
| Real estate – construction, land development & other land loans | 1,478                        | 1,100                        | 8,550               | 230,182   | 241,310                      |
| Real estate – residential, farmland, and multi-family           | 11,401                       | 1,655                        | 18,648              | 838,650   | 870,354                      |
| Real estate – home equity lines of credit                       | 413                          | 277                          | 2,295               | 197,872   | 200,857                      |
| Real estate - commercial  | 4,550                        | 399                          | 8,885               | 698,675   | 712,509                      |
| Consumer  | 374                          | 165                          | 470                 | 45,460    | 46,469                       |
| Total non-covered   | \$20,110                     | 3,912                        | 44,129              | 2,187,816 | 2,255,967                    |
| Unamortized net deferred loan costs                             |                              |                              |                     |           | 759                          |
| Total non-covered loans   |                              |                              |                     |           | \$2,256,726                  |
| Covered loans   | \$6,140                      | 163                          | 31,986              | 152,262   | 190,551                      |
| Total loans   | \$26,250                     | 4,075                        | 76,115              | 2,340,078 | 2,447,277                    |

The Company had no non-covered or covered loans that were past due greater than 90 days and accruing interest at March 31, 2014.

The following table presents an analysis of the payment status of the Company's loans as of December 31, 2013.

| (\$ in thousands)                            | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | Nonaccrual<br>Loans | Current | Total<br>Loans<br>Receivable |
|--|------------------------------|------------------------------|---------------------|---------|------------------------------|
| Non-covered loans                            |                              |                              |                     |         |                              |
| Commercial, financial, and agricultural:     |                              |                              |                     |         |                              |
| Commercial - unsecured                       | \$347                        | 94                           | 222                 | 36,352  | 37,015                       |
| Commercial - secured                         | 1,233                        | 462                          | 2,662               | 117,923 | 122,280                      |
| Secured by inventory and accounts receivable | 438                          | 767                          | 545                 | 19,426  | 21,176                       |



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|   |          |       |        |           |             |
|---|----------|-------|--------|-----------|-------------|
| Real estate – construction, land development & other land loans | 2,304    | 1,391 | 8,055  | 232,920   | 244,670     |
| Real estate – residential, farmland, and multi-family           | 11,682   | 2,631 | 17,814 | 837,260   | 869,387     |
| Real estate – home equity lines of credit                       | 1,465    | 305   | 2,200  | 194,157   | 198,127     |
| Real estate - commercial  | 3,196    | 214   | 10,115 | 696,081   | 709,606     |
| Consumer  | 494      | 187   | 325    | 48,690    | 49,696      |
| Total non-covered   | \$21,159 | 6,051 | 41,938 | 2,182,809 | 2,251,957   |
| Unamortized net deferred loan costs                             |          |       |        |           | 928         |
| Total non-covered loans   |          |       |        |           | \$2,252,885 |
| Covered loans   | \$5,179  | 768   | 37,217 | 167,145   | 210,309     |
| Total loans   | \$26,338 | 6,819 | 79,155 | 2,349,954 | 2,463,194   |

The Company had no non-covered or covered loans that were past due greater than 90 days and accruing interest at December 31, 2013.

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The following table presents the activity in the allowance for loan losses for non-covered loans for the three months ended March 31, 2014.

| (\$ in thousands)   | Commercial<br>Financial,<br>and<br>Agricultural | Real<br>Estate –<br>Construction<br>Land<br>Development<br>&<br>Other<br>Land<br>Loans | Real<br>Estate –<br>Residential<br>Farmland,<br>and<br>Multi-<br>family | Real<br>Estate –<br>Home<br>Equity<br>Lines of<br>Credit | Real<br>Estate –<br>Commercial<br>and<br>Other | Consumer | Unallo-<br>cated | Total     |
|---|---|--|---|--|--|----------|------------------|-----------|
| As of and for the three months ended March 31, 2014             |   |  |   |  |  |          |                  |           |
| Beginning balance   | \$7,432   | 12,966   | 15,142  | 1,838  | 5,524  | 1,513    | (152)            | 44,153    |
| Charge-offs   | (625 )  | (927 )   | (770 )  | (106 )   | (612 )   | (428 )   | —                | (3,468)   |
| Recoveries  | 28  | 236  | 65  | 5  | 95   | 117      | —                | 546       |
| Provisions  | 2,054   | (3,625 )   | (1,704 )  | 1,925  | 4,368  | (172 )   | 519              | 3,363     |
| Ending balance  | \$8,889   | 8,650  | 12,733  | 3,662  | 9,375  | 1,030    | 367              | 44,706    |
| Ending balances as of March 31, 2014: Allowance for loan losses |   |  |   |  |  |          |                  |           |
| Individually evaluated for impairment                           | \$197   | 466  | 2,285   | —  | 571  | —        | —                | 3,519     |
| Collectively evaluated for impairment                           | \$8,692   | 8,184  | 10,448  | 3,662  | 8,804  | 1,030    | 367              | 41,187    |
| Loans acquired with deteriorated credit quality                 | \$—   | —  | —   | —  | —  | —        | —                | —         |
| Loans receivable as of March 31, 2014:                          |   |  |   |  |  |          |                  |           |
| Ending balance – total  | \$184,468                                       | 241,310  | 870,354   | 200,857  | 712,509  | 46,469   | —                | 2,255,967 |
| Ending balances as of March 31, 2014: Loans                     |   |  |   |  |  |          |                  |           |
| Individually evaluated for impairment                           | \$1,093   | 7,411  | 21,110  | 499  | 16,050   | 11       | —                | 46,174    |
| Collectively evaluated for impairment                           | \$183,375                                       | 233,899  | 849,244   | 200,358  | 696,459  | 46,458   | —                | 2,209,793 |
| Loans acquired with deteriorated credit quality                 | \$—   | —  | —   | —  | —  | —        | —                | —         |

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The following table presents the activity in the allowance for loan losses for non-covered loans for the year ended December 31, 2013.

| (\$ in thousands)  | Commercial<br>Financial,<br>and<br>Agricultural | Real<br>Estate –<br>Construction,<br>Land<br>Development,<br>&<br>Other<br>Land<br>Loans | Real<br>Estate –<br>Residential<br>Farmland,<br>and<br>Multi-family | Real<br>Estate –<br>Home<br>Equity<br>Lines of<br>Credit | Real<br>Estate –<br>Commercial<br>and<br>Other | Consumer | Unallo-<br>cated | Total     |
|--|---|--|---|--|--|----------|------------------|-----------|
| As of and for the year ended December 31, 2013                     |   |  |   |  |  |          |                  |           |
| Beginning balance  | \$4,687   | 12,856   | 14,082  | 1,884  | 5,247  | 1,939    | 948              | 41,643    |
| Charge-offs  | (4,418 )  | (2,739 )   | (3,732 )  | (1,314 )   | (4,346 )                                       | (2,174 ) | (660)            | (19,383)  |
| Recoveries   | 299   | 743  | 753   | 87   | 1,381  | 474      | —                | 3,737     |
| Provisions   | 6,864   | 2,106  | 4,039   | 1,181  | 3,242  | 1,274    | (440)            | 18,065    |
| Ending balance   | \$7,432   | 12,966   | 15,142  | 1,838  | 5,524  | 1,513    | (152)            | 44,252    |
| Ending balances as of December 31, 2013: Allowance for loan losses |   |  |   |  |  |          |                  |           |
| Individually evaluated for impairment                              | \$202   | 544  | 1,162   | 1  | 649  | 1        | —                | 2,569     |
| Collectively evaluated for impairment                              | \$7,230   | 12,422   | 13,980  | 1,837  | 4,875  | 1,512    | (152)            | 41,683    |
| Loans acquired with deteriorated credit quality                    | \$—   | —  | —   | —  | —  | —        | —                | —         |
| Loans receivable as of December 31, 2013:                          |   |  |   |  |  |          |                  |           |
| Ending balance – total   | \$180,471                                       | 244,670  | 869,387   | 198,127  | 709,606  | 49,696   | —                | 2,292,357 |
| Ending balances as of December 31, 2013: Loans                     |   |  |   |  |  |          |                  |           |
| Individually evaluated for impairment                              | \$582   | 8,027  | 19,111  | 22   | 16,894   | 13       | —                | 44,649    |
| Collectively evaluated for impairment                              | \$179,889                                       | 236,643  | 850,276   | 198,105  | 692,712  | 49,683   | —                | 2,247,707 |
| Loans acquired with deteriorated credit quality                    | \$—   | —  | —   | —  | —  | —        | —                | —         |

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The following table presents the activity in the allowance for loan losses for non-covered loans for the three months ended March 31, 2013.

| (\$ in thousands)   | Commercial<br>Financial,<br>and<br>Agricultural | Real<br>Estate –<br>Construction<br>Land<br>Development<br>&<br>Other<br>Land<br>Loans | Real<br>Estate –<br>Residential<br>Farmland,<br>and<br>Multi-<br>family | Real<br>Estate –<br>Home<br>Equity<br>Lines of<br>Credit | Real<br>Estate –<br>Commercial<br>and<br>Other | Consumer | Unallo-<br>cated | Total     |
|---|---|--|---|--|--|----------|------------------|-----------|
| As of and for the three months ended March 31, 2013             |   |  |   |  |  |          |                  |           |
| Beginning balance   | \$4,687   | 12,856   | 14,082  | 1,884  | 5,247  | 1,939    | 948              | 41,643    |
| Charge-offs   | (824 )  | (823 )   | (797 )  | (624 )   | (540 )   | (528 )   | (659)            | (4,705)   |
| Recoveries  | 19  | 593  | 546   | 58   | 789  | 137      | —                | 2,142     |
| Provisions  | 1,067   | 2,231  | 1,454   | 722  | 218  | 243      | (164)            | 5,770     |
| Ending balance  | \$4,949   | 14,857   | 15,285  | 2,040  | 5,714  | 1,791    | 125              | 44,761    |
| Ending balances as of March 31, 2013: Allowance for loan losses |   |  |   |  |  |          |                  |           |
| Individually evaluated for impairment                           | \$192   | 1,085  | 1,664   | 1  | 1,271  | 2        | —                | 4,215     |
| Collectively evaluated for impairment                           | \$4,757   | 13,772   | 13,621  | 2,039  | 4,443  | 1,789    | 125              | 40,546    |
| Loans acquired with deteriorated credit quality                 | \$—   | —  | —   | —  | —  | —        | —                | —         |
| Loans receivable as of March 31, 2013:                          |   |  |   |  |  |          |                  |           |
| Ending balance – total  | \$171,721                                       | 220,702  | 838,273   | 200,136  | 648,732  | 51,796   | —                | 2,101,350 |
| Ending balances as of March 31, 2013: Loans                     |   |  |   |  |  |          |                  |           |
| Individually evaluated for impairment                           | \$1,098   | 7,001  | 19,725  | 22   | 21,375   | 14       | —                | 49,535    |
| Collectively evaluated for impairment                           | \$170,623                                       | 213,701  | 818,548   | 200,114  | 627,357  | 51,782   | —                | 2,051,817 |
| Loans acquired with deteriorated credit quality                 | \$—   | —  | —   | —  | —  | —        | —                | —         |

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The following table presents the activity in the allowance for loan losses for covered loans for the three months ended March 31, 2014.

| (\$ in thousands)                                   | Covered Loans |
|---|---------------|
| As of and for the three months ended March 31, 2014 |               |
| Beginning balance                                   | \$ 4,242      |
| Charge-offs   | (2,948 )      |
| Recoveries  | 1,917         |
| Provisions  | 210           |
| Ending balance                                      | \$ 3,421      |

Ending balances as of March 31, 2014: Allowance for loan losses

|   |        |
|---|--------|
| Individually evaluated for impairment           | \$ 629 |
| Collectively evaluated for impairment           | 2,792  |
| Loans acquired with deteriorated credit quality | 12     |

Loans receivable as of March 31, 2014:

|                        |            |
|------------------------|------------|
| Ending balance – total | \$ 190,551 |
|------------------------|------------|

Ending balances as of March 31, 2014: Loans

|   |           |
|---|-----------|
| Individually evaluated for impairment           | \$ 31,547 |
| Collectively evaluated for impairment           | 159,004   |
| Loans acquired with deteriorated credit quality | 3,288     |

The following table presents the activity in the allowance for loan losses for covered loans for the year ended December 31, 2013.

| (\$ in thousands)                              | Covered Loans |
|--|---------------|
| As of and for the year ended December 31, 2013 |               |
| Beginning balance                              | \$ 4,759      |
| Charge-offs                                    | (13,053 )     |
| Recoveries                                     | 186           |
| Provisions                                     | 12,350        |
| Ending balance                                 | \$ 4,242      |

Ending balances as of December 31, 2013: Allowance for loan losses

|   |          |
|---|----------|
| Individually evaluated for impairment           | \$ 3,133 |
| Collectively evaluated for impairment           | 1,109    |
| Loans acquired with deteriorated credit quality | 25       |

Loans receivable as of December 31, 2013:

Ending balance – total \$ 210,309

Ending balances as of December 31, 2013: Loans

|   |           |
|---|-----------|
| Individually evaluated for impairment           | \$ 46,126 |
| Collectively evaluated for impairment           | 164,183   |
| Loans acquired with deteriorated credit quality | 3,142     |

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The following table presents the activity in the allowance for loan losses for covered loans for the three months ended March 31, 2013.

| (\$ in thousands)                                   | Covered Loans |
|---|---------------|
| As of and for the three months ended March 31, 2013 |               |
| Beginning balance                                   | \$ 4,759      |
| Charge-offs   | (5,109 )      |
| Recoveries  | —             |
| Provisions  | 5,378         |
| Ending balance                                      | \$ 5,028      |

Ending balances as of March 31, 2013: Allowance for loan losses

|   |          |
|---|----------|
| Individually evaluated for impairment           | \$ 3,862 |
| Collectively evaluated for impairment           | 1,166    |
| Loans acquired with deteriorated credit quality | 17       |

Loans receivable as of March 31, 2013:

|                        |            |
|------------------------|------------|
| Ending balance – total | \$ 263,468 |
|------------------------|------------|

Ending balances as of March 31, 2013: Loans

|   |           |
|---|-----------|
| Individually evaluated for impairment           | \$ 61,803 |
| Collectively evaluated for impairment           | 201,665   |
| Loans acquired with deteriorated credit quality | 4,726     |

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The following table presents the Company's impaired loans as of March 31, 2014.

| (\$ in thousands)   | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment |
|---|---------------------|--------------------------|-------------------|-----------------------------|
| Non-covered loans with no related allowance recorded:           |                     |                          |                   |                             |
| Commercial, financial, and agricultural:                        |                     |                          |                   |                             |
| Commercial - unsecured  | \$ 65               | 65                       | —                 | 33                          |
| Commercial - secured  | 332                 | 334                      | —                 | 166                         |
| Secured by inventory and accounts receivable                    | —                   | —                        | —                 | —                           |
| Real estate – construction, land development & other land loans | 5,848               | 6,715                    | —                 | 6,123                       |
| Real estate – residential, farmland, and multi-family           | 6,884               | 7,736                    | —                 | 5,384                       |
| Real estate – home equity lines of credit                       | 499                 | 499                      | —                 | 250                         |
| Real estate – commercial  | 8,647               | 10,485                   | —                 | 7,986                       |
| Consumer  | 11                  | 13                       | —                 | 6                           |
| Total non-covered impaired loans with no allowance              | \$ 22,286           | 25,847                   | —                 | 19,948                      |
| Total covered impaired loans with no allowance                  | \$ 26,074           | 40,664                   | —                 | 27,566                      |
| Total impaired loans with no allowance recorded                 | \$ 48,360           | 66,511                   | —                 | 47,514                      |
| Non-covered loans with an allowance recorded:                   |                     |                          |                   |                             |
| Commercial, financial, and agricultural:                        |                     |                          |                   |                             |
| Commercial - unsecured  | \$ 115              | 116                      | 115               | 115                         |
| Commercial - secured  | 581                 | 581                      | 82                | 487                         |
| Secured by inventory and accounts receivable                    | —                   | —                        | —                 | 38                          |
| Real estate – construction, land development & other land loans | 1,563               | 1,787                    | 466               | 1,596                       |
| Real estate – residential, farmland, and multi-family           | 14,226              | 14,408                   | 2,285             | 14,727                      |
| Real estate – home equity lines of credit                       | —                   | —                        | —                 | 11                          |
| Real estate – commercial  | 7,403               | 7,811                    | 571               | 8,487                       |
| Consumer  | —                   | —                        | —                 | 7                           |
| Total non-covered impaired loans with allowance                 | \$ 23,888           | 24,703                   | 3,519             | 25,468                      |
| Total covered impaired loans with allowance                     | \$ 5,473            | 6,080                    | 629               | 11,271                      |
| Total impaired loans with an allowance recorded                 | \$ 29,361           | 30,783                   | 4,148             | 36,739                      |



Interest income recorded on non-covered and covered impaired loans during the three months ended March 31, 2014 is considered insignificant.

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The following table presents the Company's impaired loans as of December 31, 2013.

| (\$ in thousands)   | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment |
|---|---------------------|--------------------------|-------------------|-----------------------------|
| Non-covered loans with no related allowance recorded:           |                     |                          |                   |                             |
| Commercial, financial, and agricultural:                        |                     |                          |                   |                             |
| Commercial - unsecured  | \$ —                | —                        | —                 | —                           |
| Commercial - secured  | —                   | —                        | —                 | 334                         |
| Secured by inventory and accounts receivable                    | —                   | —                        | —                 | —                           |
| Real estate – construction, land development & other land loans | 6,398               | 6,907                    | —                 | 5,005                       |
| Real estate – residential, farmland, and multi-family           | 3,883               | 4,429                    | —                 | 2,329                       |
| Real estate – home equity lines of credit                       | —                   | —                        | —                 | —                           |
| Real estate – commercial  | 7,324               | 9,008                    | —                 | 9,981                       |
| Consumer  | —                   | —                        | —                 | —                           |
| Total non-covered impaired loans with no allowance              | \$ 17,605           | 20,344                   | —                 | 17,649                      |
| Total covered impaired loans with no allowance                  | \$ 29,058           | 48,785                   | —                 | 39,215                      |
| Total impaired loans with no allowance recorded                 | \$ 46,663           | 69,129                   | —                 | 56,864                      |
| Non-covered loans with an allowance recorded:                   |                     |                          |                   |                             |
| Commercial, financial, and agricultural:                        |                     |                          |                   |                             |
| Commercial - unsecured  | \$ 115              | 115                      | 63                | 72                          |
| Commercial - secured  | 392                 | 394                      | 64                | 1,081                       |
| Secured by inventory and accounts receivable                    | 75                  | 75                       | 75                | 80                          |
| Real estate – construction, land development & other land loans | 1,629               | 2,148                    | 544               | 2,339                       |
| Real estate – residential, farmland, and multi-family           | 15,228              | 15,642                   | 1,162             | 13,417                      |
| Real estate – home equity lines of credit                       | 22                  | 22                       | 1                 | 637                         |
| Real estate – commercial  | 9,570               | 10,873                   | 649               | 5,914                       |
| Consumer  | 13                  | 35                       | 1                 | 466                         |
| Total non-covered impaired loans with allowance                 | \$ 27,044           | 29,304                   | 2,559             | 24,006                      |
| Total covered impaired loans with allowance                     | \$ 17,068           | 22,367                   | 3,133             | 14,343                      |
| Total impaired loans with an allowance recorded                 | \$ 44,112           | 51,671                   | 5,692             | 38,349                      |

Interest income recorded on non-covered and covered impaired loans during the year ended December 31, 2013 was insignificant.

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The Company tracks credit quality based on its internal risk ratings. Upon origination a loan is assigned an initial risk grade, which is generally based on several factors such as the borrower's credit score, the loan-to-value ratio, the debt-to-income ratio, etc. Loans that are risk-graded as substandard during the origination process are declined. After loans are initially graded, they are monitored monthly for credit quality based on many factors, such as payment history, the borrower's financial status, and changes in collateral value. Loans can be downgraded or upgraded depending on management's evaluation of these factors. Internal risk-grading policies are consistent throughout each loan type.

The following describes the Company's internal risk grades in ascending order of likelihood of loss:

| Numerical<br>Risk Grade       | Description  |
|-------------------------------|--|
| <u>Pass:</u>                  |  |
| 1                             | Cash secured loans.  |
| 2                             | Non-cash secured loans that have no minor or major exceptions to the lending guidelines.   |
| 3                             | Non-cash secured loans that have no major exceptions to the lending guidelines.  |
| <u>Weak Pass:</u>             |  |
| 4                             | Non-cash secured loans that have minor or major exceptions to the lending guidelines, but the exceptions are properly mitigated.   |
| <u>Watch or<br/>Standard:</u> |  |
| 9                             | Loans that meet the guidelines for a Risk Graded 5 loan, except the collateral coverage is sufficient to satisfy the debt with no risk of loss under reasonable circumstances. This category also includes all loans to insiders and any other loan that management elects to monitor on the watch list. |
| <u>Special<br/>Mention:</u>   |  |
| 5                             | Existing loans with major exceptions that cannot be mitigated.   |
| <u>Classified:</u>            |  |
| 6                             | Loans that have a well-defined weakness that may jeopardize the liquidation of the debt if deficiencies are not corrected.   |
| 7                             | Loans that have a well-defined weakness that make the collection or liquidation improbable.  |
| 8                             | Loans that are considered uncollectible and are in the process of being charged-off.   |

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The following table presents the Company's recorded investment in loans by credit quality indicators as of March 31, 2014.

| (\$ in thousands)   | Credit Quality Indicator (Grouped by Internally Assigned Grades) |                        |  |   |   |                          |
|---|--|------------------------|--|---|---|--------------------------|
|   | Pass<br>(Grades<br>1, 2,<br>& 3)                                 | Weak Pass<br>(Grade 4) | Watch<br>or<br>Standard<br>Loans<br>(Grade<br>9) | Special<br>Mention<br>Loans<br>(Grade<br>5) | Classified<br>Loans<br>(Grades<br>6, 7, &<br>8) | Non-<br>Covered<br>Loans |
| Non-covered loans:  |  |                        |  |   |   |                          |
| Commercial, financial, and agricultural:                        |  |                        |  |   |   |                          |
| Commercial - unsecured  | \$9,173  | 21,607                 | 7  | 1,563                                       | 2,265   | 281                      |
| Commercial - secured  | 33,729   | 80,771                 | 98   | 4,512                                       | 5,583   | 4,031                    |
| Secured by inventory and accounts receivable                    | 5,306  | 12,189                 | —  | 1,108                                       | 1,276   | 963                      |
| Real estate – construction, land development & other land loans | 46,739   | 161,944                | 2,309  | 11,135                                      | 10,633  | 8,551                    |
| Real estate – residential, farmland, and multi-family           | 224,433  | 540,190                | 5,343  | 41,802                                      | 39,938  | 18,611                   |
| Real estate – home equity lines of credit                       | 122,366  | 63,737                 | 1,492  | 5,223                                       | 5,744   | 2,291                    |
| Real estate - commercial  | 122,674  | 527,655                | 8,944  | 28,457                                      | 15,894  | 8,881                    |
| Consumer  | 24,389   | 19,836                 | 54   | 663   | 1,057   | 470                      |
| Total   | \$588,809  | 1,427,929              | 18,247   | 94,463                                      | 82,390  | 44,111                   |
| Unamortized net deferred loan costs                             |  |                        |  |   |   |                          |
| Total non-covered loans   |  |                        |  |   |   |                          |
| Total covered loans   | \$18,501   | 98,742                 | —  | 12,209                                      | 29,113  | 31,911                   |
| Total loans   | \$607,310  | 1,526,671              | 18,247   | 106,672                                     | 111,503   | 76,022                   |

At March 31, 2014, there was an insignificant amount of loans that were graded “8” with an accruing status.

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The following table presents the Company's recorded investment in loans by credit quality indicators as of December 31, 2013.

| (\$ in thousands)   | Credit Quality Indicator (Grouped by Internally Assigned Grades) |                        |  |   |   |                          |
|---|--|------------------------|--|---|---|--------------------------|
|   | Pass<br>(Grades<br>1, 2,<br>& 3)                                 | Weak Pass<br>(Grade 4) | Watch<br>or<br>Standard<br>Loans<br>(Grade<br>9) | Special<br>Mention<br>Loans<br>(Grade<br>5) | Classified<br>Loans<br>(Grades<br>6, 7, &<br>8) | Non-<br>Covered<br>Loans |
| Non-covered loans:  |  |                        |  |   |   |                          |
| Commercial, financial, and agricultural:                        |  |                        |  |   |   |                          |
| Commercial - unsecured  | \$8,495  | 24,415                 | 7  | 1,509                                       | 2,367   | 222                      |
| Commercial - secured  | 31,494   | 77,441                 | 100  | 5,597                                       | 4,986   | 2,666                    |
| Secured by inventory and accounts receivable                    | 4,098  | 12,800                 | —  | 2,022                                       | 1,711   | 545                      |
| Real estate – construction, land development & other land loans | 31,221   | 181,050                | 2,365  | 11,646                                      | 10,333  | 8,050                    |
| Real estate – residential, farmland, and multi-family           | 227,053  | 540,349                | 5,062  | 41,583                                      | 37,526  | 17,800                   |
| Real estate – home equity lines of credit                       | 120,205  | 63,400                 | 1,499  | 5,699                                       | 5,124   | 2,200                    |
| Real estate - commercial  | 115,397  | 533,680                | 10,014   | 24,557                                      | 15,843  | 10,100                   |
| Consumer  | 25,703   | 21,790                 | 54   | 829   | 995   | 325                      |
| Total   | \$563,666  | 1,454,925              | 19,101   | 93,442                                      | 78,885  | 41,900                   |
| Unamortized net deferred loan costs                             |  |                        |  |   |   |                          |
| Total non-covered loans   |  |                        |  |   |   |                          |
| Total covered loans   | \$25,078   | 92,147                 | —  | 8,857                                       | 47,010  | 37,200                   |
| Total loans   | \$588,744  | 1,547,072              | 19,101   | 102,299                                     | 125,895   | 79,100                   |

At December 31, 2013, there was an insignificant amount of loans that were graded “8” with an accruing status.

*Troubled Debt Restructurings*

The restructuring of a loan is considered a “troubled debt restructuring” if both (i) the borrower is experiencing financial difficulties and (ii) the creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses.

The vast majority of the Company's troubled debt restructurings modified during the periods ended March 31, 2014 and 2013 related to interest rate reductions combined with restructured amortization schedules. The Company does not generally grant principal forgiveness.

All loans classified as troubled debt restructurings are considered to be impaired and are evaluated as such for determination of the allowance for loan losses. The Company's troubled debt restructurings can be classified as either nonaccrual or accruing based on the loan's payment status. The troubled debt restructurings that are nonaccrual are reported within the nonaccrual loan totals presented previously.

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The following table presents information related to loans modified in a troubled debt restructuring during the three months ended March 31, 2014 and 2013.

| (\$ in thousands)                                     | For the three months ended March 31, 2014 |  |   |
|---|---|--|---|
|   | Number of Contracts                       | Pre-Modification Restructured Balances | Post-Modification Restructured Balances |
| Non-covered TDRs – Accruing                           |   |  |   |
| Real estate – residential, farmland, and multi-family | 1   | \$ 266                                 | \$ 266                                  |
| Non-covered TDRs - Nonaccrual                         |   |  |   |
| Real estate – residential, farmland, and multi-family | 2   | 106                                    | 106                                     |
| Total non-covered TDRs arising during period          | 3   | 372                                    | 372                                     |
| Total covered TDRs arising during period– Accruing    | —   | \$ —                                   | \$ —                                    |
| Total covered TDRs arising during period – Nonaccrual | 5   | 710                                    | 682                                     |
| Total TDRs arising during period                      | 8   | \$ 1,082                               | \$ 1,054                                |

| (\$ in thousands)                                     | For the three months ended March 31, 2013 |  |   |
|---|---|--|---|
|   | Number of Contracts                       | Pre-Modification Restructured Balances | Post-Modification Restructured Balances |
| Non-covered TDRs – Accruing                           |   |  |   |
| Real estate – residential, farmland, and multi-family | 6   | \$ 508                                 | \$ 508                                  |
| Real estate – commercial                              | 1   | 61                                     | 61                                      |
| Consumer  | 1   | 14                                     | 14                                      |
| Non-covered TDRs - Nonaccrual                         |   |  |   |
| Real estate – residential, farmland, and multi-family | 3   | 209                                    | 209                                     |
| Total non-covered TDRs arising during period          | 11  | 792                                    | 792                                     |
| Total covered TDRs arising during period– Accruing    | 1   | \$ 47                                  | \$ 40                                   |
| Total covered TDRs arising during period – Nonaccrual | —   | —                                      | —                                       |
| Total TDRs arising during period                      | 12  | \$ 839                                 | \$ 832                                  |

Accruing restructured loans that were modified in the previous 12 months and that defaulted during the three months ended March 31, 2014 are presented in the table below. The Company considers a loan to have defaulted when it becomes 90 or more days delinquent under the modified terms, has been transferred to nonaccrual status, or has been



transferred to foreclosed real estate.

(\$ in thousands)

For the three months ended  
March 31, 2014

| Number<br>of<br>Contracts | Recorded<br>Investment |
|---------------------------|------------------------|
|---------------------------|------------------------|

|   |   |       |
|---|---|-------|
| Non-covered accruing TDRs that subsequently defaulted           |   |       |
| Real estate – construction, land development & other land loans | 1 | \$ 5  |
| Real estate – commercial  | 1 | 71    |
| Total non-covered TDRs that subsequently defaulted              | 2 | \$ 76 |
| Total accruing covered TDRs that subsequently defaulted         | — | \$ —  |
| Total accruing TDRs that subsequently defaulted                 | 2 | \$ 76 |

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Accruing restructured loans that were modified in the previous 12 months and that defaulted during the three months ended March 31, 2013 are presented in the table below.

| (\$ in thousands)                                       | For the three<br>months ended<br>March 31, 2013 | Number<br>of Recorded<br>Investment<br>Contracts |
|---|---|--|
| Non-covered accruing TDRs that subsequently defaulted   |   |  |
| Real estate – residential, farmland, and multi-family   | 1   | \$ 252   |
| Total non-covered TDRs that subsequently defaulted      | 1   | \$ 252   |
| Total accruing covered TDRs that subsequently defaulted | 1   | \$ 3,501   |
| Total accruing TDRs that subsequently defaulted         | 2   | \$ 3,753   |

Note 8 – Deferred Loan Costs

The amount of loans shown on the Consolidated Balance Sheets includes net deferred loan costs of approximately \$759,000, \$928,000, and \$1,323,000 at March 31, 2014, December 31, 2013, and March 31, 2013, respectively.

Note 9 – FDIC Indemnification Asset

The FDIC indemnification asset is the estimated amount that the Company will receive from the FDIC under loss share agreements associated with two FDIC-assisted failed bank acquisitions. See page 41 of the Company’s 2013 Annual Report on Form 10-K for a detailed explanation of this asset.

The FDIC indemnification asset was comprised of the following components as of the dates shown:

| (\$ in thousands)  | March 31,<br>2014 | December 31,<br>2013 | March 31,<br>2013 |
|--|-------------------|----------------------|-------------------|
| Receivable related to loss claims incurred, not yet reimbursed | \$ 7,101          | 12,649               | 41,701            |
| Receivable related to estimated future claims on loans         | 24,764            | 33,398               | 53,054            |

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|   |           |        |         |
|---|-----------|--------|---------|
| Receivable related to estimated future claims on foreclosed real estate | 3,639     | 2,575  | 5,839   |
| FDIC indemnification asset  | \$ 35,504 | 48,622 | 100,594 |

The following presents a rollforward of the FDIC indemnification asset since December 31, 2013.

(\$ in thousands)

|   |          |
|---|----------|
| Balance at December 31, 2013                              | \$48,622 |
| Increase related to unfavorable changes in loss estimates | 1,195    |
| Increase related to reimbursable expenses                 | 1,104    |
| Cash received   | (9,384 ) |
| Accretion of loan discount                                | (5,936 ) |
| Other   | (97 )    |
| Balance at March 31, 2014                                 | \$35,504 |

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## Note 10 – Goodwill and Other Intangible Assets

The following is a summary of the gross carrying amount and accumulated amortization of amortizable intangible assets as of March 31, 2014, December 31, 2013, and March 31, 2013 and the carrying amount of unamortized intangible assets as of those same dates.

| (\$ in thousands)                | March 31, 2014        |                          | December 31, 2013     |                          | March 31, 2013        |                          |
|----------------------------------|-----------------------|--------------------------|-----------------------|--------------------------|-----------------------|--------------------------|
|                                  | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Amortizable intangible assets:   |                       |                          |                       |                          |                       |                          |
| Customer lists                   | \$678                 | 473                      | 678                   | 462                      | 678                   | 428                      |
| Core deposit premiums            | 8,560                 | 6,125                    | 8,560                 | 5,942                    | 8,560                 | 5,316                    |
| Total                            | \$9,238               | 6,598                    | 9,238                 | 6,404                    | 9,238                 | 5,744                    |
| Unamortizable intangible assets: |                       |                          |                       |                          |                       |                          |
| Goodwill                         | \$65,835              |                          | 65,835                |                          | 65,835                |                          |

Amortization expense totaled \$194,000 and \$199,000 for the three months ended March 31, 2014 and 2013, respectively.

The following table presents the estimated amortization expense for the last three quarters of calendar year 2014 and for each of the four calendar years ending December 31, 2018 and the estimated amount amortizable thereafter. These estimates are subject to change in future periods to the extent management determines it is necessary to make adjustments to the carrying value or estimated useful lives of amortized intangible assets.

| (\$ in thousands)            | Estimated Amortization Expense |
|------------------------------|--------------------------------|
| April 1 to December 31, 2014 | \$ 583                         |
| 2015                         | 721                            |
| 2016                         | 654                            |
| 2017                         | 404                            |
| 2018                         | 129                            |
| Thereafter                   | 149                            |
| Total                        | \$ 2,640                       |

## Note 11 – Pension Plans

The Company has historically sponsored two defined benefit pension plans – a qualified retirement plan (the “Pension Plan”) which was generally available to all employees, and a Supplemental Executive Retirement Plan (the “SERP”), which was for the benefit of certain senior management executives of the Company. Effective December 31, 2012, the Company froze both plans for all participants. Although no previously accrued benefits were lost, employees no longer accrue benefits for service subsequent to 2012.

The Company recorded pension income totaling \$285,000 and \$149,000 for the three months ended March 31, 2014 and 2013, respectively, which primarily related to investment income from the Pension Plan’s assets. The following table contains the components of the pension income.

| (\$ in thousands)                                | For the Three Months Ended March 31, |                   |           |           |                       |                       |
|--|--------------------------------------|-------------------|-----------|-----------|-----------------------|-----------------------|
|  | 2014 Pension Plan                    | 2013 Pension Plan | 2014 SERP | 2013 SERP | 2014 Total Both Plans | 2013 Total Both Plans |
| Service cost – benefits earned during the period | \$—                                  | —                 | 56        | —         | 56                    | —                     |
| Interest cost                                    | 349                                  | 372               | 53        | 67        | 402                   | 439                   |
| Expected return on plan assets                   | (689)                                | (591)             | —         | —         | (689)                 | (591)                 |
| Amortization of transition obligation            | —                                    | —                 | —         | —         | —                     | —                     |
| Amortization of net (gain)/loss                  | —                                    | 3                 | (54)      | —         | (54)                  | 3                     |
| Amortization of prior service cost               | —                                    | —                 | —         | —         | —                     | —                     |
| Net periodic pension cost                        | \$(340)                              | (216)             | 55        | 67        | (285)                 | (149)                 |

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The Company's contributions to the Pension Plan are based on computations by independent actuarial consultants and are intended to be deductible for income tax purposes. The contributions are invested to provide for benefits under the Pension Plan. The Company expects that it will contribute \$2,000,000 to the Pension Plan in 2014.

The Company's funding policy with respect to the SERP is to fund the related benefits from the operating cash flow of the Company.

## Note 12 – Comprehensive Income

Comprehensive income is defined as the change in equity during a period for non-owner transactions and is divided into net income and other comprehensive income. Other comprehensive income includes revenues, expenses, gains, and losses that are excluded from earnings under current accounting standards. The components of accumulated other comprehensive income for the Company are as follows:

| (\$ in thousands)   | March 31, 2014 | December 31, 2013 | March 31, 2013 |
|---|----------------|-------------------|----------------|
| Unrealized gain (loss) on securities available for sale     | \$ (1,718 )    | (2,021 )          | 2,982          |
| Deferred tax asset (liability)                              | 671            | 789               | (1,163 )       |
| Net unrealized gain (loss) on securities available for sale | (1,047 )       | (1,232 )          | 1,819          |
| Additional pension asset (liability)                        | 5,081          | 5,135             | (3,576 )       |
| Deferred tax asset (liability)                              | (1,970 )       | (2,003 )          | 1,395          |
| Net additional pension asset (liability)                    | 3,111          | 3,132             | (2,181 )       |
| Total accumulated other comprehensive income (loss)         | \$ 2,064       | 1,900             | (362 )         |

The following table discloses the changes in accumulated other comprehensive income (loss) for the three months ended March 31, 2014 (all amounts are net of tax).

| (\$ in thousands)  | Unrealized Gain<br>(Loss) on<br>Securities<br>Available for<br>Sale | Additional<br>Pension Asset<br>(Liability) | Total |
|--|---|--|-------|
| Beginning balance at January 1, 2014                             | \$ (1,232 )   | 3,132                                      | 1,900 |
| Other comprehensive income (loss) before reclassifications       | 185   | —  | 185   |
| Amounts reclassified from accumulated other comprehensive income | —   | (21 )                                      | (21 ) |

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|  |           |     |       |       |
|--|-----------|-----|-------|-------|
| Net current-period other comprehensive income (loss) | 185       | (21 | )     | 164   |
| Ending balance at March 31, 2014                     | \$ (1,047 | )   | 3,111 | 2,064 |

The following table discloses the changes in accumulated other comprehensive income (loss) for the three months ended March 31, 2013 (all amounts are net of tax).

| (\$ in thousands)  | Unrealized Gain<br>(Loss) on<br>Securities<br>Available for Sale | Additional<br>Pension Asset<br>(Liability) | Total   |
|--|--|--|---------|
| Beginning balance at January 1, 2013                             | \$ 2,007   | (2,183                                     | ) (176) |
| Other comprehensive income (loss) before reclassifications       | (188   | )  | — (188) |
| Amounts reclassified from accumulated other comprehensive income | —  | 2  | 2       |
| Net current-period other comprehensive income (loss)             | (188   | )  | 2 (186) |
| Ending balance at March 31, 2013                                 | \$ 1,819   | (2,181                                     | ) (362) |

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## Note 13 – Fair Value

Relevant accounting guidance establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The guidance describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) of identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The following table summarizes the Company's financial instruments that were measured at fair value on a recurring and nonrecurring basis at March 31, 2014. The impaired loans shown below are those in which the value is based on the underlying collateral value.

(\$ in thousands)

| Description of Financial Instruments       | Fair Value at March 31, 2014 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|--|------------------------------|--|---|---|
| <b>Recurring</b>                           |                              |  |   |   |
| Securities available for sale:             |                              |  |   |   |
| Government-sponsored enterprise securities | \$22,296                     | —  | 22,296  | —   |
| Mortgage-backed securities                 | 148,081                      | —  | 148,081                                       | —   |
| Corporate bonds                            | 3,675                        | —  | 3,675   | —   |
| Equity securities                          | 6,138                        | —  | 6,138   | —   |
| Total available for sale securities        | \$180,190                    | —  | 180,190                                       | —   |
| <b>Nonrecurring</b>                        |                              |  |   |   |
| Impaired loans – covered                   | \$14,284                     | —  | —   | 14,284                                    |



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|                                      |        |   |   |        |
|--------------------------------------|--------|---|---|--------|
| Impaired loans – non-covered         | 13,007 | — | — | 13,007 |
| Foreclosed real estate – covered     | 19,504 | — | — | 19,504 |
| Foreclosed real estate – non-covered | 11,740 | — | — | 11,740 |

The following table summarizes the Company’s financial instruments that were measured at fair value on a recurring and nonrecurring basis at December 31, 2013.

(\$ in thousands)

| Description of Financial Instruments       | Fair Value at December 31, 2013 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|--|---------------------------------|--|---|---|
| <b>Recurring</b>                           |                                 |  |   |   |
| Securities available for sale:             |                                 |  |   |   |
| Government-sponsored enterprise securities | \$ 18,245                       | —  | 18,245  | —   |
| Mortgage-backed securities                 | 147,187                         | —  | 147,187                                       | —   |
| Corporate bonds                            | 3,598                           | —  | 3,598   | —   |
| Equity securities                          | 4,011                           | —  | 4,011   | —   |
| Total available for sale securities        | \$ 173,041                      | —  | 173,041                                       | —   |
| <b>Nonrecurring</b>                        |                                 |  |   |   |
| Impaired loans – covered                   | \$ 15,284                       | —  | —   | 15,284                                    |
| Impaired loans – non-covered               | 13,020                          | —  | —   | 13,020                                    |
| Foreclosed real estate – covered           | 24,497                          | —  | —   | 24,497                                    |
| Foreclosed real estate – non-covered       | 12,251                          | —  | —   | 12,251                                    |

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The following is a description of the valuation methodologies used for instruments measured at fair value.

**Securities Available for Sale** — When quoted market prices are available in an active market, the securities are classified as Level 1 in the valuation hierarchy. If quoted market prices are not available, but fair values can be estimated by observing quoted prices of securities with similar characteristics, the securities are classified as Level 2 on the valuation hierarchy. Most of the fair values for the Company's Level 2 securities are determined by our third-party securities portfolio manager using matrix pricing. Matrix pricing is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. For the Company, Level 2 securities include mortgage-backed securities, collateralized mortgage obligations, government-sponsored enterprise securities, and corporate bonds. In cases where Level 1 or Level 2 inputs are not available, securities are classified within Level 3 of the hierarchy.

The Company reviews the pricing methodologies utilized by the portfolio manager to ensure the fair value determination is consistent with the applicable accounting guidance and that the investments are properly classified in the fair value hierarchy. Further, the Company validates the fair values for a sample of securities in the portfolio by comparing the fair values provided by the portfolio manager to prices from other independent sources for the same or similar securities. The Company analyzes unusual or significant variances and conducts additional research with the portfolio manager, if necessary, and takes appropriate action based on its findings.

**Impaired loans** — Fair values for impaired loans in the above tables are generally collateral dependent and are estimated based on underlying collateral values securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined using an income or market valuation approach based on an appraisal conducted by an independent, licensed third party appraiser (Level 3). The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable borrower's financial statements if not considered significant. Likewise, values for inventory and accounts receivable collateral are based on borrower financial statement balances or aging reports on a discounted basis as appropriate (Level 3). Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

**Foreclosed real estate** – Foreclosed real estate, consisting of properties obtained through foreclosure or in satisfaction of loans, is reported at the lower of cost or fair value, based on a current appraisal that is generally prepared using an income or market valuation approach and conducted by an independent, licensed third party appraiser, adjusted for estimated selling costs (Level 3). At the time of foreclosure, any excess of the loan balance over the fair value of the real estate held as collateral is treated as a charge against the allowance for loan losses. For any real estate valuations subsequent to foreclosure, any excess of the real estate recorded value over the fair value of the real estate is treated as a foreclosed real estate write-down on the Consolidated Statements of Income.

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For Level 3 assets and liabilities measured at fair value on a recurring or non-recurring basis as of March 31, 2014, the significant unobservable inputs used in the fair value measurements were as follows:

(\$ in thousands)

| Description                          | Fair Value at March 31, 2014 | Valuation Technique | Significant Unobservable Inputs  | General Range of Significant Unobservable Input Values |
|--------------------------------------|------------------------------|---------------------|--|--|
| Impaired loans – covered             | \$ 14,284                    | Appraised value     | Discounts to reflect current market conditions, ultimate collectability, and estimated costs to sell   | 0-10%  |
| Impaired loans – non-covered         | 13,007                       | Appraised value     | Discounts to reflect current market conditions, ultimate collectability, and estimated costs to sell   | 0-39%  |
| Foreclosed real estate – covered     | 19,504                       | Appraised value     | Discounts to reflect current market conditions and estimated costs to sell                             | 0-10%  |
| Foreclosed real estate – non-covered | 11,740                       | Appraised value     | Discounts to reflect current market conditions, abbreviated holding period and estimated costs to sell | 0-40%  |

For Level 3 assets and liabilities measured at fair value on a recurring or non-recurring basis as of December 31, 2013, the significant unobservable inputs used in the fair value measurements were as follows:

(\$ in thousands)

| Description                          | Fair Value at December 31, 2013 | Valuation Technique | Significant Unobservable Inputs  | General Range of Significant Unobservable Input Values |
|--------------------------------------|---------------------------------|---------------------|--|--|
| Impaired loans – covered             | \$ 15,284                       | Appraised value     | Discounts to reflect current market conditions, ultimate collectability, and estimated costs to sell   | 0-10%  |
| Impaired loans – non-covered         | 13,020                          | Appraised value     | Discounts to reflect current market conditions, ultimate collectability, and estimated costs to sell   | 0-37%  |
| Foreclosed real estate – covered     | 24,497                          | Appraised value     | Discounts to reflect current market conditions and estimated costs to sell                             | 0-10%  |
| Foreclosed real estate – non-covered | 12,251                          | Appraised value     | Discounts to reflect current market conditions, abbreviated holding period and estimated costs to sell | 0-40%  |

Transfers of assets or liabilities between levels within the fair value hierarchy are recognized when an event or change in circumstances occurs. There were no transfers between Level 1 and Level 2 for assets or liabilities measured on a recurring basis during the three months ended March 31, 2014 or 2013.

For the three months ended March 31, 2014, the increase in the fair value of securities available for sale was \$303,000, which is included in other comprehensive income (net of tax expense of \$118,000). For the three months ended March 31, 2013, the decrease in the fair value of securities available for sale was \$308,000, which is included in other comprehensive loss (net of tax benefit of \$120,000). Fair value measurement methods at March 31, 2014 and 2013 are consistent with those used in prior reporting periods.

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The carrying amounts and estimated fair values of financial instruments at March 31, 2014 and December 31, 2013 are as follows:

| (\$ in thousands)                            | Level in Fair Value Hierarchy | March 31, 2014  |                      | December 31, 2013 |                      |
|--|-------------------------------|-----------------|----------------------|-------------------|----------------------|
|  |                               | Carrying Amount | Estimated Fair Value | Carrying Amount   | Estimated Fair Value |
| Cash and due from banks, noninterest-bearing | Level 1                       | \$219,779       | 219,779              | 83,881            | 83,881               |
| Due from banks, interest-bearing             | Level 1                       | 163,489         | 163,489              | 136,644           | 136,644              |
| Federal funds sold                           | Level 1                       | 821             | 821                  | 2,749             | 2,749                |
| Securities available for sale                | Level 2                       | 180,190         | 180,190              | 173,041           | 173,041              |
| Securities held to maturity                  | Level 2                       | 53,937          | 57,192               | 53,995            | 56,700               |
| Presold mortgages in process of settlement   | Level 1                       | 4,587           | 4,587                | 5,422             | 5,422                |
| Total loans, net of allowance                | Level 3                       | 2,399,150       | 2,340,855            | 2,414,689         | 2,352,834            |
| Accrued interest receivable                  | Level 1                       | 8,990           | 8,990                | 9,649             | 9,649                |
| FDIC indemnification asset                   | Level 3                       | 35,504          | 34,292               | 48,622            | 47,032               |
| Bank-owned life insurance                    | Level 1                       | 44,367          | 44,367               | 44,040            | 44,040               |
| Deposits                                     | Level 2                       | 2,786,724       | 2,788,007            | 2,751,019         | 2,752,375            |
| Borrowings                                   | Level 2                       | 136,394         | 122,218              | 46,394            | 34,795               |
| Accrued interest payable                     | Level 2                       | 758             | 758                  | 879               | 879                  |

Fair value methods and assumptions are set forth below for the Company's financial instruments.

Cash and Amounts Due from Banks, Federal Funds Sold, Presold Mortgages in Process of Settlement, Accrued Interest Receivable, and Accrued Interest Payable - The carrying amounts approximate their fair value because of the short maturity of these financial instruments.

Available for Sale and Held to Maturity Securities - Fair values are provided by a third-party and are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments or matrix pricing.

Loans - For nonimpaired loans, fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, financial and agricultural, real estate construction, real estate mortgages and installment loans to individuals. Each loan category is further segmented into fixed and variable interest rate terms. The fair value for each category is determined by discounting scheduled future cash flows using current interest rates offered on loans with similar risk characteristics. Fair values for impaired loans are primarily based on estimated proceeds expected upon liquidation of the collateral.

FDIC Indemnification Asset – Fair value is equal to the FDIC reimbursement rate of the expected losses to be incurred and reimbursed by the FDIC and then discounted over the estimated period of receipt.

Bank-Owned Life Insurance – The carrying value of life insurance approximates fair value because this investment is carried at cash surrender value, as determined by the issuer.

Deposits - The fair value of deposits with no stated maturity, such as noninterest-bearing checking accounts, savings accounts, interest-bearing checking accounts, and money market accounts, is equal to the amount payable on demand as of the valuation date. The fair value of certificates of deposit is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered in the marketplace for deposits of similar remaining maturities.

Borrowings - The fair value of borrowings is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered by the Company's lenders for debt of similar remaining maturities.

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no highly liquid market exists for a significant portion of the Company's financial instruments, fair value estimates are 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.

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Fair value estimates are based on existing on- and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial assets or liabilities include net premises and equipment, intangible and other assets such as deferred income taxes, prepaid expense accounts, income taxes currently payable and other various accrued expenses. In addition, the income tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of the estimates.

Note 14 – Shareholders’ Equity Transactions

*Small Business Lending Fund*

On September 1, 2011, the Company completed the sale of \$63.5 million of Series B Preferred Stock to the Secretary of the Treasury under the Small Business Lending Fund (SBLF). The fund was established under the Small Business Jobs Act of 2010 that was created to encourage lending to small businesses by providing capital to qualified community banks with assets less than \$10 billion.

Under the terms of the stock purchase agreement, the Treasury received 63,500 shares of non-cumulative perpetual preferred stock with a liquidation value of \$1,000 per share, in exchange for \$63.5 million.

The Series B Preferred Stock qualifies as Tier 1 capital. The dividend rate, as a percentage of the liquidation amount, fluctuated on a quarterly basis during the first 10 quarters during which the Series B Preferred Stock was outstanding, based upon changes in the level of “Qualified Small Business Lending” or “QSBL”. For the first nine quarters after issuance, the dividend rate could range from one percent (1%) to five percent (5%) per annum based upon the increase in QSBL as compared to the baseline. For the tenth calendar quarter through four and one half years after issuance, the dividend rate will be fixed at between one percent (1%) and seven percent (7%) based upon the level of QSBL compared to the baseline. After four and one half years from the issuance, the dividend rate will increase to nine percent (9%). For quarters subsequent to the issuance in 2011, the Company has been able to continually increase its level of small business lending and as a result, the dividend rate has steadily decreased from 5.0% in 2011 and the first half of 2012 to 1.0% throughout most of 2013. The Company expects its dividend rate to remain at an annualized rate of 1.0% until 2016, unless the Series B Preferred Stock is redeemed at an earlier date. Subject to regulatory approval, the Company is generally permitted to redeem the Series B Preferred Shares at par plus unpaid dividends.

For the first three months of 2014 and 2013, the Company accrued approximately \$159,000 and \$187,000, respectively, in preferred dividend payments for the Series B Preferred Stock. This amount is deducted from net income in computing “Net income available to common shareholders.”

*Stock Issuance*

On December 21, 2012, the Company issued 2,656,294 shares of its common stock and 728,706 shares of the Company's Series C Preferred Stock to certain accredited investors, each at the price of \$10.00 per share, pursuant to a private placement transaction. Net proceeds from this sale of common and preferred stock were \$33.8 million and were used to strengthen and remove risk from the Company's balance sheet in anticipation of a planned disposition of certain classified loans and write-down of foreclosed real estate.

The Series C Preferred Stock qualifies as Tier 1 capital and is Convertible Perpetual Preferred Stock, with dividend rights equal to the Company's Common Stock. Each share of Series C Preferred Stock will automatically convert into one share of Common Stock on the date the holder of Series C Preferred Stock transfers any shares of Series C Preferred Stock to a non-affiliate of the holder in certain permissible transfers. The Series C Preferred Stock is non-voting, except in limited circumstances.

The Series C Preferred Stock pays a dividend per share equal to that of the Company's common stock. During each of the first quarters of 2014 and 2013, the Company accrued approximately \$58,000 in preferred dividend payments for the Series C Preferred Stock.



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

**Critical Accounting Policies**

The accounting principles we follow and our methods of applying these principles conform with accounting principles generally accepted in the United States of America and with general practices followed by the banking industry. Certain of these principles involve a significant amount of judgment and may involve the use of estimates based on our best assumptions at the time of the estimation. The allowance for loan losses, intangible assets, and the fair value and discount accretion of loans acquired in FDIC-assisted transactions are three policies we have identified as being more sensitive in terms of judgments and estimates, taking into account their overall potential impact to our consolidated financial statements.

Allowance for Loan Losses

Due to the estimation process and the potential materiality of the amounts involved, we have identified the accounting for the allowance for loan losses and the related provision for loan losses as an accounting policy critical to our consolidated financial statements. The provision for loan losses charged to operations is an amount sufficient to bring the allowance for loan losses to an estimated balance considered adequate to absorb losses inherent in the portfolio.

Our determination of the adequacy of the allowance is based primarily on a mathematical model that estimates the appropriate allowance for loan losses. This model has three components. The first component involves the estimation of losses on individually significant "impaired loans". A loan is considered to be impaired when, based on current information and events, it is probable we will be unable to collect all amounts due according to the contractual terms of the loan agreement. A loan is specifically evaluated for an appropriate valuation allowance if the loan balance is above a prescribed evaluation threshold (which varies based on credit quality, accruing status, and type of collateral) and the loan is determined to be impaired. The estimated valuation allowance is the difference, if any, between the loan balance outstanding and the value of the impaired loan as determined by either 1) an estimate of the cash flows that we expect to receive from the borrower discounted at the loan's effective rate, or 2) in the case of a collateral-dependent loan, the fair value of the collateral.

The second component of the allowance model is the estimation of losses for impaired loans that have common risk characteristics and are aggregated to measure impairment. These impaired loans generally have loan balances below the thresholds that result in an individual review discussed above. For these impaired loans, we aggregate loans among similar loan types and apply loss rates that are derived from historical statistics.

The third component of the allowance model is the estimation of losses for loans that are not considered to be impaired loans. Loans not considered to be impaired are segregated by loan type, and estimated loss percentages are assigned to each loan type, based on historical losses, current economic conditions, and operational conditions specific to each loan type. For loans with more than standard risk, loss percentages are based on a multiple of the estimated loss rate for loans of a similar loan type with normal risk. The multiples assigned vary by type of loan, depending on risk, and we have consulted with an external credit review firm in assigning those multiples.

The reserves estimated for impaired loans (specifically reviewed and aggregate) are then added to the reserve estimated for all other loans. This becomes our “allocated allowance.” In addition to the allocated allowance derived from the model, we also evaluate other data such as the ratio of the allowance for loan losses to total loans, net loan growth information, nonperforming asset levels and trends in such data. Based on this additional analysis, we may determine that an additional amount of allowance for loan losses is necessary to reserve for probable losses. This additional amount, if any, is our “unallocated allowance.” The sum of the allocated allowance and the unallocated allowance is compared to the actual allowance for loan losses recorded on our books and any adjustment necessary for the recorded allowance to equal the computed allowance is recorded as a provision for loan losses. The provision for loan losses is a direct charge to earnings in the period recorded.

Loans covered under loss share agreements (referred to as “covered loans”) are recorded at fair value at acquisition date. Therefore, amounts deemed uncollectible at acquisition date become a part of the fair value calculation and are excluded from the allowance for loan losses. Subsequent decreases in the amount expected to be collected result in a provision for loan losses with a corresponding increase in the allowance for loan losses. Subsequent increases in the amount expected to be collected are accreted into income over the life of the loan. Proportional adjustments are also recorded to the FDIC indemnification asset.

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Although we use the best information available to make evaluations, future material adjustments may be necessary if economic, operational, or other conditions change. In addition, various regulatory agencies, as an integral part of their examination process, periodically review our allowance for loan losses. Such agencies may require us to recognize additions to the allowance based on the examiners' judgment about information available to them at the time of their examinations.

For further discussion, see "Nonperforming Assets" and "Summary of Loan Loss Experience" below.

## Intangible Assets

Due to the estimation process and the potential materiality of the amounts involved, we have also identified the accounting for intangible assets as an accounting policy critical to our consolidated financial statements.

When we complete an acquisition transaction, the excess of the purchase price over the amount by which the fair market value of assets acquired exceeds the fair market value of liabilities assumed represents an intangible asset. We must then determine the identifiable portions of the intangible asset, with any remaining amount classified as goodwill. Identifiable intangible assets associated with these acquisitions are generally amortized over the estimated life of the related asset, whereas goodwill is tested annually for impairment, but not systematically amortized. Assuming no goodwill impairment, it is beneficial to our future earnings to have a lower amount assigned to identifiable intangible assets and higher amount of goodwill as opposed to having a higher amount considered to be identifiable intangible assets and a lower amount classified as goodwill.

The primary identifiable intangible asset we typically record in connection with a whole bank or bank branch acquisition is the value of the core deposit intangible, whereas when we acquire an insurance agency, the primary identifiable intangible asset is the value of the acquired customer list. Determining the amount of identifiable intangible assets and their average lives involves multiple assumptions and estimates and is typically determined by performing a discounted cash flow analysis, which involves a combination of any or all of the following assumptions: customer attrition/runoff, alternative funding costs, deposit servicing costs, and discount rates. We typically engage a third party consultant to assist in each analysis. For the whole bank and bank branch transactions recorded to date, the core deposit intangibles have generally been estimated to have a life ranging from seven to ten years, with an accelerated rate of amortization. For insurance agency acquisitions, the identifiable intangible assets related to the customer lists were determined to have a life of ten to fifteen years, with amortization occurring on a straight-line basis.

Subsequent to the initial recording of the identifiable intangible assets and goodwill, we amortize the identifiable intangible assets over their estimated average lives, as discussed above. In addition, on at least an annual basis, goodwill is evaluated for impairment by comparing the fair value of our reporting units to their related carrying value,

including goodwill (our community banking operation is our only material reporting unit). If the carrying value of a reporting unit were ever to exceed its fair value, we would determine whether the implied fair value of the goodwill, using a discounted cash flow analysis, exceeded the carrying value of the goodwill. If the carrying value of the goodwill exceeded the implied fair value of the goodwill, an impairment loss would be recorded in an amount equal to that excess. Performing such a discounted cash flow analysis would involve the significant use of estimates and assumptions.

In our 2013 goodwill impairment evaluation, we engaged a consulting firm that used various valuation techniques to assist us in concluding that our goodwill was not impaired.

We review identifiable intangible assets for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Our policy is that an impairment loss is recognized, equal to the difference between the asset's carrying amount and its fair value, if the sum of the expected undiscounted future cash flows is less than the carrying amount of the asset. Estimating future cash flows involves the use of multiple estimates and assumptions, such as those listed above.

#### Fair Value and Discount Accretion of Loans Acquired in FDIC-Assisted Transactions

We consider the determination of the initial fair value of loans acquired in FDIC-assisted transactions, the initial fair value of the related FDIC indemnification asset, and the subsequent discount accretion of the purchased loans to involve a high degree of judgment and complexity. We determine fair value accounting estimates of newly assumed assets and liabilities in accordance with relevant accounting guidance. However, the amount that we realize on these assets could differ materially from the carrying value reflected in our financial statements, based upon the timing of collections on the acquired loans in future periods. To the extent the actual values realized for the acquired loans are different from the estimates, the FDIC indemnification asset will generally be impacted in an offsetting manner due to the loss-sharing support from the FDIC.

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Because of the inherent credit losses associated with the acquired loans in a failed bank acquisition, the amount that we record as the fair values for the loans is generally less than the contractual unpaid principal balance due from the borrowers, with the difference being referred to as the “discount” on the acquired loans. We have applied the cost recovery method of accounting to all purchased impaired loans due to the uncertainty as to the timing of expected cash flows. This will generally result in the recognition of interest income on these impaired loans only when the cash payments received from the borrower exceed the recorded net book value of the related loans.

For nonimpaired purchased loans, we accrete the discount over the lives of the loans in a manner consistent with the guidance for accounting for loan origination fees and costs.

Index**FDIC Indemnification Asset**

The FDIC indemnification asset is the estimated amount that the Company will receive from the FDIC under loss share agreements associated with two FDIC-assisted failed bank acquisitions. See page 41 of the Company's 2013 Annual Report on Form 10-K for a detailed explanation of this asset.

The following table presents additional information regarding our covered loans, loan discounts, allowances for loan losses, foreclosed properties, and the corresponding FDIC indemnification asset:

(\$ in thousands)

| At March 31, 2014                      | Cooperative<br>Single<br>Family<br>Loss Share<br>Loans | Cooperative<br>Non-Single<br>Family<br>Loss<br>Share<br>Loans | Bank of<br>Asheville<br>Single<br>Family Loss<br>Share Loans | Bank of<br>Asheville<br>Non-Single<br>Family<br>Loss Share<br>Loans | Total     |
|--|--|---|--|---|-----------|
| Expiration of loss share agreement     | 6/30/2019  | 6/30/2014   | 3/31/2021  | 3/31/2016   |           |
| Nonaccrual covered loans               |  |   |  |   |           |
| Unpaid principal balance               | \$ 9,089   | 32,244  | 571  | 7,398   | 49,302    |
| Carrying value prior to loan discount* | 8,933  | 21,098  | 453  | 6,281   | 36,765    |
| Loan discount                          | 1,368  | 980   | 258  | 2,173   | 4,779     |
| Net carrying value                     | 7,565  | 20,118  | 195  | 4,108   | 31,986    |
| Allowance for loan losses              | 439  | 937   | 1  | 85  | 1,462     |
| Indemnification asset recorded         | 1,405  | 1,100   | 198  | 1,592   | 4,295     |
| All other covered loans                |  |   |  |   |           |
| Unpaid principal balance               | 112,527  | 30,678  | 10,450   | 32,186  | 185,841   |
| Carrying value prior to loan discount* | 112,431  | 30,277  | 10,361   | 31,957  | 185,026   |
| Loan discount                          | 15,335   | 1,021   | 2,916  | 7,189   | 26,461    |
| Net carrying value                     | 97,096   | 29,256  | 7,445  | 24,768  | 158,565   |
| Allowance for loan losses              | 168  | 1,508   | 11   | 272   | 1,959     |
| Indemnification asset recorded         | 11,934   | 817   | 2,309  | 5,563   | 20,623    |
| All covered loans                      |  |   |  |   |           |
| Unpaid principal balance               | 121,616  | 62,922  | 11,021   | 39,584  | 235,143   |
| Carrying value prior to loan discount* | 121,364  | 51,375  | 10,814   | 38,238  | 221,791   |
| Loan discount                          | 16,703   | 2,001   | 3,174  | 9,362   | 31,240    |
| Net carrying value                     | 104,661  | 49,374  | 7,640  | 28,876  | 190,551   |
| Allowance for loan losses              | 607  | 2,445   | 12   | 357   | 3,421     |
| Indemnification asset recorded         | 13,339   | 1,917   | 2,507  | 7,155   | 24,918 ** |
| Foreclosed Properties                  |  |   |  |   |           |
| Net carrying value                     | 3,391  | 10,670  | 170  | 5,273   | 19,504    |

|                                |       |     |     |       |       |
|--------------------------------|-------|-----|-----|-------|-------|
| Indemnification asset recorded | 1,594 | 879 | 125 | 1,041 | 3,639 |
|--------------------------------|-------|-----|-----|-------|-------|

\* Reflects partial charge-offs

\*\* A present value adjustment of \$154 reduces the carrying value of this asset to \$24,764.

As noted in the table above, our loss share agreement related to Cooperative Bank's non-single family assets expires in June 2014 and our loss share agreement related to Bank of Asheville's non-single family assets expires in January 2016. We continue to make progress in winding down these portfolios, and we do not currently expect that the upcoming expiration of the Cooperative non-single family agreement will have a material impact on our company. As it relates to those portions of covered loans, we expect accelerated amounts of loan discount accretion and corresponding indemnification asset expense until the expiration dates and the loss share attributes of the loan portfolio are resolved.

At June 30, 2014, the remaining balances associated with the Cooperative non-single family loans and foreclosed properties will be transferred from the covered portfolio to the non-covered portfolio. Therefore, after June 30, 2014, we will bear all future losses on that portfolio of loans and foreclosed properties.

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**Current Accounting Matters**

See Note 2 to the Consolidated Financial Statements above for information about accounting standards that we have recently adopted.

**RESULTS OF OPERATIONS**

**Overview**

Net income available to common shareholders for the first quarter of 2014 amounted to \$5.5 million, or \$0.27 per diluted common share, compared to net income available to common shareholders of \$2.9 million, or \$0.14 per diluted common share, recorded in the first quarter of 2013. The higher earnings in 2014 were the result of a higher net interest margin, lower provision for loan losses and higher fee income.

Net Interest Income and Net Interest Margin

Net interest income for the first quarter of 2014 amounted to \$35.5 million, an 11.3% increase from the \$31.9 million recorded in the first quarter of 2013.

Our net interest margin (tax-equivalent net interest income divided by average earning assets) in the first quarter of 2014 was 5.13% compared to 4.69% for the first quarter of 2013. The 5.13% net interest margin realized in the first quarter of 2014 was a nine basis point increase from the 5.04% margin realized in the fourth quarter of 2013. The higher margins are primarily due to higher amounts of discount accretion on loans purchased in failed-bank acquisitions recognized during the respective periods. Loan discount accretion amounted to \$6.4 million in the first quarter of 2014, \$5.6 million in the fourth quarter of 2013, and \$3.7 million in the first quarter of 2013.

Our cost of funds has steadily declined from 0.45% in the first quarter of 2013 to 0.31% in the first quarter of 2014, which also had a positive impact on our net interest margin.

Provision for Loan Losses and Asset Quality



We recorded total provisions for loan losses of \$3.6 million in the first quarter of 2014 compared to \$11.1 million for the first quarter of 2013, with the provisions related to both non-covered loans and covered loans being lower in 2014 compared to 2013 – see explanation of the terms “non-covered” and “covered” in the section entitled “Note Regarding Components of Earnings.”

Total non-covered nonperforming assets have remained relatively unchanged over the past year, amounting to \$82.2 million at March 31, 2014 (2.65% of total non-covered assets), \$82.0 million at December 31, 2013 and \$83.4 million at March 31, 2013.

Total covered nonperforming assets have steadily declined in the past year, amounting to \$58.9 million at March 31, 2014 compared to \$70.6 million at December 31, 2013 and \$92.0 million at March 31, 2013. We continue to resolve significant amounts of covered loans and to experience strong property sales along the North Carolina coast, which is where most of our covered assets are located.

#### Noninterest Income

Total noninterest income for the three months ended March 31, 2014 was \$0.3 million compared to \$7.1 million for the comparable period of 2013.

Core noninterest income for the first quarter of 2014 was \$7.5 million, an increase of 15.5% over the \$6.5 million reported for the first quarter of 2013. Core noninterest income includes i) service charges on deposit accounts, ii) other service charges, commissions, and fees, iii) fees from presold mortgages, iv) commissions from financial product sales, and v) bank-owned life insurance income. The largest component of the increase in core noninterest income was in the amount of service charges on deposits that we recorded. In December 2013, we introduced a new deposit product line-up and altered the fee structure of many of our accounts.

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Noncore components of noninterest income resulted in net losses of \$7.2 million in the first quarter of 2014 compared to net gains of \$0.6 million in the first quarter of 2013. The largest variance related to indemnification asset income (expense) – see discussion in the section entitled “Components of Earnings”.

## Noninterest Expenses

Noninterest expenses amounted to \$23.6 million in the first quarter of 2014 compared to \$23.2 million recorded in the first quarter of 2013. Salaries expense increased in the first quarter of 2014 in comparison to the first quarter of 2013 due to hiring additional employees during 2013 in our credit administration and mortgage banking divisions. Partially offsetting the increase in salaries expense were lower collection and foreclosed property expenses in 2014, which reflects lower levels of problem assets.

## Balance Sheet and Capital

Total assets at March 31, 2014 amounted to \$3.3 billion, a 1.0% increase from a year earlier. Total loans at March 31, 2014 amounted to \$2.4 billion, a 2.1% increase from a year earlier, and total deposits amounted to \$2.8 billion at March 31, 2014, a 2.5% decrease from a year earlier.

Total loans increased over the past year, as growth in non-covered loans has exceeded the steady decline in covered loans. Our non-covered loans increased by \$124 million at March 31, 2014 compared to a year earlier, representing growth of 5.8%. We continue to see improved loan demand as the local economies in our market areas improve.

The lower amount of deposits at March 31, 2014 compared to March 31, 2013 was primarily due to declines in time deposits, with increases in checking accounts offsetting most of the decline. Time deposits are generally one of our most expensive funding sources, and thus the shift from this category benefited our overall cost of funds.

We obtained new borrowings of \$90 million in the first quarter of 2014 from a low cost funding source in order to enhance our cash position and in anticipation of future loan growth.

We remain well-capitalized by all regulatory standards, with a Total Risk-Based Capital Ratio at March 31, 2014 of 16.83% compared to the 10.00% minimum to be considered well-capitalized. Our tangible common equity to tangible assets ratio was 7.30% at March 31, 2014, an increase of 54 basis points from a year earlier.

Note Regarding Components of Earnings

Our results of operation are significantly affected by the on-going accounting for two FDIC-assisted failed bank acquisitions. In the discussion above and elsewhere in this document, the term “covered” is used to describe assets included as part of FDIC loss share agreements, which generally result in the FDIC reimbursing the Company for 80% of losses incurred on those assets. The term “non-covered” refers to the Company’s legacy assets, which are not included in any type of loss share arrangement.

For covered loans that deteriorate in terms of repayment expectations, we record immediate allowances through the provision for loan losses. For covered loans that experience favorable changes in credit quality compared to what was expected at the acquisition date, including loans that payoff, we record positive adjustments to interest income over the life of the respective loan – also referred to as loan discount accretion. For covered foreclosed properties that are sold at gains or losses or that are written down to lower values, we record the gains/losses within noninterest income.

The adjustments discussed above are recorded within the income statement line items noted without consideration of the FDIC loss share agreements. Because favorable changes in covered assets result in lower expected FDIC claims, and unfavorable changes in covered assets result in higher expected FDIC claims, the FDIC indemnification asset is adjusted to reflect those expectations. The net increase or decrease in the indemnification asset is reflected within noninterest income.

The adjustments noted above can result in volatility within individual income statement line items. Because of the FDIC loss share agreements and the associated indemnification asset, pretax income resulting from amounts recorded as provisions for loan losses on covered loans, discount accretion, and losses from covered foreclosed properties is generally only impacted by 20% of these amounts due to the corresponding adjustments made to the indemnification asset.

Index**Components of Earnings**

Net interest income is the largest component of earnings, representing the difference between interest and fees generated from earning assets and the interest costs of deposits and other funds needed to support those assets. Net interest income for the three month period ended March 31, 2014 amounted to \$35.5 million, an increase of \$3.6 million, or 11.3%, from the \$31.9 million recorded in the first quarter of 2013. Net interest income on a tax-equivalent basis for the three month period ended March 31, 2014 amounted to \$35.9 million, an increase of \$3.6 million, or 11.2%, from the \$32.3 million recorded in the first quarter of 2013. We believe that analysis of net interest income on a tax-equivalent basis is useful and appropriate because it allows a comparison of net interest income amounts in different periods without taking into account the different mix of taxable versus non-taxable investments that may have existed during those periods.

| (\$ in thousands)                   | Three Months Ended March 31, |        |
|-------------------------------------|------------------------------|--------|
|                                     | 2014                         | 2013   |
| Net interest income, as reported    | \$ 35,535                    | 31,921 |
| Tax-equivalent adjustment           | 373                          | 372    |
| Net interest income, tax-equivalent | \$ 35,908                    | 32,293 |

There are two primary factors that cause changes in the amount of net interest income we record - 1) changes in our loans and deposits balances, and 2) our net interest margin (tax-equivalent net interest income divided by average interest-earning assets).

For the three months ended March 31, 2014, the higher net interest income compared to the same period of 2013 was due to a higher net interest margin, increases in interest-earning assets (primarily average loan balances), and decreases in interest-bearing liabilities (see discussion below).

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The following table presents net interest income analysis on a tax-equivalent basis.

|  | For the Three Months Ended March 31, |                 |                               |                   |                 |                               |
|--|--------------------------------------|-----------------|-------------------------------|-------------------|-----------------|-------------------------------|
|  | 2014                                 |                 |                               | 2013              |                 |                               |
|  | Average<br>Volume                    | Average<br>Rate | Interest<br>Earned<br>or Paid | Average<br>Volume | Average<br>Rate | Interest<br>Earned<br>or Paid |
| <i>(\$ in thousands)</i>                                     |                                      |                 |                               |                   |                 |                               |
| <b>Assets</b>  |                                      |                 |                               |                   |                 |                               |
| Loans (1)  | \$2,459,368                          | 5.95%           | \$36,086                      | \$2,382,861       | 5.71%           | \$33,551                      |
| Taxable securities   | 180,228                              | 2.25%           | 1,001                         | 164,284           | 2.23%           | 905                           |
| Non-taxable securities (2)                                   | 53,975                               | 6.33%           | 843                           | 55,948            | 6.17%           | 851                           |
| Short-term investments, principally federal funds            | 143,235                              | 0.34%           | 119                           | 187,652           | 0.33%           | 154                           |
| Total interest-earning assets                                | 2,836,806                            | 5.44%           | 38,049                        | 2,790,745         | 5.15%           | 35,461                        |
| Cash and due from banks                                      | 83,243                               |                 |                               | 81,081            |                 |                               |
| Premises and equipment                                       | 77,440                               |                 |                               | 75,255            |                 |                               |
| Other assets   | 181,359                              |                 |                               | 281,382           |                 |                               |
| Total assets   | \$3,178,848                          |                 |                               | \$3,228,463       |                 |                               |
| <b>Liabilities</b>   |                                      |                 |                               |                   |                 |                               |
| Interest bearing checking                                    | \$529,110                            | 0.06%           | \$80                          | \$520,936         | 0.13%           | \$162                         |
| Money market deposits  | 553,792                              | 0.11%           | 151                           | 560,203           | 0.22%           | 306                           |
| Savings deposits   | 173,228                              | 0.05%           | 21                            | 162,403           | 0.10%           | 42                            |
| Time deposits >\$100,000                                     | 575,627                              | 0.83%           | 1,183                         | 653,930           | 1.00%           | 1,613                         |
| Other time deposits  | 414,987                              | 0.45%           | 456                           | 496,029           | 0.65%           | 789                           |
| Total interest-bearing deposits                              | 2,246,744                            | 0.34%           | 1,891                         | 2,393,501         | 0.49%           | 2,912                         |
| Borrowings   | 47,394                               | 2.14%           | 250                           | 46,394            | 2.24%           | 256                           |
| Total interest-bearing liabilities                           | 2,294,138                            | 0.38%           | 2,141                         | 2,439,895         | 0.53%           | 3,168                         |
| Noninterest bearing checking                                 | 492,450                              |                 |                               | 409,744           |                 |                               |
| Other liabilities  | 15,842                               |                 |                               | 19,462            |                 |                               |
| Shareholders' equity   | 376,418                              |                 |                               | 359,362           |                 |                               |
| Total liabilities and shareholders' equity                   | \$3,178,848                          |                 |                               | \$3,228,463       |                 |                               |
| Net yield on interest-earning assets and net interest income |                                      | 5.13%           | \$35,908                      |                   | 4.69%           | \$32,293                      |
| Interest rate spread   |                                      | 5.06%           |                               |                   | 4.62%           |                               |
| Average prime rate   |                                      | 3.25%           |                               |                   | 3.25%           |                               |

(1) Average loans include nonaccruing loans, the effect of which is to lower the average rate shown.

(2) Includes tax-equivalent adjustments of \$373,000 and \$372,000 in 2014 and 2013, respectively, to reflect the tax benefit that we receive related to tax-exempt securities, which carry interest rates lower than similar taxable investments due to their tax exempt status. This amount has been computed assuming a 39% tax rate and is reduced by the related nondeductible portion of interest expense.

Average loans outstanding for the first quarter of 2014 were \$2.459 billion, which was 3.2% higher than the average loans outstanding for the first quarter of 2013 (\$2.383 billion). The higher amount of average loans outstanding in 2014 is due to internal loan growth. Partially offsetting the internal loan growth was the resolution of covered loans within our “covered loan” portfolio through foreclosure, charge-off, or repayment.

The mix of our loan portfolio remained substantially the same at March 31, 2014 compared to December 31, 2013, with approximately 90% of our loans being real estate loans, 7% being commercial, financial, and agricultural loans, and the remaining 3% being consumer installment loans. The majority of our real estate loans are personal and commercial loans where real estate provides additional security for the loan.

Average total deposits outstanding for the first quarter of 2014 were \$2.739 billion, which was 2.3% less than the average deposits outstanding for the first quarter of 2013 (\$2.803 billion). Average transaction deposit accounts (noninterest bearing checking, interest bearing checking, money market and savings accounts) increased from \$1.653 billion at March 31, 2013 to \$1.749 billion at March 31, 2014, representing growth of \$96 million, or 5.8%. With the growth of our transaction deposit accounts, we were able to lessen our reliance on higher cost sources of funding, specifically time deposits. Average time deposits declined from \$1.150 billion at March 31, 2013 to \$991 million at March 31, 2014, a decrease of \$159 million, or 13.9%. The favorable change in the funding mix was largely responsible for our average cost of interest bearing liabilities decreasing from 0.53% in the first quarter of 2013 to 0.38% in the first quarter of 2014. Our total cost of funds, which includes noninterest bearing checking accounts at a zero percent cost, was 0.31% in the first quarter of 2014 compared to 0.45% in the first quarter of 2013.

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See additional information regarding changes in the Company's loans and deposits in the section below entitled "Financial Condition."

Our net interest margin (tax-equivalent net interest income divided by average earning assets) for the first quarter of 2014 was 5.13% compared to 4.69% for the first quarter of 2013. The higher margin was primarily a result of a higher amount of discount accretion on loans purchased in failed-bank acquisitions (see discussion below), as well as the lower overall funding costs just discussed.

Our net interest margin benefitted from the net accretion of purchase accounting premiums/discounts associated with the Cooperative acquisition that occurred in June 2009 and, to a lesser degree, the acquisition of The Bank of Asheville in January 2011. For the three months ended March 31, 2014 and 2013, we recorded \$6,362,000 and \$3,551,000, respectively, in net accretion of purchase accounting premiums/discounts that increased net interest income. The following table presents the detail of the purchase accounting adjustments that impacted net interest income.

| \$ in thousands  | For the Three Months Ended |                |
|--|----------------------------|----------------|
|  | March 31,<br>2014          | March 31, 2013 |
| Interest income – reduced by premium amortization on loans     | \$ (49 )                   | (116 )         |
| Interest income – increased by accretion of loan discount      | 6,408                      | 3,658          |
| Interest expense – reduced by premium amortization of deposits | 3                          | 9              |
| Impact on net interest income                                  | \$ 6,362                   | 3,551          |

See additional information regarding net interest income in the section entitled "Interest Rate Risk."

The increase in discount accretion is primarily due to payoffs of loans with loan discounts and increased expectations regarding the collectability of other loans.

We recorded total provisions for loan losses of \$3.6 million in the first quarter of 2014 compared to \$11.1 million for the first quarter of 2013.

Our provision for loan losses on non-covered loans amounted to \$3.4 million in the first quarter of 2014 compared to \$5.8 million in the first quarter of 2013. The lower provision in 2014 was primarily the result of lower loan growth during the quarter, stable overall asset quality and low levels of net charge-offs.

Our provision for loan losses on covered loans amounted to \$0.2 million in the first quarter of 2014 compared to \$5.4 million in the first quarter of 2013. The decrease was primarily due to lower levels of covered nonperforming loans during the period, stabilization in the underlying collateral values of nonperforming loans, and a \$1.9 million recovery that we realized in the first quarter of 2014.

Total noninterest income was \$0.3 million in the first quarter of 2014 compared to \$7.1 million for the first quarter of 2013.

As presented in the table below, core noninterest income for the first quarter of 2014 was \$7.5 million, an increase of 15.5% over the \$6.5 million reported for the first quarter of 2013. Core noninterest income includes i) service charges on deposit accounts, ii) other service charges, commissions, and fees, iii) fees from presold mortgages, iv) commissions from financial product sales, and v) bank-owned life insurance income.



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The following table presents our core noninterest income for the three month periods ending March 31, 2014 and 2013, respectively.

| \$ in thousands  | For the Three Months Ended |                |
|--|----------------------------|----------------|
|  | March 31, 2014             | March 31, 2013 |
| Service charges on deposit accounts                        | \$ 3,573                   | 2,935          |
| Other service charges, commissions, and fees               | 2,367                      | 2,175          |
| Fees from presold mortgages                                | 607                        | 747            |
| Commissions from sales of insurance and financial products | 594                        | 399            |
| Bank-owned life insurance income                           | 327                        | 208            |
| Core noninterest income                                    | \$ 7,468                   | 6,464          |

Most categories of core noninterest income increased during the first three months of 2014 compared to the same period in 2013.

As shown in the table above, service charges on deposit accounts increased from \$2.9 million in the first quarter of 2013 to \$3.6 million in the first quarter of 2014. In December 2013, we introduced a new deposit product line-up that simplified our product offering and also altered the fee structure of many accounts. Some customer charges were lowered or eliminated, while other fees were increased, with the most significant change being the elimination of free checking for customers maintaining low account balances, which is the primary cause of the higher service charges in 2014.

Other service charges, commissions, and fees increased in 2014 compared to 2013 primarily as a result of higher debit card interchange fees. We earn a small fee each time a customer uses a debit card to make a purchase. Due to the growth in checking accounts and increased customer usage of debit cards, we have experienced increases in this line item.

Fees from presold mortgages decreased from \$0.7 million in the first quarter of 2013 to \$0.6 million in the first quarter of 2014. Mortgage loan refinancing activity has slowed down since the second quarter of 2013.

Commissions from sales of insurance and financial products have increased in 2014 compared to 2013 as a result of increased sales volume generated by additional personnel hired in our wealth management division over the past three years.

Bank-owned life insurance income was \$0.3 million in the first quarter of 2014 compared to \$0.2 million in the first quarter of 2013. The increase was due to the purchase of \$15 million in bank-owned life insurance in June 2013.

Within the noncore components of noninterest income, we recorded a net loss on non-covered foreclosed properties of \$0.2 million during the first quarter of 2014 compared to a net gain of \$0.8 million during the first quarter of 2013.

For the first quarter of 2014, we recorded losses of \$2.1 million on covered foreclosed properties compared to losses of \$4.6 million for the comparable period of 2013. The lower level of losses on covered properties in 2014 has been primarily a result of lower levels of covered foreclosed properties. In addition, losses on covered assets have declined due to stabilization in real estate market values in the coastal region of North Carolina, where most of our covered foreclosed properties are located.

Indemnification asset income (expense) is recorded to reflect additional (decreased) amounts expected to be received from the FDIC related to covered assets arising during the period. The three primary items that result in the recording of indemnification asset income (expense) are 1) loan discount accretion, 2) provisions for loan losses on covered loans and 3) foreclosed property gains (losses) on covered assets. Income and gains on covered assets generally result in the recording of indemnification asset expense, while losses result in indemnification asset income. In the first quarter of 2014, we recorded \$4.9 million in indemnification asset expense compared to \$4.9 million in indemnification asset income in the first quarter of 2013. The variance between the first quarter of 2014 and the first quarter of 2013 is primarily due to higher indemnification asset expense associated with higher loan discount accretion and fewer covered loan and foreclosed property losses that result in indemnification asset income, as shown in the following table:

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| (\$ in millions)  | For the Three Months Ended |                |
|---|----------------------------|----------------|
|   | March 31, 2014             | March 31, 2013 |
| Indemnification asset expense associated with loan discount accretion income        | \$ (5.9 )                  | (2.9 )         |
| Indemnification asset income (expense) associated with loan losses (recoveries),net | (0.4 )                     | 3.9            |
| Indemnification asset income associated with foreclosed property losses             | 1.6                        | 3.7            |
| Other sources of indemnification asset income (expense)                             | (0.2 )                     | 0.2            |
| Total indemnification asset income (expense)  | \$ (4.9 )                  | 4.9            |

During the first quarter of 2013, we recorded “other losses” of \$0.4 million related to the sale of a parcel of property that we had previously held for a future branch. We decided not to use the property for a branch and disposed of the property.

Noninterest expenses amounted to \$23.6 million in the first quarter of 2014, a 1.4% increase over the \$23.2 million recorded in the same period of 2013.

Salaries expense was \$11.6 million for the first quarter of 2014 compared to \$10.7 million in the first quarter of 2013. The increase in salaries expense has been primarily associated with the hiring of additional employees in our credit administration and mortgage banking divisions.

Employee benefits expense was \$2.3 million in the first quarter of 2014 compared to \$2.6 million in the first quarter of 2013. The decrease primarily relates to a \$0.3 million decline in health care expense resulting from lower incurred medical claims.

The combined amount of occupancy and equipment expense did not vary materially when comparing the first quarter of 2014 to the first quarter of 2013, amounting to approximately \$2.8 million in each quarter.

Other noninterest expenses amounted to \$6.6 million for the first quarter of 2014 compared to \$7.0 million in the first quarter of 2013. The biggest variance in this line item was lower repossession and collection expenses. Total collection expenses (net of FDIC reimbursement of covered assets) amounted to \$0.3 million in the first quarter of 2014 compared to \$1.2 million in the first quarter of 2013 and resulted from lower levels of collection activity and lower levels of foreclosed properties.

For the first quarter of 2014, the provision for income taxes was \$3.0 million, an effective tax rate of 34.8%. For the first quarter of 2013, the provision for income taxes was \$1.6 million, an effective tax rate of 33.4%.

We accrued total preferred stock dividends of \$0.2 million in each of the three months ended March 31, 2014 and 2013. These amounts are deducted from net income in computing “net income available to common shareholders.” The dividend rate can range from 1% to 5% per annum based upon changes in the level of our “Qualified Small Business Lending” (“QSBL”). We have been able to continually increase our levels of QSBL since 2011 and as such, our Series B Preferred Stock dividend rate has decreased to around 1.0% for both the first quarter of 2013 and 2014. We expect our Series B Preferred Stock dividend rate to remain at an annualized rate of 1.0% until 2016, unless that preferred stock is redeemed at an earlier date.

The Consolidated Statements of Comprehensive Income reflect other comprehensive income of \$164,000 during the first quarter of 2014 compared to other comprehensive loss of \$186,000 during the first quarter of 2013. The primary component of other comprehensive income (loss) for the periods presented was changes in unrealized holding gains (losses) of our available for sale securities. Our available for sale securities portfolio is predominantly comprised of fixed rate bonds that generally increase in value when market yields for fixed rate bonds decrease and decline in value when market yields for fixed rate bonds increase. Management has evaluated any unrealized losses on individual securities at each period end and determined that there is no other-than-temporary impairment.

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Total assets at March 31, 2014 amounted to \$3.31 billion, a 1.0% increase from a year earlier. Total loans at March 31, 2014 amounted to \$2.45 billion, a 2.1% increase from a year earlier, and total deposits amounted to \$2.79 billion, a 2.5 % decrease from a year earlier.

The following table presents information regarding the nature of our growth for the twelve months ended March 31, 2014 and for the first quarter of 2014.

| April 1, 2013 to<br>March 31, 2014      | Balance at<br>beginning<br>of period | Internal<br>Growth,<br>net (1) | Growth<br>from<br>Acquisitions | Balance at<br>end of<br>period | Total<br>percentage<br>growth | Internal<br>percentage<br>growth (1) |
|---|--------------------------------------|--------------------------------|--------------------------------|--------------------------------|-------------------------------|--------------------------------------|
| Loans – Non-covered                     | \$2,132,683                          | 124,043                        | —                              | 2,256,726                      | 5.8%                          | 5.8%                                 |
| Loans – Covered                         | 263,468                              | (72,917 )                      | —                              | 190,551                        | -27.7%                        | -27.7%                               |
| Total loans                             | 2,396,151                            | 51,126                         | —                              | 2,447,277                      | 2.1%                          | 2.1%                                 |
| Deposits – Noninterest bearing checking | 429,202                              | 82,410                         | —                              | 511,612                        | 19.2%                         | 19.2%                                |
| Deposits – Interest bearing checking    | 539,270                              | 11,432                         | —                              | 550,702                        | 2.1%                          | 2.1%                                 |
| Deposits – Money market                 | 568,092                              | (14,157 )                      | —                              | 553,935                        | -2.5%                         | -2.5%                                |
| Deposits – Savings                      | 166,510                              | 11,234                         | —                              | 177,744                        | 6.7%                          | 6.7%                                 |
| Deposits – Brokered                     | 118,117                              | 32,155                         | —                              | 150,272                        | 27.2%                         | 27.2%                                |
| Deposits – Internet time                | 7,689                                | (5,722 )                       | —                              | 1,967                          | -74.4%                        | -74.4%                               |
| Deposits – Time>\$100,000               | 532,747                              | (96,502 )                      | —                              | 436,245                        | -18.1%                        | -18.1%                               |
| Deposits – Time<\$100,000               | 495,940                              | (91,693 )                      | —                              | 404,247                        | -18.5%                        | -18.5%                               |
| Total deposits                          | \$2,857,567                          | (70,843 )                      | —                              | 2,786,724                      | -2.5%                         | -2.5%                                |
| January 1, 2014 to<br>March 31, 2014    |                                      |                                |                                |                                |                               |                                      |
| Loans – Non-covered                     | \$2,252,885                          | 3,841                          | —                              | 2,256,726                      | 0.2%                          | 0.2%                                 |
| Loans – Covered                         | 210,309                              | (19,758)                       | —                              | 190,551                        | -9.4%                         | -9.4%                                |
| Total loans                             | \$2,463,194                          | (15,917)                       | —                              | 2,447,277                      | -0.6%                         | -0.6%                                |
| Deposits – Noninterest bearing checking | \$482,650                            | 28,962                         | —                              | 511,612                        | 6.0%                          | 6.0%                                 |
| Deposits – Interest bearing checking    | 557,413                              | (6,711 )                       | —                              | 550,702                        | -1.2%                         | -1.2%                                |
| Deposits – Money market                 | 547,556                              | 6,379                          | —                              | 553,935                        | 1.2%                          | 1.2%                                 |
| Deposits – Savings                      | 169,023                              | 8,721                          | —                              | 177,744                        | 5.2%                          | 5.2%                                 |
| Deposits – Brokered                     | 116,087                              | 34,185                         | —                              | 150,272                        | 29.4%                         | 29.4%                                |
| Deposits – Internet time                | 1,319                                | 648                            | —                              | 1,967                          | 49.1%                         | 49.1%                                |
| Deposits – Time>\$100,000               | 451,741                              | (15,496)                       | —                              | 436,245                        | -3.4%                         | -3.4%                                |

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|                           |             |          |   |           |       |       |
|---------------------------|-------------|----------|---|-----------|-------|-------|
| Deposits – Time<\$100,000 | 425,230     | (20,983) | — | 404,247   | -4.9% | -4.9% |
| Total deposits            | \$2,751,019 | 35,705   | — | 2,786,724 | 1.3%  | 1.3%  |

(1) Excludes the impact of acquisitions in the year of acquisition, but includes growth or declines in acquired operations after the date of acquisition.

As derived from the table above, for the twelve months preceding March 31, 2014, our total loans increased \$51 million, or 2.1%. Over that period, we experienced internal growth in our non-covered loan portfolio of \$124 million, or 5.8%. Partially offsetting the growth in non-covered loans were normal loan pay-downs, foreclosures, and loan charge-offs of our covered loans, which declined by \$73 million at March 31, 2014 compared to a year earlier. We continue to pursue lending opportunities in order to improve our asset yields.

For the first three months of 2014, we experienced internal growth in our non-covered loan portfolio of \$4 million, or 0.2%. These increases were more than offset by a decline in our covered loans of \$20 million. We expect to experience higher loan growth in our non-covered loans portfolio for the remainder of 2014, while we expect our current portfolio of covered loans to continue to steadily decline. As discussed previously, at June 30, 2014, one of our loss share agreements expires and we will transfer that portfolio of loans from the “covered” category to the “non-covered” category.

The mix of our loan portfolio remains substantially the same at March 31, 2014 compared to December 31, 2013. The majority of our real estate loans are personal and commercial loans where real estate provides additional security for the loan.

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Note 7 to the consolidated financial statements presents additional detailed information regarding our mix of loans, including a break-out between loans covered by FDIC loss share agreements and non-covered loans. Additionally, the section above titled “FDIC Indemnification Asset” contains detail of our covered loans and foreclosed properties segregated by each of the four loss-share agreements.

For the twelve month periods ended March 31, 2014, we experienced a net decline in total deposits of \$71 million, which was a result of growth in our transaction account deposits (checking, money market, and savings) that was more than offset by declines in our time deposit accounts. Over this period, growth of \$91 million in our transaction account categories was more than offset by a \$162 million decline in time deposits, including brokered deposits and internet time deposits.

For the first three months of 2014, we experienced a net increase in total deposits of \$36 million. Transaction account deposits increased \$37 million, while the net decline in time deposits was only \$2 million. Within time deposits, we obtained \$34 million in brokered deposits to help offset declines of \$36 million in the retail time deposit categories (“Time>\$100,000” and “Time<\$100,000” categories).

As shown above, the retail time deposit categories experienced significant declines over the time periods shown. Due to the low interest rates we are currently offering as a result of the overall low interest rate environment in the marketplace, our analysis indicates that some customers are shifting their funds related to matured time deposits to their transaction accounts at our company, while other customers are withdrawing their funds from our company in search of higher yields from other companies. We expect this trend to continue.

We obtained new borrowings of \$90 million in the first quarter of 2014 from a low cost funding source in order to enhance our cash position and in anticipation of future loan growth.

**Nonperforming Assets**

Nonperforming assets include nonaccrual loans, troubled debt restructurings, loans past due 90 or more days and still accruing interest, nonperforming loans held for sale, and foreclosed real estate. As previously discussed, as a result of two FDIC-assisted transactions, we entered into loss share agreements that afford us significant protection from losses from all loans and foreclosed real estate acquired in those acquisitions.

Because of the loss protection provided by the FDIC, the financial risk of the acquired loans and foreclosed real estate is significantly different from the risk associated with assets not covered under the loss share agreements. Accordingly, we present separately nonperforming assets subject to the loss share agreements as “covered”

nonperforming assets, and nonperforming assets that are not subject to the loss share agreements as “non-covered.”

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Nonperforming assets are summarized as follows:

| <b>ASSET QUALITY DATA</b> ( <i>\$ in thousands</i> )           | As of/for the<br>quarter ended<br>March 31,<br>2014 | As of/for the<br>quarter ended<br>December 31,<br>2013 | As of/for the<br>quarter ended<br>March 31,<br>2013 |
|--|---|--|---|
| <b>Non-covered nonperforming assets</b>                        |   |  |   |
| Nonaccrual loans   | \$ 44,129   | 41,938   | 38,917  |
| Restructured loans – accruing                                  | 26,335  | 27,776   | 24,378  |
| Accruing loans >90 days past due                               | —   | —  | —   |
| Total non-covered nonperforming loans                          | 70,464  | 69,714   | 63,295  |
| Foreclosed real estate   | 11,740  | 12,251   | 20,115  |
| Total non-covered nonperforming assets                         | \$ 82,204   | 81,965   | 83,410  |
| <b>Covered nonperforming assets (1)</b>                        |   |  |   |
| Nonaccrual loans   | \$ 31,986   | 37,217   | 51,221  |
| Restructured loans – accruing                                  | 7,429   | 8,909  | 10,582  |
| Accruing loans > 90 days past due                              | —   | —  | —   |
| Total covered nonperforming loans                              | 39,415  | 46,126   | 61,803  |
| Foreclosed real estate   | 19,504  | 24,497   | 30,156  |
| Total covered nonperforming assets                             | \$ 58,919   | 70,623   | 91,959  |
| <b>Total nonperforming assets</b>                              | <b>\$ 141,123</b>                                   | <b>152,588</b>   | <b>175,369</b>                                      |
| <b>Asset Quality Ratios – All Assets</b>                       |   |  |   |
| Net charge-offs to average loans - annualized                  | 0.65%   | 1.31%  | 1.32%   |
| Nonperforming loans to total loans                             | 4.49%   | 4.70%  | 5.22%   |
| Nonperforming assets to total assets                           | 4.26%   | 4.79%  | 5.35%   |
| Allowance for loan losses to total loans                       | 1.97%   | 1.97%  | 2.08%   |
| Allowance for loan losses to nonperforming loans               | 43.80%  | 41.87%   | 39.80%  |
| <b>Asset Quality Ratios – Based on Non-covered Assets only</b> |   |  |   |
| Net charge-offs to average non-covered loans - annualized      | 0.52%   | 0.74%  | 0.51%   |
| Non-covered nonperforming loans to non-covered loans           | 3.12%   | 3.09%  | 2.97%   |
| Non-covered nonperforming assets to total non-covered assets   | 2.65%   | 2.78%  | 2.79%   |
| Allowance for loan losses to non-covered loans                 | 1.98%   | 1.96%  | 2.10%   |
| Allowance for loan losses to non-covered nonperforming loans   | 63.45%  | 63.49%   | 70.72%  |

(1) Covered nonperforming assets consist of assets that are included in loss share agreements with the FDIC.

We have reviewed the collateral for our nonperforming assets, including nonaccrual loans, and have included this review among the factors considered in the evaluation of the allowance for loan losses discussed below.

Consistent with the continuing weak economy in our market area, particularly in more rural areas, we have experienced high levels of loan losses, delinquencies and nonperforming assets compared to our historical averages.

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The following is the composition, by loan type, of all of our nonaccrual loans (covered and non-covered) at each period end, as classified for regulatory purposes:

| (\$ in thousands)  | At                   | At                      | At                   |
|--|----------------------|-------------------------|----------------------|
|  | March<br>31,<br>2014 | December<br>31,<br>2013 | March<br>31,<br>2013 |
| Commercial, financial, and agricultural                            | \$5,627              | 5,690                   | 2,866                |
| Real estate – construction, land development, and other land loans | 20,692               | 22,688                  | 26,657               |
| Real estate – mortgage – residential (1-4 family) first mortgages  | 20,290               | 21,751                  | 21,067               |
| Real estate – mortgage – home equity loans/lines of credit         | 3,999                | 4,081                   | 2,987                |
| Real estate – mortgage – commercial and other                      | 25,017               | 24,568                  | 35,590               |
| Installment loans to individuals                                   | 490                  | 377                     | 971                  |
| Total nonaccrual loans   | \$76,115             | 79,155                  | 90,138               |

The following segregates our nonaccrual loans at March 31, 2014 into covered and non-covered loans, as classified for regulatory purposes:

| (\$ in thousands)  | Covered             | Non-covered         | Total               |
|--|---------------------|---------------------|---------------------|
|  | Nonaccrual<br>Loans | Nonaccrual<br>Loans | Nonaccrual<br>Loans |
| Commercial, financial, and agricultural                            | \$ 399              | 5,228               | 5,627               |
| Real estate – construction, land development, and other land loans | 10,836              | 9,856               | 20,692              |
| Real estate – mortgage – residential (1-4 family) first mortgages  | 7,240               | 13,050              | 20,290              |
| Real estate – mortgage – home equity loans/lines of credit         | 461                 | 3,538               | 3,999               |
| Real estate – mortgage – commercial and other                      | 13,050              | 11,967              | 25,017              |
| Installment loans to individuals                                   | —                   | 490                 | 490                 |
| Total nonaccrual loans   | \$ 31,986           | 44,129              | 76,115              |

The following segregates our nonaccrual loans at December 31, 2013 into covered and non-covered loans, as classified for regulatory purposes:

| (\$ in thousands)  | Covered             | Non-covered         | Total               |
|--|---------------------|---------------------|---------------------|
|  | Nonaccrual<br>Loans | Nonaccrual<br>Loans | Nonaccrual<br>Loans |
| Commercial, financial, and agricultural                            | \$ 935              | 4,755               | 5,690               |
| Real estate – construction, land development, and other land loans | 13,274              | 9,414               | 22,688              |
| Real estate – mortgage – residential (1-4 family) first mortgages  | 9,447               | 12,304              | 21,751              |
| Real estate – mortgage – home equity loans/lines of credit         | 509                 | 3,572               | 4,081               |
| Real estate – mortgage – commercial and other                      | 13,050              | 11,518              | 24,568              |
| Installment loans to individuals                                   | 2                   | 375                 | 377                 |

|                        |           |        |        |
|------------------------|-----------|--------|--------|
| Total nonaccrual loans | \$ 37,217 | 41,938 | 79,155 |
|------------------------|-----------|--------|--------|

Among non-covered loans, the tables above indicate small increases in most categories of non-covered nonaccrual loans. Residential first mortgage loans experienced the largest increase, which was caused by increased efforts to work with home borrowers on repayment plans, increased legal delays in the foreclosure process, and continued challenging economic conditions in some of our more rural market areas.

“Restructured loans - accruing”, or troubled debt restructurings (TDRs), are accruing loans for which we have granted concessions to the borrower as a result of the borrower’s financial difficulties. As seen in the previous table “Asset Quality Data”, at March 31, 2014, total TDRs (covered and non-covered) amounted to \$33.8 million, compared to \$36.7 million at December 31, 2013, and \$35.0 million at March 31, 2013. The decline from December 31, 2013 to March 31, 2014 is primarily a result of TDRs that re-defaulted during the quarter and were placed on nonaccrual status.

Foreclosed real estate includes primarily foreclosed properties. Non-covered foreclosed real estate has decreased over the past year, amounting to \$11.7 million at March 31, 2014, \$12.3 million at December 31, 2013, and \$20.1 million at March 31, 2013. The decreases were the result of strong sales activity during the periods, which was consistent with our strategy implemented in 2012 to accelerate the disposition of foreclosed properties.

At March 31, 2014, we also held \$19.5 million in foreclosed real estate that is subject to the loss share agreements with the FDIC, which is a decline from \$24.5 million at December 31, 2013 and \$30.2 million at March 31, 2013. The decreases are due to increased property sales activity, particularly along the North Carolina coast, which is where most of our covered foreclosed properties are located.

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We believe that the fair values of the items of foreclosed real estate, less estimated costs to sell, equal or exceed their respective carrying values at the dates presented.

The following table presents the detail of all of our foreclosed real estate at each period end (covered and non-covered):

| (\$ in thousands)                 | At March 31, 2014 | At December 31, 2013 | At March 31, 2013 |
|-----------------------------------|-------------------|----------------------|-------------------|
| Vacant land                       | \$ 16,374         | 19,295               | 30,229            |
| 1-4 family residential properties | 6,856             | 7,982                | 11,713            |
| Commercial real estate            | 8,014             | 9,471                | 8,329             |
| Total foreclosed real estate      | \$ 31,244         | 36,748               | 50,271            |

The following segregates our foreclosed real estate at March 31, 2014 into covered and non-covered:

| (\$ in thousands)                 | Covered Foreclosed<br>Real Estate | Non-covered<br>Foreclosed Real Estate | Total Foreclosed<br>Real Estate |
|-----------------------------------|-----------------------------------|---------------------------------------|---------------------------------|
| Vacant land                       | \$ 11,508                         | 4,866                                 | 16,374                          |
| 1-4 family residential properties | 4,730                             | 2,126                                 | 6,856                           |
| Commercial real estate            | 3,266                             | 4,748                                 | 8,014                           |
| Total foreclosed real estate      | \$ 19,504                         | 11,740                                | 31,244                          |

The following segregates our foreclosed real estate at December 31, 2013 into covered and non-covered:

| (\$ in thousands)                 | Covered Foreclosed<br>Real Estate | Non-covered<br>Foreclosed Real Estate | Total Foreclosed<br>Real Estate |
|-----------------------------------|-----------------------------------|---------------------------------------|---------------------------------|
| Vacant land                       | \$ 14,043                         | 5,252                                 | 19,295                          |
| 1-4 family residential properties | 5,102                             | 2,880                                 | 7,982                           |
| Commercial real estate            | 5,352                             | 4,119                                 | 9,471                           |
| Total foreclosed real estate      | \$ 24,497                         | 12,251                                | 36,748                          |

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The following table presents geographical information regarding our nonperforming assets at March 31, 2014.

| (\$ in thousands)  | As of March 31, 2014 |             |         | Total<br>Loans | Nonperforming<br>Loans to<br>Total<br>Loans |
|--|----------------------|-------------|---------|----------------|---|
|  | Covered              | Non-covered | Total   |                |   |
| Nonaccrual loans and<br>Troubled Debt Restructurings (1) |                      |             |         |                |   |
| Eastern Region (NC)                                      | \$30,769             | 11,728      | 42,497  | \$569,000      | 7.5%  |
| Triangle Region (NC)                                     | —                    | 21,343      | 21,343  | 765,000        | 2.8%  |
| Triad Region (NC)  | —                    | 17,606      | 17,606  | 372,000        | 4.7%  |
| Charlotte Region (NC)                                    | —                    | 2,351       | 2,351   | 97,000         | 2.4%  |
| Southern Piedmont Region (NC)                            | 1,861                | 6,541       | 8,402   | 237,000        | 3.5%  |
| Western Region (NC)                                      | 6,656                | 14          | 6,670   | 55,000         | 12.1%                                       |
| South Carolina Region                                    | 129                  | 3,396       | 3,525   | 108,000        | 3.3%  |
| Virginia Region  | —                    | 7,485       | 7,485   | 232,000        | 3.2%  |
| Other  | —                    | —           | —       | 12,000         | 0.0%  |
| Total nonaccrual loans and troubled debt restructurings  | \$39,415             | 70,464      | 109,879 | \$2,447,000    | 4.5%  |
| Foreclosed Real Estate (1)                               |                      |             |         |                |   |
| Eastern Region (NC)                                      | \$13,601             | 1,705       | 15,306  |                |   |
| Triangle Region (NC)                                     | —                    | 3,642       | 3,642   |                |   |
| Triad Region (NC)  | —                    | 2,976       | 2,976   |                |   |
| Charlotte Region (NC)                                    | —                    | 687         | 687     |                |   |
| Southern Piedmont Region (NC)                            | 411                  | 842         | 1,253   |                |   |
| Western Region (NC)                                      | 5,443                | —           | 5,443   |                |   |
| South Carolina Region                                    | 49                   | 1,317       | 1,366   |                |   |
| Virginia Region  | —                    | 154         | 154     |                |   |
| Other  | —                    | 417         | 417     |                |   |
| Total foreclosed real estate                             | \$19,504             | 11,740      | 31,244  |                |   |

(1) The counties comprising each region are as follows:

Eastern North Carolina Region - New Hanover, Brunswick, Duplin, Dare, Beaufort, Onslow, Carteret

Triangle North Carolina Region - Moore, Lee, Harnett, Chatham, Wake

Triad North Carolina Region - Montgomery, Randolph, Davidson, Rockingham, Guilford, Stanly

Charlotte North Carolina Region - Iredell, Cabarrus, Rowan, Mecklenburg

Southern Piedmont North Carolina Region - Anson, Richmond, Scotland, Robeson, Bladen, Columbus, Cumberland

Western North Carolina Region - Buncombe

South Carolina Region - Chesterfield, Dillon, Florence, Horry

Virginia Region - Wythe, Washington, Montgomery, Pulaski, Roanoke

### **Summary of Loan Loss Experience**

The allowance for loan losses is created by direct charges to operations (known as a “provision for loan losses” for the period in which the charge is taken). Losses on loans are charged against the allowance in the period in which such loans, in management’s opinion, become uncollectible. The recoveries realized during the period are credited to this allowance.

We have no foreign loans, few agricultural loans and do not engage in significant lease financing or highly leveraged transactions. Commercial loans are diversified among a variety of industries. The majority of our real estate loans are primarily personal and commercial loans where real estate provides additional security for the loan. Collateral for virtually all of these loans is located within our principal market area.

The weak economic environment since 2009 has resulted in elevated levels of classified and nonperforming assets, which has led to higher provisions for loan losses compared to historical averages. While we have begun to see signs of a recovering economy in most of our market areas, the recovery seems to be lagging and is less robust than that of the national economy. We continue to have an elevated level of past due and adversely classified assets compared to historic averages. In fact, over the past year we have experienced steady, but small, increases in our non-covered nonperforming and adversely classified assets – see Note 7 to the consolidated financial statements for detail. Despite the higher levels of these problem assets, based on our analysis, we believe the severity of the loss rate inherent in our classified loans is less than in recent years. In addition, we believe that our allowance for loan losses is sufficient to absorb the probable losses inherent in our portfolio at March 31, 2014.

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Our total provision for loan losses was \$3.6 million for the first quarter of 2014 compared to \$11.1 million in the first quarter of 2013. The total provision for loan losses is comprised of provisions for loan losses for non-covered loans and provisions for loan losses for covered loans, as discussed in the following paragraphs.

The provision for loan losses on non-covered loans amounted to \$3.4 million in the first quarter of 2014 compared to \$5.8 million in the first quarter of 2013. The lower provision in 2014 was primarily the result of lower loan growth during the quarter, less inherent risk in our portfolio resulting from stabilization of overall asset quality, and low levels of net charge-offs.

The provision for loan losses on covered loans amounted to \$0.2 million in the first quarter of 2014 compared to \$5.4 million in the first quarter of 2013. The decrease was primarily due to lower levels of covered nonperforming loans during the period, stabilization in the underlying collateral values of nonperforming loans, and a \$1.9 million recovery that we realized in the first quarter of 2014.

For the first three months of 2014, we recorded \$4.0 million in net charge-offs, compared to \$7.8 million for the comparable period of 2013. The net charge-offs in 2014 included \$1.0 million of covered loans and \$2.9 million of non-covered loans, whereas in 2013 net charge-offs included \$5.1 million of covered loans and \$2.7 million of non-covered loans. The charge-offs in 2014 continue a trend that began in 2010, with charge-offs being concentrated in the construction and land development real estate categories. These types of loans have been impacted the most by the recession and decline in new housing.

The allowance for loan losses amounted to \$48.1 million at March 31, 2014, compared to \$48.5 million at December 31, 2013 and \$49.8 million at March 31, 2013. At March 31, 2014, December 31, 2013, and March 31, 2013, the allowance for loan losses attributable to covered loans was \$3.4 million, \$4.2 million, and \$5.0 million, respectively. The allowance for loan losses for covered loans is attributable to covered loans that have exhibited credit quality deterioration due to lower collateral valuations. The allowance for loan losses for non-covered loans has remained stable and amounted to \$44.7 million, \$44.3 million, and \$44.8 million at March 31, 2014, December 31, 2013, and March 31, 2013, respectively.

We believe our reserve levels are adequate to cover probable loan losses on the loans outstanding as of each reporting date. It must be emphasized, however, that the determination of the reserve using our procedures and methods rests upon various judgments and assumptions about economic conditions and other factors affecting loans. No assurance can be given that we will not in any particular period sustain loan losses that are sizable in relation to the amounts reserved or that subsequent evaluations of the loan portfolio, in light of conditions and factors then prevailing, will not require significant changes in the allowance for loan losses or future charges to earnings. See “Critical Accounting Policies – Allowance for Loan Losses” above.



In addition, various regulatory agencies, as an integral part of their examination process, periodically review our allowance for loan losses and value of other real estate. Such agencies may require us to recognize adjustments to the allowance or the carrying value of other real estate based on their judgments about information available at the time of their examinations.

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For the periods indicated, the following table summarizes our balances of loans outstanding, average loans outstanding, changes in the allowance for loan losses arising from charge-offs and recoveries, and additions to the allowance for loan losses that have been charged to expense.

| (\$ in thousands)   | Three Months<br>Ended<br>March 31,<br>2014 | Twelve Months<br>Ended<br>December 31,<br>2013 | Three Months<br>Ended<br>March 31,<br>2013 |
|---|--|--|--|
| Loans outstanding at end of period                                | \$ 2,447,277                               | 2,463,194                                      | 2,396,151                                  |
| Average amount of loans outstanding                               | \$ 2,459,368                               | 2,419,679                                      | 2,382,861                                  |
| Allowance for loan losses, at beginning of year                   | \$ 48,505                                  | 46,402   | 46,402                                     |
| Provision for loan losses   | 3,575                                      | 30,616   | 11,149                                     |
|   | 52,080                                     | 77,018   | 57,551                                     |
| Loans charged off:  |  |  |  |
| Commercial, financial, and agricultural                           | (1,559)                                    | (4,667)  | (1,431)                                    |
| Real estate – construction, land development & other land loans   | (2,019)                                    | (10,582)                                       | (4,782)                                    |
| Real estate – mortgage – residential (1-4 family) first mortgages | (1,078)                                    | (4,764)  | (653)                                      |
| Real estate – mortgage – home equity loans / lines of credit      | (285)                                      | (3,143)  | (746)                                      |
| Real estate – mortgage – commercial and other                     | (934)                                      | (7,027)  | (1,763)                                    |
| Installment loans to individuals                                  | (541)                                      | (2,253)  | (529)                                      |
| Total charge-offs   | (6,416)                                    | (32,436)                                       | (9,904)                                    |
| Recoveries of loans previously charged-off:                       |  |  |  |
| Commercial, financial, and agricultural                           | 26   | 198  | 23   |
| Real estate – construction, land development & other land loans   | 2,155                                      | 777  | 605  |
| Real estate – mortgage – residential (1-4 family) first mortgages | 30   | 595  | 526  |
| Real estate – mortgage – home equity loans / lines of credit      | 21   | 199  | 66   |
| Real estate – mortgage – commercial and other                     | 112  | 1,531  | 787  |
| Installment loans to individuals                                  | 119  | 623  | 135  |
| Total recoveries  | 2,463                                      | 3,923  | 2,142                                      |
| Net charge-offs   | (3,953)                                    | (28,513)                                       | (7,762)                                    |
| Allowance for loan losses, at end of period                       | \$ 48,127                                  | 48,505   | 49,789                                     |
| Ratios:   |  |  |  |
| Net charge-offs as a percent of average loans (annualized)        | 0.65%                                      | 1.18%  | 1.32%                                      |
| Allowance for loan losses as a percent of loans at end of period  | 1.97%                                      | 1.97%  | 2.08%                                      |

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The following table discloses the activity in the allowance for loan losses for the three months ended March 31, 2014, segregated into covered and non-covered.

| (\$ in thousands)   | As of March 31, 2014 |             |           |
|---|----------------------|-------------|-----------|
|   | Covered              | Non-covered | Total     |
| Loans outstanding at end of period                                | \$ 190,551           | 2,256,726   | 2,447,277 |
| Average amount of loans outstanding                               | \$ 200,430           | 2,258,938   | 2,459,368 |
| Allowance for loan losses, at beginning of year                   | \$ 4,242             | 44,263      | 48,505    |
| Provision for loan losses   | 210                  | 3,365       | 3,575     |
|   | 4,452                | 47,628      | 52,080    |
| Loans charged off:  |                      |             |           |
| Commercial, financial, and agricultural                           | (1,045 )             | (514 )      | (1,559 )  |
| Real estate – construction, land development & other land loans   | (1,076 )             | (943 )      | (2,019 )  |
| Real estate – mortgage – residential (1-4 family) first mortgages | (480 )               | (598 )      | (1,078 )  |
| Real estate – mortgage – home equity loans / lines of credit      | (23 )                | (262 )      | (285 )    |
| Real estate – mortgage – commercial and other                     | (322 )               | (612 )      | (934 )    |
| Installment loans to individuals                                  | (2 )                 | (539 )      | (541 )    |
| Total charge-offs   | (2,948 )             | (3,468 )    | (6,416 )  |
| Recoveries of loans previously charged-off:                       |                      |             |           |
| Commercial, financial, and agricultural                           | —                    | 26          | 26        |
| Real estate – construction, land development & other land loans   | 1,917                | 238         | 2,155     |
| Real estate – mortgage – residential (1-4 family) first mortgages | —                    | 30          | 30        |
| Real estate – mortgage – home equity loans / lines of credit      | —                    | 21          | 21        |
| Real estate – mortgage – commercial and other                     | —                    | 112         | 112       |
| Installment loans to individuals                                  | —                    | 119         | 119       |
| Total recoveries  | 1,917                | 546         | 2,463     |
| Net charge-offs   | (1,031 )             | (2,922 )    | (3,953 )  |
| Allowance for loan losses, at end of period                       | \$ 3,421             | 44,706      | 48,127    |

The following table discloses the activity in the allowance for loan losses for the three months ended March 31, 2013, segregated into covered and non-covered.

| (\$ in thousands)                               | As of March 31, 2013 |             |           |
|---|----------------------|-------------|-----------|
|   | Covered              | Non-covered | Total     |
| Loans outstanding at end of period              | \$ 263,468           | 2,132,683   | 2,396,151 |
| Average amount of loans outstanding             | \$ 272,891           | 2,109,970   | 2,382,861 |
| Allowance for loan losses, at beginning of year | \$ 4,759             | 41,643      | 46,402    |
| Provision for loan losses                       | 5,378                | 5,771       | 11,149    |
|   | 10,137               | 47,414      | 57,551    |

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|   |          |          |          |
|---|----------|----------|----------|
| Loans charged off:  |          |          |          |
| Commercial, financial, and agricultural                           | (608 )   | (823 )   | (1,431 ) |
| Real estate – construction, land development & other land loans   | (2,999 ) | (1,783 ) | (4,782 ) |
| Real estate – mortgage – residential (1-4 family) first mortgages | (258 )   | (395 )   | (653 )   |
| Real estate – mortgage – home equity loans / lines of credit      | (21 )    | (725 )   | (746 )   |
| Real estate – mortgage – commercial and other                     | (1,223 ) | (540 )   | (1,763 ) |
| Installment loans to individuals                                  | 0        | (529 )   | (529 )   |
| Total charge-offs   | (5,109 ) | (4,795 ) | (9,904 ) |
| Recoveries of loans previously charged-off:                       |          |          |          |
| Commercial, financial, and agricultural                           | —        | 23       | 23       |
| Real estate – construction, land development & other land loans   | —        | 605      | 605      |
| Real estate – mortgage – residential (1-4 family) first mortgages | —        | 526      | 526      |
| Real estate – mortgage – home equity loans / lines of credit      | —        | 66       | 66       |
| Real estate – mortgage – commercial and other                     | —        | 787      | 787      |
| Installment loans to individuals                                  | —        | 135      | 135      |
| Total recoveries  | —        | 2,142    | 2,142    |
| Net charge-offs   | (5,109 ) | (2,653 ) | (7,762 ) |
| Allowance for loan losses, at end of period                       | \$5,028  | 44,761   | 49,789   |

Based on the results of our loan analysis and grading program and our evaluation of the allowance for loan losses at March 31, 2014, there have been no material changes to the allocation of the allowance for loan losses among the various categories of loans since December 31, 2013.

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**Liquidity, Commitments, and Contingencies**

Our liquidity is determined by our ability to convert assets to cash or acquire alternative sources of funds to meet the needs of our customers who are withdrawing or borrowing funds, and to maintain required reserve levels, pay expenses and operate the Company on an ongoing basis. Our primary liquidity sources are net income from operations, cash and due from banks, federal funds sold and other short-term investments. Our securities portfolio is comprised almost entirely of readily marketable securities, which could also be sold to provide cash.

In addition to internally generated liquidity sources, we have the ability to obtain borrowings from the following three sources - 1) an approximately \$438 million line of credit with the Federal Home Loan Bank (of which \$70 million was outstanding at March 31, 2014), 2) a \$50 million overnight federal funds line of credit with a correspondent bank (of which \$10 million was outstanding at March 31, 2014), and 3) an approximately \$83 million line of credit through the Federal Reserve Bank of Richmond's discount window (of which \$10 million was outstanding at March 31, 2014). In addition to the outstanding borrowings from the FHLB that reduce the available borrowing capacity of that line of credit, our borrowing capacity was reduced by \$193 million and \$143 million at March 31, 2014 and 2013, respectively, as a result of our pledging letters of credit for public deposits at each of those dates. Unused and available lines of credit amounted to \$288 million at March 31, 2014 compared to \$254 million at December 31, 2013.

Our overall liquidity has increased since March 31, 2013, primarily as a result of our increased borrowings. Our liquid assets (cash and securities) as a percentage of our total deposits and borrowings increased from 18.7% at March 31, 2013 to 21.1% at March 31, 2014.

We believe our liquidity sources, including unused lines of credit, are at an acceptable level and remain adequate to meet our operating needs in the foreseeable future. We will continue to monitor our liquidity position carefully and will explore and implement strategies to increase liquidity if deemed appropriate.

The amount and timing of our contractual obligations and commercial commitments has not changed materially since December 31, 2013, detail of which is presented in Table 18 on page 87 of our 2013 Annual Report on Form 10-K.

We are not involved in any legal proceedings that, in our opinion, could have a material effect on our consolidated financial position.

**Off-Balance Sheet Arrangements and Derivative Financial Instruments**

Off-balance sheet arrangements include transactions, agreements, or other contractual arrangements pursuant to which we have obligations or provide guarantees on behalf of an unconsolidated entity. We have no off-balance sheet arrangements of this kind other than letters of credit and repayment guarantees associated with our trust preferred securities.

Derivative financial instruments include futures, forwards, interest rate swaps, options contracts, and other financial instruments with similar characteristics. We have not engaged in significant derivative activities through March 31, 2014, and have no current plans to do so.

### **Capital Resources**

We are regulated by the Board of Governors of the Federal Reserve Board (FED) and are subject to the securities registration and public reporting regulations of the Securities and Exchange Commission. Our banking subsidiary is regulated by the Federal Deposit Insurance Corporation (FDIC) and the North Carolina Office of the Commissioner of Banks. We are not aware of any recommendations of regulatory authorities or otherwise which, if they were to be implemented, would have a material effect on our liquidity, capital resources, or operations.

We must comply with regulatory capital requirements established by the FED and FDIC. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on our financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that involve quantitative measures of our assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. Our capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. These capital standards require us to maintain minimum ratios of “Tier 1” capital to total risk-weighted assets and total capital to risk-weighted assets of 4.00% and 8.00%, respectively. Tier 1 capital is comprised of total shareholders’ equity calculated in accordance with generally accepted accounting principles, excluding accumulated other comprehensive income (loss), less intangible assets, and total capital is comprised of Tier 1 capital plus certain adjustments, the largest of which is our allowance for loan losses. Risk-weighted assets refer to our on- and off-balance sheet exposures, adjusted for their related risk levels using formulas set forth in FED and FDIC regulations.

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In addition to the risk-based capital requirements described above, we are subject to a leverage capital requirement, which calls for a minimum ratio of Tier 1 capital (as defined above) to quarterly average total assets of 3.00% to 5.00%, depending upon the institution's composite ratings as determined by its regulators. The FED has not advised us of any requirement specifically applicable to us.

At March 31, 2014, our capital ratios exceeded the regulatory minimum ratios discussed above. The following table presents our capital ratios and the regulatory minimums discussed above for the periods indicated.

|  | March 31,<br>2014 | December 31,<br>2013 | March 31,<br>2013 |
|--|-------------------|----------------------|-------------------|
| Risk-based capital ratios:   |                   |                      |                   |
| Tier I capital to Tier I risk adjusted assets                          | 15.57%            | 15.53%               | 15.56%            |
| Minimum required Tier I capital  | 4.00%             | 4.00%                | 4.00%             |
| Total risk-based capital to Tier II risk-adjusted assets               |                   |                      |                   |
| Minimum required total risk-based capital                              | 8.00%             | 8.00%                | 8.00%             |
| Leverage capital ratios:   |                   |                      |                   |
| Tier I leverage capital to adjusted most recent quarter average assets | 11.27%            | 11.18%               | 10.55%            |
| Minimum required Tier I leverage capital                               | 4.00%             | 4.00%                | 4.00%             |

Our bank subsidiary is also subject to capital requirements similar to those discussed above. The bank subsidiary's capital ratios do not vary materially from our capital ratios presented above. At March 31, 2014, our bank subsidiary exceeded the minimum ratios established by the FED and FDIC.

In addition to regulatory capital ratios, we also closely monitor our ratio of tangible common equity to tangible assets ("TCE Ratio"). Our TCE ratio was 7.30% at March 31, 2014 compared to 7.46% at December 31, 2013 and 6.76% at March 31, 2013.

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**BUSINESS DEVELOPMENT MATTERS**

The following is a list of business development and other miscellaneous matters affecting First Bancorp and First Bank, our bank subsidiary.

On January 15, 2014, the First Bank branch located in Wallace, North Carolina relocated to a new location at 517 North Norwood Street. A grand opening celebration was held on January 24, 2014 with the staff welcoming customers to its new and improved facility.

On January 16, 2014, the Company unveiled its new website, [www.LocalFirstBank.com](http://www.LocalFirstBank.com), which has a new look and many new features that make banking with First Bank better than ever.

On March 14, 2014, the Company announced a quarterly cash dividend of \$0.08 cents per share payable on April 25, 2014 to shareholders of record on March 31, 2014. This is the same dividend rate as the Company declared in the first quarter of 2013.

On March 21, 2014, the First Bank branch located in West Innes Street in Salisbury, North Carolina was closed. The accounts at that branch were reassigned to First Bank's branch located at 1525 Jake Alexander Boulevard.

The Company expects to open a full-service branch in Fuquay-Varina, North Carolina, in the second quarter of 2014. The new branch will be located at 125 North Main Street.

The Company is planning to construct a new branch facility at 4110 Bradham Drive, Jacksonville, North Carolina. Upon completion, the First Bank branch located on Western Boulevard will be closed and the accounts at that branch will be reassigned to the new and improved branch. This is expected to occur in the first quarter of 2015 and is subject to regulatory approval.

**SHARE REPURCHASES**

We did not repurchase any shares of our common stock during the first three months of 2014. At March 31, 2014, we had approximately 214,000 shares available for repurchase under existing authority from our board of directors. We may repurchase these shares in open market and privately negotiated transactions, as market conditions and our liquidity warrants, subject to compliance with applicable regulations. See also Part II, Item 2 "Unregistered Sales of Equity Securities and Use of Proceeds."



Item 3 – Quantitative and Qualitative Disclosures About Market Risk

**INTEREST RATE RISK (INCLUDING QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK)**

Net interest income is our most significant component of earnings. Notwithstanding changes in volumes of loans and deposits, our level of net interest income is continually at risk due to the effect that changes in general market interest rate trends have on interest yields earned and paid with respect to our various categories of earning assets and interest-bearing liabilities. It is our policy to maintain portfolios of earning assets and interest-bearing liabilities with maturities and repricing opportunities that will afford protection, to the extent practical, against wide interest rate fluctuations. Our exposure to interest rate risk is analyzed on a regular basis by management using standard GAP reports, maturity reports, and an asset/liability software model that simulates future levels of interest income and expense based on current interest rates, expected future interest rates, and various intervals of “shock” interest rates. Over the years, we have been able to maintain a fairly consistent yield on average earning assets (net interest margin). Over the past five calendar years, our net interest margin has ranged from a low of 3.81% (realized in 2009) to a high of 4.92% (realized in 2013). During that five year period, the prime rate of interest has consistently remained at 3.25% (which was the rate as of March 31, 2014). The consistency of the net interest margin is aided by the relatively low level of long-term interest rate exposure that we maintain. At March 31, 2014, approximately 74% of our interest-earning assets are subject to repricing within five years (because they are either adjustable rate assets or they are fixed rate assets that mature) and substantially all of our interest-bearing liabilities reprice within five years.

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Using stated maturities for all fixed rate instruments except mortgage-backed securities (which are allocated in the periods of their expected payback) and securities and borrowings with call features that are expected to be called (which are shown in the period of their expected call), at March 31, 2014, we had approximately \$953 million more in interest-bearing liabilities that are subject to interest rate changes within one year than earning assets. This generally would indicate that net interest income would experience downward pressure in a rising interest rate environment and would benefit from a declining interest rate environment. However, this method of analyzing interest sensitivity only measures the magnitude of the timing differences and does not address earnings, market value, or management actions. Also, interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. In addition to the effects of “when” various rate-sensitive products reprice, market rate changes may not result in uniform changes in rates among all products. For example, included in interest-bearing liabilities subject to interest rate changes within one year at March 31, 2014 are deposits totaling \$1.3 billion comprised of checking, savings, and certain types of money market deposits with interest rates set by management. These types of deposits historically have not repriced with, or in the same proportion, as general market indicators.

Overall, we believe that in the near term (twelve months), net interest income will not likely experience significant downward pressure from rising interest rates. Similarly, we would not expect a significant increase in near term net interest income from falling interest rates. Generally, when rates change, our interest-sensitive assets that are subject to adjustment reprice immediately at the full amount of the change, while our interest-sensitive liabilities that are subject to adjustment reprice at a lag to the rate change and typically not to the full extent of the rate change. In the short-term (less than six months), this results in us being asset-sensitive, meaning that our net interest income benefits from an increase in interest rates and is negatively impacted by a decrease in interest rates. However, in the twelve-month horizon, the impact of having a higher level of interest-sensitive liabilities lessens the short-term effects of changes in interest rates.

The general discussion in the foregoing paragraph applies most directly in a “normal” interest rate environment in which longer-term maturity instruments carry higher interest rates than short-term maturity instruments, and is less applicable in periods in which there is a “flat” interest rate curve. A “flat yield curve” means that short-term interest rates are substantially the same as long-term interest rates. As a result of the prolonged negative economic environment that continued into 2013, the Federal Reserve took steps to suppress long-term interest rates in an effort to boost the housing market, increase employment, and stimulate the economy, which resulted in a flat interest rate curve. A flat interest rate curve is an unfavorable interest rate environment for many banks, including the Company, as short-term interest rates generally drive our deposit pricing and longer-term interest rates generally drive loan pricing. When these rates converge, the profit spread we realize between loan yields and deposit rates narrows, which pressures our net interest margin.

In June 2013, the economy began to show signs of improvement and the Federal Reserve suggested that it may lessen its involvement in the economic recovery process in the near future, which could result in a rise in interest rates, especially longer-term interest rates. The marketplace began to anticipate that result and accordingly, longer-term interest rates increased in 2013, while short-term rates have remained stable. For example, from March 31, 2013 to March 31, 2014, the interest rate on three-month Treasury bills remained stable, but the interest rate for seven-year Treasury notes increased by 106 basis points. These increases result in a “steepening” of the yield curve and is a more favorable interest rate environment for many banks, including the Company, because as noted above, short-term

interest rates generally drive our deposit pricing and longer-term interest rates generally drive loan pricing. However, intense competition for high-quality loans in our market areas has thus far negated the impact of the higher long-term market rates by limiting our ability to charge higher rates on loans, and thus we continue to experience downward pressure on our loan yields and net interest margin.

As it relates to deposits, the Federal Reserve has made no changes to the short term interest rates it sets directly since 2008, and since that time we have been able to reprice many of our maturing time deposits at lower interest rates. We were also able to generally decrease the rates we paid on other categories of deposits as a result of declining short-term interest rates in the marketplace and an increase in liquidity that lessened our need to offer premium interest rates. However, as short-term rates are already near zero, it is unlikely that we will be able to continue the trend of reducing our funding costs in the same proportion as experienced in recent years.

As previously discussed in the section “Net Interest Income,” our net interest income has been impacted by certain purchase accounting adjustments related primarily to our acquisitions of Cooperative Bank and The Bank of Asheville. The purchase accounting adjustments related to the premium amortization on loans, deposits and borrowings are based on amortization schedules and are thus systematic and predictable. The accretion of the loan discount on loans acquired from Cooperative Bank and The Bank of Asheville, which amounted to \$6.4 million and \$3.7 million for the first quarters of 2014 and 2013, respectively, is less predictable and could be materially different among periods. This is because of the magnitude of the discounts that were initially recorded (\$280 million in total) and the fact that the accretion being recorded is dependent on both the credit quality of the acquired loans and the impact of any accelerated loan repayments, including payoffs. If the credit quality of the loans declines, some, or all, of the remaining discount will cease to be accreted into income. If the underlying loans experience accelerated paydowns or improved performance expectations, the remaining discount will be accreted into income on an accelerated basis. In the event of total payoff, the remaining discount will be entirely accreted into income in the period of the payoff. Each of these factors is difficult to predict and susceptible to volatility.

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Based on our most recent interest rate modeling, which assumes no changes in interest rates for 2014 (federal funds rate = 0.25%, prime = 3.25%), we project that our net interest margin for the remainder of 2014 will experience some compression. We expect loan yields to continue to trend downwards, while many of our deposit products already have interest rates near zero.

We have no market risk sensitive instruments held for trading purposes, nor do we maintain any foreign currency positions.

See additional discussion regarding net interest income, as well as discussion of the changes in the annual net interest margin in the section entitled “Net Interest Income” above.

Item 4 – Controls and Procedures

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures, which are our controls and other procedures that are designed to ensure that information required to be disclosed in our periodic reports with the SEC is recorded, processed, summarized and reported within the required time periods. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed is communicated to our management to allow timely decisions regarding required disclosure. Based on the evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are effective in allowing timely decisions regarding disclosure to be made about material information required to be included in our periodic reports with the SEC. In addition, no change in our internal control over financial reporting has occurred during, or subsequent to, the period covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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## Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds

## Issuer Purchases of Equity Securities

| Period                                | Total Number of Shares Purchased (2) | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1) | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (1) |
|---------------------------------------|--------------------------------------|------------------------------|--|--|
| January 1, 2014 to January 31, 2014   | —                                    | —                            | —  | 214,241  |
| February 1, 2014 to February 28, 2014 | —                                    | —                            | —  | 214,241  |
| March 1, 2014 to March 31, 2014       | —                                    | —                            | —  | 214,241  |
| Total                                 | —                                    | —                            | —  | 214,241  |

Footnotes to the Above Table

All shares available for repurchase are pursuant to publicly announced share repurchase authorizations. On July 30, 2004, the Company announced that its board of directors had approved the repurchase of 375,000 shares of the (1) Company's common stock. The repurchase authorization does not have an expiration date. There are no plans or programs the Company has determined to terminate prior to expiration, or under which we do not intend to make further purchases.

The table above does not include shares that were used by option holders to satisfy the exercise price of the call (2) options issued by the Company to its employees and directors pursuant to the Company's stock option plans. There were no such exercises during the three months ended March 31, 2014.

There were no unregistered sales of our securities during the three months ended March 31, 2014.

## Item 6 - Exhibits

The following exhibits are filed with this report or, as noted, are incorporated by reference. Management contracts, compensatory plans and arrangements are marked with an asterisk (\*).

- Articles of Incorporation of the Company and amendments thereto were filed as Exhibits 3.a.i through 3.a.v to the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2002, and are incorporated herein by reference. Articles of Amendment to the Articles of Incorporation were filed as Exhibits 3.1 and 3.2 to the Company's Current Report on Form 8-K filed on January 13, 2009, and are incorporated herein by reference.
- 3.a Articles of Amendment to the Articles of Incorporation were filed as Exhibit 3.1.b to the Company's Registration Statement on Form S-3D filed on June 29, 2010, and are incorporated herein by reference. Articles of Amendment to the Articles of Incorporation were filed as Exhibit 3.1 to the Company's Current Report on Form 8-K filed on September 6, 2011, and are incorporated herein by reference. Articles of Amendment to the Articles of Incorporation were filed as Exhibit 3.1 to the Company's Current Report on Form 8-K filed on December 26, 2012, and are incorporated herein by reference.
- 3.b Amended and Restated Bylaws of the Company were filed as Exhibit 3.1 to the Company's Current Report on Form 8-K filed on November 23, 2009, and are incorporated herein by reference.
- 4.a Form of Common Stock Certificate was filed as Exhibit 4 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1999, and is incorporated herein by reference.
- 4.b Form of Certificate for Series B Preferred Stock was filed as Exhibit 4.1 to the Company's Current Report on Form 8-K filed on September 6, 2011, and is incorporated herein by reference.
- 4.c Form of Certificate for Series C Preferred Stock was filed as Exhibit 4.1 to the Company's Current Report on Form 8-K filed on December 26, 2012, and is incorporated herein by reference.
- 10.a Employment Agreement Between the Company and Edward F. Soccorso dated March 19, 2014. (\*)
- 10.b Employment Agreement Between the Company and Michael G. Mayer dated March 10, 2014 was filed as Exhibit 10.z to the Company's Annual Report on Form 10-K for the year ended December 31, 2013 and is incorporated herein by reference. (\*)

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Amendment to the First Bancorp Senior Management Supplemental Executive Retirement Plan Dated March 11, 2014 was filed as Exhibit 10.aa to the Company's Annual Report on Form 10-K for the year ended December 31, 2013 and is incorporated herein by reference. (\*)

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|------|---|
| 12   | Computation of Ratio of Earnings to Fixed Charges.  |
| 31.1 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.                      |
| 31.2 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.                      |
| 32.1 | Chief Executive Officer Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Chief Financial Officer Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |

The following financial information from the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2014, formatted in eXtensible Business Reporting Language (XBRL): (i) the Consolidated Balance Sheet, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Shareholders' Equity, (v) the Consolidated Statements of Cash Flows, and (vi) the Notes to Consolidated Financial Statements. (1)

**Copies of exhibits are available upon written request to: First Bancorp, Elizabeth B. Bostian, Secretary, 300 SW Broad Street, Southern Pines, North Carolina, 28387**

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As provided in Rule 406T of Regulation S-T, this information shall not be deemed "filed" for purposes of Section 11 (1) and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934 or otherwise subject to liability under those sections.

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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.

FIRST BANCORP

May 12, 2014 BY:/s/ Richard H. Moore

Richard H. Moore  
President  
(Principal Executive Officer),  
Treasurer and Director

May 12, 2014 BY:/s/ Eric P. Credle

Eric P. Credle  
Executive Vice President  
and Chief Financial Officer