

LAKELAND BANCORP INC  
Form 10-Q  
November 08, 2013  
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# SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

## FORM 10-Q

(Mark one)

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

For the quarterly period ended September 30, 2013

OR

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

For the transition period from            to

Commission file number 000-17820

# LAKELAND BANCORP, INC.

(Exact name of registrant as specified in its charter)

New Jersey  
(State or other jurisdiction of  
incorporation or organization)

22-2953275  
(I.R.S. Employer  
Identification No.)

250 Oak Ridge Road, Oak Ridge, New Jersey  
(Address of principal executive offices)

07438  
(Zip Code)

(973) 697-2000

(Registrant's telephone number, including area code)

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer 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

### APPLICABLE ONLY TO CORPORATE ISSUERS:

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

As of October 30, 2013 there were 35,832,759 outstanding shares of Common Stock, no par value.

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The Securities and Exchange Commission maintains a web site which contains reports, proxy and information statements and other information relating to registrants that file electronically at the address: [http:// www.sec.gov](http://www.sec.gov).

**Table of Contents****Lakeland Bancorp, Inc. and Subsidiaries****CONSOLIDATED BALANCE SHEETS**

|  | September 30, 2013<br>(unaudited)<br>(dollars in thousands except<br>share and per share amounts) | December 31,<br>2012 |
|--|---|----------------------|
| <b>ASSETS:</b>   |   |                      |
| Cash   | \$ 130,035  | \$ 100,926           |
| Interest-bearing deposits due from banks   | 15,219  | 6,619                |
| Total cash and cash equivalents  | 145,254   | 107,545              |
| Investment securities available for sale, at fair value  | 418,562   | 393,710              |
| Investment securities held to maturity; fair value of \$96,196 at September 30, 2013 and \$99,784 at December 31, 2012                               | 96,702  | 96,925               |
| Federal Home Loan Bank Stock, at cost  | 5,965   | 5,382                |
| Loans held for sale  | 901   |                      |
| Loans, net of deferred costs (fees)  | 2,427,684   | 2,146,843            |
| Less: allowance for loan and lease losses  | 29,757  | 28,931               |
| Net loans  | 2,397,927   | 2,117,912            |
| Premises and equipment, net  | 37,351  | 33,280               |
| Accrued interest receivable  | 8,173   | 7,643                |
| Goodwill   | 110,381   | 87,111               |
| Other identifiable intangible assets   | 2,548   |                      |
| Bank owned life insurance  | 55,534  | 46,143               |
| Other assets   | 20,002  | 23,052               |
| <b>TOTAL ASSETS</b>  | <b>\$ 3,299,300</b>   | <b>\$ 2,918,703</b>  |
| <b>LIABILITIES</b>   |   |                      |
| Deposits:  |   |                      |
| Noninterest bearing  | \$ 623,562  | \$ 498,066           |
| Savings and interest-bearing transaction accounts  | 1,770,299   | 1,569,139            |
| Time deposits under \$100 thousand   | 190,996   | 188,278              |
| Time deposits \$100 thousand and over  | 123,597   | 115,514              |
| Total deposits   | 2,708,454   | 2,370,997            |
| Federal funds purchased and securities sold under agreements to repurchase   | 110,525   | 117,289              |
| Other borrowings   | 75,000  | 85,000               |
| Subordinated debentures  | 42,548  | 51,548               |
| Other liabilities  | 15,248  | 13,002               |
| <b>TOTAL LIABILITIES</b>   | <b>2,951,775</b>  | <b>2,637,836</b>     |
| <b>STOCKHOLDERS EQUITY</b>   |   |                      |
| Common stock, no par value; authorized shares, 70,000,000; issued 35,823,147 shares at September 30, 2013 and 29,941,967 shares at December 31, 2012 | 362,549   | 303,794              |
| Accumulated deficit  | (13,192)  | (24,145)             |
| Treasury stock, at cost, 0 shares at September 30, 2013 and 216,077 at December 31, 2012   |   | (2,718)              |
| Accumulated other comprehensive (loss) gain  | (1,832)   | 3,936                |

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|  |                     |                     |
|--|---------------------|---------------------|
| TOTAL STOCKHOLDERS EQUITY                        | 347,525             | 280,867             |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b> | <b>\$ 3,299,300</b> | <b>\$ 2,918,703</b> |

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

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## CONSOLIDATED STATEMENTS OF INCOME UNAUDITED

|  | For the Three Months Ended September 30, |               | For the Nine Months Ended September 30, |               |
|--|--|---------------|---|---------------|
|  | 2013                                     | 2012          | 2013                                    | 2012          |
|  | (In thousands, except per share data)    |               |   |               |
| <b>INTEREST INCOME</b>   |  |               |   |               |
| Loans, leases and fees   | \$ 27,350                                | \$ 24,929     | \$ 77,122                               | \$ 75,659     |
| Federal funds sold and interest-bearing deposits with banks                | 27                                       | 17            | 57                                      | 29            |
| Taxable investment securities and other                                    | 2,017                                    | 2,121         | 5,544                                   | 6,668         |
| Tax-exempt investment securities   | 461                                      | 428           | 1,331                                   | 1,371         |
| <b>TOTAL INTEREST INCOME</b>   | <b>29,855</b>                            | <b>27,495</b> | <b>84,054</b>                           | <b>83,727</b> |
| <b>INTEREST EXPENSE</b>  |  |               |   |               |
| Deposits   | 1,518                                    | 2,026         | 4,740                                   | 6,421         |
| Federal funds purchased and securities sold under agreements to repurchase | 14                                       | 12            | 36                                      | 68            |
| Other borrowings   | 836                                      | 1,802         | 2,709                                   | 5,889         |
| <b>TOTAL INTEREST EXPENSE</b>  | <b>2,368</b>                             | <b>3,840</b>  | <b>7,485</b>                            | <b>12,378</b> |
| <b>NET INTEREST INCOME</b>   | <b>27,487</b>                            | <b>23,655</b> | <b>76,569</b>                           | <b>71,349</b> |
| Provision for loan and lease losses  | 1,879                                    | 3,350         | 7,656                                   | 11,783        |
| <b>NET INTEREST INCOME AFTER PROVISION FOR LOAN AND LEASE LOSSES</b>       | <b>25,608</b>                            | <b>20,305</b> | <b>68,913</b>                           | <b>59,566</b> |
| <b>NONINTEREST INCOME</b>  |  |               |   |               |
| Service charges on deposit accounts  | 2,838                                    | 2,757         | 8,052                                   | 7,914         |
| Commissions and fees   | 1,139                                    | 1,162         | 3,495                                   | 3,401         |
| Gains on sales of investment securities                                    |  |               | 506                                     | 273           |
| Gain on debt extinguishment  |  |               | 1,197                                   |               |
| Income on bank owned life insurance  | 383                                      | 357           | 1,036                                   | 1,035         |
| Other income   | 285                                      | 364           | 1,203                                   | 845           |
| <b>TOTAL NONINTEREST INCOME</b>  | <b>4,645</b>                             | <b>4,640</b>  | <b>15,489</b>                           | <b>13,468</b> |
| <b>NONINTEREST EXPENSE</b>   |  |               |   |               |
| Salaries and employee benefits   | 11,019                                   | 9,578         | 31,105                                  | 28,578        |
| Net occupancy expense  | 2,060                                    | 1,807         | 5,921                                   | 5,131         |
| Furniture and equipment  | 1,582                                    | 1,205         | 4,492                                   | 3,427         |
| Stationery, supplies and postage   | 348                                      | 388           | 1,086                                   | 1,079         |
| Marketing expense  | 715                                      | 718           | 1,438                                   | 1,646         |
| FDIC insurance expense   | 436                                      | 519           | 1,505                                   | 1,620         |
| Legal expense  | 406                                      | 135           | 934                                     | 880           |
| Expenses on other real estate owned and other repossessed assets           | (2)                                      | 13            | 15                                      | 89            |
| Long term debt prepayment fee  |  |               | 526                                     |               |
| Merger related expenses  | 744                                      |               | 2,827                                   |               |
| Core deposit intangible amortization                                       | 123                                      |               | 164                                     |               |
| Other expenses   | 2,976                                    | 2,605         | 8,014                                   | 7,263         |
| <b>TOTAL NONINTEREST EXPENSE</b>   | <b>20,407</b>                            | <b>16,968</b> | <b>58,027</b>                           | <b>49,713</b> |

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|  |                 |                 |                  |                  |
|--|-----------------|-----------------|------------------|------------------|
| Income before provision for income taxes           | 9,846           | 7,977           | 26,375           | 23,321           |
| Income tax expense                                 | 3,229           | 2,488           | 8,747            | 7,408            |
| <b>NET INCOME</b>                                  | <b>\$ 6,617</b> | <b>\$ 5,489</b> | <b>\$ 17,628</b> | <b>\$ 15,913</b> |
| Dividends on Preferred Stock and Accretion         |                 |                 |                  | 620              |
| <b>Net Income Available to Common Stockholders</b> | <b>\$ 6,617</b> | <b>\$ 5,489</b> | <b>\$ 17,628</b> | <b>\$ 15,293</b> |
| <b>PER SHARE OF COMMON STOCK</b>                   |                 |                 |                  |                  |
| Basic earnings                                     | \$ 0.18         | \$ 0.20         | \$ 0.54          | \$ 0.56          |
| Diluted earnings                                   | \$ 0.18         | \$ 0.20         | \$ 0.54          | \$ 0.56          |
| Dividends  | \$ 0.07         | \$ 0.06         | \$ 0.21          | \$ 0.18          |

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

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

|  | For the Three Months Ended September 30, |                 | For the Nine Months Ended September 30, |                  |
|--|--|-----------------|---|------------------|
|  | 2013                                     | 2012            | 2013                                    | 2012             |
|  | (in thousands)                           |                 | (in thousands)                          |                  |
| <b>NET INCOME</b>                                  | <b>\$ 6,617</b>                          | <b>\$ 5,489</b> | <b>\$ 17,628</b>                        | <b>\$ 15,913</b> |
| <b>OTHER COMPREHENSIVE INCOME, NET OF TAX:</b>     |  |                 |   |                  |
| Unrealized securities gains (losses) during period | 1,118                                    | 1,220           | (5,454)                                 | 2,174            |
| Reclassification for gains included in net income  | 0  | 0               | (329)                                   | (177)            |
| Change in pension liability, net                   | 5  | 5               | 15                                      | 15               |
| Other Comprehensive Income (Loss)                  | 1,123                                    | 1,225           | (5,768)                                 | 2,012            |
| <b>TOTAL COMPREHENSIVE INCOME (LOSS)</b>           | <b>\$ 7,740</b>                          | <b>\$ 6,714</b> | <b>\$ 11,860</b>                        | <b>\$ 17,925</b> |

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



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## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY UNAUDITED

Nine Months Ended September 30, 2013

|  | Common stock     |            | Accumulated deficit<br>(dollars in thousands) | Treasury Stock | Accumulated Other Comprehensive Income (Loss) | Total      |
|--|------------------|------------|---|----------------|---|------------|
|  | Number of Shares | Amount     |   |                |   |            |
| BALANCE January 1, 2013  | 29,941,967       | \$ 303,794 | (\$ 24,145)                                   | (\$ 2,718)     | \$ 3,936                                      | \$ 280,867 |
| Net Income   |                  |            | 17,628  |                |   | 17,628     |
| Other comprehensive loss, net of tax                               |                  |            |   |                | (5,768)                                       | (5,768)    |
| Stock based compensation   |                  | 669        |   |                |   | 669        |
| Issuance of restricted stock awards                                |                  | (1,301)    |   | 1,301          |   |            |
| Issuance of stock for acquisition                                  | 5,794,079        | 57,419     |   |                |   | 57,419     |
| Issuance of stock options for acquisition                          |                  | 1,603      |   |                |   | 1,603      |
| Issuance of stock to dividend reinvestment and stock purchase plan | 27,270           | 108        | (901)   | 938            |   | 145        |
| Exercise of stock options, net of excess tax benefits              | 59,831           | 257        |   | 479            |   | 736        |
| Cash dividends, common stock                                       |                  |            | (5,774)                                       |                |   | (5,774)    |
| BALANCE September 30, 2013 (UNAUDITED)                             | 35,823,147       | \$ 362,549 | (\$ 13,192)                                   | \$             | (\$ 1,832)                                    | \$ 347,525 |

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

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## CONSOLIDATED STATEMENTS OF CASH FLOWS UNAUDITED

|  | For the Nine Months Ended<br>September 30, |                 |
|--|--|-----------------|
|  | 2013                                       | 2012            |
|  | (dollars in thousands)                     |                 |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>  |  |                 |
| Net income   | \$ 17,628                                  | \$ 15,913       |
| Adjustments to reconcile net income to net cash provided by operating activities:      |  |                 |
| Net amortization of premiums, discounts and deferred loan fees and costs               | 3,695                                      | 4,616           |
| Depreciation and amortization  | 2,770                                      | 2,229           |
| Provision for loan and lease losses  | 7,656                                      | 11,783          |
| Loans originated for sale  | (27,125)                                   |                 |
| Proceeds from sales of loans   | 29,368                                     |                 |
| Gains on securities  | (506)                                      | (273)           |
| Gain on early debt extinguishment  | (1,197)                                    |                 |
| Gains on sales of loans held for sale  | (612)                                      |                 |
| Gains on leases  |  | (365)           |
| Gains on sales of other real estate and other repossessed assets                       | (277)                                      | (240)           |
| Gains on sales of premises and equipment   | (68)                                       | (2)             |
| Stock-based compensation   | 669  | 559             |
| Decrease in other assets   | 7,837                                      | 1,131           |
| Increase in other liabilities  | 468  | 2,171           |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>                                       | <b>40,306</b>                              | <b>37,522</b>   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>  |  |                 |
| Net cash acquired in acquisition   | 74,316                                     |                 |
| Proceeds from repayments on and maturity of securities:                                |  |                 |
| Available for sale   | 55,913                                     | 87,327          |
| Held to maturity   | 20,397                                     | 24,640          |
| Proceeds from sales of securities  |  |                 |
| Available for sale   | 53,670                                     | 53,718          |
| Purchase of securities:  |  |                 |
| Available for sale   | (144,004)                                  | (97,545)        |
| Held to maturity   | (11,768)                                   | (49,066)        |
| Net (increase) decrease in Federal Home Loan Bank Stock                                | (90)                                       | 2,484           |
| Net increase in loans and leases   | (47,537)                                   | (35,403)        |
| Proceeds from sales of other real estate and repossessed assets                        | 1,751                                      | 1,299           |
| Capital expenditures   | (1,986)                                    | (7,549)         |
| Proceeds from sales of bank premises and equipment                                     | 462  | 2               |
| <b>NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES</b>                             | <b>1,124</b>                               | <b>(20,093)</b> |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>  |  |                 |
| Net increase in deposits   | 25,739                                     | 91,455          |
| Decrease in federal funds purchased and securities sold under agreements to repurchase | (6,764)                                    | (17,550)        |
| Proceeds from other borrowings   |  | 280,000         |
| Repayments of other borrowings   | (10,000)                                   | (340,000)       |
| Early extinguishment of subordinated debentures  | (7,803)                                    |                 |
| Redemption of preferred stock and common stock warrant                                 |  | (21,800)        |
| Proceeds from issuance of common stock, net of expenses                                |  | 25,021          |
| Excess tax benefits  | 27   | 18              |

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|  |                   |                   |
|--|-------------------|-------------------|
| Exercise of stock options  | 709               |                   |
| Issuance of stock to dividend reinvestment and stock purchase plan | 145               | 141               |
| Dividends paid   | (5,774)           | (4,221)           |
| <b>NET CASH (USED IN) PROVIDED BY FINANCING ACTIVITIES</b>         | <b>(3,721)</b>    | <b>13,064</b>     |
| Net increase in cash and cash equivalents                          | 37,709            | 30,493            |
| Cash and cash equivalents, beginning of period                     | 107,545           | 72,558            |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>                    | <b>\$ 145,254</b> | <b>\$ 103,051</b> |

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

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### **Notes to Consolidated Financial Statements (Unaudited)**

#### **Note 1. Significant Accounting Policies**

##### *Basis of Presentation.*

This quarterly report presents the consolidated financial statements of Lakeland Bancorp, Inc. (the Company) and its subsidiary, Lakeland Bank (Lakeland). The accounting and reporting policies of the Company conform with accounting principles generally accepted in the United States of America (U.S. GAAP) and predominant practices within the banking industry.

The Company's unaudited interim financial statements reflect all adjustments, such as normal recurring accruals that are, in the opinion of management, necessary for the fair presentation of the results of the interim periods. The results of operations for the quarter presented do not necessarily indicate the results that the Company will achieve for all of 2013. You should read these interim financial statements in conjunction with the audited consolidated financial statements and accompanying notes that are presented in the Lakeland Bancorp, Inc. Annual Report on Form 10-K for the year ended December 31, 2012.

On May 31, 2013, the Company completed its acquisition of Somerset Hills Bancorp ( Somerset Hills ). For more information, see Note 14 below.

The financial information in this quarterly report has been prepared in accordance with the Company's customary accounting practices. Certain information and footnote disclosures required under U.S. GAAP have been condensed or omitted, as permitted by rules and regulations of the Securities and Exchange Commission.

All weighted average, actual share and per share information set forth in this Quarterly Report on Form 10-Q have been adjusted retroactively for the effects of stock dividends.

Certain reclassifications have been made to prior period financial statements to conform to the 2013 presentation.

#### **Note 2. Stock-Based Compensation**

Share-based compensation expense of \$669,000 and \$559,000 was recognized for the nine months ended September 30, 2013 and 2012, respectively. As of September 30, 2013, there was unrecognized compensation cost of \$1.6 million related to unvested restricted stock; that cost is expected to be recognized over a weighted average period of approximately 2.9 years. Unrecognized compensation expense related to unvested stock options was approximately \$138,000 as of September 30, 2013 and is expected to be recognized over a period of 2.5 years.

In the first nine months of 2013, the Company granted 104,182 shares of restricted stock at an average grant date fair value of \$9.88 per share under the Company's 2009 equity compensation program. These shares vest over a five year period. Compensation expense on these shares is expected to average approximately \$206,000 per year for the next five years. In the first nine months of 2012, the Company granted 91,269 shares of restricted stock at a grant date fair value of \$9.50 per share under the 2009 program. Compensation expense on these shares is expected to average approximately \$173,000 per year over a five year period.

On May 31, 2013, the Company granted options to purchase 50,000 shares to two new non-employee directors of the Company at an exercise price of \$9.91 per share under the 2009 program. Each director's options are exercisable in five equal installments beginning at the date of grant and continuing on the next four anniversaries of the grant date. The fair value of these options were estimated using the Black-Scholes option pricing model with the following weighted average assumptions:

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|  |         |
|--|---------|
| Risk-free interest rates                       | 1.55%   |
| Expected dividend yield                        | 2.82%   |
| Expected volatility                            | 45.45%  |
| Expected lives (years)                         | 7.00    |
| Weighted average fair value of options granted | \$ 3.48 |

There were no grants of stock options in the first nine months of 2012.

The Company also assumed the outstanding options granted under Somerset Hills stock option plans at the time of merger. Based on the conversion ratio in the merger, the Company assumed options to purchase 376,372 shares of Lakeland stock in these plans at a weighted average exercise price of \$6.65.

Option activity under the Company's stock option plans is as follows:

|                                 | Number of shares | Weighted average exercise price | Weighted average remaining contractual term (in years) | Aggregate intrinsic value |
|---------------------------------|------------------|---------------------------------|--|---------------------------|
| Outstanding, January 1, 2013    | 475,697          | \$ 12.31                        |  | \$ 53,853                 |
| Issued                          | 426,372          | 7.03                            |  |                           |
| Exercised                       | (98,895)         | 7.18                            |  |                           |
| Forfeited                       | (7,826)          | 12.93                           |  |                           |
| Outstanding, September 30, 2013 | 795,348          | \$ 10.11                        | 2.88   | \$ 1,504,444              |
| Options exercisable at          |                  |                                 |  |                           |
| September 30, 2013              | 749,835          | \$ 10.14                        | 2.49   | \$ 1,434,088              |

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading day of the first nine months of 2013 and the exercise price, multiplied by the number of in-the-money options).

The aggregate intrinsic value of stock options exercised during the nine months ended September 30, 2013 was \$391,000. Exercise of stock options during the first nine months of 2013 resulted in cash receipts of \$709,000.

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Information regarding the Company's restricted stock (all unvested) and changes during the nine months ended September 30, 2013 is as follows:

|                                 | Number of<br>shares | Weighted<br>average<br>price |
|---------------------------------|---------------------|------------------------------|
| Outstanding, January 1, 2013    | 222,556             | \$ 9.15                      |
| Granted                         | 104,182             | 9.88                         |
| Vested                          | (65,782)            | 8.60                         |
| Forfeited                       | (2,711)             | 9.26                         |
| Outstanding, September 30, 2013 | 258,245             | \$ 9.58                      |

**Note 3. Comprehensive Income**

The components of other comprehensive income are as follows:

| For the quarter ended:  | September 30, 2013      |  |                         | September 30, 2012      |  |                         |
|---|-------------------------|--|-------------------------|-------------------------|--|-------------------------|
|   | Before tax<br>amount    | Tax Benefit<br>(Expense)<br>(in thousands) | Net of<br>tax<br>amount | Before tax<br>amount    | Tax Benefit<br>(Expense)<br>(in thousands) | Net of tax<br>amount    |
| Net unrealized gains on available for sale securities               |                         |  |                         |                         |  |                         |
| Net unrealized holding gains arising during period                  | \$ 1,765                | (\$ 647)                                   | \$ 1,118                | \$ 1,933                | (\$ 713)                                   | \$ 1,220                |
| Reclassification adjustment for net gains arising during the period |                         |  |                         |                         |  |                         |
| Net unrealized gains  | \$ 1,765                | (\$ 647)                                   | \$ 1,118                | \$ 1,933                | (\$ 713)                                   | \$ 1,220                |
| Change in minimum pension liability                                 | 8                       | (3)  | 5                       | 8                       | (3)  | 5                       |
| Other comprehensive income, net                                     | \$ 1,773                | (\$ 650)                                   | \$ 1,123                | \$ 1,941                | (\$ 716)                                   | \$ 1,225                |
| For the nine months ended:  | Before<br>tax<br>amount | Tax Benefit<br>(Expense)<br>(in thousands) | Net of<br>tax<br>amount | Before<br>tax<br>amount | Tax Benefit<br>(Expense)<br>(in thousands) | Net<br>of tax<br>amount |
| Net unrealized gains (losses) on available for sale securities      |                         |  |                         |                         |  |                         |
| Net unrealized holding gains (losses) arising during period         | (\$ 8,635)              | \$ 3,181                                   | (\$ 5,454)              | \$ 3,441                | (\$ 1,267)                                 | \$ 2,174                |
| Reclassification adjustment for net gains arising during the period | (506)                   | 177  | (329)                   | (273)                   | 96   | (177)                   |
| Net unrealized gains (losses)                                       | (\$ 9,141)              | \$ 3,358                                   | (\$ 5,783)              | \$ 3,168                | (\$ 1,171)                                 | \$ 1,997                |
| Change in minimum pension liability                                 | 23                      | (8)  | 15                      | 23                      | (8)  | 15                      |
| Other comprehensive income (loss), net                              | (\$ 9,118)              | \$ 3,350                                   | (\$ 5,768)              | \$ 3,191                | (\$ 1,179)                                 | \$ 2,012                |

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The following table shows the changes in the balances of each of the components of other comprehensive income for the periods presented:

## Changes in Accumulated Other Comprehensive Income by Component (a)

|  | For the Three Months Ended  |               |            | For the Three Months Ended  |               |          |
|--|---|---------------|------------|---|---------------|----------|
|  | September 30, 2013  |               |            | September 30, 2012  |               |          |
|  | Unrealized Gains<br>and<br>Losses<br>on<br>Available-for-sale<br>Securities | Pension Items | Total      | Unrealized Gains<br>and<br>Losses<br>on<br>Available-for-sale<br>Securities | Pension Items | Total    |
| Beginning Balance  | (\$ 2,348)  | (\$ 607)      | (\$ 2,955) | \$ 4,283  | (\$ 625)      | \$ 3,658 |
|  | (in thousands)  |               |            |   |               |          |
| Other comprehensive income before classifications                | 1,118   | 5             | 1,123      | 1,220   | 5             | 1,225    |
| Amounts reclassified from accumulated other comprehensive income |   |               |            |   |               |          |
| Net current period other comprehensive income                    | 1,118   | 5             | 1,123      | 1,220   | 5             | 1,225    |
| Ending balance   | (\$ 1,230)  | (\$ 602)      | (\$ 1,832) | \$ 5,503  | (\$ 620)      | \$ 4,883 |

(a) All amounts are net of tax.

## Changes in Accumulated Other Comprehensive Income by Component (a)

|  | For the Nine Months Ended  |               |            | For the Nine Months Ended   |               |          |
|--|--|---------------|------------|---|---------------|----------|
|  | September 30, 2013   |               |            | September 30, 2012  |               |          |
|  | Unrealized Gains<br>and<br>Losses on<br>Available-for-sale<br>Securities | Pension Items | Total      | Unrealized Gains<br>and<br>Losses<br>on<br>Available-for-sale<br>Securities | Pension Items | Total    |
| Beginning Balance  | \$ 4,553   | (\$ 617)      | \$ 3,936   | \$ 3,506  | (\$ 635)      | \$ 2,871 |
|  | (in thousands)   |               |            |   |               |          |
| Other comprehensive income (loss) before classifications         | (5,454)  | 15            | (5,439)    | 2,174   | 15            | 2,189    |
| Amounts reclassified from accumulated other comprehensive income | (329)  |               | (329)      | (177)   |               | (177)    |
| Net current period other comprehensive income (loss)             | (5,783)  | 15            | (5,768)    | 1,997   | 15            | 2,012    |
| Ending balance   | (\$ 1,230)   | (\$ 602)      | (\$ 1,832) | \$ 5,503  | (\$ 620)      | \$ 4,883 |

(a) All amounts are net of tax.





**Table of Contents****Note 4. Statement of Cash Flow Information, Supplemental Information**

|  | For the Nine Months Ended |                       |
|--|---------------------------|-----------------------|
|  | September 30,<br>2013     | September 30,<br>2012 |
|  | (in thousands)            |                       |
| <b>Supplemental schedule of noncash investing and financing activities:</b>            |                           |                       |
| Cash paid during the period for income taxes   | \$ 8,497                  | \$ 6,467              |
| Cash paid during the period for interest   | 7,750                     | 12,504                |
| Transfer of loans and leases into other repossessed assets and other real estate owned | 3,098                     | 651                   |

**Note 5. Earnings Per Share**

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

| (In thousands, except per share data)                        | For the Three Months Ended |                       | For the Nine Months Ended |                       |
|--|----------------------------|-----------------------|---------------------------|-----------------------|
|  | September 30,<br>2013      | September 30,<br>2012 | September 30,<br>2013     | September 30,<br>2012 |
| Net income available to common shareholders                  | \$ 6,617                   | \$ 5,489              | \$ 17,628                 | \$ 15,293             |
| Less: earnings allocated to participating securities         | 48                         | 49                    | 125                       | 134                   |
| <b>Net income allocated to common shareholders</b>           | <b>\$ 6,569</b>            | <b>\$ 5,440</b>       | <b>\$ 17,503</b>          | <b>\$ 15,159</b>      |
| Weighted average number of common shares outstanding - basic | 35,512                     | 27,550                | 32,223                    | 26,998                |
| Share-based plans  | 224                        | 92                    | 131                       | 67                    |
| Weighted average number of common shares - diluted           | 35,736                     | 27,642                | 32,354                    | 27,065                |
| <b>Basic earnings per share</b>                              | <b>\$ 0.18</b>             | <b>\$ 0.20</b>        | <b>\$ 0.54</b>            | <b>\$ 0.56</b>        |
| Diluted earnings per share                                   | \$ 0.18                    | \$ 0.20               | \$ 0.54                   | \$ 0.56               |

Options to purchase 461,366 shares of common stock at a weighted average price of \$12.41 per share were outstanding and were not included in the computation of diluted earnings per share for the quarter ended September 30, 2013 because the exercise price was greater than the average market price. Options to purchase 569,222 shares of common stock at a weighted average price of \$12.79 were outstanding and were not included in the computation of diluted earnings per share for the quarter ended September 30, 2012 because the exercise price was greater than the average market price.

Options to purchase 490,307 shares of common stock at a weighted average price of \$12.29 per share were outstanding and were not included in the computation of diluted earnings per share for the nine months ended September 30, 2013 because the exercise price was greater than the average market price. Options to purchase 569,222 shares of common stock at a weighted average price of \$12.79 were outstanding and were not included in the computation of diluted earnings per share for the nine months ended September 30, 2012 because the exercise price was greater than the average market price.

**Table of Contents****Note 6. Investment Securities**

| AVAILABLE FOR SALE                               | September 30, 2013 |  |   |                   | December 31, 2012 |  |   |                   |
|--|--------------------|--|---|-------------------|-------------------|--|---|-------------------|
|  | Amortized<br>Cost  | Gross<br>Unrealized<br>Gains<br>(in thousands) | Gross<br>Unrealized<br>Losses<br>(in thousands) | Fair<br>Value     | Amortized<br>Cost | Gross<br>Unrealized<br>Gains<br>(in thousands) | Gross<br>Unrealized<br>Losses<br>(in thousands) | Fair Value        |
| U.S. treasury and U.S. government agencies       | \$ 62,117          | \$   | \$ (1,953)                                      | \$ 60,164         | \$ 86,002         | \$ 577   | \$ (8)  | \$ 86,571         |
| Mortgage-backed securities, residential          | 291,961            | 3,031  | (3,994)   | 290,998           | 235,052           | 5,086  | (579)   | 239,559           |
| Obligations of states and political subdivisions | 37,210             | 922  | (441)   | 37,691            | 36,848            | 1,832  | (60)  | 38,620            |
| Other debt securities                            | 13,560             | 59   | (215)   | 13,404            | 13,576            | 189  | (321)   | 13,444            |
| Equity securities                                | 15,607             | 991  | (293)   | 16,305            | 14,984            | 608  | (76)  | 15,516            |
|  | <b>\$ 420,455</b>  | <b>\$ 5,003</b>                                | <b>\$ (6,896)</b>                               | <b>\$ 418,562</b> | <b>\$ 386,462</b> | <b>\$ 8,292</b>                                | <b>\$ (1,044)</b>                               | <b>\$ 393,710</b> |

| HELD TO MATURITY                                 | September 30, 2013 |  |   |                  | December 31, 2012 |  |   |                  |
|--|--------------------|--|---|------------------|-------------------|--|---|------------------|
|  | Amortized<br>Cost  | Gross<br>Unrealized<br>Gains<br>(in thousands) | Gross<br>Unrealized<br>Losses<br>(in thousands) | Fair<br>Value    | Amortized<br>Cost | Gross<br>Unrealized<br>Gains<br>(in thousands) | Gross<br>Unrealized<br>Losses<br>(in thousands) | Fair Value       |
| U.S. government agencies                         | \$ 15,989          | \$ 63  | \$ (326)  | \$ 15,726        | \$ 16,089         | \$ 385   | \$  | \$ 16,474        |
| Mortgage-backed securities, residential          | 36,081             | 569  | (753)   | 35,897           | 39,065            | 1,313  | (27)  | 40,351           |
| Mortgage-backed securities, multifamily          | 2,380              |  | (159)   | 2,221            | 1,421             |  | (13)  | 1,408            |
| Obligations of states and political subdivisions | 40,710             | 594  | (658)   | 40,646           | 38,801            | 1,068  | (68)  | 39,801           |
| Other debt securities                            | 1,542              | 164  |   | 1,706            | 1,549             | 201  |   | 1,750            |
|  | <b>\$ 96,702</b>   | <b>\$ 1,390</b>                                | <b>\$ (1,896)</b>                               | <b>\$ 96,196</b> | <b>\$ 96,925</b>  | <b>\$ 2,967</b>                                | <b>\$ (108)</b>                                 | <b>\$ 99,784</b> |

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

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|  | September 30, 2013 |            |                   |            |
|--|--------------------|------------|-------------------|------------|
|  | Available for Sale |            | Held to Maturity  |            |
|  | Amortized<br>Cost  | Fair Value | Amortized<br>Cost | Fair Value |
| Due in one year or less                | \$ 5,848           | \$ 5,896   | \$ 6,065          | \$ 6,096   |
| Due after one year through five years  | 36,066             | 36,365     | 14,046            | 14,619     |
| Due after five years through ten years | 68,169             | 66,502     | 30,659            | 30,206     |
| Due after ten years                    | 2,804              | 2,496      | 7,471             | 7,157      |
|  | 112,887            | 111,259    | 58,241            | 58,078     |
| Mortgage-backed securities             | 291,961            | 290,998    | 38,461            | 38,118     |
| Equity securities                      | 15,607             | 16,305     |                   |            |
| Total securities                       | \$ 420,455         | \$ 418,562 | \$ 96,702         | \$ 96,196  |

The following table shows proceeds from sales of securities, gross gains and gross losses on sales or calls of securities and other than temporary impairments for the periods indicated (in thousands):

|               | For the Three Months Ended<br>September 30, |      | For the Nine Months Ended<br>September 30, |           |
|---------------|---|------|--|-----------|
|               | 2013  | 2012 | 2013                                       | 2012      |
| Sale proceeds | \$  | \$   | \$ 53,670                                  | \$ 53,718 |
| Gross gains   |   |      | 509  | 584       |
| Gross losses  |   |      | (3)  | (311)     |

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

Securities with a carrying value of approximately \$334.5 million and \$328.4 million at September 30, 2013 and December 31, 2012, respectively, were pledged to secure public deposits and for other purposes required by applicable laws and regulations.

The following table indicates the length of time individual securities have been in a continuous unrealized loss position at September 30, 2013 and December 31, 2012:

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| September 30, 2013                               | Less than 12 months |                   | 12 months or longer    |                   |                      | Total      |                   |
|--|---------------------|-------------------|------------------------|-------------------|----------------------|------------|-------------------|
|  | Fair value          | Unrealized Losses | Fair value             | Unrealized Losses | Number of securities | Fair value | Unrealized Losses |
| <b>AVAILABLE FOR SALE</b>                        |                     |                   | (dollars in thousands) |                   |                      |            |                   |
| U.S. treasury and U.S. government agencies       | \$ 60,164           | \$ 1,953          | \$                     | \$                | 13                   | \$ 60,164  | \$ 1,953          |
| Mortgage-backed securities, residential          | 129,802             | 3,734             | 6,251                  | 260               | 35                   | 136,053    | 3,994             |
| Obligations of states and political subdivisions | 6,122               | 298               | 1,585                  | 143               | 15                   | 7,707      | 441               |
| Other debt securities                            |                     |                   | 5,764                  | 215               | 2                    | 5,764      | 215               |
| Equity securities                                | 9,996               | 272               | 225                    | 21                | 3                    | 10,221     | 293               |
|  | \$ 206,084          | \$ 6,257          | \$ 13,825              | \$ 639            | 68                   | \$ 219,909 | \$ 6,896          |
| <b>HELD TO MATURITY</b>                          |                     |                   |                        |                   |                      |            |                   |
| U.S. government agencies                         | \$ 10,658           | \$ 326            | \$                     | \$                | 2                    | \$ 10,658  | \$ 326            |
| Mortgage-backed securities, residential          | 22,325              | 753               |                        |                   | 9                    | 22,325     | 753               |
| Mortgage-backed securities, multifamily          | 2,221               | 159               |                        |                   | 2                    | 2,221      | 159               |
| Obligations of states and political subdivisions | 14,453              | 654               | 351                    | 4                 | 44                   | 14,804     | 658               |
|  | \$ 49,657           | \$ 1,892          | \$ 351                 | \$ 4              | 57                   | \$ 50,008  | \$ 1,896          |
| <b>December 31, 2012</b>                         |                     |                   |                        |                   |                      |            |                   |
| AVAILABLE FOR SALE                               | Less than 12 months |                   | 12 months or longer    |                   |                      | Total      |                   |
|  | Fair value          | Unrealized Losses | Fair value             | Unrealized Losses | Number of securities | Fair value | Unrealized Losses |
|  |                     |                   | (dollars in thousands) |                   |                      |            |                   |
| U.S. government agencies                         | \$ 3,992            | \$ 8              | \$                     | \$                | 1                    | \$ 3,992   | \$ 8              |
| Mortgage-backed securities, residential          | 30,359              | 572               | 3,239                  | 7                 | 10                   | 33,598     | 579               |
| Obligations of states and political subdivisions | 2,825               | 60                |                        |                   | 7                    | 2,825      | 60                |
| Other debt securities                            |                     |                   | 5,661                  | 321               | 2                    | 5,661      | 321               |
| Equity securities                                | 4,621               | 76                |                        |                   | 2                    | 4,621      | 76                |
|  | \$ 41,797           | \$ 716            | \$ 8,900               | \$ 328            | 22                   | \$ 50,697  | \$ 1,044          |
| <b>HELD TO MATURITY</b>                          |                     |                   |                        |                   |                      |            |                   |
| Mortgage-backed securities, residential          | \$ 1,239            | \$ 27             | \$                     | \$                | 1                    | \$ 1,239   | \$ 27             |
| Mortgage-backed securities, multifamily          | 1,408               | 13                |                        |                   | 1                    | 1,408      | 13                |
| Obligations of states and political subdivisions | 3,705               | 63                | 371                    | 5                 | 10                   | 4,076      | 68                |
|  | \$ 6,352            | \$ 103            | \$ 371                 | \$ 5              | 12                   | \$ 6,723   | \$ 108            |

Management has evaluated the securities in the above table and has concluded that none of the securities with unrealized losses have impairments that are other-than-temporary. Fair value below cost is due to interest rate movements and is deemed temporary. All investment securities are evaluated on a periodic basis to determine if factors are identified that would require further analysis. In evaluating the Company's securities, management considers the following items:

The Company's ability and intent to hold the securities, including an evaluation of the need to sell the security to meet certain liquidity measures, or whether the Company has sufficient levels of cash to hold the identified security in order to recover the entire amortized cost of the security;

The financial condition of the underlying issuer;

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The credit ratings of the underlying issuer and if any changes in the credit rating have occurred;

The length of time the security's fair value has been less than amortized cost; and

Adverse conditions related to the security or its issuer if the issuer has failed to make scheduled payments or other factors. If the above factors indicate that additional analysis is required, management will consider the results of discounted cash flow analysis.

As of September 30, 2013, the equity securities include investments in other financial institutions for market appreciation purposes. Those equities had a net amortized cost of \$2.4 million and a market value of \$3.4 million as of September 30, 2013.

As of September 30, 2013, equity securities also included \$12.9 million in investment funds that do not have a quoted market price but use net asset value per share or its equivalent to measure fair value.

The funds include \$2.9 million in funds that are primarily invested in community development loans that are guaranteed by the Small Business Administration (SBA). Because the funds are primarily guaranteed by the federal government there are minimal changes in market value between accounting periods. These funds can be redeemed within 60 days notice at the net asset value less unpaid management fees with the approval of the fund manager. As of September 30, 2013, the net amortized cost equaled the market value of the investment. There are no unfunded commitments related to this investment.

The funds also include \$10.0 million in funds that are invested in government guaranteed loans, mortgage-backed securities, small business loans and other instruments supporting affordable housing and economic development. The Company may redeem these funds at the net asset value calculated at the end of the current business day less any unpaid management fees. As of September 30, 2013, the amortized cost of these securities was \$10.3 million and the fair value was \$10.0 million. There are no restrictions on redemptions for the holdings in these investments other than the notice required by the fund manager. There are no unfunded commitments related to this investment.

**Note 7. Loans and Leases.**

The following sets forth the composition of Lakeland's loan and lease portfolio as of September 30, 2013 and December 31, 2012:

|                                    | September 30,<br>2013 | December 31,<br>2012 |
|------------------------------------|-----------------------|----------------------|
|                                    | (in thousands)        |                      |
| Commercial, secured by real estate | \$ 1,348,314          | \$ 1,125,137         |
| Commercial, industrial and other   | 214,877               | 216,129              |
| Leases                             | 37,845                | 26,781               |
| Real estate-residential mortgage   | 437,788               | 423,262              |
| Real estate-construction           | 50,121                | 46,272               |
| Home equity and consumer           | 339,805               | 309,626              |
| <b>Total loans</b>                 | <b>2,428,750</b>      | <b>2,147,207</b>     |
| Plus: deferred fees                | (1,066)               | (364)                |
| <b>Loans, net of deferred fees</b> | <b>\$ 2,427,684</b>   | <b>\$ 2,146,843</b>  |

At September 30, 2013 and December 31, 2012, home equity and consumer loans included overdraft deposit balances of \$381,000 and \$532,000, respectively. At September 30, 2013 and December 31, 2012, the Company had \$273.3 million and \$203.1 million in residential loans pledged for potential borrowings at the Federal Home Loan Bank of New York (FHLB).

The carrying value of loans acquired and accounted for in accordance with ASC Subtopic 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality, was \$1.6 million at September 30, 2013, which was substantially the same as the balance at the acquisition date of

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May 31, 2013. Under ASC Subtopic 310-30, loans may be aggregated and accounted for as pools of loans if the loans being aggregated have common risk characteristics. The Company elected to account for the loans with evidence of credit deterioration individually rather than aggregate them into pools. The difference between the undiscounted cash

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flows expected at acquisition and the investment in the acquired loans, or the accretable yield, is recognized as interest income utilizing the level-yield method over the life of each loan. Contractually required payments for interest and principal that exceed the undiscounted cash flows expected at acquisition, or the non-accretable difference, are not recognized as a yield adjustment, as a loss accrual or as a valuation allowance.

Increases in expected cash flows subsequent to the acquisition are recognized prospectively through an adjustment of the yield on the loans over the remaining life, while decreases in expected cash flows are recognized as impairment through a loss provision and an increase in the allowance for loan losses. Valuation allowances (recognized in the allowance for loan losses) on these impaired loans reflect only losses incurred after the acquisition (representing all cash flows that were expected at acquisition but currently are not expected to be received).

There were no material increases or decreases in the expected cash flows between May 31, 2013 (the acquisition date) and September 30, 2013. The Company recognized \$43,000 of interest income on the loans acquired.

*Non-Performing Assets and Past Due Loans*

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

| (in thousands)                                   | September 30,<br>2013 | December 31,<br>2012 |
|--|-----------------------|----------------------|
| Commercial, secured by real estate               | \$ 6,585              | \$ 10,511            |
| Commercial, industrial and other                 | 184                   | 1,476                |
| Leases   |                       | 32                   |
| Real estate residential mortgage                 | 5,996                 | 8,733                |
| Real estate construction                         | 921                   | 4,031                |
| Home equity and consumer                         | 2,819                 | 3,197                |
| <b>Total non-accrual loans and leases</b>        | <b>\$ 16,505</b>      | <b>\$ 27,980</b>     |
| Other real estate and other repossessed assets   | 2,154                 | 529                  |
| <b>TOTAL NON-PERFORMING ASSETS</b>               | <b>\$ 18,659</b>      | <b>\$ 28,509</b>     |
| <br>Troubled debt restructurings, still accruing | <br>\$ 11,006         | <br>\$ 7,336         |

Non-accrual loans included \$2.3 million and \$3.4 million of troubled debt restructurings as of September 30, 2013 and December 31, 2012, respectively.

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An age analysis of past due loans, segregated by class of loans as of September 30, 2013 and December 31, 2012, is as follows:

|                                    | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater<br>Than<br>89 Days | Total Past<br>Due<br>(in thousands) | Current      | Total<br>Loans<br>and Leases | Recorded<br>Investment greater<br>than 89 Days<br>and<br>still accruing |
|------------------------------------|------------------------|------------------------|----------------------------|-------------------------------------|--------------|------------------------------|---|
| <b>September 30, 2013</b>          |                        |                        |                            |                                     |              |                              |   |
| Commercial, secured by real estate | \$ 9,075               | \$ 3,783               | \$ 7,222                   | \$ 20,080                           | \$ 1,328,234 | \$ 1,348,314                 | \$ 637  |
| Commercial, industrial and other   | 191                    | 571                    | 192                        | 954                                 | 213,923      | 214,877                      | 8   |
| Leases                             | 12                     |                        |                            | 12                                  | 37,833       | 37,845                       |   |
| Real estate residential mortgage   | 3,261                  | 1,085                  | 6,942                      | 11,288                              | 426,500      | 437,788                      | 946   |
| Real estate construction           |                        |                        | 921                        | 921                                 | 49,200       | 50,121                       |   |
| Home equity and consumer           | 2,521                  | 694                    | 3,711                      | 6,926                               | 332,879      | 339,805                      | 892   |
|                                    | \$ 15,060              | \$ 6,133               | \$ 18,988                  | \$ 40,181                           | \$ 2,388,569 | \$ 2,428,750                 | \$ 2,483  |
| <b>December 31, 2012</b>           |                        |                        |                            |                                     |              |                              |   |
| Commercial, secured by real estate | \$ 3,831               | \$ 2,308               | \$ 10,511                  | \$ 16,650                           | \$ 1,108,487 | \$ 1,125,137                 | \$  |
| Commercial, industrial and other   | 400                    | 171                    | 1,476                      | 2,047                               | 214,082      | 216,129                      |   |
| Leases                             | 367                    | 36                     | 32                         | 435                                 | 26,346       | 26,781                       |   |
| Real estate residential mortgage   | 2,370                  | 821                    | 10,012                     | 13,203                              | 410,059      | 423,262                      | 1,279   |
| Real estate construction           | 1,100                  |                        | 4,031                      | 5,131                               | 41,141       | 46,272                       |   |
| Home equity and consumer           | 2,479                  | 363                    | 3,355                      | 6,197                               | 303,429      | 309,626                      | 158   |
|                                    | \$ 10,547              | \$ 3,699               | \$ 29,417                  | \$ 43,663                           | \$ 2,103,544 | \$ 2,147,207                 | \$ 1,437  |



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Impaired loans as of September 30, 2013, September 30, 2012 and December 31, 2012 are as follows:

|                                    | Recorded<br>Investment in<br>Impaired loans | Contractual<br>Unpaid<br>Principal<br>Balance | Specific<br>Allowance<br>(in thousands) | Interest<br>Income<br>Recognized | Average<br>Investment in<br>Impaired loans |
|------------------------------------|---|---|---|----------------------------------|--|
| <b>September 30, 2013</b>          |   |   |   |                                  |  |
| Loans without specific allowance:  |   |   |   |                                  |  |
| Commercial, secured by real estate | \$ 7,098                                    | \$ 7,352                                      | \$                                      | \$ 137                           | \$ 7,663                                   |
| Commercial, industrial and other   | 4,037                                       | 4,002   |   | 142                              | 4,428                                      |
| Real estate-residential mortgage   |   |   |   |                                  |  |
| Real estate-construction           |   |   |   |                                  | 1,328                                      |
| Home equity and consumer           | 18  | 18  |   | 1                                | 18   |
| Loans with specific allowance:     |   |   |   |                                  |  |
| Commercial, secured by real estate | 11,769                                      | 12,890  | 1,044                                   | 298                              | 11,024                                     |
| Commercial, industrial and other   | 388   | 498   | 78                                      | 6                                | 659  |
| Real estate-residential mortgage   | 479   | 479   | 72                                      |                                  | 497  |
| Real estate-construction           | 921   | 3,015   | 41                                      |                                  | 1,307                                      |
| Home equity and consumer           | 1,351                                       | 1,351   | 203                                     | 33                               | 1,292                                      |
| Total:                             |   |   |   |                                  |  |
| Commercial, secured by real estate | \$ 18,867                                   | \$ 20,242                                     | \$ 1,044                                | \$ 435                           | \$ 18,687                                  |
| Commercial, industrial and other   | 4,425                                       | 4,500   | 78                                      | 148                              | 5,087                                      |
| Real estate residential mortgage   | 479   | 479   | 72                                      |                                  | 497  |
| Real estate-construction           | 921   | 3,015   | 41                                      |                                  | 2,635                                      |
| Home equity and consumer           | 1,369                                       | 1,369   | 203                                     | 34                               | 1,310                                      |
|                                    | \$ 26,061                                   | \$ 29,605                                     | \$ 1,438                                | \$ 617                           | \$ 28,216                                  |

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|                                    | Recorded<br>Investment in<br>Impaired loans | Contractual<br>Unpaid<br>Principal<br>Balance | Specific<br>Allowance<br>(in thousands) | Interest<br>Income<br>Recognized | Average<br>Investment<br>in<br>Impaired loans |
|------------------------------------|---|---|---|----------------------------------|---|
| <b>September 30, 2012</b>          |   |   |   |                                  |   |
| Loans without specific allowance:  |   |   |   |                                  |   |
| Commercial, secured by real estate | \$ 14,263                                   | \$ 18,253                                     | \$                                      | \$ 260                           | \$ 15,605                                     |
| Commercial, industrial and other   | 4,927                                       | 4,938   |   | 67                               | 3,555   |
| Real estate-residential mortgage   | 366   | 366   |   | 6                                | 386   |
| Real estate-construction           | 3,977                                       | 4,606   |   |                                  | 7,611   |
| Home equity and consumer           | 350   | 350   |   |                                  | 337   |
| Loans with specific allowance:     |   |   |   |                                  |   |
| Commercial, secured by real estate | 3,127                                       | 3,895   | 313                                     | 45                               | 4,389   |
| Commercial, industrial and other   | 787   | 902   | 216                                     |                                  | 641   |
| Real estate-residential mortgage   | 288   | 288   | 43                                      | 4                                | 384   |
| Real estate-construction           | 120   | 997   | 12                                      |                                  | 331   |
| Home equity and consumer           | 946   | 946   | 142                                     | 36                               | 946   |
| Total:                             |   |   |   |                                  |   |
| Commercial, secured by real estate | \$ 17,390                                   | \$ 22,148                                     | \$ 313                                  | \$ 305                           | \$ 19,994                                     |
| Commercial, industrial and other   | 5,714                                       | 5,840   | 216                                     | 67                               | 4,196   |
| Real estate residential mortgage   | 654   | 654   | 43                                      | 10                               | 770   |
| Real estate-construction           | 4,097                                       | 5,603   | 12                                      |                                  | 7,942   |
| Home equity and consumer           | 1,296                                       | 1,296   | 142                                     | 36                               | 1,283   |
|                                    | \$ 29,151                                   | \$ 35,541                                     | \$ 726                                  | \$ 418                           | \$ 34,185                                     |

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|                                    | Recorded<br>Investment in<br>Impaired loans | Contractual<br>Unpaid<br>Principal<br>Balance | Specific<br>Allowance<br>(in thousands) | Interest<br>Income<br>Recognized | Average<br>Investment in<br>Impaired loans |
|------------------------------------|---|---|---|----------------------------------|--|
| <b>December 31, 2012</b>           |   |   |   |                                  |  |
| Loans without specific allowance:  |   |   |   |                                  |  |
| Commercial, secured by real estate | \$ 16,458                                   | \$ 21,665                                     | \$                                      | \$ 495                           | \$ 18,301                                  |
| Commercial, industrial and other   | 4,896                                       | 4,932   |   | 116                              | 3,838                                      |
| Real estate-residential mortgage   | 360   | 360   |   | 6                                | 385  |
| Real estate-construction           | 3,332                                       | 4,433   |   |                                  | 5,533                                      |
| Home equity and consumer           | 369   | 369   |   | 1                                | 360  |
| Loans with specific allowance:     |   |   |   |                                  |  |
| Commercial, secured by real estate | 3,346                                       | 4,088   | 368                                     | 46                               | 3,825                                      |
| Commercial, industrial and other   | 808   | 871   | 219                                     | 1                                | 769  |
| Real estate-residential mortgage   | 288   | 288   | 43                                      | 4                                | 374  |
| Real estate-construction           | 698   | 1,085   | 97                                      |                                  | 1,445                                      |
| Home equity and consumer           | 976   | 976   | 146                                     | 55                               | 934  |
| Total:                             |   |   |   |                                  |  |
| Commercial, secured by real estate | \$ 19,804                                   | \$ 25,753                                     | \$ 368                                  | \$ 541                           | \$ 22,126                                  |
| Commercial, industrial and other   | 5,704                                       | 5,803   | 219                                     | 117                              | 4,607                                      |
| Real estate residential mortgage   | 648   | 648   | 43                                      | 10                               | 759  |
| Real estate-construction           | 4,030                                       | 5,518   | 97                                      |                                  | 6,978                                      |
| Home equity and consumer           | 1,345                                       | 1,345   | 146                                     | 56                               | 1,294                                      |
|                                    | \$ 31,531                                   | \$ 39,067                                     | \$ 873                                  | \$ 724                           | \$ 35,764                                  |

Interest that would have been accrued on impaired loans during the first nine months of 2013 and 2012 had the loans been performing under original terms would have been \$1.7 million and \$2.1 million, respectively. Interest that would have accrued for the year ended December 31, 2012 was \$2.8 million.

*Credit Quality Indicators*

The primary credit quality indicator is an internal risk rating whereby management closely and continually monitors the quality of its loans and leases and assesses the quantitative and qualitative risks arising from the credit quality of its loans and leases. It is the policy of Lakeland to require that a Credit Risk Rating be assigned to all commercial loans and loan commitments. The Credit Risk Rating System has been developed by management to provide a methodology to be used by Loan Officers, department heads and Senior Management in identifying various levels of credit risk that exist within Lakeland's loan portfolios. The risk rating system assists Senior Management in evaluating Lakeland's commercial loan portfolio, analyzing trends, and determining the proper level of required reserves to be recommended to the Board. In assigning risk ratings, management considers, among other things, a borrower's debt service coverage, earnings strength, loan to value ratios, industry conditions and economic conditions. Management categorizes loans and commitments into a one (1) to nine (9) numerical structure with rating 1 being the strongest rating and rating 9 being the weakest. Ratings 1 through 5W are considered Pass ratings.

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The following table shows the Company's commercial loan portfolio as of September 30, 2013 and December 31, 2012, by the risk ratings discussed above (in thousands):

September 30, 2013

| Risk Rating                         | Commercial,<br>secured by<br>real estate | Commercial,<br>industrial<br>and other | Real estate-<br>construction |
|-------------------------------------|--|--|------------------------------|
| 1                                   | \$                                       | \$ 774                                 | \$                           |
| 2                                   |  | 16,089                                 |                              |
| 3                                   | 71,453                                   | 9,822                                  |                              |
| 4                                   | 420,190                                  | 57,793                                 |                              |
| 5                                   | 733,677                                  | 87,859                                 | 46,515                       |
| 5W Watch                            | 38,488                                   | 11,150                                 |                              |
| 6 Other Assets Especially Mentioned | 28,003                                   | 8,730                                  | 2,639                        |
| 7 Substandard                       | 56,418                                   | 22,660                                 | 967                          |
| 8 Doubtful                          | 85                                       |  |                              |
| 9 Loss                              |  |  |                              |
| <b>Total</b>                        | <b>\$ 1,348,314</b>                      | <b>\$ 214,877</b>                      | <b>\$ 50,121</b>             |

December 31, 2012

| Risk Rating                         | Commercial,<br>secured by<br>real estate | Commercial,<br>industrial<br>and other | Real estate-<br>construction |
|-------------------------------------|--|--|------------------------------|
| 1                                   | \$                                       | \$ 996                                 | \$                           |
| 2                                   |  | 12,899                                 |                              |
| 3                                   | 44,448                                   | 15,676                                 |                              |
| 4                                   | 350,145                                  | 62,676                                 | 795                          |
| 5                                   | 623,912                                  | 88,033                                 | 34,682                       |
| 5W Watch                            | 43,515                                   | 13,261                                 |                              |
| 6 Other Assets Especially Mentioned | 21,132                                   | 2,845                                  | 6,535                        |
| 7 Substandard                       | 41,817                                   | 19,743                                 | 4,260                        |
| 8 Doubtful                          | 168                                      |  |                              |
| 9 Loss                              |  |  |                              |
| <b>Total</b>                        | <b>\$ 1,125,137</b>                      | <b>\$ 216,129</b>                      | <b>\$ 46,272</b>             |

The risk rating tables above do not include consumer or residential loans or leases because the evaluation of their primary credit quality indicator is based on the loans' payment performance status.

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

The following table details activity in the allowance for loan and lease losses by portfolio segment and the related recorded investment in loans and leases for the nine months ended September 30, 2013 and the year ended December 31, 2012:

| <b>Nine Months Ended September 30, 2013</b>                     | Commercial,<br>secured by<br>real estate | Commercial,<br>industrial<br>and other | Leases           | Real estate-<br>residential<br>mortgage<br>(in thousands) | Real<br>estate-<br>construction | Home<br>equity and<br>consumer | Total               |
|---|--|--|------------------|---|---------------------------------|--------------------------------|---------------------|
| <b>Allowance for Loan and Lease Losses:</b>                     |  |  |                  |   |                                 |                                |                     |
| Beginning Balance   | \$ 16,258                                | \$ 5,103                               | \$ 578           | \$ 3,568  | \$ 587                          | \$ 2,837                       | \$ 28,931           |
| Charge-offs   | (1,192)                                  | (1,103)                                | (206)            | (903)   | (3,652)                         | (1,252)                        | (\$ 8,308)          |
| Recoveries  | 955                                      | 139                                    | 119              | 97  | 12                              | 156                            | \$ 1,478            |
| Provision   | 1,684                                    | 971                                    | 17               | 423   | 3,431                           | 1,130                          | \$ 7,656            |
| <b>Ending Balance</b>   | <b>\$ 17,705</b>                         | <b>\$ 5,110</b>                        | <b>\$ 508</b>    | <b>\$ 3,185</b>   | <b>\$ 378</b>                   | <b>\$ 2,871</b>                | <b>\$ 29,757</b>    |
| Ending Balance: Individually evaluated for impairment           | \$ 1,044                                 | \$ 78                                  | \$               | \$ 72   | \$ 41                           | \$ 203                         | \$ 1,438            |
| Ending Balance: Collectively evaluated for impairment           | 16,661                                   | 5,032                                  | 508              | 3,113   | 337                             | 2,668                          | \$ 28,319           |
| Ending Balance: Loans acquired with deteriorated credit quality |  |  |                  |   |                                 |                                |                     |
| Ending Balance  | \$ 17,705                                | \$ 5,110                               | \$ 508           | \$ 3,185  | \$ 378                          | \$ 2,871                       | \$ 29,757           |
| <b>Loans and Leases:</b>  |  |  |                  |   |                                 |                                |                     |
| Ending Balance: Individually evaluated for impairment           | \$ 18,867                                | \$ 4,425                               | \$               | \$ 479  | \$ 921                          | \$ 1,369                       | \$ 26,061           |
| Ending Balance: Collectively evaluated for impairment           | 1,328,185                                | 210,452                                | 37,845           | 437,309   | 49,200                          | 338,066                        | \$ 2,401,057        |
| Ending Balance: Loans acquired with deteriorated credit quality | 1,262                                    |  |                  |   |                                 | 370                            | \$ 1,632            |
| <b>Ending Balance (1)</b>                                       | <b>\$ 1,348,314</b>                      | <b>\$ 214,877</b>                      | <b>\$ 37,845</b> | <b>\$ 437,788</b>   | <b>\$ 50,121</b>                | <b>\$ 339,805</b>              | <b>\$ 2,428,750</b> |

(1) Excludes deferred fees

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| Year Ended December 31, 2012                          | Commercial,<br>secured by<br>real estate | Commercial,<br>industrial<br>and other | Leases           | Real<br>estate-<br>residential<br>mortgage<br>(in thousands) | Real<br>estate-<br>construction | Home<br>equity and<br>consumer | Total               |
|---|--|--|------------------|--|---------------------------------|--------------------------------|---------------------|
| <b>Allowance for Loan and Lease Losses:</b>           |  |  |                  |  |                                 |                                |                     |
| Beginning Balance                                     | \$ 16,618                                | \$ 3,477                               | \$ 688           | \$ 3,077   | \$ 1,424                        | \$ 3,132                       | \$ 28,416           |
| Charge-offs   | (7,287)                                  | (949)                                  | (999)            | (1,822)  | (2,888)                         | (2,074)                        | (\$ 16,019)         |
| Recoveries  | 280                                      | 428                                    | 504              | 66   | 43                              | 306                            | \$ 1,627            |
| Provision   | 6,647                                    | 2,147                                  | 385              | 2,247  | 2,008                           | 1,473                          | \$ 14,907           |
| <b>Ending Balance</b>                                 | <b>\$ 16,258</b>                         | <b>\$ 5,103</b>                        | <b>\$ 578</b>    | <b>\$ 3,568</b>  | <b>\$ 587</b>                   | <b>\$ 2,837</b>                | <b>\$ 28,931</b>    |
| Ending Balance: Individually evaluated for impairment | \$ 368                                   | \$ 219                                 | \$               | \$ 43  | \$ 97                           | \$ 146                         | \$ 873              |
| Ending Balance: Collectively evaluated for impairment | 15,890                                   | 4,884                                  | 578              | 3,525  | 490                             | 2,691                          | \$ 28,058           |
| <b>Ending Balance</b>                                 | <b>\$ 16,258</b>                         | <b>\$ 5,103</b>                        | <b>\$ 578</b>    | <b>\$ 3,568</b>  | <b>\$ 587</b>                   | <b>\$ 2,837</b>                | <b>\$ 28,931</b>    |
| <b>Loans and Leases:</b>                              |  |  |                  |  |                                 |                                |                     |
| Ending Balance: Individually evaluated for impairment | \$ 19,804                                | \$ 5,704                               | \$               | \$ 648   | \$ 4,030                        | \$ 1,345                       | \$ 31,531           |
| Ending Balance: Collectively evaluated for impairment | 1,105,333                                | 210,425                                | 26,781           | 422,614  | 42,242                          | 308,281                        | \$ 2,115,676        |
| <b>Ending Balance(1)</b>                              | <b>\$ 1,125,137</b>                      | <b>\$ 216,129</b>                      | <b>\$ 26,781</b> | <b>\$ 423,262</b>  | <b>\$ 46,272</b>                | <b>\$ 309,626</b>              | <b>\$ 2,147,207</b> |

(1) Excludes deferred fees

Lakeland also maintains a reserve for unfunded lending commitments which are included in other liabilities. This reserve was \$1.1 million both at September 30, 2013 and December 31, 2012. The Company analyzes the adequacy of the reserve for unfunded lending commitments in conjunction with its analysis of the adequacy of the allowance for loan and lease losses. For more information on this analysis, see Risk Elements in Management's Discussion and Analysis.

*Troubled Debt Restructurings*

Troubled debt restructurings are those loans where concessions have been made due to borrowers' financial difficulties. Restructured loans typically involve a modification of terms such as a reduction of the stated interest rate, a moratorium of principal payments and/or an extension of the maturity date at a stated interest rate lower than the current market rate of a new loan with similar risk. The Company considers the potential losses on these loans as well as the remainder of its impaired loans while considering the adequacy of the allowance for loan and lease losses.

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The following tables summarize loans that have been restructured during the three and nine months ended September 30, 2013 and 2012:

|                                      | For the Three Months Ended<br>September 30, 2013 |   |  | For the Three Months Ended<br>September 30, 2012 |   |  |
|--------------------------------------|--|---|--|--|---|--|
|                                      | Number of<br>Contracts                           | Pre-<br>Modification<br>Outstanding<br>Recorded<br>Investment<br>(Dollars in thousands) | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment<br>(Dollars in thousands) | Number of<br>Contracts                           | Pre-<br>Modification<br>Outstanding<br>Recorded<br>Investment<br>(Dollars in thousands) | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment<br>(Dollars in thousands) |
| <b>Troubled Debt Restructurings:</b> |  |   |  |  |   |  |
| Commercial, secured by real estate   |  | \$  | \$   | 3  | \$ 521  | \$ 432   |
| Commercial, industrial and other     |  |   |  | 2  | 56  | 52   |
| Leases                               |  |   |  |  |   |  |
| Real estate residential mortgage     |  |   |  |  |   |  |
| Real estate construction             |  |   |  |  |   |  |
| Home equity and consumer             |  |   |  |  |   |  |
|                                      |  | \$  | \$   | 5  | \$ 577  | \$ 484   |

|                                      | For the Nine Months Ended<br>September 30, 2013 |   |  | For the Nine Months Ended<br>September 30, 2012 |   |  |
|--------------------------------------|---|---|--|---|---|--|
|                                      | Number of<br>Contracts                          | Pre-<br>Modification<br>Outstanding<br>Recorded<br>Investment<br>(Dollars in thousands) | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment<br>(Dollars in thousands) | Number of<br>Contracts                          | Pre-<br>Modification<br>Outstanding<br>Recorded<br>Investment<br>(Dollars in thousands) | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment<br>(Dollars in thousands) |
| <b>Troubled Debt Restructurings:</b> |   |   |  |   |   |  |
| Commercial, secured by real estate   | 11  | \$ 5,472  | \$ 5,468   | 8   | \$ 1,524  | \$ 1,407   |
| Commercial, industrial and other     | 1   | 127   | 125  | 4   | 4,231   | 4,218  |
| Leases                               |   |   |  |   |   |  |
| Real estate residential mortgage     |   |   |  |   |   |  |
| Real estate construction             |   |   |  |   |   |  |
| Home equity and consumer             | 1   | 11  | 11   |   |   |  |
|                                      | 13  | \$ 5,610  | \$ 5,604   | 12  | \$ 5,755  | \$ 5,625   |

The following table summarizes as of September 30, 2013 and 2012, loans that were restructured within the last 12 months that have subsequently defaulted:

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|  | For the Nine Months Ended                        |  |  |  |
|--|--|--|--|--|
|  | September 30, 2013                               |  | September 30, 2012                               |  |
|  | Number of<br>Contracts<br>(Dollars in thousands) | Recorded<br>Investment<br>(Dollars in thousands) | Number of<br>Contracts<br>(Dollars in thousands) | Recorded<br>Investment<br>(Dollars in thousands) |
| <b>Defaulted Troubled Debt Restructurings:</b> |  |  |  |  |
| Commercial, secured by real estate             | 5  | \$ 3,084   | 2  | \$ 267   |
| Commercial, industrial and other               |  |  | 1  | 62   |
| Leases   |  |  |  |  |
| Real estate residential mortgage               |  |  |  |  |
| Real estate construction                       |  |  |  |  |
| Home equity and consumer                       |  |  |  |  |
|  | 5  | \$ 3,084   | 3  | \$ 329   |

*Mortgages Held for Sale*

Residential mortgages originated by the bank and held for sale in the secondary market are carried at the lower of cost or fair market value. Fair value is generally determined by the value of purchase commitments. Losses are recorded as a valuation allowance and charged to earnings. As of September 30, 2013, the Company had \$901,000 in mortgages held for sale.

*Leases*

Lakeland had no leases held for sale as of September 30, 2013 and December 31, 2012. The following table shows the components of gains on leasing related assets for the periods presented:

|                                       | For the Three Months Ended |        | For the Nine Months Ended |        |
|---------------------------------------|----------------------------|--------|---------------------------|--------|
|                                       | September 30,              |        | September 30,             |        |
|                                       | 2013                       | 2012   | 2013                      | 2012   |
|                                       | (in thousands)             |        | (in thousands)            |        |
| Gains (losses) on sales of leases     | \$                         | \$     | \$                        | \$     |
| Realized gains on paid off leases     | 20                         | 92     | 51                        | 365    |
| Gains on other repossessed assets     |                            | 8      | 12                        | 38     |
| Total gains on leasing related assets | \$ 20                      | \$ 100 | \$ 63                     | \$ 403 |

*Other Real Estate and Other Repossessed Assets*

At September 30, 2013, the Company had other repossessed assets and other real estate owned of \$44,000 and \$2.1 million, respectively. At December 31, 2012, the Company had other repossessed assets and other real estate owned of \$77,000 and \$452,000, respectively.



**Table of Contents****Note 8. Employee Benefit Plans**

The components of net periodic pension cost for the Newton Trust Company's defined benefit pension plan are as follows:

|   | For the Three Months Ended<br>September 30, |       | For the Nine Months Ended<br>September 30, |       |
|---|---|-------|--|-------|
|   | 2013  | 2012  | 2013                                       | 2012  |
|   | (in thousands)                              |       | (in thousands)                             |       |
| Interest cost                                   | \$ 22                                       | \$ 22 | \$ 67                                      | \$ 65 |
| Expected return on plan assets                  | (18)  | (19)  | (54)                                       | (57)  |
| Amortization of unrecognized net actuarial loss | 21  | 18    | 62   | 54    |
| Net periodic benefit expense                    | \$ 25                                       | \$ 21 | \$ 75                                      | \$ 62 |

**Note 9. Directors' Retirement Plan**

The components of net periodic plan costs for the directors' retirement plan are as follows:

|   | For the Three Months Ended<br>September 30, |       | For the Nine Months Ended<br>September 30, |       |
|---|---|-------|--|-------|
|   | 2013  | 2012  | 2013                                       | 2012  |
|   | (in thousands)                              |       | (in thousands)                             |       |
| Service cost                                    | \$ 8  | \$ 8  | \$ 22                                      | \$ 23 |
| Interest cost                                   | 9   | 11    | 27   | 31    |
| Amortization of prior service cost              | 3   | 3     | 10   | 10    |
| Amortization of unrecognized net actuarial loss | 2   | 3     | 6  | 9     |
| Net periodic benefit expense                    | \$ 22                                       | \$ 25 | \$ 65                                      | \$ 73 |

The Company made contributions of \$75,000 and \$88,000 to the plan during the nine month periods ended September 30, 2013 and 2012, respectively. The Company does not expect to make any more contributions for the remainder of 2013.

**Note 10. Estimated Fair Value of Financial Instruments and Fair Value Measurement*****Fair Value Measurement***

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

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

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



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

The Company's assets that are measured at fair value on a recurring basis are its available for sale investment securities. The Company obtains fair values on its securities using information from a third party servicer. If quoted prices for securities are available in an active market, those securities are classified as Level 1 securities. The Company has U.S. Treasury Notes and certain equity securities that are classified as Level 1 securities. Level 2 securities were primarily comprised of U.S. Agency bonds, residential mortgage-backed securities, obligations of state and political subdivisions and corporate securities. Fair values were estimated primarily by obtaining quoted prices for similar assets in active markets or through the use of pricing models supported with market data information. Standard inputs include benchmark yields, reported trades, issuer spreads, bids and offers. On a quarterly basis, the Company reviews the pricing information received from the Company's third party pricing service. This review includes a comparison to non-binding third-party quotes. As a result of our review, we did not have any adjustments to prices from our third party servicer.

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

The following table sets forth the Company's financial assets that were accounted for at fair value on a recurring basis as of the periods presented by level within the fair value hierarchy. During the nine months ended September 30, 2013, the Company did not make any transfers between recurring Level 1 fair value measurements and recurring Level 2 fair value measurements. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement:

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|  | Quoted Prices in<br>Active<br>Markets<br>for Identical<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total<br>Fair Value |
|--|--|---|--|---------------------|
|  | (in thousands)   |   |  |                     |
| <b>September 30, 2013</b>                        |  |   |  |                     |
| <b>Assets:</b>                                   |  |   |  |                     |
| Investment securities, available for sale        |  |   |  |                     |
| U.S. treasury and government agencies            | \$ 4,366   | \$ 55,798   | \$   | \$ 60,164           |
| Mortgage backed securities                       |  | 290,998   |  | 290,998             |
| Obligations of states and political subdivisions |  | 37,691  |  | 37,691              |
| Corporate debt securities                        |  | 13,404  |  | 13,404              |
| Equity securities                                | 2,741  | 13,564  |  | 16,305              |
| <b>Total securities available for sale</b>       | <b>7,107</b>   | <b>411,455</b>  |  | <b>418,562</b>      |
| Non-hedging interest rate derivatives            |  | 361   |  | 361                 |
| <b>Total Assets</b>                              | <b>\$ 7,107</b>  | <b>\$ 411,816</b>   |  | <b>\$ 418,923</b>   |
| Non-hedging interest rate derivatives            | \$   | \$ 361  | \$   | \$ 361              |
| <b>Total Liabilities</b>                         | <b>\$</b>  | <b>\$ 361</b>   | <b>\$</b>  | <b>\$ 361</b>       |
| <b>December 31, 2012</b>                         |  |   |  |                     |
| <b>Assets:</b>                                   |  |   |  |                     |
| Investment securities, available for sale        |  |   |  |                     |
| U.S. treasury and government agencies            | \$ 3,493   | \$ 83,078   | \$   | \$ 86,571           |
| Mortgage backed securities                       |  | 239,559   |  | 239,559             |
| Obligations of states and political subdivisions |  | 38,620  |  | 38,620              |
| Corporate debt securities                        |  | 13,444  |  | 13,444              |
| Equity securities                                | 2,010  | 13,506  |  | 15,516              |
| <b>Total securities available for sale</b>       | <b>5,503</b>   | <b>388,207</b>  |  | <b>393,710</b>      |
| Non-hedging interest rate derivatives            |  | 195   |  | 195                 |
| <b>Total Assets</b>                              | <b>\$ 5,503</b>  | <b>\$ 388,402</b>   | <b>\$</b>  | <b>\$ 393,905</b>   |
| Non-hedging interest rate derivatives            | \$   | \$ 195  | \$   | \$ 195              |
| <b>Total Liabilities</b>                         | <b>\$</b>  | <b>\$ 195</b>   | <b>\$</b>  | <b>\$ 195</b>       |

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

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|  | Quoted Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) |     |    | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total<br>Fair Value |
|--|---|-----|----|---|--|---------------------|
|  | (in thousands)  |     |    |   |  |                     |
| <b>September 30, 2013</b>                            |   |     |    |   |  |                     |
| <b>Assets:</b>                                       |   |     |    |   |  |                     |
| Impaired Loans and Leases                            | \$  | \$  | \$ | 26,061  | \$   | 26,061              |
| Loans held for sale                                  |   | 901 |    |   |  | 901                 |
| Other real estate owned and other repossessed assets |   |     |    | 2,154   |  | 2,154               |
| <b>December 31, 2012</b>                             |   |     |    |   |  |                     |
| <b>Assets:</b>                                       |   |     |    |   |  |                     |
| Impaired Loans and Leases                            | \$  | \$  | \$ | 31,531  | \$   | 31,531              |
| Other real estate owned and other repossessed assets |   |     |    | 529   |  | 529                 |

Impaired loans are evaluated and valued at the time the loan is identified as impaired at the lower of cost or market value. Because most of Lakeland's impaired loans are collateral dependent, fair value is generally measured based on the value of the collateral securing these loans and leases and is classified at a level 3 in the fair value hierarchy. Collateral may be real estate, accounts receivable, inventory, equipment and/or other business assets. The value of the real estate is assessed based on appraisals by qualified third party licensed appraisers. The appraisers may use the sales comparison approach, the cost approach or the income approach to value the collateral using discount rates (with ranges of 5-11%) or capitalization rates (with ranges of 5-9%) to evaluate the property. The value of the equipment may be determined by an appraiser, if significant, inquiry through a recognized valuation resource, or by the value on the borrower's financial statements. Field examiner reviews on business assets may be conducted based on the loan exposure and reliance on this type of collateral. Appraised and reported values may be adjusted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and client's business. Loans that are not collateral dependent are evaluated based on a discounted cash flow method. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above.

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

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

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

***Fair Value of Certain Financial Instruments***

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

The estimation methodologies used, the estimated fair values, and recorded book balances at September 30, 2013 and December 31, 2012 are outlined below.



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

The fair value of Investment Securities Held to Maturity was measured using information from the same third-party servicer used for Investment Securities Available for Sale using the same methodologies discussed above. Investment Securities Held to Maturity includes \$4.5 million in short-term municipal bond anticipation notes that are non-rated and do not have an active secondary market or information readily available on standard financial systems. As a result, the securities are classified as Level 3 securities. These are investments in municipalities in the Company's market area, and management performs a credit analysis on the municipality before investing in these securities.

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

The net loan portfolio at September 30, 2013 and December 31, 2012 has been valued using a present value discounted cash flow where market prices were not available. The discount rate used in these calculations is the estimated current market rate adjusted for credit risk. The carrying value of accrued interest approximates fair value.

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

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

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

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The following table presents the carrying values, fair values and placement in the fair value hierarchy of the Company's financial instruments as of September 30, 2013 and December 31, 2012:

|  | Carrying Value | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|--|----------------|------------|--|---|---|
| (in thousands)                         |                |            |  |   |   |
| <b>September 30, 2013</b>              |                |            |  |   |   |
| Financial Instruments - Assets         |                |            |  |   |   |
| Investment securities held to maturity | \$ 96,702      | \$ 96,196  | \$   | \$ 91,651                                     | \$ 4,545                                  |
| Federal Home Loan Bank Stock           | 5,965          | 5,965      |  | 5,965   |   |
| Loans and leases                       | 2,427,684      | 2,421,527  |  |   | 2,421,527                                 |
| Financial Instruments - Liabilities    |                |            |  |   |   |
| Certificates of Deposit                | 314,593        | 315,213    |  | 315,213                                       |   |
| Other borrowings                       | 75,000         | 78,905     |  | 78,905  |   |
| Subordinated debentures                | 42,548         | 28,753     |  |   | 28,753                                    |
| Commitments:                           |                |            |  |   |   |
| Standby letters of credit              |                | 7          |  |   | 7   |
| <b>December 31, 2012</b>               |                |            |  |   |   |
| Financial Instruments - Assets         |                |            |  |   |   |
| Investment securities held to maturity | \$ 96,925      | \$ 99,784  | \$   | \$ 87,336                                     | \$ 12,448                                 |
| Federal Home Loan Bank Stock           | 5,382          | 5,382      |  | 5,382   |   |
| Loans and leases                       | 2,146,843      | 2,154,507  |  |   | 2,154,507                                 |
| Financial Instruments - Liabilities    |                |            |  |   |   |
| Certificates of Deposit                | 303,792        | 305,398    |  | 305,398                                       |   |
| Other borrowings                       | 85,000         | 91,325     |  | 91,325  |   |
| Subordinated debentures                | 51,548         | 33,403     |  |   | 33,403                                    |
| Commitments:                           |                |            |  |   |   |
| Standby letters of credit              |                | 4          |  |   | 4   |

**Note 11. Derivatives**

Lakeland is a party to interest rate derivatives that are not designated as hedging instruments. These derivatives relate to interest rate swaps that the Company enters into with customers to allow customers to convert variable rate loans to a fixed rate. Lakeland pays interest to the customer at a floating rate on the notional amount and receives interest from the customer at a fixed rate for the same notional amount. At the same time the interest rate swap is entered into with the customer, an offsetting interest rate swap is entered into with another financial institution. Lakeland pays the other financial institution interest at the same fixed rate on the same notional amount as the swap entered into with the customer, and receives interest from the financial institution for the same floating rate on the same notional amount. The changes in the fair value of the swaps offset each other, except for the credit risk of the counterparties, which is determined by taking into consideration the risk rating, probability of default and loss of given default for all counterparties. As of September 30, 2013 and December 31, 2012, Lakeland had \$1.5 million and \$497,000, respectively, in securities pledged for collateral on its interest rate swaps with the financial institution.



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

September 30, 2013

|   | Notional Amount | Average Maturity | Weighted Average<br>Rate Fixed | Weighted Average<br>Variable Rate | Fair Value |
|---|-----------------|------------------|--------------------------------|-----------------------------------|------------|
| 3rd party interest rate swaps                     | \$ 17,802       | 7.0              | 3.830%                         | 1 Mo Libor + 2.21                 | (\$ 361)   |
| Customer interest rate swaps<br>December 31, 2012 | (17,802)        | 7.0              | 3.830%                         | 1 Mo Libor + 2.21                 | 361        |

|                               | Notional Amount | Average Maturity | Weighted Average<br>Rate Fixed | Weighted Average<br>Variable Rate | Fair Value |
|-------------------------------|-----------------|------------------|--------------------------------|-----------------------------------|------------|
| 3rd party interest rate swaps | \$ 6,400        | 10.1             | 4.625%                         | 1 Mo Libor + 2.61                 | \$ 195     |
| Customer interest rate swaps  | (6,400)         | 10.1             | 4.625%                         | 1 Mo Libor + 2.61                 | (\$ 195)   |

The following shows the Company's transactions that are subject to an enforceable master netting arrangement or other such similar agreements for the periods presented:

September 30, 2013

| Description                  | Gross Amounts of Recognized Assets | Gross Amounts Offset in the Balance Sheet | Net Amounts of Assets Presented in the Balance Sheet (in thousands) | Gross Amounts not Offset in the Balance Sheet |                          | Net Amount    |
|------------------------------|------------------------------------|---|---|---|--------------------------|---------------|
|                              |                                    |   |   | Financial Instruments                         | Cash Collateral Received |               |
| Customer interest rate swaps | \$ 17,802                          | (\$ 17,441)                               | \$ 361  | \$  | \$                       | \$ 361        |
| <b>Total</b>                 | <b>\$ 17,802</b>                   | <b>(\$ 17,441)</b>                        | <b>\$ 361</b>   | <b>\$</b>                                     | <b>\$</b>                | <b>\$ 361</b> |

| Description                  | Gross Amounts of Recognized Liabilities | Gross Amounts Offset in the Balance Sheet | Net Amounts of Liabilities Presented in the Balance Sheet (in thousands) | Gross Amounts not Offset in the Balance Sheet |                          | Net Amount    |
|------------------------------|---|---|--|---|--------------------------|---------------|
|                              |   |   |  | Financial Instruments                         | Cash Collateral Received |               |
| Customer interest rate swaps | \$ 17,802                               | (\$ 17,441)                               | \$ 361   | \$  | \$                       | \$ 361        |
| <b>Total</b>                 | <b>\$ 17,802</b>                        | <b>(\$ 17,441)</b>                        | <b>\$ 361</b>  | <b>\$</b>                                     | <b>\$</b>                | <b>\$ 361</b> |

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| Description                     |           |             |        |    |    |        |
|---------------------------------|-----------|-------------|--------|----|----|--------|
| Third party interest rate swaps | \$ 17,802 | (\$ 17,441) | \$ 361 | \$ | \$ | \$ 361 |
| Total                           | \$ 17,802 | (\$ 17,441) | \$ 361 | \$ | \$ | \$ 361 |

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December 31, 2012

| Description  | Gross Amounts of Recognized Assets | Gross Amounts Offset in the Balance Sheet | Net Amounts of Assets Presented in the Balance Sheet (in thousands) | Gross Amounts not Offset in the Balance Sheet |                          | Net Amount    |
|--|------------------------------------|---|---|---|--------------------------|---------------|
|  |                                    |   |   | Financial Instruments                         | Cash Collateral Received |               |
| Offsetting of Financial Assets and Derivative Assets |                                    |   |   |   |                          |               |
| Third party interest rate swaps                      | \$ 6,400                           | (\$ 6,205)                                | \$ 195  | \$  | \$                       | \$ 195        |
| <b>Total</b>   | <b>\$ 6,400</b>                    | <b>(\$ 6,205)</b>                         | <b>\$ 195</b>   | <b>\$</b>                                     | <b>\$</b>                | <b>\$ 195</b> |

| Description  | Gross Amounts of Recognized Liabilities | Gross Amounts Offset in the Balance Sheet | Net Amounts of Liabilities Presented in the Balance Sheet (in thousands) | Gross Amounts not Offset in the Balance Sheet |                          | Net Amount    |
|--|---|---|--|---|--------------------------|---------------|
|  |   |   |  | Financial Instruments                         | Cash Collateral Received |               |
| Offsetting of Financial Liabilities and Derivative Liabilities |   |   |  |   |                          |               |
| Customer interest rate swaps                                   | \$ 6,400                                | (\$ 6,205)                                | \$ 195   | \$  | \$                       | \$ 195        |
| <b>Total</b>   | <b>\$ 6,400</b>                         | <b>(\$ 6,205)</b>                         | <b>\$ 195</b>  | <b>\$</b>                                     | <b>\$</b>                | <b>\$ 195</b> |

**Note 12. Preferred Stock**

On February 8, 2012, the Company redeemed its remaining 19,000 shares of its Fixed Rate Cumulative Preferred Stock, Series A originally issued to the U.S. Department of the Treasury under the Troubled Asset Relief Program Capital Purchase Program ( CPP ). The Company paid to the Treasury \$19.2 million, which included \$19.0 million of principal and \$219,000 in accrued and unpaid dividends, on February 8, 2012. As a result of the early payment, the Company also accelerated the accretion of \$501,000 of the preferred stock discount.

On February 29, 2012, the Company repurchased the outstanding common stock warrant previously issued to the Treasury for the purchase of 1,046,901 shares of its common stock at an exercise price of \$8.45 per share, for \$2.8 million, completing the Company's participation in the Treasury's CPP. Upon repurchase, the common stock warrant had a carrying value of \$3.3 million. The repurchase price of \$2.8 million was recorded as a reduction to common stock on the statement of changes in stockholders' equity.

**Note 13. Common Stock**

On September 4, 2012, the Company issued and sold an aggregate of 2,667,253 shares of common stock at a price of \$9.65 per share pursuant to a takedown off of the Company's shelf registration statement. The Company received net proceeds of \$25.0 million which it used to repay \$25.8 million in junior subordinated debentures on October 7, 2012. The junior subordinated debentures had been issued by the Company to Lakeland Capital Trust III in December 2003, had a coupon rate of 7.535% at the time of redemption and were due on January 7, 2034. The capital and common securities issued by the Trust in December 2003 were also redeemed.

**Note 14. Acquisitions**

On May 31, 2013, the Company completed its acquisition of Somerset Hills Bancorp, a bank holding company headquartered in Bernardsville, New Jersey. This acquisition enables the Company to expand into Somerset and Union counties, and broaden its presence in Morris county. Effective at the close of business on May 31, 2013, Somerset Hills Bancorp merged into the Company, and Somerset Hills Bank merged into Lakeland Bank. The Merger Agreement provided that

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the shareholders of Somerset Hills Bancorp would receive, at their election, for each outstanding share of Somerset Hills Bancorp common stock that they own at the effective time of the merger, either 1.1962 shares of Lakeland Bancorp common stock or \$12.00 in cash, subject to proration as described in the Merger Agreement, so that 90% of the aggregate merger consideration was shares of Lakeland Bancorp common stock and 10% was cash. Lakeland Bancorp issued an aggregate of 5,794,079 shares of its common stock in the merger, and also assumed outstanding Somerset Hills Bancorp stock options (which were converted into options to purchase Lakeland Bancorp common stock). Lakeland Bancorp paid \$6.5 million in cash in the transaction.

The acquisition was accounted for under the acquisition method of accounting and accordingly, assets acquired, liabilities assumed and consideration exchanged were recorded at their estimated fair values as of the acquisition date. Somerset Hills' assets were recorded at their preliminary estimated fair values as of May 31, 2013 and Somerset Hills' results of operations have been included in the Company's Consolidated Statements of Income since that date.

The assets acquired and liabilities assumed in the acquisition were recorded at their estimated fair values based on management's best estimates using information available at the date of the acquisition, including the use of a third party valuation specialist. The fair values are preliminary estimates and subject to adjustment for up to one year after the closing date of the acquisition. The following table summarizes the estimated fair value of the acquired assets and liabilities (in thousands).

**Consideration Paid**

|  |                  |
|--|------------------|
| Lakeland Bancorp stock issued  | \$ 57,419        |
| Cash Payment   | 6,460            |
| Fair value of Somerset Hills stock options converted to Lakeland Bancorp stock options | 1,603            |
| <b>Total Consideration Paid</b>  | <b>\$ 65,482</b> |

**Recognized amounts of identifiable assets and liabilities assumed at fair value**

|  |                  |
|--|------------------|
| Cash and cash equivalents                    | \$ 80,359        |
| Securities available for sale                | 1,737            |
| Securities held to maturity                  | 8,686            |
| Federal Home Loan Bank stock                 | 493              |
| Loans and leases                             | 243,888          |
| Loans held for sale                          | 2,532            |
| Premises and equipment                       | 5,214            |
| Identifiable intangible assets               | 2,712            |
| Accrued interest receivable and other assets | 10,270           |
| Deposits                                     | (311,801)        |
| Other liabilities                            | (1,877)          |
| <b>Total identifiable assets</b>             | <b>\$ 42,213</b> |

|                 |                  |
|-----------------|------------------|
| <b>Goodwill</b> | <b>\$ 23,269</b> |
|-----------------|------------------|

Loans acquired in the Somerset Hills acquisition were recorded at fair value and subsequently accounted for in accordance with ASC Topic 310, and there was no carryover related allowance for loan and lease losses. The fair values of loans acquired from Somerset Hills were estimated using cash flow projections based on the remaining maturity and repricing terms. Cash flows were adjusted for estimated future credit losses and the rate of prepayments. Projected cash flows were then discounted to present value using a risk-adjusted market rate for similar loans.



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The following is a summary of the loans acquired in the Somerset Hills acquisition as of the closing date.

|   | Acquired<br>Credit<br>Impaired<br>Loans | Acquired<br>Non-Credit<br>Impaired<br>Loans | Total<br>Acquired<br>Loans |
|---|---|---|----------------------------|
| (in thousands)  |   |   |                            |
| Contractually required principal and interest at acquisition                    | \$ 4,507                                | \$ 352,148                                  | \$ 356,655                 |
| Contractual cash flows not expected to be collected (non-accretable difference) | 2,541                                   |   | 2,541                      |
| Expected cash flows at acquisition  | \$ 1,966                                | \$ 352,148                                  | \$ 354,114                 |
| Interest component of expected cash flows (accretable difference)               | 361                                     | 107,333                                     | 107,694                    |
| Fair value of acquired loans, including mortgages held for sale                 | \$ 1,605                                | \$ 244,815                                  | \$ 246,420                 |

The core deposit intangible totaled \$2.7 million and is being estimated over its estimated useful life of approximately 10 years using an accelerated method. The goodwill will be evaluated annually for impairment. The goodwill is not deductible for tax purposes.

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

Direct costs related to the acquisition were expensed as incurred. During the three and nine months ended September 30, 2013, the Company incurred \$744,000 and \$2.8 million, respectively, of merger and acquisition integration-related expenses, which have been separately stated in the Company's Consolidated Statements of Income.

**Supplemental Pro Forma Financial Information**

The following table presents financial information regarding the former Somerset Hills operations included in our Consolidated Statements of Income from the date of the acquisition (May 31, 2013) through September 30, 2013 under the column Actual from acquisition date through September 30, 2013. In addition, the table provides unaudited condensed pro forma financial information assuming that the Somerset Hills acquisition had been completed as of January 1, 2013, for the nine months ended September 30, 2013 and as of January 1, 2012 for the nine months ended September 30, 2012. The table below has been prepared for comparative purposes only and is not necessarily indicative of the actual results that would have been attained had the acquisition occurred as of the beginning of the periods presented, nor is it indicative of future results. Furthermore, the unaudited proforma information does not reflect management's estimate of any revenue-enhancing opportunities nor anticipated cost savings or the impact of conforming certain accounting policies of the acquired company to the Company's policies that may have occurred as a result of the integration and consolidation of Somerset Hills operations. The pro forma information shown reflects adjustments related to certain purchase accounting fair value adjustments; amortization of core deposit and other intangibles; and related income tax effects.

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| (in thousands)      | Actual from<br>acquisition to<br>September 30, 2013 | Pro-forma<br>September 30, 2013 | Pro-forma<br>September 30, 2012 |
|---------------------|---|---------------------------------|---------------------------------|
| Net interest income | \$ 3,534  | \$ 81,331                       | \$ 80,352                       |
| Noninterest income  | 513   | 16,624                          | 15,312                          |
| Noninterest expense | 2,047   | 60,024                          | 56,835                          |
| Net income          | 1,300   | 20,477                          | 17,573                          |
| Earnings per share: |   |                                 |                                 |
| Fully diluted       |   | \$ 0.57                         | \$ 0.54                         |

**Note 15. Goodwill and Intangible Assets**

The Company has goodwill of \$110.4 million which includes \$23.3 million from the Somerset Hills acquisition and \$87.1 million from prior acquisitions. The Company reviews its goodwill and intangible assets annually, on November 30, or more frequently if conditions warrant, for impairment. In testing goodwill for impairment, the Company compares the estimated fair value of each reporting unit to their respective carrying amounts, including goodwill. The Company has determined that it has one reporting unit, Community Banking.

As stated above, the Company recorded \$2.7 million in core deposit intangible for the Somerset Hills acquisition. Year-to-date, it has amortized \$164,000 in core deposit intangible. The estimated future amortization expense for each of the succeeding five years ended December 31 is as follows (dollars in thousands):

|                     |        |
|---------------------|--------|
| For the year ended: |        |
| 2013                | \$ 123 |
| 2014                | 464    |
| 2015                | 415    |
| 2016                | 366    |
| 2017                | 316    |

**Note 16. Early Extinguishment of Debt**

On June 18, 2013, the Company acquired and extinguished \$9.0 million of Lakeland Bancorp Capital Trust I debentures and recorded a \$1.2 million gain on extinguishment of debt. The interest rate on this debenture floated at LIBOR plus 310 basis points and had a rate of 3.38% at the time of extinguishment. The Company redeemed the remaining \$1.0 million in the fourth quarter of 2013 at par value.

**Note 17. Recent Accounting Pronouncements**

In July 2013, the Financial Accounting Standards Board (the "FASB") issued an accounting pronouncement to improve the reporting for unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The pronouncement is expected to reduce diversity in practice by providing guidance on the presentation of unrecognized tax benefits and will better reflect the manner in which an entity would settle at the reporting date any additional income taxes that would result from the disallowance of a tax position when net operating loss carryforwards, similar tax losses, or tax credit carryforwards exist. The pronouncement is effective prospectively for fiscal years, and interim periods within those years, beginning after December 15, 2013. The adoption of this pronouncement is not expected to have a material impact on the Company's financial statements.



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In July 2013, the FASB issued guidance permitting the Fed Funds Effective Swap Rate to be used as a U.S. benchmark interest rate for hedge accounting purposes, in addition to interest rates on direct Treasury obligations of the U.S. government and the London Interbank Offered Rate ( LIBOR ). This guidance is effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013 and is not expected to have a significant impact on the Company's financial statements.

In February 2013, the FASB issued guidance relating to the reporting of amounts reclassified out of accumulated other comprehensive income. This guidance further updates guidance issued in 2011 increasing the prominence of items reported in other comprehensive income and facilitating the convergence of U.S. GAAP and International Financial Reporting Standards ( IFRS ). The guidance issued in 2013 requires an entity to provide information about the items reclassified out of other comprehensive income by component. This guidance is effective during interim and annual periods beginning after December 15, 2012, and is to be applied retrospectively. The Company adopted this guidance in the first quarter of 2013. Adoption of this guidance did not have a significant impact on the Company's consolidated financial statements.

In December 2011, the FASB issued accounting guidance regarding disclosures about offsetting assets and liabilities. The scope of this accounting guidance was further clarified by the FASB on January 1, 2013. This guidance affects all entities that have financial instruments and derivative instruments that are either (1) offset in accordance with U.S. GAAP or (2) subject to an enforceable master netting arrangement or similar agreement. This information will enable users of an entity's financial statements to evaluate the effect or potential effect of netting arrangements on an entity's financial position, including the effect or potential effect of rights of setoff associated with certain financial instruments and derivative instruments in the scope of this guidance. The Company adopted this guidance in the first quarter of 2013 and provided the disclosures required by those amendments retrospectively for all comparative periods presented. Adoption of this guidance did not have a significant impact on the Company's consolidated financial statements.

**PART I ITEM 2**

**Management's Discussion and Analysis of**

**Financial Condition and Results of Operations**

This section should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

**Statements Regarding Forward Looking Information**

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

In addition to the risk factors disclosed elsewhere in this document, the following factors, among others, could cause the Company's actual results to differ materially and adversely from such forward-looking statements: changes in the financial services industry and the U.S. and global capital markets, changes in economic conditions nationally, regionally and in the Company's markets, the nature and timing of actions of the Federal Reserve Board and other regulators, the nature and timing of legislation affecting the financial services industry including, but not limited to, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, government intervention in the U.S. financial system, changes in levels of market interest rates, pricing pressures on loan and deposit products, credit risks of the Company's lending and leasing activities, customers' acceptance of the Company's products and services, competition, and the failure to realize anticipated efficiencies and synergies of the merger of Somerset Hills Bank into Lakeland Bank and of Somerset Hills Bancorp into the Company.

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



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### **Critical Accounting Policies, Judgments and Estimates**

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

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

### **Management Overview**

The quarter and nine months ended September 30, 2013, represented a period of continued growth for the Company. As discussed in this Management's Discussion and Analysis:

Net income available to common shareholders increased \$1.1 million to \$6.6 million, or 21% from the third quarter of 2012 to the same period in 2013. Included in the third quarter of 2013 earnings was \$744,000 in merger related expenses. Exclusive of these expenses, fully diluted earnings per share would have been \$0.20 per common share or the same as fully diluted earnings per share for the third quarter of 2012.

Net income available to common stockholders increased \$2.3 million, or 15%, from the first nine months of 2012 to the same period in 2013. Included in the 2013 first nine months earnings was \$2.8 million in expenses related to the merger with Somerset Hills Bancorp. Exclusive of these expenses, fully diluted earnings per share for the first nine months of 2013 was \$0.61 per common share, a 9% increase over the fully diluted earnings per share for the same period last year.

Non-performing assets declined for the eighth consecutive quarter. Non-performing assets have declined \$9.9 million, or 35%, from \$28.5 million reported at year end.

As a result of improving loan quality, the provision for loan and lease losses was reduced from \$3.4 million in the third quarter of 2012 to \$1.9 million in the third quarter of 2013.

The Company's net interest margin has been stable for the last four quarters. In the third quarter of 2013 net interest margin was 3.68%, which equaled the net interest margin for the second quarter of 2013 and was two basis points higher than the third quarter of 2012.

The Somerset Hills acquisition, which was consummated on May 31, 2013, added six full service branches, \$355.9 million in total assets, \$10.4 million in investment securities, \$246.4 million in loans (including \$2.5 million in residential mortgages held for sale), and \$311.8 million in deposits (\$80.8 million in non-interest bearing demand deposits and \$231.0 million in interest-bearing deposits) at fair value. For more information on the Somerset Hills acquisition, please see Note 14 Acquisitions in this Quarterly Report on Form 10-Q.

During the first nine months of 2013, the Company acquired and extinguished \$9.0 million of Lakeland Bancorp Capital Trust I debentures and recorded a \$1.2 million pre-tax gain on extinguishment of debt.



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**Results of Operations**

**(Third Quarter 2013 Compared to Third Quarter 2012)**

**Net Income**

Net income was \$6.6 million in the third quarter of 2013 compared to net income of \$5.5 million for the third quarter of 2012. Diluted earnings per share was \$0.18 for the third quarter of 2013, compared to diluted earnings per share of \$0.20 for the same period last year. Net interest income for the third quarter of 2013 increased \$3.8 million compared to the third quarter of 2012 due to a \$2.4 million increase in interest income and a \$1.5 million reduction in interest expense.

**Net Interest Income**

Net interest income is the difference between interest income on earning assets and the cost of funds supporting those assets. The Company's net interest income is determined by: (i) the volume of interest-earning assets that it holds and the yields that it earns on those assets, and (ii) the volume of interest-bearing liabilities that it has assumed and the rates that it pays on those liabilities. Net interest income increases when the Company can use noninterest-bearing deposits to fund or support interest-earning assets. The Company's net interest income is influenced by the current low interest rate environment. For information on how interest rate change can influence the Company's net interest income, and how the Company manages its net interest income, please see Quantitative and Qualitative Disclosures About Market Risk in Item 3 of this Quarterly Report on Form 10-Q. The Company's net interest margin can also be impacted by its level of non-performing loans. If non-performing loans decline, this could increase the net interest margin.

Net interest income on a tax equivalent basis for the third quarter of 2013 was \$27.7 million, compared to \$23.9 million for the third quarter of 2012. The net interest margin increased from 3.66% in the third quarter of 2012 to 3.68% in the third quarter of 2013 primarily as a result of a 32 basis point decrease in the yield on interest bearing liabilities partially offset by a 25 basis point decline in the yield on interest earning assets. The net interest margin would have been 3.76% and 3.74% for the third quarter of 2013 and 2012, respectively, had the Company's non-performing loans performed in accordance with their terms. The increase in the net interest margin was augmented by an increase in income earned on free funds (interest earning assets funded by non-interest bearing liabilities) resulting from an increase in average non-interest bearing deposits of \$143.2 million. The components of net interest income will be discussed in greater detail below.

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

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|  | For the Three Months Ended,<br>September 30, 2013 |                                |   | For the Three Months Ended,<br>September 30, 2012 |                                |                                     |
|--|---|--------------------------------|---|---|--------------------------------|-------------------------------------|
|  | Average<br>Balance                                | Interest<br>Income/<br>Expense | Average<br>rates<br>earned/<br>paid<br>(dollars in thousands) | Average<br>Balance                                | Interest<br>Income/<br>Expense | Average<br>rates<br>earned/<br>paid |
| <b>Assets</b>                                    |   |                                |   |   |                                |                                     |
| Interest-earning assets:                         |   |                                |   |   |                                |                                     |
| Loans and leases (A)                             | \$ 2,435,658                                      | \$ 27,350                      | 4.45%   | \$ 2,062,928                                      | \$ 24,929                      | 4.81%                               |
| Taxable investment securities and other          | 430,369   | 2,017                          | 1.87%   | 433,233   | 2,121                          | 1.96%                               |
| Tax-exempt securities                            | 75,894  | 709                            | 3.74%   | 68,629  | 658                            | 3.84%                               |
| Federal funds sold (B)                           | 45,487  | 27                             | 0.24%   | 33,271  | 17                             | 0.20%                               |
| <b>Total interest-earning assets</b>             | <b>2,987,408</b>                                  | <b>30,103</b>                  | <b>4.00%</b>  | <b>2,598,061</b>                                  | <b>27,725</b>                  | <b>4.25%</b>                        |
| Noninterest-earning assets:                      |   |                                |   |   |                                |                                     |
| Allowance for loan and lease losses              | (30,039)  |                                |   | (28,515)  |                                |                                     |
| Other assets                                     | 286,628   |                                |   | 258,339   |                                |                                     |
| <b>TOTAL ASSETS</b>                              | <b>\$ 3,243,997</b>                               |                                |   | <b>\$ 2,827,885</b>                               |                                |                                     |
| <b>Liabilities and Stockholders Equity</b>       |   |                                |   |   |                                |                                     |
| Interest-bearing liabilities:                    |   |                                |   |   |                                |                                     |
| Savings accounts                                 | \$ 374,141  | \$ 51                          | 0.05%   | \$ 350,135  | \$ 92                          | 0.11%                               |
| Interest-bearing transaction accounts            | 1,403,227   | 955                            | 0.27%   | 1,169,953   | 1,168                          | 0.40%                               |
| Time deposits                                    | 322,371   | 512                            | 0.64%   | 324,355   | 766                            | 0.94%                               |
| Borrowings                                       | 165,261   | 850                            | 2.06%   | 234,204   | 1,814                          | 3.10%                               |
| <b>Total interest-bearing liabilities</b>        | <b>2,265,000</b>                                  | <b>2,368</b>                   | <b>0.42%</b>  | <b>2,078,647</b>                                  | <b>3,840</b>                   | <b>0.74%</b>                        |
| Noninterest-bearing liabilities:                 |   |                                |   |   |                                |                                     |
| Demand deposits                                  | 620,499   |                                |   | 477,311   |                                |                                     |
| Other liabilities                                | 15,016  |                                |   | 14,370  |                                |                                     |
| Stockholders equity                              | 343,482   |                                |   | 257,557   |                                |                                     |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b> | <b>\$ 3,243,997</b>                               |                                |   | <b>\$ 2,827,885</b>                               |                                |                                     |
| Net interest income/spread                       |   | 27,735                         | 3.58%   |   | 23,885                         | 3.51%                               |
| Tax equivalent basis adjustment                  |   | 248                            |   |   | 230                            |                                     |
| <b>NET INTEREST INCOME</b>                       |   | <b>\$ 27,487</b>               |   |   | <b>\$ 23,655</b>               |                                     |
| Net interest margin (C)                          |   |                                | 3.68%   |   |                                | 3.66%                               |

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

(B) Includes interest-bearing cash accounts.

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

Interest income on a tax equivalent basis increased from \$27.7 million in the third quarter of 2012 to \$30.1 million in the third quarter of 2013, an increase of \$2.4 million, or 9%. The increase in interest income was primarily due to a \$372.7 million increase in average loans and leases partially offset by a decrease in the yield on interest earning assets. The increase in average loans and leases is due primarily to the acquisition of Somerset Hills loans and leases which totaled \$243.9 million at the time of acquisition. The yield on average loans and leases at 4.45% in the third quarter of 2013 was 36 basis points lower than the third quarter of 2012. The yield on average taxable and tax exempt investment securities decreased by 9 basis points and 10 basis points, respectively, compared to the third quarter of 2012.

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Total interest expense decreased from \$3.8 million in the third quarter of 2012 to \$2.4 million in the third quarter of 2013, a decrease of \$1.5 million, or 38%. The cost of average interest-bearing liabilities decreased from 0.74% in the third quarter of 2012 to 0.42% in 2013. The decrease in yield was due primarily to a 104 basis point reduction in the cost of borrowings, a \$68.9 million reduction in higher yielding average borrowings and the continuing low rate environment. In the fourth quarter of 2012, the Company redeemed a \$25.8 million subordinated debenture that was paying 7.535%. In the second quarter of 2013, the Company acquired and extinguished \$9 million in subordinated debentures that were paying LIBOR plus 310 basis points. From the third quarter of 2012 to the third quarter of 2013, average savings accounts and interest-bearing transaction accounts increased by \$24.0 million and \$233.3 million, respectively. Average rates paid on interest-bearing liabilities declined in all categories.

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

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

In the third quarter of 2013, a \$1.9 million provision for loan and lease losses was recorded, which was \$1.5 million lower than the provision for the same period last year. During the third quarter of 2013, the Company charged off loans and leases of \$2.8 million and recovered \$1.1 million in previously charged off loans and leases compared to \$3.4 million and \$180,000, respectively, during the same period in 2012. The lower provision resulted from a decline in non-performing assets and from lower net charge-offs during the quarter. For more information regarding the determination of the provision, see Risk Elements below.

**Noninterest Income**

Noninterest income at \$4.6 million in the third quarter of 2013 was equivalent to the third quarter of 2012. Income on bank owned life insurance at \$383,000 in the third quarter increased \$26,000 or 7% compared to the same period in 2012 primarily resulting from the addition of policies acquired in the Somerset Hills merger. Other income totaling \$285,000 in the third quarter of 2013 was \$79,000 lower than the same period in 2012, primarily due to a reduction in gains on leasing related assets.

**Noninterest Expense**

Noninterest expense totaling \$20.4 million increased \$3.4 million in the third quarter of 2013 from the third quarter of 2012. In the third quarter of 2013 noninterest expense included \$744,000 in merger related expenses. Salary and employee benefits at \$11.0 million increased by \$1.4 million, or 15%, primarily as a result of increased staffing levels from the six new Somerset Hills branches, as well as the retention of some administrative personnel from the Somerset Hills acquisition. Net occupancy expense at \$2.1 million in the third quarter of 2013 increased \$253,000 from the same period last year, due primarily to expenses relating to the six new branch locations acquired in the Somerset Hills acquisition and a new branch opening in the fourth quarter of 2012. Furniture and equipment at \$1.6 million increased \$377,000 from the same period last year due primarily to the new branches previously mentioned and increased service contract expenses. Stationary, supplies and postage at \$348,000 decreased \$40,000 compared to the third quarter of 2012 due primarily to the opening of a new branch and the new operations and training center in the third quarter of 2012 as well as general declines in postage resulting from greater usage of electronic delivery. FDIC insurance expense at \$436,000 in the third quarter of 2013 decreased \$83,000 compared to the same period last year due primarily to improved assessment rates resulting from a reduction in nonperforming assets. Legal expense at \$406,000 increased \$271,000 compared to the same period last year. In the third quarter of 2012 the Company recovered \$150,000 in previously expensed legal fees. Other expenses at \$3.0 million increased \$371,000 compared to the third quarter of 2012, due primarily to an increase in data processing expenses reflecting technological improvements, an increase in telecommunications expense and Somerset Hills costs. The Company's efficiency ratio, a non-GAAP financial measure, was 59.98% in the third quarter of 2013, compared to 58.91% for the same period last year. The increase was primarily due to an increase in noninterest expense partially offset by an increase in revenue. The Company uses this ratio because it believes that the ratio provides a good comparison of period-to-period performance and because the ratio is widely accepted in the banking industry. The following table shows the calculation of the efficiency ratio for the periods presented:



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|   | For the Three Months Ended September 30, |           |
|---|--|-----------|
|   | 2013                                     | 2012      |
|   | (dollars in thousands)                   |           |
| <b>Calculation of efficiency ratio:</b>                     |  |           |
| Total noninterest expense                                   | \$ 20,407                                | \$ 16,968 |
| <b>Less:</b>  |  |           |
| Amortization of core deposit intangibles                    | (123)                                    |           |
| Other real estate owned and other repossessed asset expense | 2  | (13)      |
| Merger related expenses                                     | (744)                                    |           |
| Provision for unfunded lending commitments                  | (121)                                    | (150)     |
| <br>  |  |           |
| Noninterest expense, as adjusted                            | \$ 19,421                                | \$ 16,805 |
| <br>  |  |           |
| Net interest income   | \$ 27,487                                | \$ 23,655 |
| Noninterest income  | 4,645                                    | 4,640     |
| <br>  |  |           |
| Total revenue   | 32,132                                   | 28,295    |
| Plus: Tax-equivalent adjustment on municipal securities     | 248                                      | 230       |
| <b>Less:</b>  |  |           |
| Gains on debt extinguishment                                |  |           |
| Gains on sales of investment securities                     |  |           |
| <br>  |  |           |
| Total revenue, as adjusted                                  | \$ 32,380                                | \$ 28,525 |
| <br>  |  |           |
| Efficiency ratio  | 59.98%                                   | 58.91%    |

**Income Tax Expense**

The effective tax rate increased from 31.2% in the third quarter of 2012 to 32.8% in the third quarter of 2013 primarily as a result of increased earnings and because of a reduction of tax advantaged items as a percent of pre-tax income.

**(Year to Date 2013 Compared to Year to Date 2012)****Net Income**

Net income for the first nine months of 2013 was \$17.6 million, compared to net income of \$15.9 million for the same period in 2012. The Company recorded a \$1.2 million gain on debt extinguishment in the first nine months of 2013 as well as \$2.8 million in merger related expenses. Net income available to common stockholders was \$17.6 million compared to \$15.3 million for the first nine months of 2012. Because the Company repaid its remaining preferred stock to the U.S. Department of the Treasury under the CPP in the first nine months of 2012, the Company had no dividends or accretion on preferred stock in the first nine months of 2013 compared to \$620,000 for the same period last year. Diluted earnings per share was \$0.54 for the first nine months of 2013 compared to \$0.56 in the first nine months of 2012. Net interest income at \$76.6 million for the first nine months of 2013 increased \$5.2 million compared to the same period in 2012 due primarily to a reduction in interest expense.

**Net Interest Income**

Net interest income on a tax equivalent basis for the first nine months of 2013 was \$77.3 million compared to \$72.1 million for the first nine months of 2012. The net interest margin decreased from 3.70% in the first nine months of 2012 to 3.69% in the first nine months of 2013 primarily as a result of a decline in yield on average interest earning assets. The net interest margin would have been 3.77% and 3.82% for the first nine months of 2013 and 2012, respectively, had the Company's non-performing loans performed in accordance with their terms. The decline in net interest margin resulting from a 29 basis point decline in the yield on interest-earning assets was offset by a 33 basis point reduction in the cost of interest-bearing liabilities. The decline in the net interest margin resulting from a decline in rates was mitigated by an increase in income earned on free funds (interest earning assets funded by non-interest bearing liabilities) resulting from an increase in average non-interest bearing deposits of \$88.9 million. The components of net interest income will be discussed in greater detail below.



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

**CONSOLIDATED STATISTICS ON A TAX EQUIVALENT BASIS**

|   | For the Nine Months Ended,<br>September 30, 2013 |                                |   | For the Nine Months Ended,<br>September 30, 2012 |                                |                                     |
|---|--|--------------------------------|---|--|--------------------------------|-------------------------------------|
|   | Average<br>Balance                               | Interest<br>Income/<br>Expense | Average<br>rates<br>earned/<br>paid<br>(dollars in thousands) | Average<br>Balance                               | Interest<br>Income/<br>Expense | Average<br>rates<br>earned/<br>paid |
| <b>Assets</b>                                     |  |                                |   |  |                                |                                     |
| Interest-earning assets:                          |  |                                |   |  |                                |                                     |
| Loans (A)   | \$ 2,279,972                                     | \$ 77,122                      | 4.52%   | \$ 2,063,609                                     | \$ 75,659                      | 4.90%                               |
| Taxable investment securities and other           | 410,508  | 5,544                          | 1.80%   | 438,418  | 6,668                          | 2.03%                               |
| Tax-exempt securities                             | 73,638   | 2,048                          | 3.71%   | 69,836   | 2,109                          | 4.03%                               |
| Federal funds sold (B)                            | 35,578   | 57                             | 0.21%   | 27,300   | 29                             | 0.14%                               |
| <b>Total interest-earning assets</b>              | <b>2,799,696</b>                                 | <b>84,771</b>                  | <b>4.05%</b>  | <b>2,599,163</b>                                 | <b>84,465</b>                  | <b>4.34%</b>                        |
| Noninterest-earning assets:                       |  |                                |   |  |                                |                                     |
| Allowance for loan and lease losses               | (30,004)   |                                |   | (29,077)   |                                |                                     |
| Other assets                                      | 269,474  |                                |   | 248,240  |                                |                                     |
| <b>TOTAL ASSETS</b>                               | <b>\$ 3,039,166</b>                              |                                |   | <b>\$ 2,818,326</b>                              |                                |                                     |
| <b>Liabilities and Stockholders' Equity</b>       |  |                                |   |  |                                |                                     |
| Interest-bearing liabilities:                     |  |                                |   |  |                                |                                     |
| Savings accounts                                  | \$ 367,245                                       | \$ 171                         | 0.06%   | \$ 346,829                                       | \$ 274                         | 0.11%                               |
| Interest-bearing transaction accounts             | 1,305,173  | 2,902                          | 0.30%   | 1,149,501  | 3,683                          | 0.43%                               |
| Time deposits                                     | 311,994  | 1,667                          | 0.71%   | 335,947  | 2,464                          | 0.98%                               |
| Borrowings  | 174,025  | 2,745                          | 2.10%   | 254,394  | 5,957                          | 3.12%                               |
| <b>Total interest-bearing liabilities</b>         | <b>2,158,437</b>                                 | <b>7,485</b>                   | <b>0.46%</b>  | <b>2,086,671</b>                                 | <b>12,378</b>                  | <b>0.79%</b>                        |
| Noninterest-bearing liabilities:                  |  |                                |   |  |                                |                                     |
| Demand deposits                                   | 555,663  |                                |   | 466,747  |                                |                                     |
| Other liabilities                                 | 14,434   |                                |   | 13,723   |                                |                                     |
| Stockholders' equity                              | 310,632  |                                |   | 251,185  |                                |                                     |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b> | <b>\$ 3,039,166</b>                              |                                |   | <b>\$ 2,818,326</b>                              |                                |                                     |
| Net interest income/spread                        |  | 77,286                         | 3.58%   |  | 72,087                         | 3.55%                               |
| Tax equivalent basis adjustment                   |  | 717                            |   |  | 738                            |                                     |
| <b>NET INTEREST INCOME</b>                        |  | <b>\$ 76,569</b>               |   |  | <b>\$ 71,349</b>               |                                     |
| Net interest margin (C)                           |  |                                | 3.69%   |  |                                | 3.70%                               |

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

Interest income on a tax equivalent basis increased from \$84.5 million in the first nine months of 2012 to \$84.8 million in the first nine months of 2013 primarily due to the same reasons discussed in the quarterly comparison. The yield on average loans and leases at 4.52% in the first nine months of 2013 was 38 basis points lower than the first nine months of 2012. The yield on average taxable and tax exempt investment securities decreased by 23 basis points and 32 basis points, respectively, compared to the first nine months of 2012. Average loans and leases at \$2.28 billion increased \$216.4 million from the first nine months of 2012, while average investment securities at \$484.1 million decreased \$24.1 million.

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Total interest expense decreased from \$12.4 million in the first nine months of 2012 to \$7.5 million in the first nine months of 2013, a decrease of \$4.9 million, or 40%. The cost of average interest-bearing liabilities decreased from 0.79% in the first nine months of 2012 to 0.46% in 2013. The decrease in yield was due primarily to a 102 basis point reduction in the cost of borrowings, an \$80.4 million reduction in higher yielding borrowings, a \$24.0 million reduction in higher yielding time deposits and the continuing low rate environment. From the first nine months of 2012 to the first nine months of 2013, average savings accounts and interest-bearing transaction accounts increased by \$20.4 million and \$155.7 million, respectively. Average rates paid on interest-bearing liabilities declined in all categories.

**Provision for Loan and Lease Losses**

In the first nine months of 2013, a \$7.7 million provision for loan and lease losses was recorded, which was \$4.1 million lower than the provision for the same period last year. During the first nine months of 2013, the Company charged off loans and leases of \$8.3 million and recovered \$1.5 million in previously charged off loans and leases compared to \$12.7 million and \$1.2 million, respectively, during the same period in 2012. The lower provision resulted from a decline in non-performing assets and from lower charge-offs during the first nine months of 2013. For more information regarding the determination of the provision, see [Risk Elements](#) below.

**Noninterest Income**

Noninterest income increased \$2.0 million, or 15%, to \$15.5 million in the first nine months of 2013 compared to the first nine months of 2012. In the first nine months of 2013 the Company recorded a \$1.2 million pre-tax gain on the purchase and early extinguishment of \$9.0 million of Lakeland Bancorp Capital Trust I debentures. Gains on sales of investment securities was \$506,000 during the first nine months of 2013 compared to \$273,000 during the same period in 2012. Other income totaling \$1.2 million in the first nine months of 2013 was \$358,000 higher than the same period in 2012 primarily due to an increase in gains on sales of residential mortgage loans and loan swap transactions.

**Noninterest Expense**

Noninterest expense totaling \$58.0 million increased \$8.3 million in the first nine months of 2013 from the first nine months of 2012. In the first nine months of 2013 noninterest expense included \$526,000 in long term debt prepayment fees and \$2.8 million in merger related expenses. Salary and employee benefits at \$31.1 million increased by \$2.5 million, or 9%, primarily due to normal salary increases and the same reasons discussed in the quarterly analysis. Net occupancy expense at \$5.9 million and furniture and equipment at \$4.5 million in the first nine months of 2013 increased \$790,000 and \$1.1 million, respectively, from the same period last year due primarily to the same reasons discussed in the quarterly analysis. Marketing expense totaling \$1.4 million decreased \$208,000 compared to the first nine months of 2012 primarily due to a reduction in advertising and the timing of marketing campaigns. Legal expense at \$934,000 increased \$54,000 due to the same reason discussed in the quarterly comparison. Other real estate and repossessed asset expense at \$15,000 decreased \$74,000 primarily due to the reduction in nonperforming assets. Other expenses at \$8.0 million in the first nine months of 2013 increased \$751,000 compared to the same period in 2012 primarily due to the same reasons discussed in the quarterly comparison. The Company's efficiency ratio, a non-GAAP financial measure, was 59.85% in the first nine months of 2013, compared to 57.93% for the same period last year due primarily to an increase in noninterest expenses partially offset by an increase in revenue. The Company uses this ratio because it believes that the ratio provides a good comparison of period-to-period performance and because the ratio is widely accepted in the banking industry. The following table shows the calculation of the efficiency ratio for the periods presented:

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|   | For the Nine Months Ended September 30, |                  |
|---|---|------------------|
|   | 2013                                    | 2012             |
|   | (dollars in thousands)                  |                  |
| <b>Calculation of efficiency ratio:</b>                     |   |                  |
| Total noninterest expense                                   | \$ 58,027                               | \$ 49,713        |
| <b>Less:</b>  |   |                  |
| Amortization of core deposit intangibles                    | (164)                                   |                  |
| Other real estate owned and other repossessed asset expense | (15)                                    | (89)             |
| Long term debt prepayment fee                               | (526)                                   |                  |
| Merger related expenses                                     | (2,827)                                 |                  |
| Provision for unfunded lending commitments                  | 8                                       | (217)            |
| <b>Noninterest expense, as adjusted</b>                     | <b>\$ 54,503</b>                        | <b>\$ 49,407</b> |
| <br>  |   |                  |
| Net interest income   | \$ 76,569                               | \$ 71,349        |
| Noninterest income  | 15,489                                  | 13,468           |
| <br>  |   |                  |
| Total revenue   | 92,058                                  | 84,817           |
| Plus: Tax-equivalent adjustment on municipal securities     | 717                                     | 738              |
| <b>Less:</b>  |   |                  |
| Gains on debt extinguishment                                | (1,197)                                 |                  |
| Gains on sales of investment securities                     | (506)                                   | (273)            |
| <b>Total revenue, as adjusted</b>                           | <b>\$ 91,072</b>                        | <b>\$ 85,282</b> |
| <br>  |   |                  |
| Efficiency ratio  | 59.85%                                  | 57.93%           |

**Income Tax Expense**

The effective tax rate increased from 31.8% in the first nine months of 2012 to 33.2% in the first nine months of 2013 for the same reasons discussed above in the quarterly comparison.

**Financial Condition**

The Company's total assets increased \$380.6 million from \$2.92 billion at December 31, 2012, to \$3.30 billion at September 30, 2013. This includes Somerset Hills' assets which were \$355.9 million at the time of acquisition. Total loans were \$2.43 billion, an increase of \$281.5 million from \$2.15 billion at December 31, 2012. Somerset Hills' loans totaled \$243.9 million at the time of acquisition. Total deposits were \$2.71 billion, an increase of \$337.5 million from December 31, 2012. Somerset Hills' deposits totaled \$311.8 million at the time of acquisition.

**Loans and Leases**

Gross loans and leases at \$2.43 billion increased by \$281.5 million from December 31, 2012. This includes Somerset Hills' loans which totaled \$243.9 million at the time of acquisition. Excluding Somerset Hills' loans, total loans have increased 2% from December 31, 2012 primarily in the commercial loans secured by real estate category. Excluding the impact of the Somerset Hills' loans of \$144.6 million, commercial loans secured by real estate increased \$78.5 million or 7% from December 31, 2012 to September 30, 2013. Leases also increased \$11.1 million or 41.3% resulting from increased demand for equipment financing and from broadening our market area. Excluding the impact of the Somerset Hills' loans of \$22.0 million, commercial, industrial and other decreased \$23.3 million or 11% resulting from large payoffs and reduced demand in a competitive lending market. Real Estate-Residential mortgages declined \$24.7 million or 6% excluding the impact of Somerset Hills' residential mortgages of \$39.3 million. The decline in residential mortgages resulted from an increase in long-term rates which occurred in the middle of 2013 causing the level of refinances to decline. The Company is also selling a larger percentage of its residential mortgage originations than it has in past years. For more information on the loan portfolio, see Note 7 in Notes to the Consolidated Financial Statements in this Quarterly Report on Form 10-Q.

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### **Risk Elements**

Non-performing assets decreased from \$28.5 million, or 0.98% of total assets, on December 31, 2012 to \$18.7 million, or 0.57% of total assets, on September 30, 2013. Non-performing assets decreased in all categories. The largest declines in non-performing loans were in commercial loans secured by real estate, real estate construction loans and residential mortgages which declined by \$3.9 million, \$3.1 million and \$2.7 million, respectively. Commercial loan non-accruals at September 30, 2013 included two loan relationships with balances \$1.0 million or over, totaling \$2.0 million, and two loan relationships between \$500,000 and \$1.0 million, totaling \$1.1 million.

There were \$2.5 million in loans and leases past due ninety days or more and still accruing at September 30, 2013 compared to \$1.4 million at December 31, 2012. Loans and leases past due 90 days or more and still accruing are those loans and leases that are considered both well-secured and in process of collection.

On September 30, 2013, the Company had \$11.0 million in loans that were troubled debt restructurings and still accruing interest income compared to \$7.3 million on December 31, 2012. Troubled debt restructurings are those loans where the Company has granted concessions to the borrower in payment terms, either in rate or in term, as a result of the financial condition of the borrower.

On September 30, 2013, the Company had \$26.1 million in impaired loans (consisting primarily of non-accrual and restructured loans and leases) compared to \$31.5 million at year-end 2012. For more information on impaired loans and leases see Note 7 in Notes to the Consolidated Financial Statements of this Quarterly Report on Form 10-Q. The impairment of the loans and leases is measured using the present value of future cash flows on certain impaired loans and is based on the fair value of the underlying collateral for the remaining loans and leases. Based on such evaluation, \$1.4 million has been allocated as a portion of the allowance for loan and lease losses for impairment at September 30, 2013. At September 30, 2013, the Company also had \$61.1 million in loans and leases that were rated substandard that were not classified as non-performing or impaired compared to \$42.7 million at December 31, 2012.

There were no loans and leases at September 30, 2013, other than those designated non-performing, impaired or substandard, where the Company was aware of any credit conditions of any borrowers or obligors that would indicate a strong possibility of the borrowers not complying with present terms and conditions of repayment and which may result in such loans and leases being included as non-accrual, past due or renegotiated at a future date. The following table sets forth for the periods presented, the historical relationships among the allowance for loan and lease losses, the provision for loan and lease losses, the amount of loans and leases charged-off and the amount of loan and lease recoveries:

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| (dollars in thousands)   | Nine Months<br>Ended<br>September 30,<br>2013 | Nine Months<br>Ended<br>September 30,<br>2012 | Year<br>Ended<br>December<br>31,<br>2012 |
|--|---|---|--|
| Balance of the allowance at the beginning of the year                                    | \$ 28,931                                     | \$ 28,416                                     | \$ 28,416                                |
| Loans and leases charged off:  |   |   |  |
| Commercial, secured by real estate   | 1,192   | 5,648   | 7,287                                    |
| Commercial, industrial and other   | 1,103   | 841   | 949                                      |
| Leases   | 206   | 694   | 999                                      |
| Real estate mortgage   | 903   | 1,436   | 1,822                                    |
| Real estate-construction   | 3,652   | 2,402   | 2,888                                    |
| Home equity and consumer   | 1,252   | 1,705   | 2,074                                    |
| <b>Total loans charged off</b>   | <b>8,308</b>                                  | <b>12,726</b>                                 | <b>16,019</b>                            |
| Recoveries:  |   |   |  |
| Commercial, secured by real estate   | 955   | 106   | 280                                      |
| Commercial, industrial and other   | 139   | 355   | 428                                      |
| Leases   | 119   | 463   | 504                                      |
| Real estate mortgage   | 97  | 10  | 66                                       |
| Real estate-construction   | 12  | 36  | 43                                       |
| Home equity and consumer   | 156   | 226   | 306                                      |
| <b>Total Recoveries</b>  | <b>1,478</b>                                  | <b>1,196</b>                                  | <b>1,627</b>                             |
| Net charge-offs:   | 6,830   | 11,530  | 14,392                                   |
| Provision for loan and lease losses  | 7,656   | 11,783  | 14,907                                   |
| Ending balance   | \$ 29,757                                     | \$ 28,669                                     | \$ 28,931                                |
| Ratio of annualized net charge-offs to average loans and leases outstanding              | 0.40%   | 0.74%   | 0.69%                                    |
| Ratio of allowance at end of period as a percentage of period end total loans and leases | 1.23%   | 1.39%   | 1.35%                                    |

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

Methodology employed for assessing the adequacy of the allowance for loan and lease losses consists of the following criteria:

The establishment of reserve amounts for all specifically identified classified loans and leases that have been designated as requiring attention by the Company or its external loan review consultants.

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

The establishment of reserve amounts for the non-classified loans and leases in each portfolio based upon the historical average loss experience of these portfolios and management's evaluation of key factors described below.



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

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The overall balance of the allowance for loan losses increased \$826,000 to \$29.8 million at September 30, 2013 compared to December 31, 2012 reflecting an increase in the commercial real estate portfolio. The allowance for loan and lease losses in the other segments declined or remained substantially the same as prior periods resulting from a decline in loans outstanding combined with a decline in non-performing loans.

Non-performing loans and leases decreased from \$28.0 million on December 31, 2012 to \$16.5 million on September 30, 2013. The allowance for loan and lease losses as a percent of total loans was 1.23% of total loans on September 30, 2013, compared to 1.35% as of December 31, 2012. The decline in the allowance for loan and lease losses as a percent of total loans results from the \$243.9 million increase in loans resulting from the Somerset Hills acquisition, which is accounted for under acquisition accounting. Excluding the Somerset Hills loans, the allowance as a percent of total loans would be 1.36%. Management believes, based on appraisals and estimated selling costs, that its non-performing loans and leases are adequately secured and reserves on these loans and leases are adequate. The preceding statement constitutes a forward-looking statement under the Private Securities Litigation Reform Act of 1995.

Based upon the process employed and giving recognition to all accompanying factors related to the loan and lease portfolio, management considers the allowance for loan and lease losses to be adequate at September 30, 2013. The preceding statement constitutes a forward-looking statement under the Private Securities Litigation Reform Act of 1995.

### **Investment Securities**

For detailed information on the composition and maturity distribution of the Company's investment securities portfolio, see the Notes to Consolidated Financial Statements contained in this Form 10-Q. Total investment securities increased from \$490.6 million on December 31, 2012 to \$515.3 million on September 30, 2013, an increase of \$24.6 million, or 5%.

### **Deposits**

Total deposits increased from \$2.37 billion on December 31, 2012 to \$2.71 billion on September 30, 2013, an increase of \$337.5 million, or 14%. Somerset Hills' deposits totaled \$311.8 million at the time of acquisition. Noninterest bearing deposits increased \$125.5 million, or 25%, to \$623.6 million. Excluding \$80.8 million in Somerset Hills' demand deposits, noninterest bearing demand deposits have increased by \$44.7 million, or 9%, from year-end 2012. Savings and interest-bearing transaction accounts and time deposits increased \$201.2 million and \$10.8 million, respectively. At the time of acquisition Somerset Hills had savings and interest-bearing transaction accounts and time deposits of \$199.1 million and \$31.7 million, respectively.

### **Liquidity**

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

Lakeland funds loan demand and operation expenses from several sources:

Net income. Cash provided by operating activities was \$40.3 million for the first nine months of 2013 compared to \$37.5 million for the same period in 2012.

Deposits. Lakeland can offer new products or change its rate structure in order to increase deposits. In the first nine months of 2013, Lakeland's deposits increased \$25.7 million excluding the impact of Somerset Hills' deposits.

Sales of securities and overnight funds. At September 30, 2013, the Company had \$418.6 million in securities designated available for sale. Of these securities, \$286.9 million were pledged to secure public deposits and for other purposes required by applicable laws and regulations.

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

Overnight credit lines. As a member of the Federal Home Loan Bank of New York (FHLB), Lakeland has the ability to borrow overnight based on the market value of collateral pledged. Lakeland had no overnight borrowings from the FHLB on September 30, 2013. Lakeland also has overnight federal funds lines available for it to borrow up to \$162.0 million. Lakeland had borrowings against these lines of \$72.0 million at September 30, 2013. Lakeland may also borrow from the discount window of the Federal Reserve Bank of New York based on the market value of collateral pledged. Lakeland had no borrowings with the Federal Reserve Bank of New York as of September 30, 2013.

Other borrowings. Lakeland can also generate funds by utilizing long-term debt or securities sold under agreements to repurchase that would be collateralized by security or mortgage collateral. At times the market values of securities collateralizing our securities sold under agreements to repurchase may decline due to changes in interest rates and may necessitate our lenders to issue a margin call which requires Lakeland to pledge additional collateral to meet that margin call. Management and the Board monitor the Company's liquidity through the asset/liability committee, which monitors the Company's compliance with certain regulatory ratios and other various liquidity guidelines.

The cash flow statements for the periods presented provide an indication of the Company's sources and uses of cash, as well as an indication of the ability of the Company to maintain an adequate level of liquidity. A discussion of the cash flow statement for the nine months ended September 30, 2013 follows.

Cash and cash equivalents totaling \$145.3 million on September 30, 2013, increased \$37.7 million from December 31, 2012. Operating activities provided \$40.3 million in net cash. Investing activities provided \$1.1 million in net cash, primarily reflecting net cash acquired in the acquisition of Somerset Hills offset by an increase in loans and leases and investment securities. Financing activities used \$3.7 million in net cash primarily reflecting repayments of \$10.0 million in other borrowings, an early extinguishment of subordinated debentures and the payment of dividends partially offset by a net increase of \$25.7 million in deposits. The Company anticipates that it will have sufficient funds available to meet its current loan commitments and deposit maturities. This constitutes a forward-looking statement under the Private Securities Litigation Reform Act of 1995.

The following table sets forth contractual obligations and other commitments representing required and potential cash outflows as of September 30, 2013. Interest on subordinated debentures and long-term borrowed funds is calculated based on current contractual interest rates.

|   | Total               | Within<br>one year | After one but<br>within three<br>years | After three<br>but within<br>five years | After<br>five years |
|---|---------------------|--------------------|--|---|---------------------|
| (dollars in thousands)                                    |                     |                    |  |   |                     |
| Minimum annual rentals on noncancellable operating leases | \$ 20,510           | \$ 2,543           | \$ 4,409                               | \$ 2,966                                | \$ 10,592           |
| Benefit plan commitments                                  | 5,580               | 209                | 384                                    | 579                                     | 4,408               |
| Remaining contractual maturities of time deposits         | 314,593             | 237,189            | 57,851                                 | 18,693                                  | 860                 |
| Subordinated debentures                                   | 42,548              |                    |  |   | 42,548              |
| Loan commitments  | 535,454             | 431,997            | 60,964                                 | 994                                     | 41,499              |
| Other borrowings  | 75,000              |                    | 10,000                                 | 45,000                                  | 20,000              |
| Interest on other borrowings*                             | 32,500              | 3,264              | 6,533                                  | 4,677                                   | 18,026              |
| Standby letters of credit                                 | 9,476               | 7,882              | 1,514                                  |   | 80                  |
| <b>Total</b>  | <b>\$ 1,035,661</b> | <b>\$ 683,084</b>  | <b>\$ 141,655</b>                      | <b>\$ 72,909</b>                        | <b>\$ 138,013</b>   |

\* Includes interest on other borrowings and subordinated debentures at a weighted rate of 2.81%.

**Table of Contents****Capital Resources**

Total stockholders' equity increased from \$280.9 million on December 31, 2012 to \$347.5 million on September 30, 2013, an increase of \$66.7 million, or 24%. Book value per common share increased to \$9.70 on September 30, 2013 from \$9.45 on December 31, 2012. The increase in stockholders' equity from December 31, 2012 to September 30, 2013 was primarily due to stock issued of \$57.4 million for the acquisition of Somerset Hills and \$17.6 million in net income, partially offset by other comprehensive loss on the Company's available for sale securities portfolio of \$5.8 million and the payment of dividends on common stock of \$5.8 million.

The Company and Lakeland are subject to various regulatory capital requirements that are monitored by federal banking agencies. Failure to meet minimum capital requirements can lead to certain supervisory actions by regulators; any supervisory action could have a direct material adverse effect on the Company or Lakeland's financial statements. Management believes, as of September 30, 2013, that the Company and Lakeland meet all capital adequacy requirements to which they are subject.

The capital ratios for the Company and Lakeland at September 30, 2013 are as follows:

|  | Tier 1<br>Capital<br>to Total Average<br>Assets Ratio<br>September 30,<br>2013 | Tier 1 Capital<br>to Risk-Weighted<br>Assets Ratio<br>September 30,<br>2013 | Total Capital<br>to Risk-Weighted<br>Assets Ratio<br>September 30,<br>2013 |
|--|--|---|--|
| <b>Capital Ratios:</b>                                 |  |   |  |
| The Company  | 8.84%  | 11.64%  | 12.89%   |
| Lakeland Bank  | 8.37%  | 11.03%  | 12.28%   |
| Well capitalized institution under FDIC<br>Regulations | 5.00%  | 6.00%   | 10.00%   |

*Basel III*

On July 2, 2013, the FRB approved the final rules implementing the Basel Committee on Banking Supervision's (BCBS) capital guidelines for U.S. banks. Under the final rules, minimum requirements will increase for both the quantity and quality of capital held by the Company. The rules include a new common equity Tier 1 capital to risk-weighted assets ratio of 4.5% and a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets. The final rules also raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0% and require a minimum leverage ratio of 4.0%. The final rules also implement strict eligibility criteria for regulatory capital instruments. On July 9, 2013, the FDIC also approved, as an interim final rule, the regulatory capital requirements for U.S. banks, following the actions of the FRB. The FDIC's rule is identical in substance to the final rules issued by the FRB. The phase-in period for the final rules will begin for the Company on January 1, 2015, with full compliance with all of the final rule's requirements phased in over a multi-year schedule through January 1, 2019. Management is currently evaluating the provisions of the final rules and their expected impact on the Company.

**Non-GAAP Financial Measures**

Reported amounts are presented in accordance with U.S. GAAP. The Company's management believes that the supplemental non-GAAP information, which consists of measurements and ratios based on tangible equity and tangible assets, is utilized by regulators and market analysts to evaluate a company's financial condition and therefore, such information is useful to investors. These disclosures should not be viewed as a substitute for financial results determined in accordance with U.S. GAAP, nor are they necessarily comparable to non-GAAP performance measures which may be presented by other companies.

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| (dollars in thousands, except per share amounts)                         | September 30,<br>2013 | December 31,<br>2012 |
|--|-----------------------|----------------------|
| <b>Calculation of tangible book value per common share</b>               |                       |                      |
| Total common stockholders' equity at end of period GAAP                  | \$ 347,525            | \$ 280,867           |
| Less:  |                       |                      |
| Goodwill   | 110,381               | 87,111               |
| Other identifiable intangible assets, net                                | 2,548                 |                      |
| <br>Total tangible common stockholders' equity at end of period Non-GAAP | <br>\$ 234,596        | <br>\$ 193,756       |
| Shares outstanding at end of period (1)                                  | 35,823                | 29,726               |
| Book value per share GAAP (1)  | \$ 9.70               | \$ 9.45              |
| Tangible book value per share Non-GAAP (1)                               | \$ 6.55               | \$ 6.52              |

(1) Adjusted for 5% stock dividend paid on April 16, 2012 to shareholders of record as of March 30, 2012.

|  |              |              |
|--|--------------|--------------|
| <b>Calculation of tangible common equity to tangible assets</b>      |              |              |
| Total tangible common stockholders' equity at end of period Non-GAAP | \$ 234,596   | \$ 193,756   |
| Total assets at end of period  | \$ 3,299,300 | \$ 2,918,703 |
| Less:  |              |              |
| Goodwill   | 110,381      | 87,111       |
| Other identifiable intangible assets, net                            | 2,548        |              |
| Total tangible assets at end of period Non-GAAP                      | \$ 3,186,371 | \$ 2,831,592 |
| Common equity to assets GAAP   | 10.53%       | 9.62%        |
| Tangible common equity to tangible assets Non-GAAP                   | 7.36%        | 6.84%        |

|   | For the three months ended,<br>September 30,<br>2013 | September 30,<br>2012 | For the nine months ended,<br>September 30,<br>2013 | September 30,<br>2012 |
|---|--|-----------------------|---|-----------------------|
| <b>Calculation of return on average tangible common equity</b>  |  |                       |   |                       |
| Net income GAAP   | \$ 6,617   | \$ 5,489              | \$ 17,628   | \$ 15,913             |
| Total average common stockholders' equity                       | \$ 343,482   | \$ 257,557            | \$ 310,632  | \$ 248,622            |
| Less:   |  |                       |   |                       |
| Average goodwill  | 110,381  | 87,111                | 97,510  | 87,111                |
| Average other identifiable intangible assets, net               | 2,624  |                       | 1,182   |                       |
| Total average tangible common stockholders' equity Non-GAAP     | \$ 230,477   | \$ 170,446            | \$ 211,940  | \$ 161,511            |
| Return on average common stockholders' equity GAAP              | 7.64%  | 8.48%                 | 7.59%   | 8.55%                 |
| Return on average tangible common stockholders' equity Non-GAAP | 11.39%   | 12.81%                | 11.12%  | 13.16%                |

**ITEM 3. Quantitative and Qualitative Disclosures about Market Risk**

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

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The starting point (or base case) for the following table is an estimate of the following year's net interest income assuming that both interest rates and the Company's interest-sensitive assets and liabilities remain at period-end levels. The net interest income estimated for the next twelve months (the base case) is \$109.2 million. The information provided for net interest income assumes that changes in interest rates of plus 200 basis points and minus 200 basis points change gradually in equal increments (rate ramp) over the twelve month period.

| Rate Ramp                    | Changes in interest rates |         |
|------------------------------|---------------------------|---------|
|                              | +200 bp                   | -200 bp |
| Asset/Liability Policy Limit | -5.0%                     | -5.0%   |
| September 30, 2013           | -2.8%                     | -2.0%   |
| December 31, 2012            | -4.9%                     | -2.2%   |

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

| Rate Shock                   | Changes in interest rates |         |         |         |         |         |         |         |
|------------------------------|---------------------------|---------|---------|---------|---------|---------|---------|---------|
|                              | +400 bp                   | +300 bp | +200 bp | +100 bp | -100 bp | -200 bp | -300 bp | -400 bp |
| Asset/Liability Policy Limit | -20.0%                    | -15.0%  | -10.0%  | -5.0%   | -5.0%   | -10.0%  | -15.0%  | -20.0%  |
| September 30, 2013           | -5.2%                     | -4.0%   | -2.6%   | -1.2%   | -4.7%   | -5.9%   | -6.7%   | -6.7%   |
| December 31, 2012            | -8.7%                     | -6.4%   | -4.2%   | -2.1%   | -4.1%   | -4.6%   | -4.6%   | -4.6%   |

The base case for the following table is an estimate of the Company's net portfolio value for the periods presented using current discount rates, and assuming the Company's interest-sensitive assets and liabilities remain at period-end levels. The net portfolio value at September 30, 2013 (the base case) was \$456.6 million. The information provided for the net portfolio value assumes fluctuations or rate shocks of plus 200 basis points and minus 200 basis points for changes in interest rates as shown in the table below. Rate shocks assume that current interest rates change immediately.

| Rate Shock                   | Changes in interest rates |         |         |         |         |         |
|------------------------------|---------------------------|---------|---------|---------|---------|---------|
|                              | +300 bp                   | +200 bp | +100 bp | -100 bp | -200 bp | -300 bp |
| Asset/Liability Policy Limit | -35.0%                    | -25.0%  |         |         | -25.0%  | -35.0%  |
| September 30, 2013           | -16.5%                    | -10.3%  | -4.5%   | 0.1%    | -4.0%   | -8.6%   |
| December 31, 2012            | -14.6%                    | -7.4%   | -2.3%   | -5.1%   | -8.9%   | -7.8%   |

The information set forth in the above tables is based on significant estimates and assumptions, and constitutes a forward-looking statement under the Private Securities Litigation Reform Act of 1995. For more information regarding the Company's market risk and assumptions used in the Company's simulation models, please refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

**ITEM 4. Controls and Procedures**

(a) **Disclosure controls and procedures.** As of the end of the Company's most recently completed fiscal quarter covered by this report, the Company carried out an evaluation, with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures pursuant to Securities Exchange Act Rule 13a-15. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in ensuring

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that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms and are operating in an effective manner and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

(b) Changes in internal controls over financial reporting. There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended September 30, 2013 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.



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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

On February 15, 2013, the Company was served with a Civil Action Summons and Class Action Complaint that was filed in the Superior Court of New Jersey, Chancery Division, Somerset County. The complaint states that the plaintiff is bringing the class action on behalf of the public stockholders of Somerset Hills Bancorp against the Board of Directors of Somerset Hills for their alleged breach of fiduciary duties arising out of the Agreement and Plan of Merger, dated as of January 28, 2013, by and between the Company and Somerset Hills Bancorp. The complaint alleges that the Company has aided and abetted the individual defendants in their alleged breaches of fiduciary duties.

On March 27, 2013, the plaintiff filed an Amended Complaint, alleging, among other things, inadequate disclosure in the definitive joint proxy statement and prospectus (the Proxy Statement ) that has been mailed to the respective shareholders of the Company and Somerset Hills. On April 26, 2013, the defendants entered into a Memorandum of Understanding with the lead plaintiff regarding settlement of the action. As part of the settlement, the Registrant agreed to make certain additional disclosures, which are contained in a Current Report on Form 8-K filed on April 29, 2013. The Memorandum of Understanding contemplated that the parties would enter into a stipulation of settlement, which would be subject to customary conditions, including the consummation of the merger and court approval following notice. The parties did, in fact, enter into a stipulation of settlement, and a hearing is scheduled for January 10, 2014 at which time the Court will consider the fairness, reasonableness and adequacy of the settlement which, if finally approved by the Court, will resolve all of the claims that were or could have been brought in the action being settled, including all claims relating to the merger, the merger agreement and any disclosures made in connection therewith. The Court will also need to approve the conditional certification of the class of plaintiffs at such hearing. In addition, in connection with the settlement, the parties contemplate that the lead plaintiff's counsel will petition the Court for an award of attorneys' fees and expenses to be paid by the Company and/or Somerset Hills. There can be no assurance that the parties will ultimately enter into a stipulation of settlement or that the Court will approve the settlement even if the parties were to enter into such a stipulation. In the event that neither of these occurs, the proposed settlement as contemplated by the Memorandum of Understanding may be terminated. The settlement did not affect the timing of consummation of the merger or the amount or nature of the merger consideration to be paid to the shareholders of Somerset Hills in the merger.

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

**Item 1A. Risk Factors**

**Our mortgage banking operations expose us to risks that are different from community banking.**

The bank's mortgage banking operations expose us to risks that are different from our retail banking operations. Our mortgage banking operations are dependent upon the level of demand for residential mortgages. During higher and rising interest rate environments, the level of refinancing activity tends to decline, which can lead to reduced volumes of business and lower revenues that may not exceed our fixed costs to run the business. In addition, mortgages sold to third-party investors are typically subject to certain repurchase provisions related to borrower refinancing, defaults, fraud or other reasons stipulated in the applicable third-party investor agreements. If the fair value of a loan when repurchased is less than the fair value when sold, the bank may be required to charge such shortfall to earnings.

In addition, the ability to repay and Qualified Mortgage rules promulgated as required by the Dodd-Frank Act, effective January 10, 2014, may expose the Company and Sullivan Financial Services, Inc. to greater losses, and litigation related expenses and delays in taking title to collateral real estate, if these loans do not perform and borrowers challenge whether the rules were satisfied when originating the loans.

Except for the above risk factor, there have been no material changes in risk factors from those disclosed under Item 1A, Risk Factors in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

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

Not Applicable

Item 3. Defaults Upon Senior Securities

Not Applicable

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|                                 |                |
|---------------------------------|----------------|
| Item 4. Mine Safety Disclosures | Not Applicable |
| Item 5. Other Information       | Not Applicable |
| Item 6. Exhibits                |                |

- 10.1 Third Amendatory Agreement to Change of Control Agreement dated October 31, 2013 among Lakeland Bancorp, Inc., Lakeland Bank and Jeffrey J. Buonforte.
- 10.2 Change of Control Agreement dated October 31, 2013 among Lakeland Bancorp, Inc., Lakeland Bank and Timothy J. Matteson.
- 31.1 Certification by Thomas J. Shara pursuant to Section 302 of the Sarbanes Oxley Act.

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|----------|--|
| 31.2     | Certification by Joseph F. Hurley pursuant to Section 302 of the Sarbanes Oxley Act.                     |
| 32.1     | Certification by Thomas J. Shara and Joseph F. Hurley pursuant to Section 906 of the Sarbanes Oxley Act. |
| 101.INS* | XBRL Instance Document   |
| 101.SCH* | XBRL Taxonomy Extension Schema Document  |
| 101.CAL* | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.DEF* | XBRL Taxonomy Extension Definition Linkbase Document   |
| 101.LAB* | XBRL Taxonomy Extension Label Linkbase Document  |
| 101.PRE* | XBRL Taxonomy Extension Presentation Linkbase Document   |

\* Pursuant to Rule 406T of Regulation S-T, this interactive data file is deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these 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.

Lakeland Bancorp, Inc.  
(Registrant)

/s/ Thomas J. Shara  
Thomas J. Shara  
President and Chief Executive Officer

/s/ Joseph F. Hurley  
Joseph F. Hurley  
Executive Vice President and  
Chief Financial Officer

Date: November 8, 2013