UNITY BANCORP INC /NJ/
Form 10-Q
November 06, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2018

OR

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

For the transition period from ____ to ____.

Commission File Number 1-12431

Unity Bancorp, Inc.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| New Jersey | 22-3282551 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 64 Old Highway 22, Clinton, NJ | 08809 |
| (Address of principal executive offices) | (Zip Code) |

Registrant’s telephone number, including area code (908) 730-7630

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, as amended, 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 x No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes x 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 (as defined in Rule 12b-2 of the Exchange Act):

Large accelerated filer Accelerated filer x Nonaccelerated filer Smaller reporting company Emerging Growth Company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. Yes No

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

The number of shares outstanding of each of the registrant's classes of common equity stock, as of October 30, 2018 common stock, no par value: 10,759,175 shares outstanding.

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PART I CONSOLIDATED FINANCIAL INFORMATION
ITEM 1 Consolidated Financial Statements (Unaudited)
Unity Bancorp, Inc.
Consolidated Balance Sheets
(Unaudited)

| (In thousands) | September 30, 2018 | December 31, 2017 |
|---|---|---|
| ASSETS | | |
| Cash and due from banks | $ 23,217 | $ 23,701 |
| Federal funds sold, interest-bearing deposits and repos | 121,339 | 126,553 |
| Cash and cash equivalents | 144,556 | 150,254 |
| Securities: | | |
| Securities available for sale (amortized cost of $48,596 and $52,763 in 2018 and 2017, respectively) | 46,874 | 52,287 |
| Securities held to maturity (fair value of $15,016 and $16,346 in 2018 and 2017, respectively) | 15,325 | 16,307 |
| Equity securities (amortized cost of $1,262 in 2018 and 2017) | 1,200 | 1,206 |
| Total securities | 63,399 | 69,800 |
| Loans: | | |
| SBA loans held for sale | 13,029 | 22,810 |
| SBA loans held for investment | 41,051 | 43,999 |
| Commercial loans | 697,075 | 628,865 |
| Residential mortgage loans | 413,652 | 365,145 |
| Consumer loans | 118,497 | 109,855 |
| Total loans | 1,283,304 | 1,170,674 |
| Allowance for loan losses | (14,988) | (13,556) |
| Net loans | 1,268,316 | 1,157,118 |
| Premises and equipment, net | 23,416 | 23,470 |
| Bank owned life insurance ("BOLI") | 24,544 | 24,227 |
| Deferred tax assets | 5,310 | 4,017 |
| Federal Home Loan Bank ("FHLB") stock | 9,445 | 12,863 |
| Accrued interest receivable | 6,412 | 5,447 |
| Other real estate owned ("OREO") | 56 | 426 |
| Goodwill | 1,516 | 1,516 |
| Prepaid expenses and other assets | 6,182 | 6,358 |
| Total assets | $ 1,553,152 | $ 1,455,496 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Liabilities: | | |
| Deposits: | | |
| Noninterest-bearing demand | $ 271,321 | $ 256,119 |
| Interest-bearing demand | 180,189 | 164,997 |
| Savings | 408,927 | 396,557 |
| Time, under $100,000 | 187,078 | 133,881 |
| Time, $100,000 to $250,000 | 112,916 | 71,480 |
| Time, $250,000 and over | 59,042 | 20,103 |
| Total deposits | 1,219,473 | 1,043,137 |
| Borrowed funds | 180,000 | 275,000 |
| Subordinated debentures | 10,310 | 10,310 |
| Accrued interest payable | 506 | 436 |

| | | |
|---|---|---|
| Accrued expenses and other liabilities | 9,796 | 8,508 |
| Total liabilities | 1,420,085 | 1,337,391 |
| Shareholders' equity: | | |
| Common stock | 88,149 | 86,782 |
| Retained earnings | 45,121 | 31,117 |
| Accumulated other comprehensive (loss) income | (203 ) | 206 |
| Total shareholders' equity | 133,067 | 118,105 |
| Total liabilities and shareholders' equity | $ 1,553,152 | $ 1,455,496 |
| | | |
| Issued and outstanding common shares | 10,756 | 10,615 |

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.
Consolidated Statements of Income
(Unaudited)

| | For the three months ended September 30, | | For the nine months ended September 30, | |
|---|---|---|---|---|
| (In thousands, except per share amounts) | 2018 | 2017 | 2018 | 2017 |
| INTEREST INCOME | | | | |
| Federal funds sold, interest-bearing deposits and repos | $187 | $262 | $563 | $595 |
| FHLB stock | 101 | 85 | 359 | 252 |
| Securities: | | | | |
| Taxable | 465 | 512 | 1,442 | 1,543 |
| Tax-exempt | 28 | 40 | 88 | 127 |
| Total securities | 493 | 552 | 1,530 | 1,670 |
| Loans: | | | | |
| SBA loans | 1,050 | 1,042 | 3,365 | 2,781 |
| Commercial loans | 8,784 | 7,211 | 24,718 | 20,562 |
| Residential mortgage loans | 4,803 | 3,636 | 13,666 | 10,603 |
| Consumer loans | 1,776 | 1,407 | 5,003 | 3,806 |
| Total loans | 16,413 | 13,296 | 46,752 | 37,752 |
| Total interest income | 17,194 | 14,195 | 49,204 | 40,269 |
| INTEREST EXPENSE | | | | |
| Interest-bearing demand deposits | 330 | 168 | 813 | 482 |
| Savings deposits | 1,049 | 733 | 2,768 | 1,994 |
| Time deposits | 1,739 | 823 | 4,042 | 2,441 |
| Borrowed funds and subordinated debentures | 509 | 654 | 1,997 | 1,992 |
| Total interest expense | 3,627 | 2,378 | 9,620 | 6,909 |
| Net interest income | 13,567 | 11,817 | 39,584 | 33,360 |
| Provision for loan losses | 500 | 500 | 1,550 | 1,150 |
| Net interest income after provision for loan losses | 13,067 | 11,317 | 38,034 | 32,210 |
| NONINTEREST INCOME | | | | |
| Branch fee income | 357 | 355 | 1,107 | 1,029 |
| Service and loan fee income | 465 | 448 | 1,441 | 1,472 |
| Gain on sale of SBA loans held for sale, net | 253 | 385 | 1,383 | 1,348 |
| Gain on sale of mortgage loans, net | 597 | 392 | 1,442 | 1,188 |
| BOLI income | 464 | 111 | 810 | 289 |
| Net security gains (losses) | 2 | 53 | (6) | 69 |
| Other income | 341 | 264 | 900 | 838 |
| Total noninterest income | 2,479 | 2,008 | 7,077 | 6,233 |
| NONINTEREST EXPENSE | | | | |
| Compensation and benefits | 5,704 | 4,268 | 15,274 | 12,662 |
| Occupancy | 675 | 600 | 2,057 | 1,791 |
| Processing and communications | 709 | 656 | 2,072 | 1,892 |
| Furniture and equipment | 586 | 513 | 1,732 | 1,537 |
| Professional services | 270 | 247 | 682 | 724 |
| Loan collection and OREO (recoveries) expenses | (331) | 114 | (320) | 493 |
| Other loan expenses | 51 | 47 | 137 | 149 |
| Deposit insurance | 191 | 156 | 593 | 376 |
| Advertising | 370 | 299 | 1,051 | 859 |

| | | | | |
|---|---|---|---|---|
| Director fees | 175 | 150 | 502 | 496 |
| Other expenses | 401 | 504 | 1,373 | 1,439 |
| Total noninterest expense | 8,801 | 7,554 | 25,153 | 22,418 |
| Income before provision for income taxes | 6,745 | 5,771 | 19,958 | 16,025 |
| Provision for income taxes | 1,255 | 2,014 | 3,841 | 5,632 |
| Net income | $5,490 | $3,757 | $16,117 | $10,393 |
| | | | | |
| Net income per common share - Basic | $0.51 | $0.36 | $1.50 | $0.99 |
| Net income per common share - Diluted | $0.50 | $0.35 | $1.48 | $0.97 |
| | | | | |
| Weighted average common shares outstanding - Basic | 10,743 | 10,572 | 10,713 | 10,543 |
| Weighted average common shares outstanding - Diluted | 10,936 | 10,761 | 10,910 | 10,734 |

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.
Consolidated Statements of Comprehensive Income
(Unaudited)

| (In thousands) | For the three months ended September 30, 2018 Before tax amount | Income tax expense (benefit) | Net of tax amount | September 30, 2017 Before tax amount | Income tax expense (benefit) | Net of tax amount |
|---|---|---|---|---|---|---|
| Net income | $6,745 | $1,255 | $5,490 | $5,771 | $2,014 | $3,757 |
| Other comprehensive loss | | | | | | |
| Investment securities available for sale: | | | | | | |
| Unrealized holding losses on securities arising during the period | (293) | (82) | (211) | (128) | (55) | (73) |
| Less: reclassification adjustment for gains on securities included in net income | 2 | — | 2 | 53 | 19 | 34 |
| Total unrealized losses on securities available for sale | (295) | (82) | (213) | (181) | (74) | (107) |
| Adjustments related to defined benefit plan: | | | | | | |
| Amortization of prior service cost | 21 | 6 | 15 | 21 | 9 | 12 |
| Total adjustments related to defined benefit plan | 21 | 6 | 15 | 21 | 9 | 12 |
| Net unrealized (losses) gains from cash flow hedges: | | | | | | |
| Unrealized holding (losses) gains on cash flow hedges arising during the period | (7) | (2) | (5) | 48 | 20 | 28 |
| Total unrealized (losses) gains on cash flow hedges | (7) | (2) | (5) | 48 | 20 | 28 |
| Total other comprehensive loss | (281) | (78) | (203) | (112) | (45) | (67) |
| Total comprehensive income | $6,464 | $1,177 | $5,287 | $5,659 | $1,969 | $3,690 |

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.
Consolidated Statements of Comprehensive Income
(Unaudited)

| (In thousands) | For the nine months ended September 30, 2018 | | | September 30, 2017 | | |
|---|---|---|---|---|---|---|
| | Before tax amount | Income tax expense (benefit) | Net of tax amount | Before tax amount | Income tax expense (benefit) | Net of tax amount |
| Net income | $19,958 | $3,841 | $16,117 | $16,025 | $5,632 | $10,393 |
| Other comprehensive loss | | | | | | |
| Investment securities available for sale: | | | | | | |
| Unrealized holding (losses) gains on securities arising during the period | (1,236) | (371) | (865) | 137 | 50 | 87 |
| Less: reclassification adjustment for gains on securities included in net income | 9 | 1 | 8 | 69 | 24 | 45 |
| Total unrealized (losses) gains on securities available for sale | (1,245) | (372) | (873) | 68 | 26 | 42 |
| Adjustments related to defined benefit plan: | | | | | | |
| Amortization of prior service cost | 63 | 167 | (104) | 63 | 26 | 37 |
| Total adjustments related to defined benefit plan | 63 | 167 | (104) | 63 | 26 | 37 |
| Net unrealized gains (losses) from cash flow hedges: | | | | | | |
| Unrealized holding gains (losses) on cash flow hedges arising during the period | 658 | 55 | 603 | (183) | (75) | (108) |
| Total unrealized gains (losses) on cash flow hedges | 658 | 55 | 603 | (183) | (75) | (108) |
| Total other comprehensive loss | (524) | (150) | (374) | (52) | (23) | (29) |
| Total comprehensive income | $19,434 | $3,691 | $15,743 | $15,973 | $5,609 | $10,364 |

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Consolidated Statements of Changes in Shareholders' Equity
For the nine months ended September 30, 2018 and 2017
(Unaudited)

| (In thousands) | Common stock Shares | Common stock Amount | Retained earnings | Accumulated other comprehensive (loss) | Total shareholders' equity |
|---|---|---|---|---|---|
| Balance, December 31, 2017 | 10,615 | $86,782 | $31,117 | $ 206 | $ 118,105 |
| Net income | | | 16,117 | | 16,117 |
| Other comprehensive loss, net of tax | | | | (374 ) | (374 ) |
| Dividends on common stock ($0.20 per share) | | 81 | (2,148 ) | | (2,067 ) |
| Common stock issued and related tax effects (1) | 141 | 1,286 | | | 1,286 |
| Balance, Retained earnings impact due to adoption of ASU 2016-01 (2) | | | (40 ) | 40 | — |
| Tax rate adjustment to AOCI (3) | | | 75 | (75 ) | — |
| Balance, September 30, 2018 | 10,756 | $88,149 | $45,121 | $ (203 ) | $ 133,067 |

| (In thousands) | Common stock Shares | Common stock Amount | Retained earnings | Accumulated other comprehensive income | Total shareholders' equity |
|---|---|---|---|---|---|
| Balance, December 31, 2016 | 10,477 | $85,383 | $20,748 | $ 160 | $ 106,291 |
| Net income | | | 10,393 | | 10,393 |
| Other comprehensive loss, net of tax | | | | (29 ) | (29 ) |
| Dividends on common stock ($0.17 per share) | | 115 | (1,881 ) | | (1,766 ) |
| Common stock issued and related tax effects (1) | 109 | 925 | | | 925 |
| Balance, September 30, 2017 | 10,586 | $86,423 | $29,260 | $ 131 | $ 115,814 |

(1) Includes the issuance of common stock under employee benefit plans, which includes nonqualified stock options and restricted stock expense related entries, employee option exercises and the tax benefit of options exercised.
(2) As a result of ASU 2016-01, "Financial Instruments Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities", the Company reclassed $40 thousand of gains (losses) on available for sale equity securities sitting in accumulated other comprehensive income to retained earnings.
(3) As a result of ASU 2018-02, "Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income", the Company reclassed $75 thousand from accumulated other comprehensive income to retained earnings.

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.
Consolidated Statements of Cash Flows
(Unaudited)

| | For the nine months ended September 30, | |
|---|---|---|
| (In thousands) | 2018 | 2017 |
| OPERATING ACTIVITIES: | | |
| Net income | $16,117 | $10,393 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 1,550 | 1,150 |
| Net amortization of purchase premiums and discounts on securities | 170 | 216 |
| Depreciation and amortization | 1,359 | 1,071 |
| Deferred income tax benefit | (1,337) | (234) |
| Net security gains | — | (69) |
| Stock compensation expense | 786 | 571 |
| (Gain) loss on sale of OREO | (169) | 253 |
| Valuation writedowns on OREO | — | 151 |
| Gain on sale of mortgage loans held for sale, net | (1,155) | (1,380) |
| Gain on sale of SBA loans held for sale, net | (1,383) | (1,348) |
| Origination of mortgage loans held for sale | (65,304) | (66,184) |
| Origination of SBA loans held for sale | (7,718) | (17,232) |
| Proceeds from sale of mortgage loans held for sale, net | 66,459 | 67,564 |
| Proceeds from sale of SBA loans held for sale, net | 18,597 | 17,035 |
| BOLI income | (810) | (289) |
| Net change in other assets and liabilities | 1,715 | 1,060 |
| Net cash provided by operating activities | 28,877 | 12,728 |
| INVESTING ACTIVITIES | | |
| Purchases of securities held to maturity | — | (163) |
| Purchases of securities available for sale | — | (25,882) |
| Purchases of FHLB stock, at cost | (51,797) | (6,136) |
| Maturities and principal payments on securities held to maturity | 954 | 1,251 |
| Maturities and principal payments on securities available for sale | 4,026 | 10,850 |
| Proceeds from sales of securities held to maturity | — | 529 |
| Proceeds from sales of securities available for sale | — | 2,777 |
| Proceeds from redemption of FHLB stock | 55,215 | 4,845 |
| Proceeds from sale of OREO | 439 | 794 |
| Net increase in loans | (122,540) | (119,404) |
| Proceeds from BOLI | 493 | — |
| Purchases of BOLI | — | (10,000) |
| Purchases of premises and equipment | (1,134) | (757) |
| Net cash used in investing activities | (114,344) | (141,296) |
| FINANCING ACTIVITIES | | |
| Net increase in deposits | 176,336 | 97,909 |
| Proceeds from new borrowings | 180,000 | 97,000 |
| Repayments of borrowings | (275,000) | (66,000) |
| Proceeds from exercise of stock options | 500 | 360 |
| Dividends on common stock | (2,067) | (1,766) |
| Net cash provided by financing activities | 79,769 | 127,503 |
| Decrease in cash and cash equivalents | (5,698) | (1,065) |

| | | |
|---|---|---|
| Cash and cash equivalents, beginning of period | 150,254 | 105,895 |
| Cash and cash equivalents, end of period | $144,556 | $104,830 |

Unity Bancorp, Inc.
Consolidated Statements of Cash Flows (Continued)
(Unaudited)

| (In thousands) | For the nine months ended September 30, 2018 | 2017 |
|---|---|---|
| SUPPLEMENTAL DISCLOSURES | | |
| Cash: | | |
| Interest paid | $9,550 | $6,939 |
| Income taxes paid | 4,241 | 4,502 |
| Noncash investing activities: | | |
| Transfer of SBA loans held for sale to held to maturity | — | 13 |
| Capitalization of servicing rights | 708 | 145 |
| Transfer of loans to OREO | 127 | 872 |

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.
Notes to the Consolidated Financial Statements (Unaudited)
September 30, 2018

NOTE 1. Significant Accounting Policies

The accompanying Consolidated Financial Statements include the accounts of Unity Bancorp, Inc. (the "Parent Company") and its wholly-owned subsidiary, Unity Bank (the "Bank" or when consolidated with the Parent Company, the "Company"), and reflect all adjustments and disclosures which are generally routine and recurring in nature, and in the opinion of management, necessary for a fair presentation of interim results. The Bank has multiple subsidiaries used to hold part of its investment and loan portfolios and OREO properties. All significant intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications have been made to prior period amounts to conform to the current year presentation, with no impact on current earnings or shareholders' equity. The financial information has been prepared in accordance with U.S. generally accepted accounting principles and has not been audited. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and revenues and expenses during the reporting periods. Actual results could differ from those estimates. Amounts requiring the use of significant estimates include the allowance for loan losses, valuation of deferred tax and servicing assets, the carrying value of loans held for sale and other real estate owned, the valuation of securities and the determination of other-than-temporary impairment for securities and fair value disclosures. Management believes that the allowance for loan losses is adequate. While management uses available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary based on changes in economic conditions. The Company has evaluated subsequent events for potential recognition and/or disclosure through the date the Consolidated Financial Statements included in this Quarterly Report on Form 10-Q were available to be issued.

The interim unaudited Consolidated Financial Statements included herein have been prepared in accordance with instructions for Form 10-Q and the rules and regulations of the Securities and Exchange Commission ("SEC") and consist of normal recurring adjustments necessary for the fair presentation of interim results. The results of operations for the three and nine months ended September 30, 2018 are not necessarily indicative of the results which may be expected for the entire year. As used in this Form 10-Q, "we" and "us" and "our" refer to Unity Bancorp, Inc., and its consolidated subsidiary, Unity Bank, depending on the context. Certain information and financial disclosures required by U.S. generally accepted accounting principles have been condensed or omitted from interim reporting pursuant to SEC rules. Interim financial statements should be read in conjunction with the Company's Consolidated Financial Statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Other-Than-Temporary Impairment

The Company has a process in place to identify securities that could potentially incur credit impairment that is other-than-temporary. This process involves monitoring late payments, pricing levels, downgrades by rating agencies, key financial ratios, financial statements, revenue forecasts and cash flow projections as indicators of credit issues. Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concern warrants such evaluation. This evaluation considers relevant facts and circumstances in evaluating whether a credit or interest rate-related impairment of a security is other-than-temporary. Relevant facts and circumstances considered include:
(1) the extent and length of time the fair value has been below cost; (2) the reasons for the decline in value; (3) the financial position and access to capital of the issuer, including the current and future impact of any specific events and (4) for fixed maturity securities, our intent to sell a security or whether it is more likely than not we will be required to sell the security before the recovery of its amortized cost which, in some cases, may extend to maturity and for equity

securities, our ability and intent to hold the security for a forecasted period of time that allows for the recovery in value.

Management assesses its intent to sell or whether it is more likely than not that it will be required to sell a security before recovery of its amortized cost basis less any current-period credit losses. For debt securities that are considered other-than-temporarily impaired with no intent to sell and no requirement to sell prior to recovery of its amortized cost basis, the amount of the impairment is separated into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is the difference between the security's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security's fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income. For debt securities where management has the intent to sell, the amount of the impairment is reflected in earnings as realized losses.

The present value of expected future cash flows is determined using the best estimate cash flows discounted at the effective interest rate implicit to the security at the date of purchase or the current yield to accrete an asset-backed or floating rate security. The methodology and assumptions for establishing the best estimate cash flows vary depending on the type of security. The asset-backed securities cash flow estimates are based on bond specific facts and circumstances that may include collateral characteristics, expectations of delinquency and default rates, loss severity and prepayment speeds and structural support, including subordination and guarantees. The corporate bond cash flow estimates are derived from scenario-based outcomes of expected corporate restructurings or the disposition of assets using bond specific facts and circumstances including timing, security interests and loss severity.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Loans

Loans Held for Sale

Loans held for sale represent the guaranteed portion of Small Business Administration ("SBA") loans and are reflected at the lower of aggregate cost or market value. The Company originates loans to customers under an SBA program that historically has provided for SBA guarantees of up to 90 percent of each loan. The Company generally sells the guaranteed portion of its SBA loans to a third party and retains the servicing, holding the nonguaranteed portion in its portfolio. The net amount of loan origination fees on loans sold is included in the carrying value and in the gain or loss on the sale. When sales of SBA loans do occur, the premium received on the sale and the present value of future cash flows of the servicing assets are recognized in income. All criteria for sale accounting must be met in order for the loan sales to occur; see details under the "Transfers of Financial Assets" heading above.

Servicing assets represent the estimated fair value of retained servicing rights, net of servicing costs, at the time loans are sold. Servicing assets are amortized in proportion to, and over the period of, estimated net servicing revenues. Impairment is evaluated based on stratifying the underlying financial assets by date of origination and term. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Any impairment, if temporary, would be reported as a valuation allowance.

Serviced loans sold to others are not included in the accompanying Consolidated Balance Sheets. Income and fees collected for loan servicing are credited to noninterest income when earned, net of amortization on the related servicing assets.

Loans Held to Maturity

Loans held to maturity are stated at the unpaid principal balance, net of unearned discounts and deferred loan origination fees and costs. In accordance with the level yield method, loan origination fees, net of direct loan origination costs, are deferred and recognized over the estimated life of the related loans as an adjustment to the loan yield. Interest is credited to operations primarily based upon the principal balance outstanding.

Loans are reported as past due when either interest or principal is unpaid in the following circumstances: fixed payment loans when the borrower is in arrears for two or more monthly payments; open end credit for two or more billing cycles; and single payment notes if interest or principal remains unpaid for 30 days or more.

Nonperforming loans consist of loans that are not accruing interest as a result of principal or interest being in default for a period of 90 days or more or when the ability to collect principal and interest according to the contractual terms is in doubt (nonaccrual loans). When a loan is classified as nonaccrual, interest accruals are discontinued and all past due interest previously recognized as income is reversed and charged against current period earnings. Generally, until the loan becomes current, any payments received from the borrower are applied to outstanding principal until such time as management determines that the financial condition of the borrower and other factors merit recognition of a portion of such payments as interest income. Loans may be returned to an accrual status when the ability to collect is reasonably assured and when the loan is brought current as to principal and interest.

Loans are charged off when collection is sufficiently questionable and when the Company can no longer justify maintaining the loan as an asset on the balance sheet.  Loans qualify for charge-off when, after thorough analysis, all possible sources of repayment are insufficient.  These include: 1) potential future cash flows, 2) value of collateral, and/or 3) strength of co-makers and guarantors.  All unsecured loans are charged off upon the establishment of the loan's nonaccrual status.  Additionally, all loans classified as a loss or that portion of the loan classified as a loss is charged off.  All loan charge-offs are approved by the Board of Directors.

Troubled debt restructurings ("TDRs") occur when a creditor, for economic or legal reasons related to a debtor's financial condition, grants a concession to the debtor that it would not otherwise consider.  These concessions typically include reductions in interest rate, extending the maturity of a loan, or a combination of both. Interest income on accruing TDRs is credited to operations primarily based upon the principal amount outstanding, as stated in the paragraphs above.

The Company evaluates its loans for impairment.  A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement.  The Company has defined impaired loans to be all TDRs and nonperforming loans individually evaluated for impairment.  Impairment is evaluated in total for smaller-balance loans of a similar nature (consumer and residential mortgage loans), and on an individual basis for all other loans.  Impairment of a loan is measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate, or as a practical expedient, based on a loan's observable market price or the fair value of collateral, net of estimated costs to sell, if the loan is collateral-dependent.  If the value of the impaired loan is less than the recorded investment in the loan, the Company establishes a valuation allowance, or adjusts existing valuation allowances, with a corresponding charge to the provision for loan losses.

For additional information on loans, see Note 8 to the Consolidated Financial Statements and the section titled "Loan Portfolio" under Item 2.  Management's Discussion and Analysis.

Allowance for Loan Losses and Reserve for Unfunded Loan Commitments

The allowance for loan losses is maintained at a level management considers adequate to provide for probable loan losses as of the balance sheet date.  The allowance is increased by provisions charged to expense and is reduced by net charge-offs.

The level of the allowance is based on management's evaluation of probable losses in the loan portfolio, after consideration of prevailing economic conditions in the Company's market area, the volume and composition of the loan portfolio, and historical loan loss experience.  The allowance for loan losses consists of specific reserves for individually impaired credits and TDRs, reserves for nonimpaired loans based on historical loss factors and reserves based on general economic factors and other qualitative risk factors such as changes in delinquency trends, industry concentrations or local/national economic trends.  This risk assessment process is performed at least quarterly, and, as adjustments become necessary, they are realized in the periods in which they become known.

Although management attempts to maintain the allowance at a level deemed adequate to provide for probable losses, future additions to the allowance may be necessary based upon certain factors including changes in market conditions and underlying collateral values.  In addition, various regulatory agencies periodically review the adequacy of the Company's allowance for loan losses.  These agencies may require the Company to make additional provisions based on their judgments about information available to them at the time of their examination.

The Company maintains an allowance for unfunded loan commitments that is maintained at a level that management believes is adequate to absorb estimated probable losses.  Adjustments to the allowance are made through other expenses and applied to the allowance which is maintained in other liabilities.

For additional information on the allowance for loan losses and unfunded loan commitments, see Note 9 to the Consolidated Financial Statements and the sections titled "Asset Quality" and "Allowance for Loan Losses and Reserve for Unfunded Loan Commitments" under Item 2. Management's Discussion and Analysis.

Income Taxes

The Company accounts for income taxes according to the asset and liability method.  Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis.  Deferred tax assets and liabilities are measured using the enacted tax rates applicable to taxable income for the years in which those temporary differences are expected to be recovered or settled.  The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Valuation reserves are established against certain deferred tax assets when it is more likely than not that the deferred tax assets will not be realized.  Increases or decreases in the valuation reserve are charged or credited to the income tax provision. When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that ultimately would be sustained.  The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any.  The evaluation of a tax position taken is considered by itself and not offset or aggregated with other positions.  Tax positions that meet the more likely than not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority.  The portion of benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest and penalties associated with unrecognized tax benefits would be recognized in income tax expense on the income statement.

NOTE 2.  Litigation

The Company may, in the ordinary course of business, become a party to litigation involving collection matters, contract claims and other legal proceedings relating to the conduct of its business.  In the best judgment of management, based upon consultation with counsel, the consolidated financial position and results of operations of the Company will not be affected materially by the final outcome of any pending legal proceedings or other contingent liabilities and commitments.

NOTE 3.  Net Income per Share

Basic net income per common share is calculated as net income divided by the weighted average common shares outstanding during the reporting period.

Diluted net income per common share is computed similarly to that of basic net income per common share, except that the denominator is increased to include the number of additional common shares that would have been outstanding if all potentially dilutive common shares, principally stock options, were issued during the reporting period utilizing the Treasury stock method.

The following is a reconciliation of the calculation of basic and diluted income per share:

| | For the three months ended September 30, | | For the nine months ended September 30, | |
|---|---|---|---|---|
| (In thousands, except per share amounts) | 2018 | 2017 | 2018 | 2017 |

| | | | | |
|---|---|---|---|---|
| Net income | $5,490 | $3,757 | $16,117 | $10,393 |
| Weighted average common shares outstanding - Basic | 10,743 | 10,572 | 10,713 | 10,543 |
| Plus: Potential dilutive common stock equivalents | 193 | 189 | 197 | 191 |
| Weighted average common shares outstanding - Diluted | 10,936 | 10,761 | 10,910 | 10,734 |
| Net income per common share - Basic | $0.51 | $0.36 | $1.50 | $0.99 |
| Net income per common share - Diluted | 0.50 | 0.35 | 1.48 | 0.97 |
| Stock options and common stock excluded from the income per share calculation as their effect would have been anti-dilutive | $40 | $77 | $103 | $70 |

NOTE 4. Income Taxes

The Company follows FASB ASC Topic 740, “Income Taxes,” which prescribes a threshold for the financial statement recognition of income taxes and provides criteria for the measurement of tax positions taken or expected to be taken in a tax return. ASC 740 also includes guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition of income taxes.

On December 22, 2017, the "Tax Cuts and Jobs Act" (TCJA) was signed into law, lowering the corporate tax rate from 35 percent to 21 percent. This provided significant tax benefits in 2018 by lowering the effective tax rate.

On July 1, 2018, New Jersey's Assembly Bill 4202 was signed into law. The new bill, effective January 1, 2018, imposed a temporary surtax on corporations earning New Jersey allocated income in excess of $1 million at a rate of 2.5 percent for tax years beginning on or after January 1, 2018, through December 31, 2019, and at 1.5 percent for tax years beginning on or after January 1, 2020, through December 31, 2021. In addition, effective for periods on or after January 1, 2019, New Jersey is adopting mandatory unitary combined reporting for its Corporation Business Tax.

For the quarter ended September 30, 2018, the Company reported income tax expense of $1.3 million for an effective tax rate of 18.6 percent, compared to an income tax expense of $2.0 million and an effective tax rate of 34.9 percent for the prior year’s quarter. For the nine months ended September 30, 2018, the Company reported income tax expense of $3.8 million for an effective tax rate of 19.2 percent, compared to an income tax expense of $5.6 million and an effective tax rate of 35.1 percent for the nine months ended September 30, 2017. The Company did not recognize or accrue any interest or penalties related to income taxes during the three or nine months ended September 30, 2018 or 2017. The Company did not have an accrual for uncertain tax positions as of September 30, 2018 or December 31, 2017, as deductions taken and benefits accrued are based on widely understood administrative practices and procedures and are based on clear and unambiguous tax law. Tax returns for all years 2013 and thereafter are subject to future examination by tax authorities.

NOTE 5. Other Comprehensive Income (Loss)

The following tables show the changes in other comprehensive income (loss) for the three and nine months ended September 30, 2018 and 2017, net of tax:

| (In thousands) | For the three months ended September 30, 2018 Net unrealized (losses) gains on securities | Adjustments related to defined benefit plan | Net unrealized gains (losses) from cash flow hedges | Accumulated other comprehensive income (loss) |
|---|---|---|---|---|
| Balance, beginning of period | $(995) | $ (460) | $ 1,490 | $ 35 |
| Other comprehensive loss before reclassification | (211) | — | (5) | (216) |
| Less amounts reclassified from accumulated other comprehensive income (loss) | 2 | (15) | — | (13) |
| Period change | (213) | 15 | (5) | (203) |
| Balance, end of period (1) | $(1,208) | $ (445) | $ 1,485 | $ (168) |

(1) AOCI does not reflect the net reclassification of $35 thousand to Retained Earnings as a result of ASU 2016-01, "Financial Instruments Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities" & ASU 2018-02, "Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income".

| (In thousands) | For the three months ended September 30, 2017 Net unrealized (losses) gains on securities | Adjustments related to defined benefit plan | Net unrealized gains from cash flow hedges | Accumulated other comprehensive income (loss) |
|---|---|---|---|---|
| Balance, beginning of period | $(12) | $ (366) | $ 576 | $ 198 |
| Other comprehensive (loss) income before reclassification | (73) | — | 28 | (45) |
| Less amounts reclassified from accumulated other comprehensive income (loss) | 34 | (12) | — | 22 |
| Period change | (107) | 12 | 28 | (67) |
| Balance, end of period | $(119) | $ (354) | $ 604 | $ 131 |

| (In thousands) | For the nine months ended September 30, 2018 Net unrealized (losses) gains on securities | Adjustments related to defined benefit plan | Net unrealized gains from cash flow hedges | Accumulated other comprehensive income (loss) |
|---|---|---|---|---|
| Balance, beginning of period | $(335) | $ (341) | $ 882 | $ 206 |
| Other comprehensive (loss) income before reclassification | (865) | — | 603 | (262) |
| Less amounts reclassified from accumulated other comprehensive income | 8 | 104 | — | 112 |

| | | | | |
|---|---|---|---|---|
| Period change | (873 ) | (104 ) | 603 | (374 ) |
| Balance, end of period (1) | $(1,208) | $ (445 ) | $ 1,485 | $ (168 ) |

(1) AOCI does not reflect the net reclassification of $35 thousand to Retained Earnings as a result of ASU 2016-01, "Financial Instruments Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities" & ASU 2018-02, "Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income".

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| (In thousands) | For the nine months ended September 30, 2017 Net unrealized (losses) gains on securities | Adjustments related to defined benefit plan | Net unrealized gains (losses) from cash flow hedges | Accumulated other comprehensive income (loss) |
|---|---|---|---|---|
| Balance, beginning of period | $(161) | $ (391) | $ 712 | $ 160 |
| Other comprehensive income (loss) before reclassification | 87 | — | (108) | (21) |
| Less amounts reclassified from accumulated other comprehensive income (loss) | 45 | (37) | — | 8 |
| Period change | 42 | 37 | (108) | (29) |
| Balance, end of period | $(119) | $ (354) | $ 604 | $ 131 |

NOTE 6. Fair Value

Fair Value Measurement

The Company follows FASB ASC Topic 820, "Fair Value Measurement and Disclosures," which requires additional disclosures about the Company's assets and liabilities that are measured at fair value. Fair value is the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. In determining fair value, the Company uses various methods including market, income and cost approaches. Based on these approaches, the Company often utilizes certain assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and/or the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated, or generally unobservable inputs. The Company utilizes techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial assets and liabilities carried at fair value will be classified and disclosed as follows:

Level 1 Inputs

- Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.
- Generally, this includes debt and equity securities and derivative contracts that are traded in an active exchange market (i.e. New York Stock Exchange), as well as certain U.S. Treasury, U.S. Government and sponsored entity agency mortgage-backed securities that are highly liquid and are actively traded in over-the-counter markets.

Level 2 Inputs

- Quoted prices for similar assets or liabilities in active markets.
- Quoted prices for identical or similar assets or liabilities in inactive markets.
- Inputs other than quoted prices that are observable, either directly or indirectly, for the term of the asset or liability (i.e., interest rates, yield curves, credit risks, prepayment speeds or volatilities) or "market corroborated inputs."
- Generally, this includes U.S. Government and sponsored entity mortgage-backed securities, corporate debt securities and derivative contracts.

Level 3 Inputs

- Prices or valuation techniques that require inputs that are both unobservable (i.e. supported by little or no market activity) and that are significant to the fair value of the assets or liabilities.
- These assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

Fair Value on a Recurring Basis

The following is a description of the valuation methodologies used for instruments measured at fair value on a recurring basis:

Securities Available for Sale

The fair value of available for sale ("AFS") securities is the market value based on quoted market prices, when available, or market prices provided by recognized broker dealers (Level 1). If listed prices or quotes are not available, fair value is based upon quoted market prices for similar or identical assets or other observable inputs (Level 2) or externally developed models that use unobservable inputs due to limited or no market activity of the instrument (Level 3).

As of September 30, 2018, the fair value of the Company's AFS securities portfolio was $46.9 million. Approximately 58 percent of the portfolio was made up of residential mortgage-backed securities, which had a fair value of $27.3 million at September 30, 2018. Approximately $26.9 million of the residential mortgage-backed securities are guaranteed by the Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA") or the Federal Home Loan Mortgage Corporation ("FHLMC"). The underlying loans for these securities are residential mortgages that are geographically dispersed throughout the United States.

All of the Company’s AFS securities were classified as Level 2 assets at September 30, 2018. The valuation of AFS securities using Level 2 inputs was primarily determined using the market approach, which uses quoted prices for similar assets or liabilities in active markets and all other relevant information. It includes model pricing, defined as valuing securities based upon their relationship with other benchmark securities.

Equity Securities

The fair value of equity securities is the market value based on quoted market prices, when available, or market prices provided by recognized broker dealers (Level 1). If listed prices or quotes are not available, fair value is based upon quoted market prices for similar or identical assets or other observable inputs (Level 2) or externally developed models that use unobservable inputs due to limited or no market activity of the instrument (Level 3).

As of September 30, 2018, the fair value of the Company's equity securities portfolio was $1.2 million.

All of the Company’s equity securities were classified as Level 2 assets at September 30, 2018. The valuation of securities using Level 2 inputs was primarily determined using the market approach, which uses quoted prices for similar assets or liabilities in active markets and all other relevant information.

There were no changes in the inputs or methodologies used to determine fair value during the period ended September 30, 2018, as compared to the periods ended December 31, 2017 and September 30, 2017.

The tables below present the balances of assets and liabilities measured at fair value on a recurring basis as of September 30, 2018 and December 31, 2017:

| | Fair Value Measurements at September 30, 2018 Using | | | |
|---|---|---|---|---|
| (In thousands) | Assets/Liabilities Measured at Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Measured on a recurring basis: | | | | |
| Assets: | | | | |
| Securities available for sale: | | | | |
| U.S. Government sponsored entities | $5,577 | $ — | $ 5,577 | $ — |
| State and political subdivisions | 4,659 | — | 4,659 | — |
| Residential mortgage-backed securities | 27,325 | — | 27,325 | — |
| Corporate and other securities | 9,313 | — | 9,313 | — |
| Total securities available for sale | $46,874 | $ — | $ 46,874 | $ — |
| | | | | |
| Equity securities | 1,200 | — | 1,200 | — |
| Total equity securities | $1,200 | $ — | $ 1,200 | $ — |
| | | | | |
| Interest rate swap agreements | 2,066 | — | 2,066 | — |
| Total swap agreements | $2,066 | $ — | $ 2,066 | $ — |

| | Fair Value Measurements at December 31, 2017 Using | | | |
|---|---|---|---|---|
| (In thousands) | Assets/Liabilities Measured at Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Measured on a recurring basis: | | | | |
| Assets: | | | | |
| Securities available for sale: | | | | |
| U.S. Government sponsored entities | $5,691 | $ — | $ 5,691 | $ — |
| State and political subdivisions | 5,192 | — | 5,192 | — |
| Residential mortgage-backed securities | 31,878 | — | 31,878 | — |
| Corporate and other securities | 10,732 | — | 10,732 | — |
| Total securities available for sale (1) | $53,493 | $ — | $ 53,493 | $ — |
| | | | | |
| Interest rate swap agreements | 1,407 | — | 1,407 | — |
| Total swap agreements | $1,407 | $ — | $ 1,407 | $ — |

(1) Securities available for sale at December 31, 2017, include equity securities of $1.2 million.

Fair Value on a Nonrecurring Basis

Certain assets and liabilities are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The following is a description of the valuation methodologies used for instruments measured at fair value on a nonrecurring basis:

Appraisal Policy

All appraisals must be performed in accordance with the Uniform Standards of Professional Appraisal Practice ("USPAP"). Appraisals are certified to the Company and performed by appraisers on the Company's approved list of appraisers. Evaluations are completed by a person independent of Company management. The content of the appraisal depends on the complexity of the property. Appraisals are completed on a "retail value" and an "as is value".

The Company requires current real estate appraisals on all loans that become OREO or in-substance foreclosure, loans that are classified substandard, doubtful or loss, or loans that are over $100 thousand and nonperforming. Prior to each balance sheet date, the Company values impaired collateral-dependent loans and OREO based upon a third party appraisal, broker's price opinion, drive by appraisal, automated valuation model, updated market evaluation, or a combination of these methods. The amount is discounted for the decline in market real estate values (for original appraisals), for any known damage or repair costs, and for selling and closing costs. The amount of the discount ranges from 10 to 25 percent and is dependent upon the method used to determine the original value. The original appraisal is generally used when a loan is first determined to be impaired. When applying the discount, the Company takes into consideration when the appraisal was performed, the collateral's location, the type of collateral, any known damage to the property and the type of business. Subsequent to entering impaired status and the Company determining that there is a collateral shortfall, the Company will generally, depending on the type of collateral, order a third party appraisal, broker's price opinion, automated valuation model or updated market evaluation. After receiving the third party results, the Company will discount the value 8 to 10 percent for selling and closing costs.

OREO

The fair value of OREO is determined using appraisals, which may be discounted based on management's review and changes in market conditions (Level 3 Inputs).

Impaired Collateral-Dependent Loans

The fair value of impaired collateral-dependent loans is derived in accordance with FASB ASC Topic 310, "Receivables." Fair value is determined based on the loan's observable market price or the fair value of the collateral. Partially charged-off loans are measured for impairment based upon an appraisal for collateral-dependent loans. When an updated appraisal is received for a nonperforming loan, the value on the appraisal is discounted in the manner discussed above. If there is a deficiency in the value after the Company applies these discounts, management applies a specific reserve and the loan remains in nonaccrual status. The receipt of an updated appraisal would not qualify as a reason to put a loan back into accruing status. The Company removes loans from nonaccrual status generally when the borrower makes nine months of contractual payments and demonstrates the ability to service the debt going forward. Charge-offs are determined based upon the loss that management believes the Company will incur after evaluating collateral for impairment based upon the valuation methods described above and the ability of the borrower to pay any deficiency.

The valuation allowance for impaired loans is included in the allowance for loan losses in the consolidated balance sheets. At September 30, 2018, the valuation allowance for impaired loans was $447 thousand, an increase of $115 thousand from $332 thousand at December 31, 2017.

The following tables present the assets and liabilities subject to fair value adjustments (impairment) on a non-recurring basis carried on the balance sheet by caption and by level within the hierarchy (as described above):

| | Fair Value Measurements at September 30, 2018 Using | | | | |
|---|---|---|---|---|---|
| (In thousands) | Assets/Liabilities Measured at Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Net Provision (Credit) During Period |
| Measured on a non-recurring basis: | | | | | |
| Financial assets: | | | | | |
| OREO | $56 | $ — | $ — | $ 56 | $ (196 ) |
| Impaired collateral-dependent loans | 2,765 | — | — | 2,765 | (84 ) |