

C & F FINANCIAL CORP  
Form 10-Q  
August 11, 2014

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**FORM 10-Q**

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**(Mark One)**

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

**For the quarterly period ended June 30, 2014**

**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: 000-23423**

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**C&F Financial Corporation**

**(Exact name of registrant as specified in its charter)**

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**Virginia** **54-1680165**  
**(State or other jurisdiction of incorporation or organization)** **(I.R.S. Employer Identification No.)**

**802 Main Street West Point, VA** **23181**  
**(Address of principal executive offices)** **(Zip Code)**

**(804) 843-2360**

**(Registrant's telephone number, including area code)**

N/A

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

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

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

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

Large accelerated filer Accelerated filer  
Non-accelerated filer (Do not check if a smaller reporting company) 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

At August 6, 2014, the latest practicable date for determination, 3,405,986 shares of common stock, \$1.00 par value, of the registrant were outstanding.

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**PART I - FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****CONSOLIDATED BALANCE SHEETS**

(In thousands, except for share and per share amounts)

|  | <b>June 30,<br/>2014</b> | <b>December<br/>31, 2013</b> |
|--|--------------------------|------------------------------|
|  | <b>(Unaudited)</b>       |                              |
| <b><u>ASSETS</u></b>   |                          |                              |
| Cash and due from banks  | <b>\$ 10,782</b>         | \$ 14,666                    |
| Interest-bearing deposits in other banks   | <b>171,572</b>           | 41,750                       |
| Federal funds sold   | <b>—</b>                 | 91,723                       |
| Total cash and cash equivalents  | <b>182,354</b>           | 148,139                      |
| Securities-available for sale at fair value, amortized cost of \$211,794 and \$217,708, respectively | <b>217,308</b>           | 218,110                      |
| Loans held for sale, at fair value   | <b>33,603</b>            | 35,879                       |
| Loans, net of allowance for loan losses of \$35,258 and \$34,852, respectively                       | <b>791,170</b>           | 785,532                      |
| Restricted stocks, at cost   | <b>3,690</b>             | 4,336                        |
| Corporate premises and equipment, net  | <b>38,937</b>            | 39,142                       |
| Other real estate owned, net of valuation allowance of \$188 and \$4,135, respectively               | <b>817</b>               | 2,769                        |
| Accrued interest receivable  | <b>6,255</b>             | 6,360                        |
| Goodwill   | <b>16,630</b>            | 16,630                       |
| Core deposit intangible, net   | <b>3,151</b>             | 3,774                        |
| Bank-owned life insurance  | <b>14,176</b>            | 13,988                       |
| Other assets   | <b>39,400</b>            | 37,638                       |
| Total assets   | <b>\$ 1,347,491</b>      | \$ 1,312,297                 |
| <b><u>LIABILITIES AND SHAREHOLDERS' EQUITY</u></b>   |                          |                              |
| Deposits   |                          |                              |
| Noninterest-bearing demand deposits  | <b>\$ 176,868</b>        | \$ 147,520                   |
| Savings and interest-bearing demand deposits   | <b>483,096</b>           | 460,889                      |
| Time deposits  | <b>379,788</b>           | 399,883                      |
| Total deposits   | <b>1,039,752</b>         | 1,008,292                    |
| Short-term borrowings  | <b>11,535</b>            | 11,780                       |
| Long-term borrowings   | <b>132,987</b>           | 132,987                      |
| Trust preferred capital notes  | <b>25,086</b>            | 25,068                       |
| Accrued interest payable   | <b>807</b>               | 843                          |
| Other liabilities  | <b>18,121</b>            | 20,386                       |

|   |                     |              |
|---|---------------------|--------------|
| Total liabilities   | <b>1,228,288</b>    | 1,199,356    |
| Commitments and contingent liabilities  | —                   | —            |
| Shareholders' equity  |                     |              |
| Common stock (\$1.00 par value, 8,000,000 shares authorized, 3,405,321 and 3,388,793 shares issued and outstanding, respectively) | <b>3,278</b>        | 3,269        |
| Additional paid-in capital  | <b>8,919</b>        | 10,686       |
| Retained earnings   | <b>103,878</b>      | 99,252       |
| Accumulated other comprehensive income (loss), net  | <b>3,128</b>        | (266 )       |
| Total shareholders' equity  | <b>119,203</b>      | 112,941      |
| Total liabilities and shareholders' equity  | <b>\$ 1,347,491</b> | \$ 1,312,297 |

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

**CONSOLIDATED STATEMENTS OF INCOME**

(Unaudited)

(In thousands, except for share and per share amounts)

|   | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|---|---------------------------|-------------|-------------------------|-------------|
|   | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|   | <b>2014</b>               | <b>2013</b> | <b>2014</b>             | <b>2013</b> |
| Interest income   |                           |             |                         |             |
| Interest and fees on loans                                  | <b>\$19,849</b>           | \$17,918    | <b>\$39,316</b>         | \$35,737    |
| Interest on money market investments and federal funds sold | <b>115</b>                | 38          | <b>196</b>              | 61          |
| Interest and dividends on securities                        |                           |             |                         |             |
| U.S. government agencies and corporations                   | <b>190</b>                | 100         | <b>384</b>              | 206         |
| Tax-exempt obligations of states and political subdivisions | <b>1,105</b>              | 1,136       | <b>2,232</b>            | 2,278       |
| Corporate bonds and other                                   | <b>453</b>                | 38          | <b>878</b>              | 71          |
| Total interest income                                       | <b>21,712</b>             | 19,230      | <b>43,006</b>           | 38,353      |
| Interest expense  |                           |             |                         |             |
| Savings and interest-bearing deposits                       | <b>248</b>                | 186         | <b>520</b>              | 405         |
| Certificates of deposit, \$100 or more                      | <b>317</b>                | 354         | <b>670</b>              | 729         |
| Other time deposits   | <b>463</b>                | 468         | <b>951</b>              | 953         |
| Borrowings  | <b>878</b>                | 885         | <b>1,748</b>            | 1,766       |
| Trust preferred capital notes                               | <b>235</b>                | 189         | <b>472</b>              | 377         |
| Total interest expense                                      | <b>2,141</b>              | 2,082       | <b>4,361</b>            | 4,230       |
| Net interest income   | <b>19,571</b>             | 17,148      | <b>38,645</b>           | 34,123      |
| Provision for loan losses                                   | <b>3,265</b>              | 3,120       | <b>6,775</b>            | 6,300       |
| Net interest income after provision for loan losses         | <b>16,306</b>             | 14,028      | <b>31,870</b>           | 27,823      |
| Noninterest income  |                           |             |                         |             |
| Gains on sales of loans                                     | <b>1,647</b>              | 3,577       | <b>2,837</b>            | 5,278       |
| Service charges on deposit accounts                         | <b>1,116</b>              | 996         | <b>2,178</b>            | 1,920       |
| Other service charges and fees                              | <b>1,615</b>              | 1,472       | <b>2,996</b>            | 2,976       |
| Net gains on sales/calls of available for sale securities   | <b>3</b>                  | 4           | <b>3</b>                | 6           |
| Other income  | <b>885</b>                | 914         | <b>2,064</b>            | 1,881       |
| Total noninterest income                                    | <b>5,266</b>              | 6,963       | <b>10,078</b>           | 12,061      |
| Noninterest expenses  |                           |             |                         |             |
| Salaries and employee benefits                              | <b>9,065</b>              | 8,229       | <b>18,224</b>           | 15,298      |
| Occupancy expenses  | <b>2,183</b>              | 1,770       | <b>4,315</b>            | 3,538       |
| Other expenses  | <b>5,008</b>              | 4,549       | <b>10,071</b>           | 8,741       |
| Total noninterest expenses                                  | <b>16,256</b>             | 14,548      | <b>32,610</b>           | 27,577      |

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|   |                  |           |                  |           |
|---|------------------|-----------|------------------|-----------|
| Income before income taxes                            | <b>5,316</b>     | 6,443     | <b>9,338</b>     | 12,307    |
| Income tax expense                                    | <b>1,574</b>     | 2,265     | <b>2,703</b>     | 4,123     |
| Net income  | <b>\$3,742</b>   | \$4,178   | <b>\$6,635</b>   | \$8,184   |
| Per common share data                                 |                  |           |                  |           |
| Net income – basic                                    | <b>\$1.10</b>    | \$1.28    | <b>\$1.95</b>    | \$2.50    |
| Net income – assuming dilution                        | <b>\$1.09</b>    | \$1.22    | <b>\$1.91</b>    | \$2.41    |
| Weighted average number of shares – basic             | <b>3,405,245</b> | 3,276,039 | <b>3,403,042</b> | 3,271,376 |
| Weighted average number of shares – assuming dilution | <b>3,442,468</b> | 3,413,052 | <b>3,467,054</b> | 3,392,165 |

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



**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(Unaudited)

(In thousands)

|   | <b>Three Months</b>   |                | <b>Six Months</b>     |                |
|---|-----------------------|----------------|-----------------------|----------------|
|   | <b>Ended June 30,</b> |                | <b>Ended June 30,</b> |                |
|   | <b>2014</b>           | <b>2013</b>    | <b>2014</b>           | <b>2013</b>    |
| Net income  | <b>\$3,742</b>        | <b>\$4,178</b> | <b>\$6,635</b>        | <b>\$8,184</b> |
| Other comprehensive income (loss), net:                                   |                       |                |                       |                |
| Changes in defined benefit plan assets and benefit obligations            |                       |                |                       |                |
| Changes in net loss arising during the period <sup>1</sup>                | <b>(8 )</b>           | 31             | <b>(16 )</b>          | 61             |
| Tax effect  | <b>3</b>              | (11 )          | <b>6</b>              | (21 )          |
| Amortization of prior service cost <sup>1</sup>                           | <b>17</b>             | (17 )          | <b>34</b>             | (34 )          |
| Tax effect  | <b>(6 )</b>           | 6              | <b>(12 )</b>          | 12             |
| Net of tax amount   | <b>6</b>              | 9              | <b>12</b>             | 18             |
| Unrealized gain on cash flow hedging instruments                          |                       |                |                       |                |
| Unrealized holding gain arising during the period                         | <b>46</b>             | 67             | <b>86</b>             | 116            |
| Tax effect  | <b>(19 )</b>          | (26 )          | <b>(34 )</b>          | (45 )          |
| Net of tax amount   | <b>27</b>             | 41             | <b>52</b>             | 71             |
| Unrealized holding gains (losses) on securities                           |                       |                |                       |                |
| Unrealized holding gains (losses) arising during the period               | <b>1,943</b>          | (4,960)        | <b>5,113</b>          | (5,785)        |
| Tax effect  | <b>(680 )</b>         | 1,736          | <b>(1,781 )</b>       | 2,025          |
| Reclassification adjustment for gains included in net income <sup>2</sup> | <b>(3 )</b>           | (4 )           | <b>(3 )</b>           | (6 )           |
| Tax effect  | <b>1</b>              | 1              | <b>1</b>              | 2              |
| Net of tax amount   | <b>1,261</b>          | (3,227)        | <b>3,330</b>          | (3,764)        |
| Other comprehensive income (loss), net:                                   | <b>1,294</b>          | (3,177)        | <b>3,394</b>          | (3,675)        |
| Comprehensive income, net   | <b>\$5,036</b>        | <b>\$1,001</b> | <b>\$10,029</b>       | <b>\$4,509</b> |

<sup>1</sup> These items are included in the computation of net periodic benefit cost. See Note 7, Employee Benefit Plan, for additional information.

<sup>2</sup> Gains are included in "Net gains on sales/calls of available for sale securities" on the income statement.

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



**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**

(Unaudited)

(In thousands, except per share amounts)

|  | <b>Common<br/>Stock</b> | <b>Additional<br/>Paid-In<br/>Capital</b> | <b>Retained<br/>Earnings</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income<br/>(Loss), Net</b> | <b>Total<br/>Shareholders'<br/>Equity</b> |
|--|-------------------------|---|------------------------------|---|---|
| Balance December 31, 2013                                | \$ 3,269                | \$ 10,686                                 | \$ 99,252                    | \$ (266 )   | \$ 112,941                                |
| Comprehensive income:                                    |                         |   |                              |   |   |
| Net income   | —                       | —   | 6,635                        | —   | 6,635                                     |
| Other comprehensive income,<br>net                       | —                       | —   | —                            | 3,394   | 3,394                                     |
| Common stock warrant<br>repurchased                      | —                       | (2,303 )                                  | —                            | —   | (2,303 )                                  |
| Share-based compensation                                 | —                       | 487                                       | —                            | —   | 487                                       |
| Restricted stock vested                                  | 7                       | (15 )                                     | —                            | —   | (8 )                                      |
| Common stock issued                                      | 2                       | 64  | —                            | —   | 66  |
| Cash dividends paid – common<br>stock (\$0.59 per share) | —                       | —   | (2,009 )                     | —   | (2,009 )                                  |
| Balance June 30, 2014                                    | \$ 3,278                | \$ 8,919                                  | \$ 103,878                   | \$ 3,128  | \$ 119,203                                |

|                                 | <b>Common<br/>Stock</b> | <b>Additional<br/>Paid-In<br/>Capital</b> | <b>Retained<br/>Earnings</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income<br/>(Loss), Net</b> | <b>Total<br/>Shareholders'<br/>Equity</b> |
|---------------------------------|-------------------------|---|------------------------------|---|---|
| Balance December 31, 2012       | \$ 3,162                | \$ 5,624                                  | \$ 88,695                    | \$ 4,716  | \$ 102,197                                |
| Comprehensive income:           |                         |   |                              |   |   |
| Net income                      | —                       | —   | 8,184                        | —   | 8,184                                     |
| Other comprehensive (loss), net | —                       | —   | —                            | (3,675 )  | (3,675 )                                  |
| Stock options exercised         | 17                      | 646                                       | —                            | —   | 663                                       |
| Share-based compensation        | —                       | 289                                       | —                            | —   | 289                                       |
| Restricted stock vested         | 5                       | (5 )                                      | —                            | —   | —   |

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|  |         |         |          |         |           |
|--|---------|---------|----------|---------|-----------|
| Common stock issued                                      | 1       | 41      | —        | —       | 42        |
| Cash dividends paid – common stock<br>(\$0.58 per share) | —       | —       | (1,900 ) | —       | (1,900 )  |
| Balance June 30, 2013                                    | \$3,185 | \$6,595 | \$94,979 | \$1,041 | \$105,800 |

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

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)

(In thousands)

|   | <b>Six Months Ended</b> |             |
|---|-------------------------|-------------|
|   | <b>June 30,</b>         |             |
|   | <b>2014</b>             | <b>2013</b> |
| Operating activities:   |                         |             |
| Net income  | <b>\$6,635</b>          | \$8,184     |
| Adjustments to reconcile net income to net cash provided by operating activities: |                         |             |
| Depreciation  | <b>1,403</b>            | 1,128       |
| Provision for loan losses   | <b>6,775</b>            | 6,300       |
| Provision for indemnifications  | <b>109</b>              | 375         |
| Provision for other real estate owned losses                                      | <b>—</b>                | 308         |
| Share-based compensation  | <b>479</b>              | 289         |
| Net accretion of acquisition-related fair value adjustments                       | <b>(1,664 )</b>         | —           |
| Accretion of discounts and amortization of premiums on securities, net            | <b>629</b>              | 335         |
| Net realized gains on sales/calls of securities                                   | <b>(3 )</b>             | (6 )        |
| Net realized gains on sales of other real estate owned                            | <b>(227 )</b>           | (115 )      |
| Net realized gain on sale of equipment  | <b>(38 )</b>            | —           |
| Income from bank-owned life insurance   | <b>(188 )</b>           | —           |
| Proceeds from sales of loans held for sale  | <b>219,742</b>          | 403,617     |
| Origination of loans held for sale  | <b>(217,466)</b>        | (390,202)   |
| Change in other assets and liabilities:   |                         |             |
| Accrued interest receivable   | <b>105</b>              | 128         |
| Other assets  | <b>(3,590 )</b>         | (1,736 )    |
| Accrued interest payable  | <b>(36 )</b>            | (51 )       |
| Other liabilities   | <b>(2,378 )</b>         | (126 )      |
| Net cash provided by operating activities   | <b>10,287</b>           | 28,428      |
| Investing activities:   |                         |             |
| Proceeds from maturities, calls and sales of securities available for sale        | <b>21,545</b>           | 15,357      |
| Purchases of securities available for sale  | <b>(15,981 )</b>        | (16,248 )   |
| Redemption of restricted stocks   | <b>646</b>              | 219         |
| Net increase in customer loans  | <b>(12,870 )</b>        | (4,644 )    |
| Proceeds from sales of other real estate owned                                    | <b>4,274</b>            | 2,188       |
| Purchases of corporate premises and equipment, net                                | <b>(1,218 )</b>         | (1,897 )    |
| Net cash used in investing activities   | <b>(3,604 )</b>         | (5,025 )    |
| Financing activities:   |                         |             |
| Net increase in demand, interest-bearing demand and savings deposits              | <b>51,555</b>           | 13,292      |
| Net decrease in time deposits   | <b>(19,532 )</b>        | (5,679 )    |
| Net (decrease) increase in borrowings   | <b>(245 )</b>           | 4,392       |
| Proceeds from exercise of stock options   | <b>—</b>                | 663         |

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|   |                  |            |
|---|------------------|------------|
| Repurchase of common stock warrant                                    | <b>(2,303 )</b>  | —          |
| Issuance of common stock  | <b>66</b>        | 42         |
| Cash dividends  | <b>(2,009 )</b>  | (1,900 )   |
| Net cash provided by financing activities                             | <b>27,532</b>    | 10,810     |
| Net increase in cash and cash equivalents                             | <b>34,215</b>    | 34,213     |
| Cash and cash equivalents at beginning of period                      | <b>148,139</b>   | 25,620     |
| Cash and cash equivalents at end of period                            | <b>\$182,354</b> | \$59,833   |
| Supplemental disclosure   |                  |            |
| Interest paid   | <b>\$4,942</b>   | \$4,281    |
| Income taxes paid   | <b>2,041</b>     | 3,034      |
| Supplemental disclosure of noncash investing and financing activities |                  |            |
| Unrealized gains (losses) on securities available for sale            | <b>\$5,110</b>   | \$(5,791 ) |
| Loans transferred to other real estate owned                          | <b>1,980</b>     | (70 )      |
| Pension adjustment  | <b>18</b>        | 27         |
| Unrealized gain on cash flow hedging instrument                       | <b>86</b>        | 116        |

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

### NOTE 1: Summary of Significant Accounting Policies

**Principles of Consolidation:** The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial reporting and with applicable quarterly reporting regulations of the Securities and Exchange Commission (the SEC). They do not include all of the information and notes required by U.S. GAAP for complete financial statements. Therefore, these consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the C&F Financial Corporation Annual Report on Form 10-K for the year ended December 31, 2013.

The unaudited consolidated financial statements include the accounts of C&F Financial Corporation (the Corporation) and its wholly-owned subsidiary, Citizens and Farmers Bank (the Bank or C&F Bank). All significant intercompany accounts and transactions have been eliminated in consolidation. In addition, C&F Financial Corporation owns C&F Financial Statutory Trust I, C&F Financial Statutory Trust II and Central Virginia Bankshares Statutory Trust I, all of which are unconsolidated subsidiaries. The subordinated debt owed to these trusts is reported as a liability of the Corporation.

**Nature of Operations:** C&F Financial Corporation is a bank holding company incorporated under the laws of the Commonwealth of Virginia. The Corporation owns all of the stock of its subsidiary, Citizens and Farmers Bank, which is an independent commercial bank chartered under the laws of the Commonwealth of Virginia. On October 1, 2013, the Corporation acquired Central Virginia Bankshares, Inc. (CVBK) and its wholly-owned subsidiary, Central Virginia Bank (CVB), which was an independent commercial bank chartered under the laws of the Commonwealth of Virginia. On March 22, 2014, CVBK was merged with and into C&F Financial Corporation and CVB was merged with and into C&F Bank.

The Bank has six wholly-owned subsidiaries: C&F Mortgage Corporation and Subsidiaries (C&F Mortgage), C&F Finance Company (C&F Finance), C&F Title Agency, Inc., C&F Investment Services, Inc., C&F Insurance Services, Inc. and CVB Title Services, Inc., all incorporated under the laws of the Commonwealth of Virginia. C&F Mortgage, organized in September 1995, was formed to originate and sell residential mortgages and through its subsidiaries, Hometown Settlement Services LLC and Certified Appraisals LLC, provides ancillary mortgage loan production services, such as loan settlements, title searches and residential appraisals. C&F Finance, acquired on September 1, 2002, is a finance company providing automobile loans through indirect lending programs. C&F Title Agency, Inc., organized in October 1992, primarily sells title insurance to the mortgage loan customers of the Bank and C&F Mortgage. C&F Investment Services, Inc., organized in April 1995, is a full-service brokerage firm offering a

comprehensive range of investment services. C&F Insurance Services, Inc., organized in July 1999, owns an equity interest in an insurance agency that sells insurance products to customers of the Bank, C&F Mortgage and other financial institutions that have an equity interest in the agency. CVB Title Services, Inc. was organized for the primary purpose of owning membership interests in two insurance-related limited liability companies. Business segment data is presented in Note 9.

**Basis of Presentation:** The preparation of financial statements in conformity with U.S. GAAP 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 and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the allowance for indemnifications, impairment of loans, impairment of securities, the valuation of other real estate owned, the projected benefit obligation under the defined benefit pension plan, the valuation of deferred taxes, fair value measurements and goodwill impairment. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, which are necessary for a fair presentation of the results of operations in these financial statements, have been made.

**Reclassification:** Certain reclassifications have been made to prior period amounts to conform to the current period presentation. None of these reclassifications are considered material.

**Derivative Financial Instruments:** The Corporation recognizes derivative financial instruments at fair value as either an other asset or an other liability in the consolidated balance sheet. The Corporation's derivative financial instruments as of June 30, 2014 and December 31, 2013 consisted of (1) the fair value of interest rate lock commitments (IRLCs) on mortgage loans that will be sold in the secondary market and the related forward commitments to sell mortgage loans and mortgage-backed securities (MBS) and (2) interest rate swaps that qualified as cash flow hedges of a portion of the Corporation's trust preferred capital notes. Adjustments to reflect unrealized gains and losses resulting from changes in fair value of the Corporation's IRLCs and forward sales commitments and realized gains and losses upon ultimate sale of the loans are classified as noninterest income. The Corporation's IRLCs and forward loan sales commitments are described more fully in Note 8 and Note 10. The effective portion of the gain or loss on the Corporation's cash flow hedges is reported as a component of other comprehensive income, net of deferred income taxes, and reclassified into earnings in the same period(s) during which the hedged transaction affects earnings. The cash flow hedges are described more fully in Note 11.



**Share-Based Compensation:** Compensation expense for the second quarter of 2014 and first six months of 2014 included expense, net of forfeitures, of \$246,000 (\$153,000 after tax) and \$487,000 (\$302,000 after tax), respectively, for restricted stock granted during 2009 through 2014. As of June 30, 2014, there was \$2.69 million of total unrecognized compensation expense related to unvested restricted stock that will be recognized over the remaining requisite service periods.

A summary of activity for restricted stock awards during the first six months of 2014 is presented below:

|                           |               | <b>Weighted-<br/>Average</b> |
|---------------------------|---------------|------------------------------|
|                           | <b>Shares</b> | <b>Grant<br/>Date</b>        |
|                           |               | <b>Fair<br/>Value</b>        |
| Unvested, January 1, 2014 | 120,183       | \$ 31.18                     |
| Granted                   | 15,750        | \$ 41.38                     |
| Vested                    | (8,100 )      | \$ 18.77                     |
| Forfeitures               | (700 )        | \$ 33.96                     |
| Unvested, June 30, 2014   | 127,133       | \$ 33.22                     |

Stock option activity during the six months ended June 30, 2014 and stock options outstanding at June 30, 2014 are summarized below:

|  | <b>Shares</b> | <b>Exercise<br/>Price*</b> | <b>Remaining<br/>Contractual<br/>Life<br/>(in years)*</b> | <b>Intrinsic<br/>Value of<br/>Unexercised<br/>In-The<br/>Money<br/>Options<br/>(in 000's)</b> |
|--|---------------|----------------------------|---|---|
| Options outstanding at January 1, 2014 | 164,150       | \$ 38.21                   | 1.7   | \$ 1,224  |
| Expired                                | (12,000 )     | \$ 37.50                   |   |   |

|  |         |          |     |      |
|--|---------|----------|-----|------|
| Options outstanding and exercisable at June 30, 2014 | 152,150 | \$ 38.27 | 1.3 | \$ 9 |
|--|---------|----------|-----|------|

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\*Weighted average

### Recent Significant Accounting Pronouncements:

In January 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-01, "Investments-Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects (a consensus of the FASB Emerging Issues Task Force)." The amendments in this ASU permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in this ASU should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The amendments in this ASU are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Corporation is currently assessing the effect that ASU 2014-01 will have on its financial statements.

In January 2014, the FASB issued ASU 2014-04, "Receivables-Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)." The amendments in this ASU clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The Corporation is currently assessing the effect that ASU 2014-04 will have on its financial statements.

In June 2014, the FASB issued ASU No. 2014-11, “Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures”. This ASU aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. The new guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement. The amendments in the ASU also require a new disclosure for transactions economically similar to repurchase agreements in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction. Additional disclosures will be required for the nature of collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. The amendments in this ASU are effective for the first interim or annual period beginning after December 15, 2014; however, the disclosure for transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and interim periods beginning after March 15, 2015. Early adoption is not permitted. The Corporation is currently assessing the effect that ASU 2014-11 will have on its financial statements.

In June 2014, the FASB issued ASU No. 2014-12, “Compensation - Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period”. The new guidance applies to reporting entities that grant employees share-based payments in which the terms of the award allow a performance target to be achieved after the requisite service period. The amendments in the ASU require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. Existing guidance in “Compensation - Stock Compensation (Topic 718)”, should be applied to account for these types of awards. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Early adoption is permitted and reporting entities may choose to apply the amendments in the ASU either on a prospective or retrospective basis. The Corporation is currently assessing the effect that ASU 2014-12 will have on its financial statements.

## **NOTE 2: Business Combinations**

On October 1, 2013, the Corporation completed its acquisition of CVBK, the one-bank holding company for CVB. Pursuant to the Agreement and Plan of Merger dated June 10, 2013, CVBK's shareholders received \$0.32 for each share of CVBK common stock they owned, or approximately \$846,000 in the aggregate. In addition, the Corporation purchased from the U.S. Treasury for \$3.35 million all of CVBK's preferred stock and warrants issued to the U.S. Treasury under the Capital Purchase Program, including accrued and unpaid dividends on the preferred stock. CVB had seven retail bank branches located in the Virginia counties of Powhatan, Cumberland, Chesterfield and Henrico.

The Corporation accounted for the acquisition using the acquisition method of accounting in accordance with Accounting Standards Codification (ASC) 805, *Business Combinations*. Under the acquisition method of accounting,

the assets and liabilities of CVBK were recorded at their respective acquisition date fair values. Determining the fair value of assets and liabilities, particularly related to the loan portfolio, is a complicated process involving significant judgment regarding methods and assumptions used to calculate the estimated fair values. The fair values are preliminary and subject to refinement for up to one year after the acquisition date as additional information relative to the acquisition date fair values becomes available. The Corporation has not made any such adjustments since the acquisition date. The following table details the total consideration paid by the Corporation on October 1, 2013 in connection with the acquisition of CVBK, the fair values of the assets acquired and liabilities assumed, and the resulting goodwill.

| <i>(Dollars in thousands)</i>                 | <b>As<br/>Recorded<br/>by CVBK</b> | <b>Fair Value<br/>Adjustments</b> | <b>As Recorded<br/>by the<br/>Corporation</b> |
|---|------------------------------------|-----------------------------------|---|
| Consideration paid:                           |                                    |                                   |   |
| CVBK common stock                             |                                    |                                   | \$ 846  |
| CVBK preferred stock and warrants             |                                    |                                   | 3,350   |
| Total consideration paid                      |                                    |                                   | 4,196   |
| Identifiable assets acquired:                 |                                    |                                   |   |
| Cash and cash equivalents                     | \$ 59,775                          | \$ —                              | \$ 59,775                                     |
| Securities available for sale, at fair value  | 119,916                            | 181                               | 120,097                                       |
| Loans, net of allowance and unearned income   | 164,814                            | (17,748 )                         | 147,066                                       |
| Corporate premises and equipment, net         | 7,448                              | 3,500                             | 10,948  |
| Other real estate owned, net                  | 895                                | (500 )                            | 395   |
| Core deposit intangibles                      | 41                                 | 4,066                             | 4,107   |
| Other assets                                  | 16,623                             | 6,030                             | 22,653  |
| Total identifiable assets acquired            | 369,512                            | (4,471 )                          | 365,041                                       |
| Identifiable liabilities assumed:             |                                    |                                   |   |
| Deposits                                      | 313,711                            | 1,710                             | 315,421                                       |
| Borrowings                                    | 40,000                             | 2,124                             | 42,124  |
| Trust preferred capital notes                 | 5,155                              | (716 )                            | 4,439   |
| Other liabilities                             | 4,684                              | 84                                | 4,768   |
| Total identifiable liabilities assumed        | 363,550                            | 3,202                             | 366,752                                       |
| Net identifiable assets (liabilities) assumed | \$ 5,962                           | \$ (7,673 )                       | (1,711 )                                      |
| Goodwill resulting from acquisition           |                                    |                                   | \$ 5,907                                      |

The following table illustrates the unaudited pro forma revenue and net income of the combined entities had the acquisition taken place on January 1, 2013. The unaudited combined pro forma revenue and net income combines the historical results of CVBK with the Corporation's consolidated statement of income for the three and six months ended June 30, 2013 and, while certain adjustments were made for the estimated effect of certain fair value adjustments and other acquisition-related activity, they are not indicative of what would have occurred had the acquisition actually taken place on January 1, 2013. Expenses related to systems conversions and other integration related expenses were incurred during the first six months of 2014 in connection with merging CVBK into the Corporation and CVB into C&F Bank. Additionally, the Corporation expects to achieve further operational cost savings and other efficiencies as a result of the acquisition which are not reflected in the unaudited pro forma amounts below.

| <i>(Dollars in thousands)</i> | <b>Unaudited<br/>Pro<br/>Forma<br/>Three<br/>Months</b> | <b>Unaudited<br/>Pro<br/>Forma Six<br/>Months<br/>Ended</b> |
|-------------------------------|---|---|
|-------------------------------|---|---|

|   | <b>Ended<br/>June 30,<br/>2013</b> | <b>June 30,<br/>2013</b> |
|---|------------------------------------|--------------------------|
| Total revenues, net of interest expense | \$ 28,044                          | \$ 54,159                |
| Net income                              | 4,205                              | 9,037                    |

**NOTE 3: Securities**

Debt and equity securities, all of which were classified as available for sale, are summarized as follows:

| <i>(Dollars in thousands)</i>                    | <b>June 30, 2014</b>                      |                             |                              |                       |
|--|---|-----------------------------|------------------------------|-----------------------|
|  | <b>Amortized<br/>Cost</b>                 | <b>Gross</b>                | <b>Gross</b>                 | <b>Estimated</b>      |
|  |   | <b>Unrealized<br/>Gains</b> | <b>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b> |
|  | U.S. government agencies and corporations | \$29,723                    | \$ 27                        | \$ (848 )             |
| Mortgage-backed securities                       | 57,411                                    | 585                         | (244 )                       | 57,752                |
| Obligations of states and political subdivisions | 124,660                                   | 6,296                       | (302 )                       | 130,654               |
|  | \$211,794                                 | \$ 6,908                    | \$ (1,394 )                  | \$ 217,308            |

| <i>(Dollars in thousands)</i>                    | <b>December 31, 2013</b>  |                             |                              |                       |
|--|---------------------------|-----------------------------|------------------------------|-----------------------|
|  | <b>Amortized<br/>Cost</b> | <b>Gross</b>                | <b>Gross</b>                 | <b>Estimated</b>      |
|  |                           | <b>Unrealized<br/>Gains</b> | <b>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b> |
|  | U.S. Treasury securities  | \$10,000                    | \$ —                         | \$ —                  |
| U.S. government agencies and corporations        | 32,503                    | 4                           | (2,557 )                     | 29,950                |
| Mortgage-backed securities                       | 51,318                    | 100                         | (555 )                       | 50,863                |
| Obligations of states and political subdivisions | 123,729                   | 4,223                       | (813 )                       | 127,139               |
| Corporate and other debt securities              | 158                       | —                           | —                            | 158                   |
|  | \$217,708                 | \$ 4,327                    | \$ (3,925 )                  | \$ 218,110            |

The amortized cost and estimated fair value of securities, all of which were classified as available for sale, at June 30, 2014, by the earlier of contractual maturity or expected maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to prepay obligations with or without call or prepayment penalties.

*(Dollars in thousands)* **June 30, 2014**  
**Amortized Estimated**

|  | <b>Cost</b>      | <b>Fair<br/>Value</b> |
|--|------------------|-----------------------|
| Due in one year or less                | <b>\$28,062</b>  | <b>\$27,899</b>       |
| Due after one year through five years  | <b>90,906</b>    | <b>93,851</b>         |
| Due after five years through ten years | <b>63,093</b>    | <b>64,459</b>         |
| Due after ten years                    | <b>29,733</b>    | <b>31,099</b>         |
|  | <b>\$211,794</b> | <b>\$217,308</b>      |

Proceeds from the maturities, calls and sales of securities available for sale for the six months ended June 30, 2014 were \$21.55 million.

The Corporation pledges securities primarily as collateral for public deposits and repurchase agreements. Securities with an aggregate amortized cost of \$105.19 million and an aggregate fair value of \$108.01 million were pledged at June 30, 2014. Securities with an aggregate amortized cost of \$149.22 million and an aggregate fair value of \$149.83 million were pledged at December 31, 2013.



Securities in an unrealized loss position at June 30, 2014, by duration of the period of the unrealized loss, are shown below.

| <i>(Dollars in thousands)</i>                    | <b>Less Than 12 Months</b> |                   | <b>12 Months or More</b> |                   | <b>Total</b> |                   |
|--|----------------------------|-------------------|--------------------------|-------------------|--------------|-------------------|
|  | <b>Fair</b>                | <b>Unrealized</b> | <b>Fair</b>              | <b>Unrealized</b> | <b>Fair</b>  | <b>Unrealized</b> |
|  | <b>Value</b>               | <b>Loss</b>       | <b>Value</b>             | <b>Loss</b>       | <b>Value</b> | <b>Loss</b>       |
| U.S. government agencies and corporations        | \$7,370                    | \$ 87             | \$21,147                 | \$ 761            | \$28,517     | \$ 848            |
| Mortgage backed securities                       | 8,330                      | 177               | 1,442                    | 67                | 9,772        | 244               |
| Obligations of states and political subdivisions | 5,765                      | 83                | 10,448                   | 219               | 16,213       | 302               |
| Total temporarily impaired securities            | \$21,465                   | \$ 347            | \$33,037                 | \$ 1,047          | \$54,502     | \$ 1,394          |

There are 96 debt securities totaling \$54.50 million considered temporarily impaired at June 30, 2014. The Corporation's unrealized loss position has improved since December 31, 2013 because interest rates fell during the first half of 2014, primarily in the intermediate and long-end of the United States Treasury yield curve, thereby increasing market values of the Corporation's portfolio of securities of U.S. government agencies and corporations and obligations of states and political subdivisions. The United States fixed income markets continued to rally throughout the second quarter due to uneven economic performance, low levels of inflation and the accommodative monetary policy maintained by the Federal Reserve. At June 30, 2014, approximately 97 percent of the Corporation's obligations of states and political subdivisions, as measured by market value, were rated "A" or better by Standard & Poor's or Moody's Investors Service. Of those in a net unrealized loss position, approximately 96 percent were rated "A" or better, as measured by market value, at June 30, 2014. For the approximate four percent not rated "A" or better, as measured by market value at June 30, 2014, the Corporation considers these to meet regulatory credit quality standards, such that the securities have low risk of default by the obligor, and the full and timely repayment of principal and interest is expected over the expected life of the investment. Because the Corporation intends to hold these investments in debt securities to maturity and it is more likely than not that the Corporation will not be required to sell these investments before a recovery of unrealized losses, the Corporation does not consider these investments to be other-than-temporarily impaired at June 30, 2014 and no other-than-temporary impairment has been recognized.

Securities in an unrealized loss position at December 31, 2013, by duration of the period of the unrealized loss, are shown below.

| <i>(Dollars in thousands)</i>             | <b>Less Than 12 Months</b> |                   | <b>12 Months or More</b> |                   | <b>Total</b> |                   |
|---|----------------------------|-------------------|--------------------------|-------------------|--------------|-------------------|
|   | <b>Fair</b>                | <b>Unrealized</b> | <b>Fair</b>              | <b>Unrealized</b> | <b>Fair</b>  | <b>Unrealized</b> |
|   | <b>Value</b>               | <b>Loss</b>       | <b>Value</b>             | <b>Loss</b>       | <b>Value</b> | <b>Loss</b>       |
| U.S. government agencies and corporations | \$29,430                   | \$ 1,385          | \$8,948                  | \$ 1,172          | \$38,378     | \$ 2,557          |

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|  |          |          |          |          |           |          |
|--|----------|----------|----------|----------|-----------|----------|
| Mortgage-backed securities                       | 40,090   | 555      | —        | —        | 40,090    | 555      |
| Obligations of states and political subdivisions | 21,260   | 656      | 3,078    | 157      | 24,338    | 813      |
| Total temporarily impaired securities            | \$90,780 | \$ 2,596 | \$12,026 | \$ 1,329 | \$102,806 | \$ 3,925 |

The Corporation's investment in restricted stocks includes membership stock in the Federal Home Loan Bank (FHLB) and the Community Bankers Bank at June 30, 2014, and additionally included stock in the Federal Reserve Bank at December 31, 2013. Restricted stocks totaled \$3.69 million at June 30, 2014 and \$4.34 million at December 31, 2013. These membership stocks are generally viewed as long-term investments and as a restricted investment securities, which are carried at cost, because there is no market for the stock, other than member institutions. Therefore, when evaluating these investments for impairment, their value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Corporation does not consider these investments to be other-than-temporarily impaired at June 30, 2014 and no impairment has been recognized. These stocks are shown as a separate line item on the balance sheet and are not a part of the available for sale securities portfolio.

**NOTE 4: Loans**

Major classifications of loans are summarized as follows:

| <i>(Dollars in thousands)</i>                       | <b>June 30,<br/>2014</b> | <b>December<br/>31,<br/>2013</b> |
|---|--------------------------|----------------------------------|
| Real estate – residential mortgage                  | <b>\$180,514</b>         | \$ 188,455                       |
| Real estate – construction <sup>1</sup>             | <b>7,580</b>             | 5,810                            |
| Commercial, financial and agricultural <sup>2</sup> | <b>295,545</b>           | 288,593                          |
| Equity lines  | <b>50,577</b>            | 50,795                           |
| Consumer  | <b>8,239</b>             | 9,007                            |
| Consumer finance                                    | <b>283,973</b>           | 277,724                          |
|   | <b>826,428</b>           | 820,384                          |
| Less allowance for loan losses                      | <b>(35,258 )</b>         | (34,852 )                        |
| Loans, net  | <b>\$791,170</b>         | \$ 785,532                       |

<sup>1</sup> Includes the Corporation's real estate construction lending and consumer real estate lot lending.

<sup>2</sup> Includes the Corporation's commercial real estate lending, land acquisition and development lending, builder line lending and commercial business lending.

Consumer loans included \$338,000 and \$354,000 of demand deposit overdrafts at June 30, 2014 and December 31, 2013, respectively.

The outstanding principal balance and the carrying amount of loans acquired pursuant to the Corporation's acquisition of CVBK (or acquired loans) that were recorded at fair value at the acquisition date and are included in the consolidated balance sheet at June 30, 2014 and December 31, 2013 were as follows:

| <i>(Dollars in thousands)</i>      | <b>June 30, 2014</b>  |  |                                       | <b>December 31, 2013</b>  |  |                                       |
|------------------------------------|---|--|---------------------------------------|---|--|---------------------------------------|
|                                    | <b>Acquired<br/>Loans -<br/>Purchased<br/>Credit<br/>Impaired<br/>(PCI)</b> | <b>Acquired<br/>Loans -<br/>Purchased<br/>Performing</b> | <b>Acquired<br/>Loans -<br/>Total</b> | <b>Acquired<br/>Loans -<br/>Purchased<br/>Credit<br/>Impaired</b> | <b>Acquired<br/>Loans -<br/>Purchased<br/>Performing</b> | <b>Acquired<br/>Loans -<br/>Total</b> |
| Outstanding principal balance      | <b>\$42,616</b>   | <b>\$ 98,071</b>   | <b>\$140,687</b>                      | \$49,041  | \$ 110,977   | \$160,018                             |
| Carrying amount                    |   |  |                                       |   |  |                                       |
| Real estate – residential mortgage | <b>\$2,078</b>  | <b>\$ 20,135</b>   | <b>\$22,213</b>                       | \$2,694   | \$ 29,285  | \$31,979                              |

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|   |                 |                  |                  |          |            |           |
|---|-----------------|------------------|------------------|----------|------------|-----------|
| Real estate – construction                          | <b>401</b>      | <b>191</b>       | <b>592</b>       | 771      | 917        | 1,688     |
| Commercial, financial and agricultural <sup>2</sup> | <b>24,619</b>   | <b>54,421</b>    | <b>79,040</b>    | 28,602   | 55,204     | 83,806    |
| Equity lines  | <b>334</b>      | <b>16,403</b>    | <b>16,737</b>    | 332      | 16,909     | 17,241    |
| Consumer  | <b>24</b>       | <b>1,438</b>     | <b>1,462</b>     | 121      | 2,156      | 2,277     |
| Total acquired loans                                | <b>\$27,456</b> | <b>\$ 92,588</b> | <b>\$120,044</b> | \$32,520 | \$ 104,471 | \$136,991 |

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<sup>1</sup> Includes the Corporation's real estate construction lending and consumer real estate lot lending.

<sup>2</sup> Includes the Corporation's commercial real estate lending, land acquisition and development lending, builder line lending and commercial business lending.

Loans on nonaccrual status were as follows:

| <i>(Dollars in thousands)</i>            | <b>June<br/>30,<br/>2014</b> | <b>December<br/>31,<br/>2013</b> |
|--|------------------------------|----------------------------------|
| Real estate – residential mortgage       | <b>\$2,153</b>               | \$ 1,996                         |
| Commercial, financial and agricultural:  |                              |                                  |
| Commercial real estate lending           | <b>1,702</b>                 | 1,486                            |
| Land acquisition and development lending | —                            | —                                |
| Builder line lending                     | —                            | 13                               |
| Commercial business lending              | <b>374</b>                   | 374                              |
| Equity lines                             | <b>209</b>                   | 291                              |
| Consumer                                 | <b>232</b>                   | 231                              |
| Consumer finance                         | <b>646</b>                   | 1,187                            |
| Total loans on nonaccrual status         | <b>\$5,316</b>               | \$ 5,578                         |

The past due status of loans as of June 30, 2014 was as follows:

| <i>(Dollars in thousands)</i>            | <b>30-59<br/>Days</b> | <b>60-89<br/>Days</b> | <b>90+<br/>Days</b> | <b>Total<br/>Past<br/>Due</b> | <b>Current<br/><sup>1</sup></b> | <b>Total<br/>Loans</b> | <b>90+ Days<br/>Past Due<br/>and<br/>Accruing</b> |
|--|-----------------------|-----------------------|---------------------|-------------------------------|---------------------------------|------------------------|---|
| Real estate – residential mortgage       | <b>\$1,038</b>        | <b>\$919</b>          | <b>\$1,482</b>      | <b>\$3,439</b>                | <b>\$177,075</b>                | <b>\$180,514</b>       | <b>\$ 72</b>                                      |
| Real estate – construction:              |                       |                       |                     |                               |                                 |                        |   |
| Construction lending                     | —                     | —                     | —                   | —                             | <b>4,408</b>                    | <b>4,408</b>           | —   |
| Consumer lot lending                     | —                     | —                     | —                   | —                             | <b>3,172</b>                    | <b>3,172</b>           | —   |
| Commercial, financial and agricultural:  |                       |                       |                     |                               |                                 |                        |   |
| Commercial real estate lending           | <b>904</b>            | <b>103</b>            | <b>942</b>          | <b>1,949</b>                  | <b>184,268</b>                  | <b>186,217</b>         | <b>178</b>  |
| Land acquisition and development lending | —                     | —                     | <b>2,936</b>        | <b>2,936</b>                  | <b>30,710</b>                   | <b>33,646</b>          | —   |
| Builder line lending                     | —                     | —                     | —                   | —                             | <b>18,132</b>                   | <b>18,132</b>          | —   |
| Commercial business lending              | <b>364</b>            | <b>11</b>             | <b>342</b>          | <b>717</b>                    | <b>56,833</b>                   | <b>57,550</b>          | —   |
| Equity lines                             | <b>349</b>            | <b>17</b>             | <b>35</b>           | <b>401</b>                    | <b>50,176</b>                   | <b>50,577</b>          | —   |
| Consumer                                 | <b>35</b>             | <b>32</b>             | <b>194</b>          | <b>261</b>                    | <b>7,978</b>                    | <b>8,239</b>           | —   |
| Consumer finance                         | <b>9,670</b>          | <b>2,491</b>          | <b>646</b>          | <b>12,807</b>                 | <b>271,166</b>                  | <b>283,973</b>         | —   |
| Total                                    | <b>\$12,360</b>       | <b>\$3,573</b>        | <b>\$6,577</b>      | <b>\$22,510</b>               | <b>\$803,918</b>                | <b>\$826,428</b>       | <b>\$ 250</b>                                     |

<sup>1</sup> For the purposes of the above table, “Current” includes loans that are 1-29 days past due.

The table above includes the following:

• nonaccrual loans that are current of \$2.56 million, 30-59 days past due of \$90,000, 60-89 days past due of \$92,000 and 90+ days past due of \$2.57 million and

• loans purchased (both performing and PCI) in the acquisition of CVBK that are current of \$114.69 million, 30-59 days past due of \$1.39 million, 60-89 days past due of \$161,000 and 90+ days past due of \$3.80 million.

The past due status of loans as of December 31, 2013 was as follows:

| <i>(Dollars in thousands)</i>            | 30-59    | 60-89   | 90+     | Total<br>Past<br>Due | Current <sup>1</sup> | Total<br>Loans | 90+ Days                 |
|--|----------|---------|---------|----------------------|----------------------|----------------|--------------------------|
|  | Days     | Days    | Days    |                      |                      |                | Past Due and<br>Accruing |
| Real estate – residential mortgage       | \$1,547  | \$952   | \$1,547 | \$4,046              | \$184,409            | \$188,455      | \$ —                     |
| Real estate – construction:              |          |         |         |                      |                      |                |                          |
| Construction lending                     | —        | —       | —       | —                    | 3,728                | 3,728          | —                        |
| Consumer lot lending                     | —        | —       | —       | —                    | 2,082                | 2,082          | —                        |
| Commercial, financial and agricultural:  |          |         |         |                      |                      |                |                          |
| Commercial real estate lending           | 5,567    | 228     | 72      | 5,867                | 162,255              | 168,122        | 72                       |
| Land acquisition and development lending | —        | —       | 272     | 272                  | 25,368               | 25,640         | —                        |
| Builder line lending                     | —        | —       | —       | —                    | 13,426               | 13,426         | —                        |
| Commercial business lending              | 306      | 368     | 2,033   | 2,707                | 78,698               | 81,405         | —                        |
| Equity lines                             | 264      | 45      | 173     | 482                  | 50,313               | 50,795         | —                        |
| Consumer                                 | 54       | 46      | 195     | 295                  | 8,712                | 9,007          | 3                        |
| Consumer finance                         | 14,174   | 2,998   | 1,187   | 18,359               | 259,365              | 277,724        | —                        |
| Total                                    | \$21,912 | \$4,637 | \$5,479 | \$32,028             | \$788,356            | \$820,384      | \$ 75                    |

<sup>1</sup> For the purposes of the table above, “Current” includes loans that are 1-29 days past due.

The table above includes the following:

nonaccrual loans that are current of \$2.15 million, 30-59 days past due of \$7,000, 60-89 days past due of \$306,000 and 90+ days past due of \$3.11 million and loans purchased (both performing and PCI) in the acquisition of CVBK that are current of \$131.82 million, 30-59 days past due of \$1.35 million, 60-89 days past due of \$841,000 and 90+ days past due of \$2.98 million of which \$3,000 are 90+ days past due and accruing.

Loan modifications that were classified as TDRs during the three and six months ended June 30, 2014 and 2013 were as follows:

| <i>(Dollars in thousands)</i> | Three Months Ended June 30,  |                              |
|-------------------------------|------------------------------|------------------------------|
|                               | 2014                         | 2013                         |
|                               | Number of Recorded Loans     | Number of Recorded Loans     |
|                               | Post-Modification Investment | Post-Modification Investment |

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|   |          |               |   |        |
|---|----------|---------------|---|--------|
| Real estate - residential mortgage - interest rate concession | <b>1</b> | <b>\$ 328</b> | 1 | \$ 89  |
| Commercial, financial and agricultural:                       |          |               |   |        |
| Commercial real estate lending - interest rate concession     | —        | —             | 1 | 473    |
| Builder line lending - interest rate concession               | —        | —             | 1 | 17     |
| Total   | <b>1</b> | <b>\$ 328</b> | 3 | \$ 579 |



| <i>(Dollars in thousands)</i>                                 | Six Months Ended June 30,<br>2014 |                              | Six Months Ended June 30,<br>2013 |                              |
|---|-----------------------------------|------------------------------|-----------------------------------|------------------------------|
|   | Number of Recorded Loans          | Post-Modification Investment | Number of Recorded Loans          | Post-Modification Investment |
| Real estate - residential mortgage - interest rate concession | 1                                 | \$ 328                       | 1                                 | \$ 89                        |
| Commercial, financial and agricultural:                       |                                   |                              |                                   |                              |
| Commercial real estate lending - interest rate concession     | —                                 | —                            | 2                                 | 479                          |
| Builder line lending - interest rate concession               | —                                 | —                            | 1                                 | 17                           |
| Total   | 1                                 | \$ 328                       | 4                                 | \$ 585                       |

A TDR payment default occurs when, within 12 months of the original TDR modification, either a full or partial charge-off occurs or a TDR becomes 90 days or more past due. There were no TDR defaults during the three and six months ended June 30, 2014. There was one \$3,000 commercial real estate loan that defaulted during the six months ended June 30, 2013.

Impaired loans, which consisted solely of TDRs, and the related allowance at June 30, 2014 were as follows:

| <i>(Dollars in thousands)</i>           | Recorded Investment in Loans | Unpaid Principal Balance | Related Allowance | Average Balance-Impaired Loans | Interest Income Recognized |
|---|------------------------------|--------------------------|-------------------|--------------------------------|----------------------------|
| Real estate – residential mortgage      | \$ 2,348                     | \$ 2,460                 | \$ 430            | \$ 2,374                       | \$ 57                      |
| Commercial, financial and agricultural: |                              |                          |                   |                                |                            |
| Commercial real estate lending          | 2,711                        | 2,851                    | 416               | 2,776                          | 65                         |
| Builder line lending                    | —                            | —                        | —                 | —                              | —                          |
| Commercial business lending             | 489                          | 489                      | 129               | 492                            | 5                          |
| Equity lines                            | 30                           | 32                       | 1                 | 32                             | —                          |
| Consumer                                | 93                           | 93                       | 14                | 93                             | 2                          |
| Total                                   | \$ 5,671                     | \$ 5,925                 | \$ 990            | \$ 5,767                       | \$ 129                     |

Impaired loans, which included TDR loans of \$5.62 million, and the related allowance at December 31, 2013 were as follows:

| <i>(Dollars in thousands)</i> | Recorded Investment in | Unpaid Principal | Related Allowance | Average Balance-Impaired | Interest Income |
|-------------------------------|------------------------|------------------|-------------------|--------------------------|-----------------|
|-------------------------------|------------------------|------------------|-------------------|--------------------------|-----------------|

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|   | <b>Loans</b>    | <b>Balance</b>  |                 | <b>Loans</b>    | <b>Recognized</b> |
|---|-----------------|-----------------|-----------------|-----------------|-------------------|
| Real estate – residential mortgage      | \$ 2,601        | \$ 2,694        | \$ 390          | \$ 2,090        | \$ 99             |
| Commercial, financial and agricultural: |                 |                 |                 |                 |                   |
| Commercial real estate lending          | 2,729           | 2,780           | 504             | 2,748           | 99                |
| Builder line lending                    | 13              | 16              | 4               | 14              | 1                 |
| Commercial business lending             | 695             | 756             | 131             | 562             | 11                |
| Equity lines                            | 131             | 132             | —               | 33              | —                 |
| Consumer                                | 93              | 93              | 14              | 95              | 9                 |
| <b>Total</b>                            | <b>\$ 6,262</b> | <b>\$ 6,471</b> | <b>\$ 1,043</b> | <b>\$ 5,542</b> | <b>\$ 219</b>     |

PCI loans had an unpaid principal balance of \$42.62 million and a carrying value of \$27.46 million at June 30, 2014. Determining the fair value of purchased credit impaired loans required the Corporation to estimate cash flows expected to result from those loans and to discount those cash flows at appropriate rates of interest. For such loans, the excess of the cash flows expected at acquisition over the estimated fair value is recognized as interest income over the remaining lives of the loans and is called the accretable yield. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition reflects the effect of estimated credit losses and is called the nonaccretable difference. In accordance with GAAP, there was no carry-over of previously established allowance for loan losses from acquired loans.

The PCI loan portfolio related to the CVBK acquisition was accounted for at fair value on the date of acquisition as follows:

|   |                            |
|---|----------------------------|
| <i>(Dollars in thousands)</i>                         | <b>October<br/>1, 2013</b> |
| Contractual principal and interest due                | \$70,390                   |
| Nonaccretable difference                              | (26,621)                   |
| Expected cash flows                                   | 43,769                     |
| Accretable yield                                      | (8,454 )                   |
| Purchase credit impaired loans - estimated fair value | \$35,315                   |

The following table presents a summary of the change in the accretable yield of the PCI loan portfolio for the period from December 31, 2013 to June 30, 2014:

|  |                             |
|--|-----------------------------|
| <i>(Dollars in thousands)</i>  | <b>Accretable<br/>Yield</b> |
| Accretable yield, December 31, 2013  | \$ 7,776                    |
| Accretion  | (1,529 )                    |
| Reclassification of nonaccretable difference due to improvement in expected cash flows | 1,820                       |
| Changes in expected cash flows <sup>1</sup>  | 7,056                       |
| Accretable yield, June 30, 2014  | \$ 15,123                   |

<sup>1</sup> Represents changes in cash flows expected to be collected due to the effects of changes in recovery approach and prepayment assumptions.

**NOTE 5: Allowance for Loan Losses**

The following table presents the changes in the allowance for loan losses by major classification during the six months ended June 30, 2014.

| <i>(Dollars in thousands)</i>              | <b>Real<br/>Estate<br/>Residential<br/>Mortgage</b> | <b>Real<br/>Estate<br/>Construction</b> | <b>Commercial,<br/>Financial<br/>and<br/>Agricultural</b> | <b>Equity<br/>Lines</b> | <b>Consumer</b> | <b>Consumer<br/>Finance</b> | <b>Total</b> |
|--|---|---|---|-------------------------|-----------------|-----------------------------|--------------|
| <b>Allowance for loan losses:</b>          |   |   |   |                         |                 |                             |              |
| Balance at December 31, 2013               | \$ 2,355  | \$ 434                                  | \$ 7,805  | \$ 892                  | \$ 273          | \$ 23,093                   | \$ 34,852    |
| Provision charged to operations            | 30  | —                                       | —   | —                       | —               | 6,745                       | 6,775        |
| Loans charged off                          | (79 )   | —                                       | (174 )  | (47 )                   | (147 )          | (8,098 )                    | (8,545 )     |
| Recoveries of loans previously charged off | 24  | —                                       | 47  | —                       | 170             | 1,935                       | 2,176        |
| Balance at June 30, 2014                   | \$ 2,330  | \$ 434                                  | \$ 7,678  | \$ 845                  | \$ 296          | \$ 23,675                   | \$ 35,258    |

The following table presents the changes in the allowance for loan losses by major classification during the six months ended June 30, 2013.

| <i>(Dollars in thousands)</i>              | Real        | Real         | Commercial,  |        | Consumer | Consumer  | Total     |
|--|-------------|--------------|--------------|--------|----------|-----------|-----------|
|  | Estate      | Estate       | Financial    | Equity |          |           |           |
|  | Residential | Construction | and          | Lines  |          |           |           |
|  | Mortgage    |              | Agricultural |        |          |           |           |
| <b>Allowance for loan losses:</b>          |             |              |              |        |          |           |           |
| Balance at December 31, 2012               | \$ 2,358    | \$ 424       | \$ 9,824     | \$ 885 | \$ 283   | \$ 22,133 | \$ 35,907 |
| Provision charged to operations            | 522         | 50           | 328          | 11     | 149      | 5,240     | 6,300     |
| Loans charged off                          | (475 )      | —            | (2,270 )     | (37 )  | (228 )   | (6,361 )  | (9,371 )  |
| Recoveries of loans previously charged off | 86          | —            | 60           | 27     | 79       | 1,681     | 1,933     |
| Balance at June 30, 2013                   | \$ 2,491    | \$ 474       | \$ 7,942     | \$ 886 | \$ 283   | \$ 22,693 | \$ 34,769 |

The following table presents, as of June 30, 2014, the total allowance for loan losses, the allowance by impairment methodology (individually evaluated for impairment or collectively evaluated for impairment or PCI loans), the total loans, and loans by impairment methodology (individually evaluated for impairment, collectively evaluated for impairment, or PCI loans).

| <i>(Dollars in thousands)</i>                         | Real        | Real         | Commercial,  |           | Consumer | Consumer   | Total      |
|---|-------------|--------------|--------------|-----------|----------|------------|------------|
|   | Estate      | Estate       | Financial    | Equity    |          |            |            |
|   | Residential | Construction | and          | Lines     |          |            |            |
|   | Mortgage    |              | Agricultural |           |          |            |            |
| <b>Allowance for loan losses:</b>                     |             |              |              |           |          |            |            |
| Balance at June 30, 2014                              | \$ 2,330    | \$ 434       | \$ 7,678     | \$ 845    | \$ 296   | \$ 23,675  | \$ 35,258  |
| Ending balance: individually evaluated for impairment | \$ 430      | \$ —         | \$ 545       | \$ 1      | \$ 14    | \$ —       | \$ 990     |
| Ending balance: collectively evaluated for impairment | \$ 1,900    | \$ 434       | \$ 7,133     | \$ 844    | \$ 282   | \$ 23,675  | \$ 34,268  |
| Ending balance: PCI loans                             | \$ —        | \$ —         | \$ —         | \$ —      | \$ —     | \$ —       | \$ —       |
| <b>Loans:</b>   |             |              |              |           |          |            |            |
| Balance at June 30, 2014                              | \$ 180,514  | \$ 7,580     | \$ 295,545   | \$ 50,577 | \$ 8,239 | \$ 283,973 | \$ 826,428 |
| Ending balance: individually evaluated for impairment | \$ 2,348    | \$ —         | \$ 3,200     | \$ 30     | \$ 93    | \$ —       | \$ 5,671   |
| Ending balance: collectively evaluated for impairment | \$ 176,088  | \$ 7,179     | \$ 267,726   | \$ 50,213 | \$ 8,122 | \$ 283,973 | \$ 793,301 |

|                           |                 |               |                  |               |              |            |                  |
|---------------------------|-----------------|---------------|------------------|---------------|--------------|------------|------------------|
| Ending balance: PCI loans | <b>\$ 2,078</b> | <b>\$ 401</b> | <b>\$ 24,619</b> | <b>\$ 334</b> | <b>\$ 24</b> | <b>\$—</b> | <b>\$ 27,456</b> |
|---------------------------|-----------------|---------------|------------------|---------------|--------------|------------|------------------|

The following table presents, as of December 31, 2013, the total allowance for loan losses, the allowance by impairment methodology (individually evaluated for impairment, collectively evaluated for impairment or PCI loans), the total loans and loans by impairment methodology (individually evaluated for impairment, collectively evaluated for impairment or PCI loans).

| <i>(Dollars in thousands)</i>                            | <b>Real<br/>Estate<br/>Residential<br/>Mortgage</b> | <b>Real<br/>Estate<br/>Construction</b> | <b>Commercial,<br/>Financial<br/>and<br/>Agricultural</b> | <b>Equity<br/>Lines</b> | <b>Consumer</b> | <b>Consumer<br/>Finance</b> | <b>Total</b> |
|--|---|---|---|-------------------------|-----------------|-----------------------------|--------------|
| <b>Allowance for loan losses:</b>                        |   |   |   |                         |                 |                             |              |
| Ending balance   | \$ 2,355  | \$ 434                                  | \$ 7,805  | \$ 892                  | \$ 273          | \$ 23,093                   | \$ 34,852    |
| Ending balance: individually<br>evaluated for impairment | \$ 390  | \$ —                                    | \$ 639  | \$ —                    | \$ 14           | \$ —                        | \$ 1,043     |
| Ending balance: collectively<br>evaluated for impairment | \$ 1,965  | \$ 434                                  | \$ 7,166  | \$ 892                  | \$ 259          | \$ 23,093                   | \$ 33,809    |
| Ending balance: PCI loans                                | \$ —  | \$ —                                    | \$ —  | \$ —                    | \$ —            | \$ —                        | \$ —         |
| <b>Loans:</b>  |   |   |   |                         |                 |                             |              |
| Ending balance   | \$ 188,455  | \$ 5,810                                | \$ 288,593  | \$ 50,795               | \$ 9,007        | \$ 277,724                  | \$ 820,384   |
| Ending balance: individually<br>evaluated for impairment | \$ 2,601  | \$ —                                    | \$ 3,437  | \$ 131                  | \$ 93           | \$ —                        | \$ 6,262     |
| Ending balance: collectively<br>evaluated for impairment | \$ 183,160  | \$ 5,039                                | \$ 256,554  | \$ 50,332               | \$ 8,793        | \$ 277,724                  | \$ 781,602   |
| Ending balance: PCI loans                                | \$ 2,694  | \$ 771                                  | \$ 28,602   | \$ 332                  | \$ 121          | \$ —                        | \$ 32,520    |

Loans by credit quality indicators as of June 30, 2014 were as follows:

| <i>(Dollars in thousands)</i>            | <b>Pass</b>      | <b>Special<br/>Mention</b> | <b>Substandard</b> | <b>Substandard<br/>Nonaccrual</b> | <b>Total<sup>1</sup></b> |
|--|------------------|----------------------------|--------------------|-----------------------------------|--------------------------|
| Real estate – residential mortgage       | <b>\$172,699</b> | <b>\$1,975</b>             | <b>\$3,687</b>     | <b>\$2,153</b>                    | <b>\$180,514</b>         |
| Real estate – construction:              |                  |                            |                    |                                   |                          |
| Construction lending                     | <b>1,759</b>     | <b>—</b>                   | <b>2,649</b>       | <b>—</b>                          | <b>4,408</b>             |
| Consumer lot lending                     | <b>3,085</b>     | <b>87</b>                  | <b>—</b>           | <b>—</b>                          | <b>3,172</b>             |
| Commercial, financial and agricultural:  |                  |                            |                    |                                   |                          |
| Commercial real estate lending           | <b>166,679</b>   | <b>4,403</b>               | <b>13,434</b>      | <b>1,702</b>                      | <b>186,218</b>           |
| Land acquisition and development lending | <b>28,608</b>    | <b>1,341</b>               | <b>3,697</b>       | <b>—</b>                          | <b>33,646</b>            |
| Builder line lending                     | <b>16,390</b>    | <b>1,174</b>               | <b>568</b>         | <b>—</b>                          | <b>18,132</b>            |
| Commercial business lending              | <b>43,174</b>    | <b>1,231</b>               | <b>12,771</b>      | <b>374</b>                        | <b>57,550</b>            |
| Equity lines                             | <b>48,644</b>    | <b>775</b>                 | <b>949</b>         | <b>209</b>                        | <b>50,577</b>            |

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|          |                  |                 |                 |                |                  |
|----------|------------------|-----------------|-----------------|----------------|------------------|
| Consumer | <b>7,889</b>     | <b>2</b>        | <b>116</b>      | <b>232</b>     | <b>8,239</b>     |
|          | <b>\$488,927</b> | <b>\$10,988</b> | <b>\$37,871</b> | <b>\$4,670</b> | <b>\$542,456</b> |

<sup>1</sup> At June 30, 2014, the Corporation did not have any loans classified as Doubtful or Loss.

Included in the table above are loans purchased in connection with the acquisition of CVBK of \$102.44 million pass rated, \$2.82 million special mention, \$14.14 million substandard and \$641,000 substandard nonaccrual.

| <i>(Dollars in thousands)</i> | <b>Performing</b> | <b>Non-Performing</b> | <b>Total</b>     |
|-------------------------------|-------------------|-----------------------|------------------|
| Consumer finance              | <b>\$283,327</b>  | <b>\$646</b>          | <b>\$283,973</b> |



Loans by credit quality indicators as of December 31, 2013 were as follows:

| <i>(Dollars in thousands)</i>            | <b>Pass</b> | <b>Special<br/>Mention</b> | <b>Substandard</b> | <b>Substandard<br/>Nonaccrual</b> | <b>Total<sup>1</sup></b> |
|--|-------------|----------------------------|--------------------|-----------------------------------|--------------------------|
| Real estate – residential mortgage       | \$ 180,670  | \$ 2,209                   | \$ 3,580           | \$ 1,996                          | \$ 188,455               |
| Real estate – construction:              |             |                            |                    |                                   |                          |
| Construction lending                     | 1,068       | 11                         | 2,649              | —                                 | 3,728                    |
| Consumer lot lending                     | 1,831       | 105                        | 146                | —                                 | 2,082                    |
| Commercial, financial and agricultural:  |             |                            |                    |                                   |                          |
| Commercial real estate lending           | 152,017     | 2,934                      | 11,685             | 1,486                             | 168,122                  |
| Land acquisition and development lending | 18,236      | 1,601                      | 5,803              | —                                 | 25,640                   |
| Builder line lending                     | 11,608      | 1,278                      | 527                | 13                                | 13,426                   |
| Commercial business lending              | 61,715      | 2,758                      | 16,558             | 374                               | 81,405                   |
| Equity lines                             | 48,603      | 1,003                      | 898                | 291                               | 50,795                   |
| Consumer                                 | 8,616       | 2                          | 158                | 231                               | 9,007                    |
|  | \$ 484,364  | \$ 11,901                  | \$ 42,004          | \$ 4,391                          | \$ 542,660               |

<sup>1</sup> At December 31, 2013, the Corporation did not have any loans classified as Doubtful or Loss.

Included in the table above are loans purchased in connection with the acquisition of CVBK of \$115.27 million pass rated, \$3.30 million special mention, \$17.77 million substandard and \$652,000 substandard nonaccrual.

| <i>(Dollars in thousands)</i> | <b>Performing</b> | <b>Non-Performing</b> | <b>Total</b> |
|-------------------------------|-------------------|-----------------------|--------------|
| Consumer finance              | \$ 276,537        | \$ 1,187              | \$ 277,724   |

#### **NOTE 6: Shareholders' Equity and Earnings Per Common Share**

##### **Accumulated Other Comprehensive Income (Loss)**

The following table presents the cumulative balances of the components of accumulated other comprehensive income (loss), net of deferred tax of \$1.66 million and \$163,000 as of June 30, 2014 and December 31, 2013, respectively.

| <i>(Dollars in thousands)</i>                       | <b>June<br/>30,<br/>2014</b> | <b>December<br/>31, 2013</b> |
|---|------------------------------|------------------------------|
| Net unrealized gains on securities                  | <b>\$3,591</b>               | \$ 261                       |
| Net unrecognized loss on cash flow hedges           | <b>(150 )</b>                | (202 )                       |
| Net unrecognized losses on defined benefit plan     | <b>(313 )</b>                | (325 )                       |
| Total accumulated other comprehensive income (loss) | <b>\$3,128</b>               | \$ (266 )                    |

### **Common Shares**

During the first six months of 2014, the Corporation repurchased 225 shares of its common stock from employees to satisfy tax withholding obligations arising upon the vesting of restricted shares. There were no stock repurchases during the first six months of 2013.

**Earnings Per Common Share**

The components of the Corporation's earnings per common share calculations are as follows:

| <i>(Dollars in thousands)</i>  | <b>Three Months Ended</b> |             |
|--|---------------------------|-------------|
|  | <b>June 30,</b>           |             |
|  | <b>2014</b>               | <b>2013</b> |
| Net income   | <b>\$3,742</b>            | \$4,178     |
| Weighted average number of common shares used in earnings per common share – basic             | <b>3,405,245</b>          | 3,276,039   |
| Effect of dilutive securities:   |                           |             |
| Stock option awards and Warrant  | <b>37,223</b>             | 137,013     |
| Weighted average number of common shares used in earnings per common share – assuming dilution | <b>3,442,468</b>          | 3,413,052   |

| <i>(Dollars in thousands)</i>  | <b>Six Months Ended</b> |             |
|--|-------------------------|-------------|
|  | <b>June 30,</b>         |             |
|  | <b>2014</b>             | <b>2013</b> |
| Net income available to common shareholders  | <b>\$6,635</b>          | \$8,184     |
| Weighted average number of common shares used in earnings per common share – basic             | <b>3,403,042</b>        | 3,271,376   |
| Effect of dilutive securities:   |                         |             |
| Stock option awards and Warrant  | <b>64,012</b>           | 120,789     |
| Weighted average number of common shares used in earnings per common share – assuming dilution | <b>3,467,054</b>        | 3,392,165   |

Potential common shares that may be issued by the Corporation for its stock option awards and Warrant are determined using the treasury stock method. Approximately 156,110 and 500 shares issuable upon exercise of options were not included in computing diluted earnings per common share for the three months ended June 30, 2014 and 2013, respectively, and approximately 136,130 and 35,100 shares issuable upon exercise of options were not included in computing earnings per common share for the six months ended June 30, 2014 and 2013, respectively, because they were anti-dilutive.

**NOTE 7: Employee Benefit Plan**

The Bank has a non-contributory defined benefit pension plan for which the components of net periodic benefit cost are as follows:

| <i>(Dollars in thousands)</i>      | <b>Three<br/>Months<br/>Ended</b> |       | <b>Six Months<br/>Ended</b> |       |
|------------------------------------|-----------------------------------|-------|-----------------------------|-------|
|                                    | <b>June 30,</b>                   |       | <b>June 30,</b>             |       |
|                                    | <b>2014</b>                       | 2013  | <b>2014</b>                 | 2013  |
| Service cost                       | <b>\$191</b>                      | \$194 | <b>\$382</b>                | \$388 |
| Interest cost                      | <b>113</b>                        | 107   | <b>226</b>                  | 213   |
| Expected return on plan assets     | <b>(208)</b>                      | (187) | <b>(416)</b>                | (374) |
| Amortization of prior service cost | <b>(17 )</b>                      | (17 ) | <b>(34 )</b>                | (34 ) |
| Amortization of net loss           | <b>8</b>                          | 31    | <b>16</b>                   | 61    |
| Net periodic benefit cost          | <b>\$87</b>                       | \$128 | <b>\$174</b>                | \$254 |

**NOTE 8: Fair Value of Assets and Liabilities**

Fair value is defined as 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. U.S. GAAP requires that valuation techniques maximize the use of observable inputs and minimize the use of unobservable inputs. U.S. GAAP also establishes a fair value hierarchy which prioritizes the valuation inputs into three broad levels. Based on the underlying inputs, each fair value measurement in its entirety is reported in one of the three levels. These levels are:

Level 1—Valuation is based upon quoted prices for identical instruments traded in active markets. Level 1 assets and liabilities include debt and equity securities traded in an active exchange market, as well as U.S. Treasury securities.

Level 2—Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3—Valuation is determined using model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect the Corporation's estimates of assumptions that market participants would use in pricing the respective asset or liability. Valuation techniques may include the use of pricing models, discounted cash flow models and similar techniques.

U.S. GAAP allows an entity the irrevocable option to elect fair value (the fair value option) for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. During the second quarter of 2013, the Corporation elected to begin using fair value accounting for its entire portfolio of loans held for sale (LHFS).

***Assets and Liabilities Measured at Fair Value on a Recurring Basis***

The following describes the valuation techniques and inputs used by the Corporation in determining the fair value of certain assets recorded at fair value on a recurring basis in the financial statements.

**Securities available for sale.** The Corporation primarily values its investment portfolio using Level 2 fair value measurements, but may also use Level 1 or Level 3 measurements if required by the composition of the portfolio. At June 30, 2014 and December 31, 2013, the Corporation's entire investment securities portfolio was valued using Level 2 fair value measurements. The Corporation has contracted with third party portfolio accounting service vendors for valuation of its securities portfolio. The vendors' sources for security valuation are Standard & Poor's Securities Evaluations Inc. (SPSE), Thomson Reuters Pricing Service (TRPS) and Interactive Data Pricing and Reference Data LLC (IDC). Each source provides opinions, known as evaluated prices, as to the value of individual securities based on model-based pricing techniques that are partially based on available market data, including prices for similar instruments in active markets and prices for identical assets in markets that are not active. SPSE and IDC provide evaluated prices for the Corporation's obligations of states and political subdivisions category of securities. Both sources use proprietary pricing models and pricing systems, mathematical tools and judgment to determine an evaluated price for a security based upon a hierarchy of market information regarding that security or securities with similar characteristics. TRPS and IDC provide evaluated prices for the Corporation's U.S. government agencies and corporations and mortgage-backed categories of securities. Fixed-rate callable securities of the U.S. government agencies and corporations category are individually evaluated on an option adjusted spread basis for callable issues or on a nominal spread basis incorporating the term structure of agency market spreads and the appropriate risk free benchmark curve for non-callable issues. Fixed-rate securities issued by the Small Business Association in the U.S. government agencies and corporations category are individually evaluated based upon a hierarchy of security specific information and market data regarding that security or securities with similar characteristics. Pass-through mortgage-backed securities in the mortgage-backed category are grouped into aggregate categories defined by issuer program, weighted average coupon, and weighted average maturity. Each aggregate is benchmarked to a relative mortgage-backed to-be-announced (TBA) or other benchmark price. TBA prices are obtained from market makers and live trading systems. Collateralized mortgage obligations in the mortgage-backed category are individually evaluated based upon a hierarchy of security specific information and market data regarding that security or securities with similar characteristics. Each evaluation is determined using an option adjusted spread and prepayment model based on volatility-driven, multi-dimensional spread tables.

**Loans held for sale.** Fair value of the Corporation's loans held for sale (LHFS) is based on observable market prices for similar instruments traded in the secondary mortgage loan markets in which the Corporation conducts business. The Corporation's portfolio of LHFS is classified as Level 2.

**IRLCs.** The Corporation recognizes IRLCs at fair value. Fair value of IRLCs is based on either (i) the price of the underlying loans obtained from an investor for loans that will be delivered on a best efforts basis or (ii) the observable price for individual loans traded in the secondary market for loans that will be delivered on a mandatory basis. All of the Corporation's IRLCs are classified as Level 2.

**Forward sales commitments.** Forward commitments to sell mortgage loans and TBAs are used to mitigate interest rate risk for residential mortgage loans held for sale and IRLCs. Forward commitments to sell mortgage loans and TBAs are considered derivatives and are recorded at fair value, based on (i) committed sales prices from investors for commitments to sell mortgage loans or (ii) observable market data inputs for commitments to sell TBAs. The Corporation's forward sales commitments are classified as Level 2.

**Derivative liability - cash flow hedges.** The Corporation's derivative financial instruments have been designated as and qualify as cash flow hedges. The fair value of the Corporation's cash flow hedges is determined using the discounted cash flow method. All of the Corporation's cash flow hedges are classified as Level 2.

The following table presents the balances of financial assets measured at fair value on a recurring basis.

| <i>(Dollars in thousands)</i>                            | <b>June 30, 2014</b>                 |                |                | <b>Assets at Fair Value</b> |
|--|--------------------------------------|----------------|----------------|-----------------------------|
|  | <b>Fair Value Measurements Using</b> |                |                |                             |
|  | <b>Level 1</b>                       | <b>Level 2</b> | <b>Level 3</b> |                             |
| <b>Assets:</b>   |                                      |                |                |                             |
| Securities available for sale                            |                                      |                |                |                             |
| U.S. government agencies and corporations                | \$—                                  | \$28,902       | \$ —           | \$28,902                    |
| Mortgage-backed securities                               | —                                    | 57,752         | —              | 57,752                      |
| Obligations of states and political subdivisions         | —                                    | 130,654        | —              | 130,654                     |
| Total securities available for sale                      | —                                    | 217,308        | —              | 217,308                     |
| Loans held for sale                                      | —                                    | 33,603         | —              | 33,603                      |
| Interest rate lock commitments included in other assets  | —                                    | 950            | —              | 950                         |
| Total assets measured at fair value on a recurring basis | \$—                                  | \$251,861      | \$ —           | \$251,861                   |
| <b>Liabilities:</b>                                      |                                      |                |                |                             |
| Derivative liability - cash flow hedges                  | \$—                                  | \$245          | \$ —           | \$245                       |





| <i>(Dollars in thousands)</i>                           | <b>December 31, 2013</b>                     |                |                    | <b>Assets at Fair<br/>Value</b> |
|---|--|----------------|--------------------|---------------------------------|
|   | <b>Fair Value<br/>Measurements<br/>Using</b> |                |                    |                                 |
|   | <b>Level<br/>1</b>                           | <b>Level 2</b> | <b>Level<br/>3</b> |                                 |
| <b>Assets:</b>  |  |                |                    |                                 |
| Securities available for sale                           |  |                |                    |                                 |
| U.S. Treasury securities                                | \$—  | \$10,000       | \$ —               | \$10,000                        |
| U.S. government agencies and corporations               |  | 29,950         |                    | 29,950                          |
| Mortgage-backed securities                              |  | — 50,863       | —                  | 50,863                          |
| Obligations of states and political subdivisions        |  | — 127,139      | —                  | 127,139                         |
| Preferred stock   |  | — 158          | —                  | 158                             |
| Total securities available for sale                     |  | — 218,110      | —                  | 218,110                         |
| Loans held for sale                                     |  | — 35,879       | —                  | 35,879                          |
| Interest rate lock commitments included in other assets |  | — 511          | —                  | 511                             |
| Forward sales commitments included in other assets      |  | — 22           | —                  | 22                              |
| Total assets  | \$—  | \$254,522      | \$ —               | \$254,522                       |
| <b>Liabilities:</b>                                     |  |                |                    |                                 |
| Derivative liability - cash flow hedges                 | \$—  | \$331          | \$ —               | \$331                           |

***Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis***

The Corporation may be required, from time to time, to measure and recognize certain other financial assets at fair value on a nonrecurring basis in accordance with GAAP. The following describes the valuation techniques and inputs used by the Corporation in determining the fair value of certain assets recorded at fair value on a nonrecurring basis in the financial statements.

**Impaired loans.** The Corporation does not record loans held for investment at fair value on a recurring basis. However, there are instances when a loan is considered impaired and an allowance for loan losses is established. A loan is considered impaired when it is probable that the Corporation will be unable to collect all interest and principal payments as scheduled in the loan agreement. All TDRs are considered impaired loans. The Corporation measures impairment on a loan-by-loan basis for commercial, construction and residential loans in excess of \$500,000 by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Additionally, management reviews current market conditions, borrower history, past experience with similar loans and economic conditions. Based on management's review, additional write-downs to fair value may be incurred. The Corporation maintains a valuation allowance to the extent that the measure of the impaired loan is less than the recorded investment. When the fair value of an impaired loan is based solely on observable cash flows, market price or a current appraisal, the Corporation

records the impaired loan as nonrecurring Level 2. However, if based on management's review, additional write-downs to fair value are required, the Corporation records the impaired loan as nonrecurring Level 3.

The measurement of impaired loans of less than \$500,000 is based on each loan's future cash flows discounted at the loan's effective interest rate rather than the market rate of interest, which is not a fair value measurement and is therefore excluded from fair value disclosure requirements.

**Other real estate owned (OREO).** Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less costs to sell at the date of foreclosure. Initial fair value is based upon appraisals the Corporation obtains from independent licensed appraisers. Subsequent to foreclosure, management periodically performs valuations of the foreclosed assets based on updated appraisals, general market conditions, recent sales of like properties, length of time the properties have been held, and our ability and intention with regard to continued ownership of the properties. The Corporation may incur additional write-downs of foreclosed assets to fair value less costs to sell if valuations indicate a further other-than-temporary deterioration in market conditions. As such, we record OREO as nonrecurring Level 3.

The following table presents the balances of financial assets measured at fair value on a non-recurring basis.

| <i>(Dollars in thousands)</i> | <b>June 30, 2014</b>                 |                |                | <b>Assets at Fair Value</b> |
|-------------------------------|--------------------------------------|----------------|----------------|-----------------------------|
|                               | <b>Fair Value Measurements Using</b> |                |                |                             |
|                               | <b>Level 1</b>                       | <b>Level 2</b> | <b>Level 3</b> |                             |
| Impaired loans, net           | \$—                                  | \$—            | \$2,583        | \$2,583                     |
| Other real estate owned, net  | —                                    | —              | 817            | 817                         |
| Total                         | \$—                                  | \$—            | \$3,400        | \$3,400                     |

| <i>(Dollars in thousands)</i> | <b>December 31, 2013</b>             |                |                | <b>Assets at Fair Value</b> |
|-------------------------------|--------------------------------------|----------------|----------------|-----------------------------|
|                               | <b>Fair Value Measurements Using</b> |                |                |                             |
|                               | <b>Level 1</b>                       | <b>Level 2</b> | <b>Level 3</b> |                             |
| Impaired loans, net           | \$—                                  | \$—            | \$3,646        | \$3,646                     |
| Other real estate owned, net  | —                                    | —              | 2,769          | 2,769                       |
| Total                         | \$—                                  | \$—            | \$6,415        | \$6,415                     |

The following table presents quantitative information about Level 3 fair value measurements for financial assets measured at fair value on a non-recurring basis as of June 30, 2014:

| <i>(Dollars in thousands)</i> | <b>Fair Value Measurements at June 30, 2014</b> |                               |  |                        |
|-------------------------------|---|-------------------------------|--|------------------------|
|                               | <b>Fair Value</b>                               | <b>Valuation Technique(s)</b> | <b>Unobservable Inputs</b>   | <b>Range of Inputs</b> |
| Impaired loans, net           | \$ 2,583  | Appraisals                    | Discount for current market conditions and estimated selling costs | 0%-50%                 |
| Other real estate owned, net  | \$ 817  | Appraisals                    | Discount for current market conditions and estimated selling costs | 0%-25%                 |
| Total                         | \$ 3,400  |                               |  |                        |

***Fair Value of Financial Instruments***

FASB ASC 825, *Financial Instruments*, requires disclosure about fair value of financial instruments, including those financial assets and financial liabilities that are not required to be measured and reported at fair value on a recurring or nonrecurring basis. ASC 825 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Corporation.

The following describes the valuation techniques used by the Corporation to measure its financial instruments at fair value as of June 30, 2014 and December 31, 2013.

**Cash and short-term investments.** The nature of these instruments and their relatively short maturities provide for the reporting of fair value equal to the historical cost.

**Loans, net.** The fair value of performing loans is estimated using a discounted expected future cash flows analysis based on current rates being offered on similar products in the market. An overall valuation adjustment is made for specific credit risks as well as general portfolio risks. Based on the valuation methodologies used in assessing the fair value of loans and the associated valuation allowance, these loans are considered Level 3.

Loan totals, as listed in the table below, include impaired loans. For valuation techniques used in relation to impaired loans, see the Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis section in this Note 8.

**Accrued interest receivable.** The carrying amount of accrued interest receivable approximates fair value.

**Bank-owned life insurance (BOLI).** The fair value of BOLI is estimated using information provided by insurance carriers. These policies are carried at their cash surrender value, which approximates the fair value.

**Deposits.** The fair value of all demand deposit accounts is the amount payable at the report date. For all other deposits, the fair value is determined using the discounted cash flow method. The discount rate was equal to the rate currently offered on similar products in active markets (Level 2).

**Borrowings.** The fair value of borrowings is determined using the discounted cash flow method. The discount rate was equal to the rate currently offered on similar products in active markets (Level 2).

**Accrued interest payable.** The carrying amount of accrued interest payable approximates fair value.

**Letters of credit.** The estimated fair value of letters of credit is based on estimated fees the Corporation would pay to have another entity assume its obligation under the outstanding arrangements. These fees are not considered material.

**Unused portions of lines of credit.** The estimated fair value of unused portions of lines of credit is based on estimated fees the Corporation would pay to have another entity assume its obligation under the outstanding arrangements. These fees are not considered material.

The following tables reflect the carrying amounts and estimated fair values of the Corporation's financial instruments whether or not recognized on the balance sheet at fair value.

| <i>(Dollars in thousands)</i> | Carrying Value | Fair Value Measurements at June 30, 2014 Using |         |         | Total Fair Value |
|-------------------------------|----------------|--|---------|---------|------------------|
|                               |                | Level 1  | Level 2 | Level 3 |                  |
| Financial assets:             |                |  |         |         |                  |
| Cash and cash equivalents     | \$182,354      | \$182,354                                      | \$—     | \$—     | \$182,354        |
| Securities available for sale | 217,308        | —  | 217,308 | —       | 217,308          |
| Restricted stocks             | 3,690          | 3,690  | —       | —       | 3,690            |
| Loans, net                    | 791,170        | —  | —       | 806,770 | 806,770          |
| Loans held for sale           | 33,603         | —  | 33,603  | —       | 33,603           |
| Accrued interest receivable   | 6,255          | 6,255  | —       | —       | 6,255            |
| BOLI                          | 14,176         | —  | 14,176  | —       | 14,176           |
| Derivative asset              | 950            | —  | 950     | —       | 950              |
| Financial liabilities:        |                |  |         |         |                  |
| Demand deposits               | \$659,964      | \$659,964                                      | \$—     | \$—     | \$659,964        |
| Time deposits                 | 379,788        | —  | 382,934 | —       | 382,934          |

|                          |                |            |                |   |                |
|--------------------------|----------------|------------|----------------|---|----------------|
| Borrowings               | <b>169,608</b> | —          | <b>162,368</b> | — | <b>162,368</b> |
| Derivative liability     | <b>245</b>     | —          | <b>245</b>     | — | <b>245</b>     |
| Accrued interest payable | <b>807</b>     | <b>807</b> | —              | — | <b>807</b>     |

**Fair Value Measurements at December  
31, 2013 Using**

| <i>(Dollars in thousands)</i> | <b>Carrying<br/>Value</b> | <b>Level 1</b> | <b>Level 2</b> | <b>Level 3</b> | <b>Total<br/>Fair<br/>Value</b> |
|-------------------------------|---------------------------|----------------|----------------|----------------|---------------------------------|
| <b>Financial assets:</b>      |                           |                |                |                |                                 |
| Cash and cash equivalents     | \$148,139                 | \$148,139      | \$—            | \$—            | \$148,139                       |
| Securities available for sale | 218,110                   | —              | 218,110        | —              | 218,110                         |
| Restricted stocks             | 4,336                     | 4,336          | —              | —              | 4,336                           |
| Loans, net                    | 785,532                   | —              | —              | 800,488        | 800,488                         |
| Loans held for sale           | 35,879                    | —              | 35,879         | —              | 35,879                          |
| Accrued interest receivable   | 6,360                     | 6,360          | —              | —              | 6,360                           |
| BOLI                          | 13,988                    | —              | 13,988         | —              | 13,988                          |
| Derivative asset              | 533                       | —              | 533            | —              | 533                             |
| <b>Financial liabilities:</b> |                           |                |                |                |                                 |
| Demand deposits               | \$608,409                 | \$608,409      | \$—            | \$—            | \$608,409                       |
| Time deposits                 | 399,883                   | —              | 403,291        | —              | 403,291                         |
| Borrowings                    | 169,835                   | —              | 162,194        | —              | 162,194                         |
| Derivative liability          | 331                       | —              | 331            | —              | 331                             |
| Accrued interest payable      | 843                       | 843            | —              | —              | 843                             |

The Corporation assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the Corporation's financial instruments will change when interest rate levels change and that change may be either favorable or unfavorable to the Corporation. Management attempts to match maturities of assets and liabilities to the extent believed necessary to balance minimizing interest rate risk and increasing net interest income in current market conditions. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors interest rates, maturities and repricing dates of assets and liabilities and attempts to manage interest rate risk by adjusting terms of new loans, deposits and borrowings and by investing in securities with terms that mitigate the Corporation's overall interest rate risk.

**NOTE 9: Business Segments**

The Corporation operates in a decentralized fashion in three principal business segments: Retail Banking, Mortgage Banking and Consumer Finance. Revenues from Retail Banking operations consist primarily of interest earned on loans and investment securities and service charges on deposit accounts. Mortgage Banking operating revenues consist principally of gains on sales of loans in the secondary market, loan origination fee income and interest earned on mortgage loans held for sale. Revenues from Consumer Finance consist primarily of interest earned on automobile retail installment sales contracts.





The Corporation's "Other" segment includes an investment company that derives revenues from brokerage services, an insurance company that derives revenues from insurance services, and a title company that derives revenues from title insurance services. The results of the other segment are not significant to the Corporation as a whole and have been included in "Other." Certain expenses of the Corporation are also included in "Other," and consist primarily of interest expense associated with the Corporation's trust preferred capital notes and other general corporate expenses.

| <i>(Dollars in thousands)</i>             | <b>Three Months Ended June 30, 2014</b> |                 |                 |              |                     |                     |
|---|---|-----------------|-----------------|--------------|---------------------|---------------------|
|   | <b>Retail</b>                           | <b>Mortgage</b> | <b>Consumer</b> | <b>Other</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|   | <b>Banking</b>                          | <b>Banking</b>  | <b>Finance</b>  |              |                     |                     |
| <b>Revenues:</b>                          |   |                 |                 |              |                     |                     |
| Interest income                           | \$10,919                                | \$ 333          | \$ 11,684       | \$—          | \$ (1,224 )         | \$ 21,712           |
| Gains on sales of loans                   | —                                       | 1,647           | —               | —            | —                   | 1,647               |
| Other noninterest income                  | 2,283                                   | 733             | 261             | 342          | —                   | 3,619               |
| Total operating income                    | 13,202                                  | 2,713           | 11,945          | 342          | (1,224 )            | 26,978              |
| <b>Expenses:</b>                          |   |                 |                 |              |                     |                     |
| Interest expense                          | 1,495                                   | 50              | 1,585           | 235          | (1,224 )            | 2,141               |
| Provision for loan losses                 | —                                       | 15              | 3,250           | —            | —                   | 3,265               |
| Salaries and employee benefits            | 5,589                                   | 1,138           | 2,107           | 231          | —                   | 9,065               |
| Other noninterest expenses                | 4,621                                   | 1,136           | 1,218           | 216          | —                   | 7,191               |
| Total operating expenses                  | 11,705                                  | 2,339           | 8,160           | 682          | (1,224 )            | 21,662              |
| Income (loss) before income taxes         | 1,497                                   | 374             | 3,785           | (340 )       | —                   | 5,316               |
| Provision for (benefit from) income taxes | 76                                      | 150             | 1,476           | (128 )       | —                   | 1,574               |
| Net income (loss)                         | \$1,421                                 | \$ 224          | \$ 2,309        | \$ (212 )    | \$ —                | \$ 3,742            |
| Total assets                              | \$1,184,486                             | \$ 48,755       | \$ 284,905      | \$3,606      | \$ (174,261 )       | \$ 1,347,491        |
| Goodwill                                  | \$5,907                                 | \$ —            | \$ 10,723       | \$ —         | \$ —                | \$ 16,630           |
| Capital expenditures                      | \$680                                   | \$ 7            | \$ 79           | \$ —         | \$ —                | \$ 766              |

| <i>(Dollars in thousands)</i>  | <b>Three Months Ended June 30, 2013</b> |                 |                 |              |                     |                     |
|--------------------------------|---|-----------------|-----------------|--------------|---------------------|---------------------|
|                                | <b>Retail</b>                           | <b>Mortgage</b> | <b>Consumer</b> | <b>Other</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|                                | <b>Banking</b>                          | <b>Banking</b>  | <b>Finance</b>  |              |                     |                     |
| <b>Revenues:</b>               |   |                 |                 |              |                     |                     |
| Interest income                | \$7,783                                 | \$ 416          | \$ 12,320       | \$1          | \$ (1,290 )         | \$ 19,230           |
| Gains on sales of loans        | —                                       | 3,577           | —               | —            | —                   | 3,577               |
| Other noninterest income       | 1,689                                   | 1,086           | 276             | 335          | —                   | 3,386               |
| Total operating income         | 9,472                                   | 5,079           | 12,596          | 336          | (1,290 )            | 26,193              |
| <b>Expenses:</b>               |   |                 |                 |              |                     |                     |
| Interest expense               | 1,473                                   | 81              | 1,628           | 190          | (1,290 )            | 2,082               |
| Provision for loan losses      | 600                                     | 30              | 2,490           | —            | —                   | 3,120               |
| Salaries and employee benefits | 4,067                                   | 2,009           | 1,944           | 209          | —                   | 8,229               |
| Other noninterest expenses     | 3,228                                   | 1,315           | 1,060           | 716          | —                   | 6,319               |

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|   |           |           |            |          |               |            |
|---|-----------|-----------|------------|----------|---------------|------------|
| Total operating expenses                  | 9,368     | 3,435     | 7,122      | 1,115    | (1,290 )      | 19,750     |
| Income (loss) before income taxes         | 104       | 1,644     | 5,474      | (779 )   | —             | 6,443      |
| Provision for (benefit from) income taxes | (395 )    | 658       | 2,135      | (133 )   | —             | 2,265      |
| Net income (loss)                         | \$499     | \$ 986    | \$ 3,339   | \$(646 ) | \$ —          | \$ 4,178   |
| Total assets                              | \$843,917 | \$ 75,448 | \$ 286,514 | \$4,054  | \$ (217,252 ) | \$ 992,681 |
| Goodwill                                  | \$—       | \$ —      | \$ 10,723  | \$—      | \$ —          | \$ 10,723  |
| Capital expenditures                      | \$527     | \$ 30     | \$ 22      | \$—      | \$ —          | \$ 579     |

| <i>(Dollars in thousands)</i>             | <b>Six Months Ended June 30, 2014</b> |                 |                 |              |                     |                     |
|---|---------------------------------------|-----------------|-----------------|--------------|---------------------|---------------------|
|   | <b>Retail</b>                         | <b>Mortgage</b> | <b>Consumer</b> | <b>Other</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|   | <b>Banking</b>                        | <b>Banking</b>  | <b>Finance</b>  |              |                     |                     |
| <b>Revenues:</b>                          |                                       |                 |                 |              |                     |                     |
| Interest income                           | \$21,687                              | \$ 631          | \$ 23,122       | \$—          | \$ (2,434 )         | \$ 43,006           |
| Gains on sales of loans                   | —                                     | 2,837           | —               | —            | —                   | 2,837               |
| Other noninterest income                  | 4,508                                 | 1,488           | 562             | 683          | —                   | 7,241               |
| Total operating income                    | 26,195                                | 4,956           | 23,684          | 683          | (2,434 )            | 53,084              |
| <b>Expenses:</b>                          |                                       |                 |                 |              |                     |                     |
| Interest expense                          | 3,070                                 | 94              | 3,159           | 472          | (2,434 )            | 4,361               |
| Provision for loan losses                 | —                                     | 30              | 6,745           | —            | —                   | 6,775               |
| Salaries and employee benefits            | 11,439                                | 2,099           | 4,254           | 432          | —                   | 18,224              |
| Other noninterest expenses                | 9,299                                 | 2,334           | 2,302           | 451          | —                   | 14,386              |
| Total operating expenses                  | 23,808                                | 4,557           | 16,460          | 1,355        | (2,434 )            | 43,746              |
| Income (loss) before income taxes         | 2,387                                 | 399             | 7,224           | (672 )       | —                   | 9,338               |
| Provision for (benefit from) income taxes | (19 )                                 | 160             | 2,817           | (255 )       | —                   | 2,703               |
| Net income (loss)                         | \$2,406                               | \$ 239          | \$ 4,407        | \$(417 )     | \$ —                | \$ 6,635            |
| Total assets                              | \$1,184,486                           | \$ 48,755       | \$ 284,905      | \$3,606      | \$ (174,261 )       | \$ 1,347,491        |
| Goodwill                                  | \$5,907                               | \$—             | \$ 10,723       | \$—          | \$—                 | \$ 16,630           |
| Capital expenditures                      | \$1,148                               | \$ 41           | \$ 84           | \$1          | \$—                 | \$ 1,274            |

| <i>(Dollars in thousands)</i>             | <b>Six Months Ended June 30, 2013</b> |                 |                 |              |                     |                     |
|---|---------------------------------------|-----------------|-----------------|--------------|---------------------|---------------------|
|   | <b>Retail</b>                         | <b>Mortgage</b> | <b>Consumer</b> | <b>Other</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|   | <b>Banking</b>                        | <b>Banking</b>  | <b>Finance</b>  |              |                     |                     |
| <b>Revenues:</b>                          |                                       |                 |                 |              |                     |                     |
| Interest income                           | \$15,599                              | \$ 843          | \$ 24,492       | \$1          | \$ (2,582 )         | \$ 38,353           |
| Gains on sales of loans                   | —                                     | 5,278           | —               | —            | —                   | 5,278               |
| Other noninterest income                  | 3,400                                 | 2,164           | 574             | 645          | —                   | 6,783               |
| Total operating income                    | 18,999                                | 8,285           | 25,066          | 646          | (2,582 )            | 50,414              |
| <b>Expenses:</b>                          |                                       |                 |                 |              |                     |                     |
| Interest expense                          | 3,017                                 | 173             | 3,244           | 378          | (2,582 )            | 4,230               |
| Provision for loan losses                 | 1,000                                 | 60              | 5,240           | —            | —                   | 6,300               |
| Salaries and employee benefits            | 8,209                                 | 2,754           | 3,934           | 401          | —                   | 15,298              |
| Other noninterest expenses                | 6,253                                 | 2,744           | 2,174           | 1,108        | —                   | 12,279              |
| Total operating expenses                  | 18,479                                | 5,731           | 14,592          | 1,887        | (2,582 )            | 38,107              |
| Income (loss) before income taxes         | 520                                   | 2,554           | 10,474          | (1,241)      | —                   | 12,307              |
| Provision for (benefit from) income taxes | (675 )                                | 1,022           | 4,085           | (309 )       | —                   | 4,123               |
| Net income (loss)                         | \$1,195                               | \$ 1,532        | \$ 6,389        | \$(932 )     | \$ —                | \$ 8,184            |
| Total assets                              | \$843,917                             | \$ 75,448       | \$ 286,514      | \$4,054      | \$ (217,252 )       | \$ 992,681          |
| Goodwill                                  | \$—                                   | \$—             | \$ 10,723       | \$—          | \$—                 | \$ 10,723           |
| Capital expenditures                      | \$1,732                               | \$ 131          | \$ 41           | \$2          | \$—                 | \$ 1,906            |

The Retail Banking segment extends a warehouse line of credit to the Mortgage Banking segment, providing a portion of the funds needed to originate mortgage loans. The Retail Banking segment charges the Mortgage Banking segment interest at the daily FHLB advance rate plus 50 basis points. The Retail Banking segment also provides the Consumer Finance segment with a portion of the funds needed to purchase loan contracts by means of a variable rate line of credit that carries interest at one-month LIBOR plus 200-225 basis points and fixed rate loans that carry interest rates ranging from 3.8 percent to 8.0 percent. The Retail Banking segment acquires certain residential real estate loans from the Mortgage Banking segment at prices similar to those paid by third-party investors. These transactions are eliminated to reach consolidated totals. Certain corporate overhead costs incurred by the Retail Banking segment are not allocated to the Mortgage Banking, Consumer Finance and Other segments.

**NOTE 10: Commitments and Financial Instruments with Off-Balance-Sheet Risk**

C&F Mortgage enters into IRLCs with customers and will sell the underlying loans to investors on either a best efforts or a mandatory delivery basis. C&F Mortgage mitigates interest rate risk on IRLCs and loans held for sale by (a) entering into forward loan sales contracts with investors for loans to be delivered on a best efforts basis or (b) entering into forward sales contracts of MBS for loans to be delivered on a mandatory basis. Both the IRLCs with customers and the forward sales contracts are considered derivative financial instruments. At June 30, 2014, the Corporation had derivative financial instruments with a notional value of \$104.30 million. The fair value of these derivative instruments at June 30, 2014 was \$950,000, which was included in other assets.

C&F Mortgage sells substantially all of the residential mortgage loans it originates to third-party counterparties. As is customary in the industry, the agreements with these counterparties require C&F Mortgage to extend representations and warranties with respect to program compliance, borrower misrepresentation, fraud, and early payment performance. Under the agreements, the counterparties are entitled to make loss claims and repurchase requests of C&F Mortgage for loans that contain covered deficiencies. C&F Mortgage has obtained early payment default recourse waivers for a significant portion of its business. Recourse periods for early payment default for the remaining counterparties vary from 90 days up to one year. Recourse periods for borrower misrepresentation or fraud, or underwriting error do not have a stated time limit. C&F Mortgage maintains an indemnification reserve for potential claims made under these recourse provisions. The following table presents the changes in the allowance for indemnification losses for the periods presented:

|                                      | <b>Three Months</b>   |             | <b>Six Months</b>     |             |
|--------------------------------------|-----------------------|-------------|-----------------------|-------------|
|                                      | <b>Ended June 30,</b> |             | <b>Ended June 30,</b> |             |
| <i>(Dollars in thousands)</i>        | <b>2014</b>           | <b>2013</b> | <b>2014</b>           | <b>2013</b> |
| Allowance, beginning of period       | <b>\$2,461</b>        | \$2,082     | <b>\$2,415</b>        | \$2,092     |
| Provision for indemnification losses | <b>63</b>             | 150         | <b>109</b>            | 375         |
| Payments                             | <b>(450 )</b>         | —           | <b>(450 )</b>         | (235 )      |
| Allowance, end of period             | <b>\$2,074</b>        | \$2,232     | <b>\$2,074</b>        | \$2,232     |

**NOTE 11: Interest Rate Swaps**

The Corporation uses interest rate swaps to manage exposure of a portion of its trust preferred capital notes to interest rate risk. Interest rate swaps involve the exchange of fixed and variable rate interest payments between two parties, based on a common notional principal amount and maturity date with no exchange of underlying principal amounts. The Corporation's interest rate swaps qualify as cash flow hedges. The Corporation's cash flow hedges effectively modify a portion of the Corporation's exposure to interest rate risk by converting variable rates of interest on \$10.00

million of the Corporation's trust preferred capital notes to fixed rates of interest until September 2015.

The cash flow hedges total notional amount is \$10.00 million. At June 30, 2014, the cash flow hedges had a fair value of (\$245,000), which is recorded in other liabilities. The cash flow hedges were fully effective at June 30, 2014 and therefore the loss on the cash flow hedges was recognized as a component of other comprehensive income (loss), net of deferred income taxes.

**NOTE 12: Other Noninterest Expenses**

The following table presents the significant components in the consolidated statements of income line “Noninterest Expenses – Other Expenses.”

|   | Three Months   |         | Six Months     |         |
|---|----------------|---------|----------------|---------|
|   | Ended June 30, |         | Ended June 30, |         |
| <i>(Dollars in thousands)</i>           | 2014           | 2013    | 2014           | 2013    |
| FDIC insurance expense                  | \$228          | \$152   | \$613          | \$324   |
| Data processing fees                    | 957            | 651     | 1,952          | 1,317   |
| Loan and OREO expenses                  | 28             | 218     | 84             | 440     |
| Amortization of core deposit intangible | 305            | —       | 624            | —       |
| Telecommunication expenses              | 405            | 304     | 753            | 592     |
| Professional fees                       | 522            | 419     | 1,192          | 960     |
| Travel and educational expenses         | 273            | 251     | 555            | 503     |
| Marketing and advertising expenses      | 426            | 240     | 595            | 440     |
| Acquisition transaction costs           | 69             | 581     | 309            | 782     |
| All other noninterest expenses          | 1,795          | 1,733   | 3,394          | 3,383   |
| Total other noninterest expenses        | \$5,008        | \$4,549 | \$10,071       | \$8,741 |

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*Cautionary Statement Regarding Forward-Looking Statements*

This report contains statements concerning the Corporation's expectations, plans, objectives, future financial performance and other statements that are not historical facts. These statements may constitute "forward-looking statements" as defined by federal securities laws and may include, but are not limited to, statements regarding future profitability and financial performance, liquidity, the Corporation's and each business segment's loan portfolio, allowance for loan losses, trends regarding the provision for loan losses, trends regarding net loan charge-offs and expected future charge-off activity, trends regarding levels of nonperforming assets and troubled debt restructurings and expenses associated with nonperforming assets, provision for indemnification losses, the effect of future market and industry trends, levels of noninterest income and expense, interest rates and yields, competitive trends in the Corporation's businesses and markets, the deposit portfolio including trends in deposit maturities and rates, interest rate sensitivity, market risk, regulatory developments, monetary policy implemented by the Federal Reserve including quantitative easing programs, capital requirements and the effect on the Corporation's capital resources of the Corporation's share repurchase program, growth strategy including the outcome of the recent business combination and financial and other goals. These statements may address issues that involve estimates and assumptions made by management and risks and uncertainties. Actual results could differ materially from historical results or those anticipated by such statements. Factors that could have a material adverse effect on the operations and future prospects of the Corporation include, but are not limited to, changes in:

- interest rates, such as the current volatility in yields on U.S. Treasury bonds and mortgage rates

- general business conditions, as well as conditions within the financial markets

- general economic conditions, including unemployment levels

- the legislative/regulatory climate, including the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) and regulations promulgated thereunder, the Consumer Financial Protection Bureau (CFPB) and the regulatory and enforcement activities of the CFPB and rules promulgated under the Basel III framework

- monetary and fiscal policies of the U.S. Government, including policies of the Treasury and the Federal Reserve Board, including the effect of these policies on interest rates and business in our markets

-



the ability to achieve the results expected from the CVB acquisition, including anticipated costs savings, continued relationships with major customers and deposit retention

the value of securities held in the Corporation's investment portfolios

the quality or composition of the loan portfolios and the value of the collateral securing those loans

the commercial and residential real estate markets

the inventory level and pricing of used automobiles, including sales prices of repossessed vehicles

the level of net charge-offs on loans and the adequacy of our allowance for loan losses

demand in the secondary residential mortgage loan markets

the level of indemnification losses related to mortgage loans sold

demand for loan products

deposit flows

the strength of the Corporation's counterparties

competition from both banks and non-banks

demand for financial services in the Corporation's market area

the Corporation's expansion and technology initiatives

reliance on third parties for key services

accounting principles, policies and guidelines and elections by the Corporation thereunder

These risks are exacerbated by the turbulence over the past several years in the global and United States financial markets. Continued weakness in the global and United States financial markets could further affect the Corporation's performance, both directly by affecting the Corporation's revenues and the value of its assets and liabilities, and indirectly by affecting the Corporation's counterparties and the economy in general. While there are some signs of improvement in the economic environment, there was a prolonged period of volatility and disruption in the markets, and unemployment has risen to, and remains at, high levels. There can be no assurance that these unprecedented developments will not continue to materially and adversely affect our business, financial condition and results of operations, as well as our ability to raise capital for liquidity and business purposes.

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships, and we routinely execute transactions with counterparties in the financial industry, including brokers and dealers, commercial banks, and other institutions. As a result, defaults by, or even rumors or questions about defaults by, one or more financial services institutions, or the financial services industry generally, could create another market-wide liquidity crisis similar to that experienced in late 2008 and early 2009 and could lead to losses or defaults by us or by other institutions. There is no assurance that any such losses would not materially adversely affect the Corporation's results of operations.

There can be no assurance that the actions taken by the federal government and regulatory agencies will alleviate the industry or economic factors that may adversely affect the Corporation's business and financial performance. Further, many aspects of the Dodd-Frank Act remain subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall effect on the Corporation's business and financial performance.

These risks and uncertainties, and the risks discussed in more detail in Item 1A, "Risk Factors" of the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013, should be considered in evaluating the forward-looking statements contained herein. We caution readers not to place undue reliance on those statements, which speak only as of the date of this report.

The following discussion supplements and provides information about the major components of the results of operations, financial condition, liquidity and capital resources of the Corporation. This discussion and analysis should be read in conjunction with the accompanying consolidated financial statements.

## **CRITICAL ACCOUNTING POLICIES**

The preparation of financial statements requires us to make estimates and assumptions. Those accounting policies with the greatest uncertainty and that require our most difficult, subjective or complex judgments affecting the application of these policies, and the likelihood that materially different amounts would be reported under different conditions, or using different assumptions, are described below.

**Allowance for Loan Losses:** We establish the allowance for loan losses through charges to earnings in the form of a provision for loan losses. Loan losses are charged against the allowance when we believe that the collection of the principal is unlikely. Subsequent recoveries of losses previously charged against the allowance are credited to the allowance. The allowance represents an amount that, in our judgment, will be adequate to absorb any losses on existing loans that may become uncollectible. Our judgment in determining the level of the allowance is based on evaluations of the collectibility of loans while taking into consideration such factors as trends in delinquencies and

charge-offs, changes in the nature and volume of the loan portfolio, current economic conditions that may affect a borrower's ability to repay and the value of collateral, overall portfolio quality and review of specific potential losses. This evaluation is inherently subjective because it requires estimates that are susceptible to significant revision as more information becomes available.

**Allowance for Indemnifications:** The allowance for indemnifications is established through charges to earnings in the form of a provision for indemnifications, which is included in other noninterest expenses. A loss is charged against the allowance for indemnifications under certain conditions when a purchaser of a loan (investor) sold by C&F Mortgage incurs a loss due to borrower misrepresentation, fraud, early default, or underwriting error. The allowance represents an amount that, in management's judgment, will be adequate to absorb any losses arising from indemnification requests. Management's judgment in determining the level of the allowance is based on the volume of loans sold, historical experience, current economic conditions and information provided by investors. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

**Impairment of Loans:** We consider a loan impaired when it is probable that the Corporation will be unable to collect all interest and principal payments as scheduled in the loan agreement. We do not consider a loan impaired during a period of delay in payment if we expect the ultimate collection of all amounts due. We measure impairment on a loan-by-loan basis for commercial, construction and residential loans in excess of \$500,000 by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. We maintain a valuation allowance to the extent that the measure of the impaired loan is less than the recorded investment. Troubled debt restructurings (TDRs) are also considered impaired loans, even if the loan balance is less than \$500,000. A TDR occurs when we agree to significantly modify the original terms of a loan due to the deterioration in the financial condition of the borrower.

**Loans Acquired in a Business Combination:** Loans acquired in a business combination, such as C&F Financial Corporation's acquisition of CVBK, are recorded at estimated fair value on the date of acquisition without the carryover of the related allowance for loan losses. Purchased credit-impaired (PCI) loans are those for which there is evidence of credit deterioration since origination and for which it is probable at the date of acquisition that the Corporation will not collect all contractually required principal and interest payments. When determining fair market value, PCI loans were aggregated into pools of loans based on common risk characteristics as of the date of acquisition such as loan type, date of origination, and evidence of credit quality deterioration such as internal risk grades and past due and nonaccrual status. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the "nonaccretable difference," and is available to absorb future credit losses on those loans. Subsequent decreases to the expected cash flows will generally result in a provision for loan losses. Subsequent significant increases in cash flows may result in a reversal of the provision for loan losses to the extent of prior charges, or a reversal of the nonaccretable difference with a positive effect on future interest income. Further, any excess of cash flows expected at acquisition over the estimated fair value is referred to as the "accretable yield" and is recognized as interest income over the remaining life of the loan when there is a reasonable expectation about the amount and timing such cash flows.

Subsequent to acquisition, we evaluate on a quarterly basis our estimate of cash flows expected to be collected. In the current economic environment, estimates of cash flows for PCI loans require significant judgment. Subsequent decreases to the expected cash flows will generally result in a provision for loan losses resulting in an increase to the allowance for loan losses. Subsequent increases in cash flows will generally result in an increase in interest income over the remaining life of the loan, or pool(s) of loans. Disposals of loans, which may include sale of loans to third parties, receipt of payments in full or in part from the borrower or foreclosure of the collateral, result in removal of the loan from the PCI loan portfolio at its carrying amount. The Corporation's PCI loans currently consist of loans acquired in connection with the acquisition of CVBK. PCI loans that were classified as nonperforming loans by CVBK are no longer classified as nonperforming so long as, at quarterly re-estimation periods, we believe we will fully collect the new carrying value of the pools of loans.

Loans not designated PCI loans as of the acquisition date are designated purchased performing loans. The Corporation accounts for purchased performing loans using the contractual cash flows method of recognizing discount accretion based on the acquired loans' contractual cash flows. Purchased performing loans are recorded at fair value, including a credit discount. The fair value discount is accreted as an adjustment to yield over the estimated lives of the loans. There is no allowance for loan losses established at the acquisition date for purchased performing loans. A provision for loan losses may be required in future periods for any deterioration in these loans subsequent to the acquisition.

**Impairment of Securities:** Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either (i) we intend to sell the security or (ii) it is more-likely-than-not that we will be required to sell the security before recovery of its amortized cost basis. If, however, we do not intend to sell the security and it is not more-likely-than-not that we will be required to sell the security before recovery, we must determine what portion of the impairment is attributable to a credit loss, which occurs when the amortized cost basis of the security exceeds the present value of the cash flows expected to be collected from the security. If there is no credit loss, there is no other-than-temporary impairment. If there is a credit loss, other-than-temporary impairment exists, and the credit loss

must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income. For equity securities, impairment is considered to be other-than-temporary based on our ability and intent to hold the investment until a recovery of fair value. Other-than-temporary impairment of an equity security results in a write-down that must be included in net income. We regularly review each investment security for other-than-temporary impairment based on criteria that includes the extent to which cost exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, our best estimate of the present value of cash flows expected to be collected from debt securities, our intention with regard to holding the security to maturity and the likelihood that we would be required to sell the security before recovery.

**Other Real Estate Owned (OREO):** Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less costs to sell at the date of foreclosure. Subsequent to foreclosure, management periodically performs valuations of the foreclosed assets based on updated appraisals, general market conditions, recent sales of like properties, length of time the properties have been held, and our ability and intention with regard to continued ownership of the properties. The Corporation may incur additional write-downs of foreclosed assets to fair value less costs to sell if valuations indicate a further other-than-temporary deterioration in market conditions.

**Goodwill:** The Corporation's goodwill was recognized in connection with the Corporation's acquisition of CVBK in October 2013 and C&F Bank's acquisition of C&F Finance Company in September 2002. With the adoption of ASU 2011-08, *Intangible-Goodwill and Other-Testing Goodwill for Impairment*, in 2012, the Corporation is no longer required to perform a test for impairment unless, based on an assessment of qualitative factors related to goodwill, we determine that it is more likely than not that the fair value of goodwill is less than its carrying amount. If the likelihood of impairment is more than 50 percent, the Corporation must perform a test for impairment and we may be required to record impairment charges. In assessing the recoverability of the Corporation's goodwill, major assumptions used in determining impairment are increases in future income, sales multiples in determining terminal value and the discount rate applied to future cash flows. If an impairment test is performed, we will prepare a sensitivity analysis by increasing the discount rate, lowering sales multiples and reducing increases in future income.

**Retirement Plan:** The Bank maintains a non-contributory, defined benefit pension plan for eligible full-time employees as specified by the plan. Plan assets, which consist primarily of mutual funds invested in marketable equity securities and corporate and government fixed income securities, are valued using market quotations. The Bank's actuary determines plan obligations and annual pension expense using a number of key assumptions. Key assumptions may include the discount rate, the interest crediting rate, the estimated future return on plan assets and the anticipated rate of future salary increases. Changes in these assumptions in the future, if any, or in the method under which benefits are calculated may affect pension assets, liabilities or expense.

**Derivative Financial Instruments:** The Corporation recognizes derivative financial instruments at fair value as either an other asset or other liability in the consolidated balance sheet. The Corporation's derivative financial instruments consist of (1) the fair value of IRLCs on mortgage loans that will be held for sale and related forward sale commitments and (2) interest rate swaps that qualify as cash flow hedges of a portion of the Corporation's trust preferred capital notes. Because the IRLCs and forward sale commitments are not designated as hedging instruments, adjustments to reflect unrealized gains and losses resulting from changes in fair value of the Corporation's IRLCs and forward sales commitments and realized gains and losses upon ultimate sale of the loans are classified as noninterest income. The effective portion of the gain or loss on the Corporation's cash flow hedges is reported as a component of other comprehensive income, net of deferred taxes, and reclassified into earnings in the same period or periods during which the hedged transactions affect earnings. For more information concerning fair value measurements of these instruments, see Part I, Item 1, "Financial Statements" in this Quarterly Report on Form 10-Q under the heading "Note 8: Fair Value of Assets and Liabilities."

**Accounting for Income Taxes:** Determining the Corporation's effective tax rate requires judgment. In the ordinary course of business, there are transactions and calculations for which the ultimate tax outcomes are uncertain. In addition, the Corporation's tax returns are subject to audit by various tax authorities. Although we believe that the estimates are reasonable, no assurance can be given that the final tax outcome will not be materially different than that which is reflected in the income tax provision and accrual.

For further information concerning accounting policies, refer to Item 8, "Financial Statements and Supplementary Data," under the heading "Note 1: Summary of Significant Accounting Policies" in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013.

## OVERVIEW

Our primary financial goals are to maximize the Corporation's earnings and to deploy capital in profitable growth initiatives that will enhance long-term shareholder value. We track three primary financial performance measures in order to assess the level of success in achieving these goals: (i) return on average assets (ROA), (ii) return on average common equity (ROE), and (iii) growth in earnings. In addition to these financial performance measures, we track the performance of the Corporation's three principal business activities: retail banking, mortgage banking, and consumer

finance. We also actively manage our capital through growth, dividends and stock repurchases, while considering the need to maintain a strong regulatory capital position.

On October 1, 2013, the Corporation acquired all of the outstanding common stock of CVBK. On March 22, 2014, CVBK was merged with and into C&F Financial Corporation and CVB was merged with and into C&F Bank. The Corporation's financial position and results of operations as of and for the three and six months ended June 30, 2014 and its financial position as of December 31, 2013 include the financial position and results of operations acquired in connection with the Corporation's purchase of CVBK and CVB.

For more information on this acquisition, see Part I, Item I, "Financial Statements" in this Quarterly Report on Form 10-Q under the heading "Note 2: Business Combinations."



## Financial Performance Measures

Net income for the Corporation was \$3.7 million, or \$1.09 per common share assuming dilution, for the three months ended June 30, 2014, compared with \$4.2 million, or \$1.22 per common share assuming dilution, for the three months ended June 30, 2013. Net income for the Corporation was \$6.6 million, or \$1.91 per common share assuming dilution, for the six months ended June 30, 2014, compared with \$8.2 million, or \$2.41 per common share assuming dilution, for the six months ended June 30, 2013. The declines in net income for the second quarter and first half of 2014, compared to the same periods of 2013, were attributable to lower earnings at the Mortgage Banking and the Consumer Finance segments, offset in part by an increase in earnings at the Retail Banking segment. At the Mortgage Banking segment, mortgage interest rate increases since May of last year led to significantly reduced refinance activity and slower than expected residential real estate purchases, which has translated into weaker mortgage loan volume and correspondingly lower income from gains on sales of loans and ancillary mortgage lending fees. Loan production in the Corporation's Mortgage Banking segment was also affected by inclement winter weather conditions, low resale and new housing inventories and loan officer turnover. At the Consumer Finance segment, higher net charge-offs attributable to the continued difficult economic environment for this segment's customers resulted in a higher provision for loan losses during the second quarter and first half of 2014, compared to the same periods of 2013. In addition, the average balance and yield on the Consumer Finance segment's loan portfolio have declined as a result of increased competition and loan pricing strategies that competitors have used to grow market share in auto financing. The Retail Banking segment, which reported an increase in earnings during the second quarter and first six months of 2014, compared to the same periods in 2013, benefited from (1) accounting adjustments associated with the acquisition of CVB, (2) the effects of the continued low interest rate environment on the cost of deposits, (3) a decline in the provision for loan losses as a result of improvement in asset quality and (4) a decline in expenses associated with foreclosed properties as a result of the sale of a majority of these properties since June 30, 2013.

The Corporation's ROE and ROA were 12.74 percent and 1.13 percent, respectively, on an annualized basis for the second quarter of 2014, compared with 15.65 percent and 1.69 percent, respectively, for the second quarter of 2013. For the first six months of 2014, on an annualized basis, the Corporation's ROE and ROA were 11.37 percent and 1.00 percent, respectively, compared with 15.55 percent and 1.66 percent, respectively, for the first six months of 2013. Both ROE and ROA for the second quarter and first half of 2014 were unfavorably affected by lower net income during 2014, compared to the same periods of 2013. The decline in ROE was further affected by internal capital growth of 12.7 percent since June 30, 2013 resulting from earnings and stock option exercises. The decline in ROA was further affected by asset growth of 35.7 percent since June 30, 2013 primarily resulting from the acquisition of CVBK on October 1, 2013.

**Principal Business Activities.** An overview of the financial results for each of the Corporation's principal business segments is presented below. A more detailed discussion is included in "Results of Operations."

**Retail Banking:** The Retail Banking segment reported net income of \$1.4 million for the second quarter of 2014, compared to net income of \$499,000 for the second quarter of 2013. For the first six months of 2014, C&F Bank reported net income of \$2.4 million, compared to net income of \$1.2 million for the first six months of 2013. Net

income of the Retail Banking segment during 2014 includes the results of operations acquired in connection with the Corporation's purchase of CVB on October 1, 2013. The results of both the second quarter and first half of 2014 for the Retail Banking segment were significantly affected by fair market value accounting adjustments resulting from the CVB acquisition. Accordingly, yields on loans and investments acquired from CVB increased and the cost of certificates of deposits assumed from CVB decreased, the benefits of which were partially offset by the amortization of the core deposit intangible and higher depreciation associated with the write-up of certain buildings recognized in the acquisition of CVB. The net accretion attributable to these adjustments was \$554,000 and \$1.1 million, net of taxes (\$852,000 and \$1.7 million prior to taxes, respectively) during the second quarter and first half of 2014, respectively.

The improvement in net income of the Retail Banking segment for the second quarter and first six months of 2014, compared to the same periods of 2013, also resulted from (1) the effects of the continued low interest rate environment on the cost of deposits, (2) improvement in loan credit quality resulting in a \$600,000 and \$1.0 million decrease in the loan loss provision for the second quarter and first half of 2014, respectively, and (3) a significant decline in OREO resulting in lower holding costs and loss provisions. Partially offsetting these positive factors were the negative effects of the following: (1) higher personnel costs associated with increased staff levels and support positions associated with the addition of seven branches through the acquisition of CVB and the addition of commercial loan personnel focused on growing the segment's commercial and small business loan portfolios, (2) one-time transaction expenses associated with the merger of CVB into C&F Bank, (3) depreciation of information technology equipment purchased to upgrade CVB's systems and equipment to conform to C&F Bank's technology infrastructure, and (4) higher operating expenses resulting from the effects of combining CVB's operations into the Bank's.

The Bank's nonperforming assets were \$5.3 million at June 30, 2014, compared to \$7.2 million at December 31, 2013. Nonperforming assets at June 30, 2014 included \$4.5 million in total nonaccrual loans, compared to \$4.4 million at December 31, 2013, and \$817,000 in OREO, compared to \$2.8 million at December 31, 2013. Troubled debt restructurings were \$5.7 million at June 30, 2014, compared to \$5.6 million at December 31, 2013, of which \$2.5 million and \$2.6 million at June 30, 2014 and at December 31, 2013, respectively, were included in nonaccrual loans. The decline in OREO during the first six months of 2014 resulted from sales of properties that had a total carrying value of \$2.4 million at December 31, 2013.

**Mortgage Banking:** The Mortgage Banking segment reported net income of \$224,000 for the second quarter of 2014, compared to net income of \$986,000 for the second quarter of 2013. For the first six months of 2014, C&F Mortgage reported net income of \$239,000, compared to \$1.5 million for the first half of 2013. The entire mortgage industry, including the Corporation's Mortgage Banking segment, is experiencing significantly reduced refinancing activity and lower-than-anticipated purchase activity, which has translated into weaker mortgage loan volume and correspondingly lower income from gains on sales of loans and ancillary mortgage lending fees. Loan originations at the Corporation's Mortgage Banking segment declined 40.54 percent and 44.27 percent during the second quarter and first half of 2014, respectively, compared to the same periods in 2013, which management believes is in line or lower than industry declines. During the second quarter of 2014, the amount of loan originations for refinancings and new and resale home purchases were \$17.7 million and \$108.4 million, respectively, compared to \$72.1 million and \$139.9 million, respectively during the second quarter of 2013. During the first half of 2014, the amount of loan originations for refinancings and new and resale home purchases were \$30.5 million and \$187.0 million, respectively, compared to \$154.1 million and \$236.1 million, respectively during the first half of 2013. Partially offsetting the negative effects of these production declines was a decline in production-based compensation.

If conditions influencing the mortgage banking environment, such as interest rates and housing inventories, do not improve, C&F Mortgage may experience a continuation of lower loan demand, particularly for mortgage refinancings, which could negatively affect earnings of the mortgage banking segment in future periods.

**Consumer Finance:** The Consumer Finance segment reported net income of \$2.3 million for the second quarter of 2014, compared to net income of \$3.3 million for the second quarter of 2013. For the first six months of 2014, C&F Finance reported net income of \$4.4 million, compared to net income of \$6.4 million for the first six months of 2013. Average loans outstanding during the second quarter and first half of 2014 declined \$2.0 million and \$2.8 million, respectively, compared to the same periods in 2013. This decline in the average consumer finance loan portfolio, coupled with a 75 basis point and a 77 basis point decline in average yield on the portfolio for the second quarter and first half of 2014, respectively, resulted in a \$593,000 decline and a \$1.3 million decline in net interest income during the second quarter and first half of 2014, respectively. The average balance and yield on the Consumer Finance segment's loan portfolio have declined as a result of increased competition and loan pricing strategies that competitors have used to grow market share.

The results of the Consumer Finance segment also included a \$760,000 and a \$1.5 million increase in the provision for loan losses during the second quarter and first half of 2014, compared to the same periods in 2013. The net charge-off ratio has remained higher through the first half of 2014, compared to the first half of 2013, as a result of the continued difficult economic environment. In particular, unemployment rates among the segment's target customers remain higher than historical levels. The increase in the provision for loan losses during the first half of 2014 and the lack of significant portfolio growth since December 31, 2013 resulted in an increase in the ratio of the allowance for loan losses to total loans to 8.34 percent at June 30, 2014 from 8.32 percent at December 31, 2013 and from 7.97 percent at June 30, 2013. Management believes that the current allowance for loan losses is adequate to absorb probable losses in the consumer finance loan portfolio. However, if the current economic environment continues to contribute to an elevated level of charge-offs, a higher provision for loan losses may be required in future periods.

**Capital Management.** Total shareholders' equity was \$119.2 million at June 30, 2014, compared to \$112.9 million at December 31, 2013. Capital growth resulted from earnings for the first half of 2014 and an increase in unrealized holding gains on securities available for sale, which are a component of accumulated other comprehensive income. These increases were offset in part by dividends declared of 30 cents and 59 cents per share during the second quarter and first half of 2014, respectively. The second quarter dividend was paid on July 1, 2014 and equated to a payout ratio of 27.3 percent of second quarter net income.

Further affecting capital during 2014 was the Corporation's repurchase from the United States Department of the Treasury (Treasury) of a warrant to purchase 167,504 shares of the Corporation's common stock at an exercise price of \$17.91 per share (Warrant). The Warrant was issued to Treasury in January 2009 in connection with the Corporation's participation in the Troubled Asset Relief Program (TARP) Capital Purchase Program. The Corporation paid an aggregate purchase price of \$2.3 million for the repurchase of the Warrant, which has been cancelled. The repurchase price was based on the fair market value of the Warrant as agreed upon by the Corporation and Treasury. With the repurchase of the Warrant, the Corporation has completely exited the TARP Capital Purchase Program.

During the second quarter of 2014, the Board of Directors of the Corporation authorized a share repurchase program to purchase up to \$5.0 million of the Corporation's common stock. No repurchases were made under this repurchase program during the second quarter of 2014.

**RESULTS OF OPERATIONS**

The following table presents the average balance sheets, the amounts of interest earned on earning assets, with related yields, and interest expense on interest-bearing liabilities, with related rates, for the three and six months ended June 30, 2014 and 2013. Loans include loans held for sale. Loans placed on nonaccrual status are included in the balances and are included in the computation of yields, but had no material effect. Accretion and amortization of fair value purchase adjustments are included in the computation of yields on loans and investments and on the cost of deposits and borrowings acquired in connection with the purchase of CVB. Interest on tax-exempt loans and securities is presented on a taxable-equivalent basis (which converts the income on loans and investments for which no income taxes are paid to the equivalent yield as if income taxes were paid using the federal corporate income tax rate of 34 percent).

**TABLE 1: Average Balances, Income and Expense, Yields and Rates**

|   | <b>Three Months Ended June 30,</b> |                |               | <b>2013</b>    |                |               |
|---|------------------------------------|----------------|---------------|----------------|----------------|---------------|
|   | <b>2014</b>                        |                |               |                |                |               |
|   | <b>Average</b>                     | <b>Income/</b> | <b>Yield/</b> | <b>Average</b> | <b>Income/</b> | <b>Yield/</b> |
| <i>(Dollars in thousands)</i>                                   |                                    |                |               |                |                |               |
|   | <b>Balance</b>                     | <b>Expense</b> | <b>Rate</b>   | <b>Balance</b> | <b>Expense</b> | <b>Rate</b>   |
| <b>Assets</b>   |                                    |                |               |                |                |               |
| Securities:   |                                    |                |               |                |                |               |
| Taxable   | <b>\$94,726</b>                    | <b>\$ 643</b>  | <b>2.72 %</b> | \$30,520       | \$137          | 1.80 %        |
| Tax-exempt  | <b>117,841</b>                     | <b>1,674</b>   | <b>5.68</b>   | 115,034        | 1,722          | 5.99          |
| Total securities  | <b>212,567</b>                     | <b>2,317</b>   | <b>4.36</b>   | 145,554        | 1,859          | 5.11          |
| Loans, net  | <b>850,513</b>                     | <b>19,860</b>  | <b>9.37</b>   | 720,237        | 17,929         | 9.98          |
| Interest-bearing deposits in other banks and federal funds sold | <b>166,908</b>                     | <b>115</b>     | <b>0.28</b>   | 62,655         | 37             | 0.24          |
| Total earning assets  | <b>1,229,988</b>                   | <b>22,292</b>  | <b>7.27</b>   | 928,446        | 19,825         | 8.56          |
| Allowance for loan losses                                       | <b>(34,874 )</b>                   |                |               | (34,238 )      |                |               |
| Total non-earning assets  | <b>131,395</b>                     |                |               | 95,019         |                |               |
| Total assets  | <b>\$1,326,509</b>                 |                |               | \$989,227      |                |               |
| <b>Liabilities and Shareholders' Equity</b>                     |                                    |                |               |                |                |               |
| Time and savings deposits:                                      |                                    |                |               |                |                |               |
| Interest-bearing demand deposits                                | <b>\$186,874</b>                   | <b>\$ 108</b>  | <b>0.23 %</b> | \$126,428      | \$95           | 0.30 %        |
| Money market deposit accounts                                   | <b>177,726</b>                     | <b>120</b>     | <b>0.27</b>   | 118,729        | 80             | 0.27          |
| Savings accounts  | <b>98,678</b>                      | <b>20</b>      | <b>0.08</b>   | 50,059         | 11             | 0.09          |
| Certificates of deposit, \$100 or more                          | <b>148,884</b>                     | <b>317</b>     | <b>0.85</b>   | 123,932        | 354            | 1.15          |
| Other certificates of deposit                                   | <b>237,978</b>                     | <b>463</b>     | <b>0.78</b>   | 158,748        | 468            | 1.18          |
| Total time and savings deposits                                 | <b>850,140</b>                     | <b>1,028</b>   | <b>0.48</b>   | 577,896        | 1,008          | 0.70          |
| Borrowings  | <b>170,385</b>                     | <b>1,113</b>   | <b>2.59</b>   | 165,985        | 1,074          | 2.56          |

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|  |                    |                 |               |           |          |        |
|--|--------------------|-----------------|---------------|-----------|----------|--------|
| Total interest-bearing liabilities                         | <b>1,020,525</b>   | <b>2,141</b>    | <b>0.84</b>   | 743,881   | 2,082    | 1.11   |
| Demand deposits  | <b>168,716</b>     |                 |               | 113,162   |          |        |
| Other liabilities  | <b>19,800</b>      |                 |               | 25,379    |          |        |
| Total liabilities  | <b>1,209,041</b>   |                 |               | 882,422   |          |        |
| Shareholders' equity                                       | <b>117,468</b>     |                 |               | 106,805   |          |        |
| Total liabilities and shareholders' equity                 | <b>\$1,326,509</b> |                 |               | \$989,227 |          |        |
| Net interest income  |                    | <b>\$20,151</b> |               |           | \$17,743 |        |
| Interest rate spread                                       |                    |                 | <b>6.43 %</b> |           |          | 7.45 % |
| Interest expense to average earning assets<br>(annualized) |                    |                 | <b>0.69 %</b> |           |          | 0.89 % |
| Net interest margin (annualized)                           |                    |                 | <b>6.58 %</b> |           |          | 7.67 % |

|   | Six Months Ended June 30, |          |        | 2013      |          |        |
|---|---------------------------|----------|--------|-----------|----------|--------|
|   | 2014                      |          |        |           |          |        |
|   | Average                   | Income/  | Yield/ | Average   | Income/  | Yield/ |
| <i>(Dollars in thousands)</i>                                   |                           | Expense  | Rate   |           | Expense  | Rate   |
|   | Balance                   |          |        | Balance   |          |        |
| <b>Assets</b>   |                           |          |        |           |          |        |
| Securities:   |                           |          |        |           |          |        |
| Taxable   | \$94,187                  | \$1,262  | 2.68 % | \$31,526  | \$277    | 1.76 % |
| Tax-exempt  | 117,967                   | 3,382    | 5.73   | 115,206   | 3,452    | 5.99   |
| Total securities  | 212,154                   | 4,644    | 4.38   | 146,732   | 3,729    | 5.08   |
| Loans, net  | 847,421                   | 39,336   | 9.36   | 724,816   | 35,758   | 9.95   |
| Interest-bearing deposits in other banks and Federal funds sold | 165,158                   | 196      | 0.24   | 51,903    | 60       | 0.23   |
| Total earning assets  | 1,224,733                 | 44,176   | 7.27   | 923,451   | 39,547   | 8.63   |
| Allowance for loan losses                                       | (34,849 )                 |          |        | (35,013 ) |          |        |
| Total non-earning assets  | 132,927                   |          |        | 95,316    |          |        |
| Total assets  | \$1,322,811               |          |        | \$983,754 |          |        |
| <b>Liabilities and Shareholders' Equity</b>                     |                           |          |        |           |          |        |
| Time and savings deposits:                                      |                           |          |        |           |          |        |
| Interest-bearing demand deposits                                | \$184,388                 | \$236    | 0.26 % | \$129,800 | \$221    | 0.34 % |
| Money market deposit accounts                                   | 176,408                   | 240      | 0.27   | 115,701   | 163      | 0.28   |
| Savings accounts  | 97,936                    | 44       | 0.09   | 49,316    | 21       | 0.09   |
| Certificates of deposit, \$100 or more                          | 150,521                   | 670      | 0.90   | 125,181   | 729      | 1.17   |
| Other certificates of deposit                                   | 241,465                   | 951      | 0.79   | 159,114   | 953      | 1.21   |
| Total time and savings deposits                                 | 850,718                   | 2,141    | 0.51   | 579,112   | 2,087    | 0.73   |
| Borrowings  | 170,635                   | 2,220    | 2.59   | 164,990   | 2,143    | 2.59   |
| Total interest-bearing liabilities                              | 1,021,353                 | 4,361    | 0.86   | 744,102   | 4,230    | 1.14   |
| Demand deposits   | 163,688                   |          |        | 109,023   |          |        |
| Other liabilities   | 21,085                    |          |        | 25,397    |          |        |
| Total liabilities   | 1,206,126                 |          |        | 878,522   |          |        |
| Shareholders' equity  | 116,685                   |          |        | 105,232   |          |        |
| Total liabilities and shareholders' equity                      | \$1,322,811               |          |        | \$983,754 |          |        |
| Net interest income   |                           | \$39,815 |        |           | \$35,317 |        |
| Interest rate spread  |                           |          | 6.41 % |           |          | 7.49 % |
| Interest expense to average earning assets (annualized)         |                           |          | 0.71 % |           |          | 0.92 % |
| Net interest margin (annualized)                                |                           |          | 6.56 % |           |          | 7.71 % |

Interest income and expense are affected by fluctuations in interest rates, by changes in the volume of earning assets and interest-bearing liabilities, and by the interaction of rate and volume factors. The following table presents the direct causes of the period-to-period changes in the components of net interest income on a taxable-equivalent basis. We calculated the rate and volume variances using a formula prescribed by the SEC. Rate/volume variances, the third element in the calculation, are not shown separately in the table, but are allocated to the rate and volume variances in proportion to the relationship of the absolute dollar amounts of the change in each. Loans include both nonaccrual loans and loans held for sale.





**TABLE 2: Rate-Volume Recap**

| <i>(Dollars in thousands)</i>                                   | <b>Three Months Ended June<br/>30, 2014 from 2013</b> |               |                                |
|---|---|---------------|--------------------------------|
|   | <b>Increase<br/>(Decrease)</b>                        |               | <b>Total</b>                   |
|   | <b>Due to<br/>Rate</b>                                | <b>Volume</b> | <b>Increase<br/>(Decrease)</b> |
| <b>Interest income:</b>   |   |               |                                |
| Loans   | \$ (6,114)  | \$ 8,045      | \$ 1,931                       |
| Securities:   |   |               |                                |
| Taxable   | 98  | 408           | 506                            |
| Tax-exempt  | (261 )  | 213           | (48 )                          |
| Interest-bearing deposits in other banks and federal funds sold | 7   | 71            | 78                             |
| Total interest income   | (6,270)   | 8,737         | 2,467                          |
| <b>Interest expense:</b>  |   |               |                                |
| Time and savings deposits:                                      |   |               |                                |
| Interest-bearing demand deposits                                | (113 )  | 126           | 13                             |
| Money market deposit accounts                                   | —   | 40            | 40                             |
| Savings accounts  | (7 )  | 16            | 9                              |
| Certificates of deposit, \$100 or more                          | (343 )  | 306           | (37 )                          |
| Other certificates of deposit                                   | (758 )  | 753           | (5 )                           |
| Total time and savings deposits                                 | (1,221)   | 1,241         | 20                             |
| Borrowings (including trust preferred capital notes)            | 11  | 28            | 39                             |
| Total interest expense  | (1,210)   | 1,269         | 59                             |
| Change in net interest income                                   | \$ (5,060)  | \$ 7,468      | \$ 2,408                       |

## Six Months Ended June 30,

## 2014 from 2013

|  | 2014 from 2013         |        | Total                  |
|--|------------------------|--------|------------------------|
|  | Increase<br>(Decrease) |        |                        |
|  | Due to                 | Volume | Increase<br>(Decrease) |
|  | Rate                   |        |                        |

*(Dollars in thousands)***Interest income:**

|   |            |          |          |
|---|------------|----------|----------|
| Loans   | \$ (5,401) | \$ 8,979 | \$ 3,578 |
| Securities:   |            |          |          |
| Taxable   | 205        | 780      | 985      |
| Tax-exempt  | (257 )     | 187      | (70 )    |
| Interest-bearing deposits in other banks and Federal funds sold | 3          | 133      | 136      |
| Total interest income   | (5,450)    | 10,079   | 4,629    |

**Interest expense:**

|  |            |          |          |
|--|------------|----------|----------|
| Time and savings deposits:                           |            |          |          |
| Interest-bearing demand deposits                     | (130 )     | 145      | 15       |
| Money market deposit accounts                        | (12 )      | 89       | 77       |
| Savings accounts                                     | —          | 23       | 23       |
| Certificates of deposit, \$100 or more               | (349 )     | 290      | (59 )    |
| Other certificates of deposit                        | (796 )     | 794      | (2 )     |
| Total time and savings deposits                      | (1,287)    | 1,341    | 54       |
| Borrowings (including Trust preferred capital notes) | —          | 77       | 77       |
| Total interest expense                               | (1,287)    | 1,418    | 131      |
| Change in net interest income                        | \$ (4,163) | \$ 8,661 | \$ 4,498 |

Net interest income, on a taxable-equivalent basis, for the three months ended June 30, 2014 was \$20.2 million, compared to \$17.7 million for the three months ended June 30, 2013. Net interest income, on a taxable-equivalent basis, for the first half of 2014 was \$39.8 million, compared to \$35.3 million for the first half of 2013. The increase in net interest income for the second quarter and first half of 2014, compared to the same periods of 2013, was a result of an increase in average earning assets resulting from the acquisition of CVBK on October 1, 2013, offset in part by a decrease in the net interest margin. Net interest margin decreased 109 basis points to 6.58 percent for the second quarter of 2014, and decreased 115 basis points to 6.56 percent for the first half of 2014 relative to the same periods in 2013. The decreases in net interest margin during 2014 can be attributed to a decrease in the yield on interest-earning assets offset in part by decreases in the cost of interest-bearing liabilities and an increase in demand deposits that pay no interest. The decreases in yield on interest-earning assets were primarily attributable to large increases in interest-bearing deposits in other banks and federal funds sold, which category of earning assets provides the lowest yield of all categories of earning assets, and decreases in the yields on the investment and loan portfolios for the three and six months ended June 30, 2014, as compared to the same periods in 2013. The decreases in the cost of interest bearing liabilities is a result of the sustained low interest rate environment, the repricing of higher-rate certificates of deposit as they mature to lower rates, and a shift in the mix of deposits from higher cost interest-bearing deposits to lower cost deposits, including non-interest-bearing demand deposits and low-cost interest-bearing demand deposits, money market deposits and savings accounts.

Average loans, which includes both loans held for investment and loans held for sale, increased \$130.3 million to \$850.5 million for the second quarter of 2014, compared to the same period of 2013. Average loans increased \$122.6 million to \$847.4 million for the first half of 2014. In total, average loans held for investment increased \$148.6 million during the second quarter of 2014 and \$144.8 million during the first half of 2014, compared to the same periods of 2013. Average loans in the Retail Banking segment increased \$150.6 million and \$147.6 million for the second quarter and first half of 2014, compared to the same periods of 2013, primarily as a result of the acquisition of CVBK on October 1, 2013. This increase was offset in part by a \$2.0 million and a \$2.8 million decrease in the Consumer Finance segment's average loan portfolio for the second quarter and first half of 2014, which declined as a result of increased competition. The Mortgage Banking segment's average portfolio of loans held for sale decreased \$18.3 million and \$22.2 million during the second quarter and first half of 2014, compared to the same periods of 2013. The decline in demand for mortgage loans and refinancing activity during the second quarter and first half of 2014 resulted in an \$85.9 million and \$172.7 million decrease in loan originations, respectively, when compared to the same periods of 2013.

The overall yield on average loans decreased 61 basis points to 9.37 percent for the second quarter of 2014 and 59 basis point to 9.36 percent for the first half of 2014, when compared to the same periods of 2013. These declines include a 75 basis point and a 77 basis point declines in the average yield on the Consumer Finance segment's loan portfolio for the second quarter and first half of 2014, respectively, as a result of aggressive pricing strategies by competitive lenders that lowered rates on newly-originated loans during the second half of 2013 and the first half of 2014. Further contributing to the decline in overall loan yield is the reduction in concentration of the Consumer Finance segment loans, which is the highest yielding component of total loans, as a percentage of total loans held for investment. The Consumer Finance segment loan portfolio comprised 34 percent of average loans held for investment during the second quarter and first half of 2014, compared to 42 percent during the same periods of 2013. Partially offsetting these factors in the second quarter and first half of 2014 was \$766,000 and \$1.5 million, respectively, of accretion related to the fair value adjustments to CVB's loan portfolio, which contributed approximately 37 basis points and 18 basis points to the yield on loans and 24 basis points and 12 basis points to the yield on interest earnings assets and the net interest margin for the second quarter of 2014 and first half of 2014, respectively.

Average securities available for sale increased \$67.0 million for the second quarter of 2014 and \$65.4 million for the second half of 2014, compared to the same periods of 2013. These increases occurred primarily in mortgage-backed securities, which were acquired in connection with the acquisition of CVBK. The average yield on the available-for-sale securities portfolio declined 75 basis points and 70 basis points for the second quarter and first half of 2014, compared to the same periods of 2013. The lower yield on the securities portfolio resulted from a shift in the mix of the securities portfolio from 79 percent concentration in higher-yielding tax-exempt securities for the second quarter and first half of 2013 to 55 and 56 percent concentration in tax-exempt securities for the second quarter and first half of 2014.

Average interest-bearing deposits in other banks and Federal funds sold increased \$104.3 million and \$113.3 million, respectively, for the second quarter and first half of 2014, compared to the same periods of 2013, primarily as a result of the acquisition of CVBK, which had excess liquidity as a result of the liquidation of a significant portion of its investment portfolio shortly after the date of acquisition. The average yield on these overnight funds increased four basis points during the second quarter of 2014 and increased one basis point during the first half of 2014, compared to the same periods of 2013.

Average interest-bearing time and savings deposits increased \$272.2 million for the second quarter of 2014 and \$271.6 million in the first half of 2014, compared to the same periods of 2013, primarily as a result of the acquisition of CVBK. However, the effect on interest expense of the higher volume of interest-bearing deposits was significantly offset by a 22 basis point decline for both the second quarter and first half of 2014 in the average cost of interest-bearing deposits, in particular on time deposits which continued to reprice at lower interest rates upon renewal, or were not renewed, as well as accretion of the fair value purchase adjustment on time deposits assumed in the CVB acquisition, which approximated \$296,000 and \$563,000 for the second quarter and first six months of 2014.

Average borrowings increased \$4.4 million and \$5.6 million during the second quarter and first half of 2014, compared to the same periods of 2013. These increases were primarily due to the assumption of trust preferred capital

notes in connection with the acquisition of CVBK, which had an average carrying value of \$4.5 million during both the second quarter and first half of 2014. In addition, average retail repurchase agreements increased on average by \$1.1 million during the first half of 2014. The cost of borrowings remained relatively constant during the second quarter and first half of 2014, compared to the same periods of 2013.

It will be challenging to maintain the Retail Banking segment's net interest margin at its current level if funds obtained from loan repayments and from deposit growth cannot be fully used to originate new loans and instead are reinvested in lower-yielding earning assets, and if the reduction in earning asset yields exceeds interest rate declines in interest-bearing liabilities, which are approaching their interest rate floors. The Retail Banking segment's net interest margin will benefit in future periods from the net accretion associated with the fair value adjustments to the loans, securities, deposits and borrowings purchased in the CVBK acquisition. If conditions influencing the mortgage banking environment do not improve, the Mortgage Banking segment may experience a continuation of lower loan demand, particularly for refinancings, which could reduce interest income on loans originated for sale, further contributing to a deterioration in net interest margin. The net interest margin at the Consumer Finance segment will be most affected by increasing competition and loan pricing strategies that competitors may use to grow market share in automobile financing and by economic conditions that are negatively affecting borrowers and could increase default rates on the segment's loans. Increased competition may result in (1) lower yields as the Consumer Finance segment responds to competitive pricing pressures and (2) fewer purchases of automobile retail installment sales contracts.

**Noninterest Income****TABLE 3: Noninterest Income***(Dollars in thousands)*

|   | <b>Three Months Ended June 30, 2014</b> |                 |                 |                     | <b>Total</b> |
|---|---|-----------------|-----------------|---------------------|--------------|
|   | <b>Retail</b>                           | <b>Mortgage</b> | <b>Consumer</b> | <b>Other and</b>    |              |
|   | <b>Banking</b>                          | <b>Banking</b>  | <b>Finance</b>  | <b>Eliminations</b> |              |
| Gains on sales of loans                         | \$—                                     | \$ 1,647        | \$ —            | \$ —                | \$1,647      |
| Service charges on deposit accounts             | 1,116                                   | —               | —               | —                   | 1,116        |
| Other service charges and fees                  | 1,049                                   | 611             | 3               | (48)                | 1,615        |
| Gains on calls of available for sale securities | 3                                       | —               | —               | —                   | 3            |
| Other income                                    | 115                                     | 122             | 258             | 390                 | 885          |
| Total noninterest income                        | \$2,283                                 | \$ 2,380        | \$ 261          | \$ 342              | \$5,266      |

*(Dollars in thousands)*

|   | <b>Three Months Ended June 30, 2013</b> |                 |                 |                     | <b>Total</b> |
|---|---|-----------------|-----------------|---------------------|--------------|
|   | <b>Retail</b>                           | <b>Mortgage</b> | <b>Consumer</b> | <b>Other and</b>    |              |
|   | <b>Banking</b>                          | <b>Banking</b>  | <b>Finance</b>  | <b>Eliminations</b> |              |
| Gains on sales of loans                         | \$—                                     | \$ 3,577        | \$ —            | \$ —                | \$3,577      |
| Service charges on deposit accounts             | 996                                     | —               | —               | —                   | 996          |
| Other service charges and fees                  | 677                                     | 758             | 2               | 35                  | 1,472        |
| Gains on calls of available for sale securities | 4                                       | —               | —               | —                   | 4            |
| Other income                                    | 12                                      | 328             | 274             | 300                 | 914          |
| Total noninterest income                        | \$1,689                                 | \$ 4,663        | \$ 276          | \$ 335              | \$6,963      |

*(Dollars in thousands)*

|   | <b>Six Months Ended June 30, 2014</b> |                 |                 |                     | <b>Total</b> |
|---|---------------------------------------|-----------------|-----------------|---------------------|--------------|
|   | <b>Retail</b>                         | <b>Mortgage</b> | <b>Consumer</b> | <b>Other and</b>    |              |
|   | <b>Banking</b>                        | <b>Banking</b>  | <b>Finance</b>  | <b>Eliminations</b> |              |
| Gains on sales of loans                         | \$—                                   | \$ 2,837        | \$ —            | \$ —                | \$2,837      |
| Service charges on deposit accounts             | 2,178                                 | —               | —               | —                   | 2,178        |
| Other service charges and fees                  | 1,902                                 | 1,070           | 7               | 17                  | 2,996        |
| Gains on calls of available for sale securities | 3                                     | —               | —               | —                   | 3            |
| Other income                                    | 425                                   | 418             | 555             | 666                 | 2,064        |
| Total noninterest income                        | \$4,508                               | \$ 4,325        | \$ 562          | \$ 683              | \$10,078     |

*(Dollars in thousands)***Six Months Ended June 30, 2013**

|   | <b>Retail</b>  | <b>Mortgage</b> | <b>Consumer</b> | <b>Other and</b>    | <b>Total</b> |
|---|----------------|-----------------|-----------------|---------------------|--------------|
|   | <b>Banking</b> | <b>Banking</b>  | <b>Finance</b>  | <b>Eliminations</b> |              |
| Gains on sales of loans                         | \$—            | \$ 5,278        | \$ —            | \$ —                | \$5,278      |
| Service charges on deposit accounts             | 1,920          | —               | —               | —                   | 1,920        |
| Other service charges and fees                  | 1,321          | 1,573           | 4               | 78                  | 2,976        |
| Gains on calls of available for sale securities | 6              | —               | —               | —                   | 6            |
| Other income                                    | 153            | 591             | 570             | 567                 | 1,881        |
| Total noninterest income                        | \$3,400        | \$ 7,442        | \$ 574          | \$ 645              | \$12,061     |

Total noninterest income decreased \$1.7 million, or 24.37 percent, in the second quarter of 2014 and decreased \$2.0 million, or 16.44 percent, in the first half of 2014, compared to the same periods in 2013. Declines of \$2.3 million and \$3.1 million in noninterest income for the second quarter and first half of 2014, respectively, compared to the same periods of 2013, occurred at the Mortgage Banking segment where gains on sales of loans and ancillary loan origination fees were negatively affected by higher mortgage interest rates and low housing inventories, which caused a 40.54 percent decline and a 44.27 percent decline in the Mortgage Banking segment's loan origination volume during the second quarter and first half of 2014, compared to the same periods of 2013. The declines in noninterest income at the Mortgage Banking segment were partially offset by increases of \$594,000 and \$1.1 million for the second quarter and first half of 2014, respectively, compared to the same periods of 2013, at the Retail Banking segment, which resulted from the acquisition of CVB on October 1, 2013 and the contribution of CVB's operations to noninterest income generated by the Retail Banking segment.

## Noninterest Expense

TABLE 4: Noninterest Expenses

| <i>(Dollars in thousands)</i>        | Three Months Ended June 30, 2014 |          |          |              | Total    |
|--------------------------------------|----------------------------------|----------|----------|--------------|----------|
|                                      | Retail                           | Mortgage | Consumer | Other and    |          |
|                                      | Banking                          | Banking  | Finance  | Eliminations |          |
| Salaries and employee benefits       | \$5,589                          | \$ 1,138 | \$ 2,107 | \$ 231       | \$9,065  |
| Occupancy expenses                   | 1,544                            | 433      | 205      | 1            | 2,183    |
| Other expenses:                      |                                  |          |          |              |          |
| OREO expenses (income)               | (10 )                            | —        | —        | —            | (10 )    |
| Provision for indemnification losses | —                                | 63       | —        | —            | 63       |
| Other expenses                       | 3,087                            | 640      | 1,013    | 215          | 4,955    |
| Total other expenses                 | 3,077                            | 703      | 1,013    | 215          | 5,008    |
| Total noninterest expenses           | \$10,210                         | \$ 2,274 | \$ 3,325 | \$ 447       | \$16,256 |

| <i>(Dollars in thousands)</i>        | Three Months Ended June 30, 2013 |          |          |              | Total    |
|--------------------------------------|----------------------------------|----------|----------|--------------|----------|
|                                      | Retail                           | Mortgage | Consumer | Other and    |          |
|                                      | Banking                          | Banking  | Finance  | Eliminations |          |
| Salaries and employee benefits       | \$4,067                          | \$ 2,009 | \$ 1,944 | \$ 209       | \$8,229  |
| Occupancy expenses                   | 1,091                            | 465      | 208      | 6            | 1,770    |
| Other expenses:                      |                                  |          |          |              |          |
| OREO expenses                        | 332                              | —        | —        | —            | 332      |
| Provision for indemnification losses | —                                | 150      | —        | —            | 150      |
| Other expenses                       | 1,805                            | 700      | 852      | 710          | 4,067    |
| Total other expenses                 | 2,137                            | 850      | 852      | 710          | 4,549    |
| Total noninterest expenses           | \$7,295                          | \$ 3,324 | \$ 3,004 | \$ 925       | \$14,548 |

| <i>(Dollars in thousands)</i>  | Six Months Ended June 30, 2014 |          |          |              | Total    |
|--------------------------------|--------------------------------|----------|----------|--------------|----------|
|                                | Retail                         | Mortgage | Consumer | Other and    |          |
|                                | Banking                        | Banking  | Finance  | Eliminations |          |
| Salaries and employee benefits | \$11,439                       | \$ 2,099 | \$ 4,254 | \$ 432       | \$18,224 |
| Occupancy expenses             | 3,031                          | 897      | 385      | 2            | 4,315    |
| Other expenses:                |                                |          |          |              |          |
| OREO expenses (income)         | (78 )                          | —        | —        | —            | (78 )    |



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|                                      |                 |                 |                 |               |                 |
|--------------------------------------|-----------------|-----------------|-----------------|---------------|-----------------|
| Provision for indemnification losses | —               | <b>109</b>      | —               | —             | <b>109</b>      |
| Other expenses                       | <b>6,346</b>    | <b>1,328</b>    | <b>1,917</b>    | <b>449</b>    | <b>10,040</b>   |
| Total other expenses                 | <b>6,268</b>    | <b>1,437</b>    | <b>1,917</b>    | <b>449</b>    | <b>10,071</b>   |
| Total noninterest expenses           | <b>\$20,738</b> | <b>\$ 4,433</b> | <b>\$ 6,556</b> | <b>\$ 883</b> | <b>\$32,610</b> |

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| <i>(Dollars in thousands)</i>        | <b>Six Months Ended June 30, 2013</b> |                 |                 |                     | <b>Total</b> |
|--------------------------------------|---------------------------------------|-----------------|-----------------|---------------------|--------------|
|                                      | <b>Retail</b>                         | <b>Mortgage</b> | <b>Consumer</b> | <b>Other and</b>    |              |
|                                      | <b>Banking</b>                        | <b>Banking</b>  | <b>Finance</b>  | <b>Eliminations</b> |              |
| Salaries and employee benefits       | \$8,209                               | \$ 2,754        | \$ 3,934        | \$ 401              | \$15,298     |
| Occupancy expenses                   | 2,177                                 | 944             | 410             | 7                   | 3,538        |
| Other expenses:                      |                                       |                 |                 |                     |              |
| OREO expenses                        | 384                                   | —               | —               | —                   | 384          |
| Provision for indemnification losses | —                                     | 375             | —               | —                   | 375          |
| Other expenses                       | 3,692                                 | 1,425           | 1,764           | 1,101               | 7,982        |
| Total other expenses                 | 4,076                                 | 1,800           | 1,764           | 1,101               | 8,741        |
| Total noninterest expenses           | \$14,462                              | \$ 5,498        | \$ 6,108        | \$ 1,509            | \$27,577     |

Total noninterest expenses increased \$1.7 million, or 11.74 percent, in the second quarter of 2014 and increased \$5.0 million, or 18.25 percent, in the first half of 2014, compared to the same periods in 2013. Noninterest expenses increased at the Retail Banking segment primarily as a result of the acquisition of CVB and the expenses associated with the operation of seven additional branches and the servicing of acquired deposits. Further increases resulted from higher personnel costs during the second quarter and first half of 2014 at (1) the Retail Banking segment due to increased staffing in the branch network to support customer service initiatives and the addition of new personnel dedicated to growing C&F Bank's commercial and small business loan portfolio and (2) at the Consumer Finance segment due to an increase in the number of personnel to support expansion into new markets. These increases were partially offset at the Mortgage Banking segment by lower (1) production-based compensation, (2) loan processing expenses and (3) provision for indemnification losses in connection with loans sold to investors; at the Retail Banking segment by lower foreclosed properties expenses as a result of the sale of a majority of these properties since the second quarter of 2013. Additionally, the Corporation recognized \$581,000 in transaction costs during the first half of 2013 associated with the acquisition of CVBK.

## Income Taxes

Income tax expense for the second quarter of 2014 totaled \$1.6 million, resulting in an effective tax rate of 29.6 percent, compared to \$2.3 million and 35.2 percent for the second quarter of 2013. Income tax expense for the first half of 2014 totaled \$2.7 million, resulting in an effective tax rate of 28.9 percent, compared to \$4.1 million and 33.5 percent for the first half of 2013. The decline in the effective tax rate during the second quarter and first half of 2014 compared to the same periods of 2013 was a result of higher earnings at the Retail Banking segment, which generates significant tax-exempt income on securities issued by states and political subdivisions and is exempt from state income taxes.

**ASSET QUALITY****Allowance for Loan Losses**

The allowance for loan losses represents an amount that, in our judgment, will be adequate to absorb any losses on existing loans that may become uncollectible. The provision for loan losses increases the allowance, and loans charged off, net of recoveries, reduce the allowance.

The following tables summarize the allowance activity for the periods indicated:

**TABLE 5: Allowance for Loan Losses**

| <i>(Dollars in thousands)</i>                       | <b>Three Months<br/>Ended June 30,</b> |             |
|---|--|-------------|
|   | <b>2014</b>                            | <b>2013</b> |
| Allowance, beginning of period                      | <b>\$34,908</b>                        | \$33,921    |
| Provision for loan losses:                          |  |             |
| Retail Banking segment                              | —                                      | 600         |
| Mortgage Banking segment                            | <b>15</b>                              | 30          |
| Consumer Finance segment                            | <b>3,250</b>                           | 2,490       |
| Total provision for loan losses                     | <b>3,265</b>                           | 3,120       |
| Loans charged off:                                  |  |             |
| Real estate—residential mortgage                    | <b>6</b>                               | 2           |
| Real estate—construction                            | —                                      | —           |
| Commercial, financial and agricultural <sup>2</sup> | <b>174</b>                             | 136         |
| Equity lines  | <b>47</b>                              | —           |
| Consumer  | <b>42</b>                              | 44          |
| Consumer finance                                    | <b>3,610</b>                           | 2,968       |
| Total loans charged off                             | <b>3,879</b>                           | 3,150       |
| Recoveries of loans previously charged off:         |  |             |
| Real estate—residential mortgage                    | <b>15</b>                              | 7           |
| Real estate—construction                            | —                                      | —           |
| Commercial, financial and agricultural <sup>2</sup> | <b>12</b>                              | 52          |
| Equity lines  | —                                      | —           |
| Consumer  | <b>24</b>                              | 32          |
| Consumer finance                                    | <b>913</b>                             | 787         |
| Total recoveries                                    | <b>964</b>                             | 878         |
| Net loans charged off                               | <b>2,915</b>                           | 2,272       |

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|   |                 |   |          |   |
|---|-----------------|---|----------|---|
| Allowance, end of period  | <b>\$35,258</b> |   | \$34,769 |   |
| Ratio of annualized net charge-offs to average total loans outstanding during period for Retail Banking   | <b>0.16</b>     | % | 0.09     | % |
| Ratio of annualized net charge-offs to average total loans outstanding during period for Consumer Finance | <b>3.85</b>     | % | 3.09     | % |

| <i>(Dollars in thousands)</i>   | <b>Six Months Ended</b> |             |      |   |
|---|-------------------------|-------------|------|---|
|   | <b>June 30,</b>         |             |      |   |
|   | <b>2014</b>             | <b>2013</b> |      |   |
| Allowance, beginning of period  | <b>\$34,852</b>         | \$35,907    |      |   |
| Provision for loan losses:  |                         |             |      |   |
| Retail Banking segment  | —                       | 1,000       |      |   |
| Mortgage Banking segment  | <b>30</b>               | 60          |      |   |
| Consumer Finance segment  | <b>6,745</b>            | 5,240       |      |   |
| Total provision for loan losses   | <b>6,775</b>            | 6,300       |      |   |
| Loans charged off:  |                         |             |      |   |
| Real estate—residential mortgage  | <b>79</b>               | 475         |      |   |
| Real estate—construction  | —                       | —           |      |   |
| Commercial, financial and agricultural <sup>2</sup>   | <b>174</b>              | 2,270       |      |   |
| Equity lines  | <b>47</b>               | 37          |      |   |
| Consumer  | <b>147</b>              | 228         |      |   |
| Consumer finance  | <b>8,098</b>            | 6,361       |      |   |
| Total loans charged off   | <b>8,545</b>            | 9,371       |      |   |
| Recoveries of loans previously charged off:   |                         |             |      |   |
| Real estate—residential mortgage  | <b>24</b>               | 86          |      |   |
| Real estate—construction  | —                       | —           |      |   |
| Commercial, financial and agricultural <sup>2</sup>   | <b>47</b>               | 60          |      |   |
| Equity lines  | —                       | 27          |      |   |
| Consumer  | <b>170</b>              | 79          |      |   |
| Consumer finance  | <b>1,935</b>            | 1,681       |      |   |
| Total recoveries  | <b>2,176</b>            | 1,933       |      |   |
| Net loans charged off   | <b>6,369</b>            | 7,438       |      |   |
| Allowance, end of period  | <b>\$35,258</b>         | \$34,769    |      |   |
| Ratio of annualized net charge-offs to average total loans outstanding during period for Retail Banking   | <b>0.08</b>             | %           | 1.41 | % |
| Ratio of annualized net charge-offs to average total loans outstanding during period for Consumer Finance | <b>4.42</b>             | %           | 3.33 | % |

<sup>1</sup>Includes the Corporation's real estate construction lending and consumer real estate lot lending.

<sup>2</sup>Includes the Corporation's commercial real estate lending, land acquisition and development lending, builder line lending and commercial business lending.

For the six months ended June 30, 2013, the annualized net charge-off ratio for the Retail Banking segment includes a \$2.1 million charge-off for a single commercial lending relationship.



Table 6 discloses the allocation of the allowance for loan losses at June 30, 2014 and December 31, 2013.

**TABLE 6: Allocation of Allowance for Loan Losses**

| <i>(Dollars in thousands)</i>                       | <b>June<br/>30,<br/>2014</b> | <b>December<br/>31,<br/>2013</b> |
|---|------------------------------|----------------------------------|
| Allocation of allowance for loan losses:            |                              |                                  |
| Real estate—residential mortgage                    | <b>\$2,330</b>               | \$ 2,355                         |
| Real estate—construction                            | <b>434</b>                   | 434                              |
| Commercial, financial and agricultural <sup>2</sup> | <b>7,678</b>                 | 7,805                            |
| Equity lines  | <b>845</b>                   | 892                              |
| Consumer  | <b>296</b>                   | 273                              |
| Consumer finance                                    | <b>23,675</b>                | 23,093                           |
| Total allowance for loan losses                     | <b>\$35,258</b>              | \$ 34,852                        |

<sup>1</sup> Includes the Corporation's real estate construction lending and consumer real estate lot lending.

<sup>2</sup> Includes the Corporation's commercial real estate lending, land acquisition and development lending, builder line lending and commercial business lending.

Loans by credit quality ratings are presented in Table 7 below. The characteristics of these loan ratings are as follows:

Pass rated loans are to persons or business entities with an acceptable financial condition, appropriate collateral margins, appropriate cash flow to service the existing loan, and an appropriate leverage ratio. The borrower has paid all obligations as agreed and it is expected that this type of payment history will continue. When necessary, acceptable personal guarantors support the loan.

Special mention loans have a specific, identified weakness in the borrower's operations and in the borrower's ability to generate positive cash flow on a sustained basis. The borrower's recent payment history is characterized by late payments. The Corporation's risk exposure is mitigated by collateral supporting the loan. The collateral is considered to be well-margined, well maintained, accessible and readily marketable.

Substandard loans are considered to have specific and well-defined weaknesses that jeopardize the viability of the Corporation's credit extension. The payment history for the loan has been inconsistent and the expected or projected primary repayment source may be inadequate to service the loan. The estimated net liquidation value of the

collateral pledged and/or ability of the personal guarantor(s) to pay the loan may not adequately protect the Corporation. There is a distinct possibility that the Corporation will sustain some loss if the deficiencies associated with the loan are not corrected in the near term. A substandard loan would not automatically meet our definition of impaired unless the loan is significantly past due and the borrower's performance and financial condition provide evidence that it is probable that the Corporation will be unable to collect all amounts due.

Substandard nonaccrual loans have the same characteristics as substandard loans; however, they have a nonaccrual classification because it is probable that the Corporation will not be able to collect all amounts due.

Doubtful loans have all the weaknesses inherent in a loan that is classified substandard but with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high.

Loss loans are not considered collectible under normal circumstances and there is no realistic expectation for any future payment on the loan. Loss rated loans are fully charged off.



**TABLE 7: Credit Quality Indicators**

Loans by credit quality indicators as of June 30, 2014 were as follows:

| <i>(Dollars in thousands)</i>                       | <b>Pass</b> | <b>Special<br/>Mention</b> | <b>Substandard</b> | <b>Substandard<br/>Nonaccrual</b> | <b>Total<sup>1</sup></b> |
|---|-------------|----------------------------|--------------------|-----------------------------------|--------------------------|
| Real estate—residential mortgage                    | \$172,699   | \$1,975                    | \$3,687            | \$2,153                           | \$180,514                |
| Real estate—construction                            | 4,844       | 87                         | 2,649              | —                                 | 7,580                    |
| Commercial, financial and agricultural <sup>3</sup> | 254,851     | 8,149                      | 30,470             | 2,076                             | 295,546                  |
| Equity lines  | 48,644      | 775                        | 949                | 209                               | 50,577                   |
| Consumer  | 7,889       | 2                          | 116                | 232                               | 8,239                    |
|   | \$488,927   | \$10,988                   | \$37,871           | \$4,670                           | \$542,456                |

| <i>(Dollars in thousands)</i> | <b>Performing</b> | <b>Non-Performing</b> | <b>Total</b> |
|-------------------------------|-------------------|-----------------------|--------------|
| Consumer finance              | \$283,327         | \$646                 | \$283,973    |

<sup>1</sup> At June 30, 2014, the Corporation did not have any loans classified as Doubtful or Loss.

<sup>2</sup> Includes the Corporation's real estate construction lending and consumer real estate lot lending.

<sup>3</sup> Includes the Corporation's commercial real estate lending, land acquisition and development lending, builder line lending and commercial business lending.

Included in the table above are loans purchased in connection with the acquisition of CVBK of \$102.4 million pass rated, \$2.8 million special mention, \$14.1 million substandard and \$641,000 substandard nonaccrual.

Loans by credit quality indicators as of December 31, 2013 were as follows:

| <i>(Dollars in thousands)</i>                       | <b>Pass</b> | <b>Special<br/>Mention</b> | <b>Substandard</b> | <b>Substandard<br/>Nonaccrual</b> | <b>Total<sup>1</sup></b> |
|---|-------------|----------------------------|--------------------|-----------------------------------|--------------------------|
| Real estate – residential mortgage                  | \$180,670   | \$2,209                    | \$3,580            | \$1,996                           | \$188,455                |
| Real estate – construction <sup>2</sup>             | 2,899       | 116                        | 2,795              | —                                 | 5,810                    |
| Commercial, financial and agricultural <sup>3</sup> | 243,576     | 8,571                      | 34,573             | 1,873                             | 288,593                  |
| Equity lines  | 48,603      | 1,003                      | 898                | 291                               | 50,795                   |
| Consumer  | 8,616       | 2                          | 158                | 231                               | 9,007                    |

\$484,364   \$11,901   \$ 42,004     \$ 4,391     \$542,660

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<sup>1</sup> At December 31, 2013, the Corporation did not have any loans classified as Doubtful or Loss.

<sup>2</sup> Includes the Corporation's real estate construction lending and consumer real estate lot lending.

<sup>3</sup> Includes the Corporation's commercial real estate lending, land acquisition and development lending, builder line lending and commercial business lending.

Included in the table above are loans purchased in connection with the acquisition of CVBK of \$115.3 million pass rated, \$3.3 million special mention, \$17.8 million substandard and \$652,000 substandard nonaccrual.

| <i>(Dollars in thousands)</i> | <b>Performing</b> | <b>Non-Performing</b> | <b>Total</b> |
|-------------------------------|-------------------|-----------------------|--------------|
| Consumer finance              | \$ 276,537        | \$ 1,187              | \$277,724    |

The Retail Banking segment's allowance for loan losses as of June 30, 2014 decreased \$206,000 since December 31, 2013 as a result of net charge-offs during 2014 that were provided for in prior periods. Because of the improvement in loan credit quality during the first half of 2014 for the Retail Banking segment, there was no provision for loan losses during this period. The allowance for loan losses as a percentage of total loans, excluding purchased credit impaired loans, was 2.16 percent and 2.22 percent at June 30, 2014 and December 31, 2013, respectively. In addition, there was a \$4.1 million decline in the Retail Banking segment's substandard loans. We believe that the current level of the allowance for loan losses at the Retail Banking segment is adequate to absorb any losses on existing loans that may become uncollectible. If current economic conditions continue or worsen, a higher level of nonperforming loans may be experienced in future periods, which may then require a higher provision for loan losses.

The Consumer Finance segment's allowance for loan losses increased by \$582,000 since December 31, 2013 to \$23.7 million at June 30, 2014, and its provision for loan losses increased \$760,000 and \$1.5 million for the second quarter and first half of 2014, respectively, compared to the same periods of 2013. The increase in the provision for loan losses during the first half of 2014 and the lack of significant loan portfolio growth since December 31, 2013 resulted in an increase in the ratio of the allowance for loan losses to total loans to 8.34 percent at June 30, 2014 from 8.32 percent at December 31, 2013. The increase in the provision for loan losses resulted from higher charge-offs throughout the first half of 2014, compared to the first half of 2013, attributable to the continued difficult economic environment. In particular, unemployment rates among the segment's target customers remain higher than historical levels. In addition, credit easing by the Consumer Finance segment's competitors is contributing to higher loan default rates in the industry. We believe that the current level of the allowance for loan losses at the Consumer Finance segment is adequate to absorb any losses on existing loans that may become uncollectible. However, if unemployment levels remain elevated or increase in the future or if the current economic environment continues to contribute to an increase in the segment's defaults, a higher provision for loan losses may become necessary.

## Nonperforming Assets

Table 8 summarizes nonperforming assets at June 30, 2014 and December 31, 2013.

**TABLE 8: Nonperforming Assets**

### Retail Banking Segment

| <i>(Dollars in thousands)</i>                      | <b>June 30,<br/>2014</b> | <b>December<br/>31,<br/>2013</b> |
|--|--------------------------|----------------------------------|
| Loans, excluding purchased loans                   | <b>\$419,629</b>         | \$402,755                        |
| Purchased performing loans <sup>1</sup>            | <b>92,588</b>            | 104,471                          |
| Purchased credit impaired loans <sup>1</sup>       | <b>27,457</b>            | 32,520                           |
| Total loans  | <b>\$539,674</b>         | \$539,746                        |
| Nonaccrual loans <sup>2</sup>                      | <b>\$3,838</b>           | \$3,740                          |
| Purchased performing-nonaccrual loans <sup>3</sup> | <b>641</b>               | 651                              |
| Total nonaccrual loans                             | <b>4,479</b>             | 4,391                            |
| OREO <sup>4</sup>                                  | <b>817</b>               | 2,768                            |
| Total nonperforming assets <sup>5</sup>            | <b>\$5,296</b>           | \$7,159                          |
| Accruing loans past due for 90 days or more        | <b>\$250</b>             | \$75                             |

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|  |                 |   |           |   |
|--|-----------------|---|-----------|---|
| Troubled debt restructurings (TDRs) <sup>2</sup>                           | <b>\$5,276</b>  |   | \$ 5,217  |   |
| Purchased performing TDRs <sup>6</sup>                                     | <b>\$395</b>    |   | \$ 403    |   |
| Allowance for loan losses (ALL)  | <b>\$11,060</b> |   | \$ 11,266 |   |
| Nonperforming assets to total loans and OREO                               | <b>0.98</b>     | % | 1.34      | % |
| ALL to total loans, excluding purchased credit impaired loans <sup>7</sup> | <b>2.16</b>     | % | 2.22      | % |
| ALL to total nonaccrual loans  | <b>246.93</b>   | % | 256.57    | % |

The loans acquired from CVB are tracked in two separate categories - "purchased performing" and "purchased credit impaired." The fair market value adjustments for the purchased performing loans are \$1.2 million at June 30, 2014 and \$1.3 million at December 31, 2013 for interest and \$4.3 million at June 30, 2014 and \$5.2 million at <sup>1</sup>December 31, 2013 for credit. The fair market value adjustments for the purchased credit impaired loans are \$5.5 million at June 30, 2014 and \$5.0 million at December 31, 2013 for interest and \$9.6 million at June 30, 2014 and \$11.5 million at December 31, 2013 for credit.

<sup>2</sup>Nonaccrual loans include nonaccrual TDRs of \$2.5 million at June 30, 2014 and \$2.6 million at December 31, 2013.

<sup>3</sup>Purchased performing-nonaccrual loans are presented net of fair market value interest and credit marks totaling \$250,000 at June 30, 2014 and \$488,000 at December 31, 2013.

<sup>4</sup>OREO is recorded at its estimated fair market value less cost to sell.

As required by acquisition accounting, purchased credit impaired loans that were considered nonaccrual and TDRs <sup>5</sup>prior to the acquisition lose these designations and are not included in post-acquisition nonperforming assets as presented in Table 8.

<sup>6</sup>Purchased performing TDRs are accruing and are presented net of fair market value interest and credit marks totaling \$10,000 at June 30, 2014 and \$11,000 at December 31, 2013.

For the purpose of calculating this ratio, purchased performing loans are included in total loans. Purchased <sup>7</sup>performing loans were marked to fair value on acquisition date; therefore, no allowance for loan losses was recorded for these loans.

**Mortgage Banking Segment**

| <i>(Dollars in thousands)</i>      | <b>June<br/>30,<br/>2014</b> | December<br>31,<br>2013 |   |
|------------------------------------|------------------------------|-------------------------|---|
| Nonaccrual loans                   | <b>\$191</b>                 | \$ —                    |   |
| Total loans                        | <b>\$2,782</b>               | \$ 2,914                |   |
| ALL                                | <b>\$523</b>                 | \$ 493                  |   |
| Nonperforming loans to total loans | <b>6.87</b> %                | —                       | % |
| ALL to loans                       | <b>18.8</b> %                | 16.92                   | % |
| ALL to nonaccrual loans            | <b>273.82</b> %              | —                       | % |

**Consumer Finance Segment**

| <i>(Dollars in thousands)</i>                                     | <b>June 30,<br/>2014</b> | December<br>31,<br>2013 |   |
|---|--------------------------|-------------------------|---|
| Nonaccrual loans  | <b>\$646</b>             | \$1,187                 |   |
| Accruing loans past due for 90 days or more                       | <b>\$—</b>               | \$—                     |   |
| Total loans   | <b>\$283,973</b>         | \$277,724               |   |
| ALL   | <b>\$23,675</b>          | \$23,093                |   |
| Nonaccrual consumer finance loans to total consumer finance loans | <b>0.23</b> %            | 0.43                    | % |
| ALL to total consumer finance loans                               | <b>8.34</b> %            | 8.32                    | % |

Total nonperforming assets of the Retail Banking segment totaled \$5.3 million at June 30, 2014, compared to \$7.2 million at December 31, 2013, a 26.02 percent decline during the first half of 2014. The Retail Banking Segment's nonperforming assets at June 30, 2014 included \$4.5 million of nonaccrual loans, compared to \$4.4 million at December 31, 2013, and \$817,000 of OREO, compared to \$2.8 million at December 31, 2013. We believe we have provided adequate loan loss reserves based on current appraisals or evaluations of the collateral. In some cases, appraisals have been adjusted to reflect current trends including sales prices, expenses, absorption periods and other current relevant factors. The 70.48 percent decline in OREO properties since December 31, 2013 resulted from sales of properties that had a total carrying value of \$2.4 million at December 31, 2013.

Nonaccrual loans at the Consumer Finance segment decreased to \$646,000 at June 30, 2014 from \$1.2 million at December 31, 2013. As noted above, the ratio of the allowance for loan losses to total consumer finance loans was 8.34 percent as of June 30, 2014, compared with 8.32 percent at December 31, 2013. Nonaccrual consumer finance loans remain relatively low compared to the allowance for loan losses and the total consumer finance loan portfolio because the Consumer Finance segment generally initiates repossession of loan collateral once a loan is 60 days or

more past due but before the loan reaches 90 days or more past due and is evaluated for nonaccrual status.

We measure impaired loans based on the present value of expected future cash flows discounted at the effective interest rate of the loan or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. We maintain a valuation allowance to the extent that the measure of the impaired loan is less than the recorded investment. TDRs occur when we agree to significantly modify the original terms of a loan by granting a concession due to the deterioration in the financial condition of the borrower. These concessions typically are made for loss mitigation purposes and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. TDRs are considered impaired loans.

**TABLE 9: Impaired Loans**

Impaired loans, which consisted solely of TDRs, and the related allowance at June 30, 2014, were as follows:

| <i>(Dollars in thousands)</i>           | <b>Recorded<br/>Investment<br/>in<br/>Loans</b> | <b>Unpaid<br/>Principal<br/>Balance</b> | <b>Related<br/>Allowance</b> | <b>Average<br/>Balance-<br/>Impaired<br/>Loans</b> | <b>Interest<br/>Income<br/>Recognized</b> |
|---|---|---|------------------------------|--|---|
| Real estate – residential mortgage      | \$ 2,348  | \$ 2,460                                | \$ 430                       | \$ 2,374   | \$ 57                                     |
| Commercial, financial and agricultural: |   |   |                              |  |   |
| Commercial real estate lending          | 2,711   | 2,851                                   | 416                          | 2,776  | 65  |
| Builder line lending                    | —   | —                                       | —                            | —  | —   |
| Commercial business lending             | 489   | 489                                     | 129                          | 492  | 5   |
| Equity lines                            | 30  | 32                                      | 1                            | 32   | —   |
| Consumer                                | 93  | 93                                      | 14                           | 93   | 2   |
| <b>Total</b>                            | <b>\$ 5,671</b>                                 | <b>\$ 5,925</b>                         | <b>\$ 990</b>                | <b>\$ 5,767</b>                                    | <b>\$ 129</b>                             |

Impaired loans, which included \$5.6 million of TDRs, and the related allowance at December 31, 2013, were as follows:

| <i>(Dollars in thousands)</i>           | <b>Recorded<br/>Investment<br/>in<br/>Loans</b> | <b>Unpaid<br/>Principal<br/>Balance</b> | <b>Related<br/>Allowance</b> | <b>Average<br/>Balance-<br/>Impaired<br/>Loans</b> | <b>Interest<br/>Income<br/>Recognized</b> |
|---|---|---|------------------------------|--|---|
| Real estate – residential mortgage      | \$ 2,601  | \$ 2,694                                | \$ 390                       | \$ 2,090   | \$ 99                                     |
| Commercial, financial and agricultural: |   |   |                              |  |   |
| Commercial real estate lending          | 2,729   | 2,780                                   | 504                          | 2,748  | 99  |
| Builder line lending                    | 13  | 16                                      | 4                            | 14   | 1   |
| Commercial business lending             | 695   | 756                                     | 131                          | 562  | 11  |
| Equity lines                            | 131   | 132                                     | —                            | 33   | —   |
| Consumer                                | 93  | 93                                      | 14                           | 95   | 9   |
| <b>Total</b>                            | <b>\$ 6,262</b>                                 | <b>\$ 6,471</b>                         | <b>\$ 1,043</b>              | <b>\$ 5,542</b>                                    | <b>\$ 219</b>                             |

TDRs (including purchased performing TDRs) at June 30, 2014 and December 31, 2013 were as follows:

**TABLE 10: Troubled Debt Restructurings**

| <i>(Dollars in thousands)</i> | <b>June 30,<br/>2014</b> | <b>December 31,<br/>2013</b> |
|-------------------------------|--------------------------|------------------------------|
| Accruing TDRs                 | <b>\$3,147</b>           | \$3,026                      |
| Nonaccrual TDRs <sup>1</sup>  | <b>2,524</b>             | 2,594                        |
| Total TDRs <sup>2</sup>       | <b>\$5,671</b>           | \$5,620                      |

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<sup>1</sup>Included in nonaccrual loans in Table 8: Nonperforming Assets.

<sup>2</sup>Included in impaired loans in Table 9: Impaired Loans.

While TDRs are considered impaired loans, not all TDRs are on nonaccrual status. If a loan was on nonaccrual status at the time of the TDR modification, the loan will remain on nonaccrual status following the modification and may be returned to accrual status based on the Corporation's policy for returning loans to accrual status. If a loan was accruing prior to being modified as a TDR and if the Corporation concludes that the borrower is able to make such modified payments, and there are no other factors or circumstances that would cause it to conclude otherwise, the TDR will remain on an accruing status.



## FINANCIAL CONDITION

At June 30, 2014, the Corporation had total assets of \$1.4 billion, which was an increase of \$35.2 million since December 31, 2013. The increase resulted primarily from a \$34.2 million increase in cash and cash equivalents, which was driven by deposit growth. The decision to deploy excess liquidity in interest-bearing deposits in other banks was influenced by the lack of attractively-priced investment securities available for purchase during the first six months of 2014 and continued weak loan demand at the Retail Banking segment in the current economic environment.

### Loan Portfolio

The following table sets forth the composition of the Corporation's loans held for investment in dollar amounts and as a percentage of the Corporation's total gross loans held for investment at the dates indicated.

**TABLE 11: Summary of Loans Held for Investment**

| <i>(Dollars in thousands)</i>                       | June 30, 2014 |         | December 31, 2013 |         |   |
|---|---------------|---------|-------------------|---------|---|
|   | Amount        | Percent | Amount            | Percent |   |
| Real estate – residential mortgage                  | \$180,514     | 22      | % \$188,455       | 23      | % |
| Real estate – construction <sup>1</sup>             | 7,580         | 1       | 5,810             | 1       |   |
| Commercial, financial and agricultural <sup>2</sup> | 295,545       | 36      | 288,593           | 35      |   |
| Equity lines  | 50,577        | 6       | 50,795            | 6       |   |
| Consumer  | 8,239         | 1       | 9,007             | 1       |   |
| Consumer finance                                    | 283,973       | 34      | 277,724           | 34      |   |
| Total loans   | 826,428       | 100     | % 820,384         | 100     | % |
| Less allowance for loan losses                      | (35,258 )     |         | (34,852 )         |         |   |
| Total loans, net                                    | \$791,170     |         | \$785,532         |         |   |

<sup>1</sup>Includes the Corporation's real estate construction lending and consumer real estate lot lending.

<sup>2</sup>Includes the Corporation's commercial real estate lending, land acquisition and development lending, builder line lending and commercial business lending.

### Investment Securities

The investment portfolio plays a primary role in the management of the Corporation's interest rate sensitivity. In addition, the portfolio serves as a source of liquidity and is used as needed to meet collateral requirements. The investment portfolio consists of securities available for sale, which may be sold in response to changes in market interest rates, changes in prepayment risk, changes in loan demand, general liquidity needs and other similar factors. These securities are carried at estimated fair value. At June 30, 2014 and December 31, 2013, all securities in the Corporation's investment portfolio were classified as available for sale.

The following table sets forth the composition of the Corporation's securities available for sale at fair value and as a percentage of the Corporation's total securities available for sale at the dates indicated.

**TABLE 12: Securities Available for Sale**

| <i>(Dollars in thousands)</i>                     | <b>June 30, 2014</b> |                | <b>December 31, 2013</b> |                |   |
|---|----------------------|----------------|--------------------------|----------------|---|
|   | <b>Amount</b>        | <b>Percent</b> | <b>Amount</b>            | <b>Percent</b> |   |
| U.S Treasury securities                           | \$ —                 | —              | % \$ 10,000              | 5              | % |
| U.S. government agencies and corporations         | <b>28,902</b>        | <b>13</b>      | 29,950                   | 14             |   |
| Mortgage-backed securities                        | <b>57,752</b>        | <b>27</b>      | 50,863                   | 23             |   |
| Obligations of states and political subdivisions  | <b>130,654</b>       | <b>60</b>      | 127,139                  | 58             |   |
| Corporate and other debt securities               | —                    | —              | 158                      | —              |   |
| Total available for sale securities at fair value | <b>\$ 217,308</b>    | <b>100</b>     | % \$ 218,110             | 100            | % |

For more information about the Corporation's securities available for sale, including a description of securities in an unrealized loss position at June 30, 2014 and December 31, 2013, see Note 3 to the consolidated financial statements filed with this Quarterly Report on Form 10-Q.

## Deposits

The Corporation's predominant source of funds is depository accounts, which consist of demand deposits, savings and money market accounts, and time deposits. The Corporation's deposits are principally provided by individuals and businesses located within the communities served.

During the first six months of 2014 deposits increased \$31.5 million to \$1.04 billion at June 30, 2014, compared to \$1.01 billion at December 31, 2013. This increase resulted primarily from a \$29.3 million increase in non-interest bearing demand deposits of individuals and corporations and a \$22.2 million increase in savings and interest-bearing demand deposits, mostly offset by a \$20.1 million decrease in time deposits.

The Corporation had \$2.7 million in brokered money market deposits outstanding at June 30, 2014, compared to \$2.4 million at December 31, 2013. The source of these brokered deposits is uninvested cash balances held in third-party brokerage sweep accounts. The Corporation uses brokered deposits as a means of diversifying liquidity sources, as opposed to a long-term deposit gathering strategy.

## Borrowings

Borrowings decreased to \$169.6 million at June 30, 2014 from \$169.8 million at December 31, 2013 as a result of a \$245,000 decrease in retail overnight repurchase agreements with commercial depositors, the level of which is a function of the deposit balances maintained by these depositors.

### **Off-Balance Sheet Arrangements**

As of June 30, 2014, there have been no material changes to the off-balance sheet arrangements disclosed in "Management's Discussion and Analysis" in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013.

### **Contractual Obligations**

As of June 30, 2014, there have been no material changes outside the ordinary course of business to the contractual obligations disclosed in "Management's Discussion and Analysis" in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013.

### **Liquidity**

The objective of the Corporation's liquidity management is to ensure the continuous availability of funds to satisfy the credit needs of our customers and the demands of our depositors, creditors and investors. Stable core deposits and a strong capital position are the foundation for the Corporation's liquidity position. Additional sources of liquidity available to the Corporation include cash flows from operations, loan payments and payoffs, deposit growth, sales of securities, principal payments and paydowns on securities, the issuance of brokered certificates of deposit and the capacity to borrow additional funds.

Liquid assets, which include cash and due from banks, interest-bearing deposits at other banks, federal funds sold and nonpledged securities available for sale, at June 30, 2014 totaled \$291.7 million, compared to \$216.4 million at December 31, 2013. The increase in liquid assets since December 31, 2013 resulted primarily from the Corporation's election in January 2014 to secure public deposits by the pooled method, rather than the dedicated or opt-out method, which reduced the amount of collateral required to secure public deposits and thus increased the amount of unpledged securities. In addition, liquidity increased as a result of reduced funding needs of the Mortgage Banking segment and growth in the Corporation's non-interest bearing demand deposit accounts. The Corporation's funding sources for borrowings, including the capacity, amount outstanding and amount available at June 30, 2014 are presented in Table 13.

**TABLE 13: Funding Sources**

| <i>(Dollars in thousands)</i>        | <b>June 30, 2014</b> |                    |                   |
|--------------------------------------|----------------------|--------------------|-------------------|
|                                      | <b>Capacity</b>      | <b>Outstanding</b> | <b>Available</b>  |
| Unsecured federal funds agreements   | \$65,000             | \$ —               | \$65,000          |
| Repurchase agreements                | 5,000                | 5,000              | —                 |
| Repurchase lines of credit           | 40,000               | —                  | 40,000            |
| Borrowings from the FHLB             | 136,822              | 52,500             | 84,322            |
| Borrowings from Federal Reserve Bank | 30,581               | —                  | 30,581            |
| Revolving line of credit             | 120,000              | 75,487             | 44,513            |
| <b>Total</b>                         | <b>\$397,403</b>     | <b>\$ 132,987</b>  | <b>\$ 264,416</b> |

We have no reason to believe these arrangements will not be renewed at maturity. Additional loans and securities are also available that can be pledged as collateral for future borrowings from the Federal Reserve Bank and the FHLB above the current lendable collateral value. Our ability to maintain sufficient liquidity may be affected by numerous factors, including economic conditions nationally and in our markets. Depending on our liquidity levels, our capital position, conditions in the capital markets, our business operations and initiatives, and other factors, we may from time to time consider the issuance of debt, equity or other securities or other possible capital market transactions, the proceeds of which could provide additional liquidity for our operations.

As a result of the Corporation's management of liquid assets and the ability to generate liquidity through liability funding, management believes that the Corporation maintains overall liquidity sufficient to satisfy its operational requirements and contractual obligations.

**Capital Resources**

The Corporation's and the Bank's actual regulatory capital amounts and ratios under currently applicable regulatory capital standards are presented in the following table.

**TABLE 14: Capital Ratios**

|  | Actual    |        | Minimum Capital Requirements |       | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|--|-----------|--------|------------------------------|-------|--|--------|
|  | Amount    | Ratio  | Amount                       | Ratio | Amount   | Ratio  |
| <i>(Dollars in thousands)</i>            |           |        |                              |       |  |        |
| As of June 30, 2014:                     |           |        |                              |       |  |        |
| Total Capital (to Risk-Weighted Assets)  |           |        |                              |       |  |        |
| Corporation                              | 133,774   | 15.2   | 70,411                       | 8.0 % | N/A  | N/A    |
| Bank                                     | 132,769   | 15.1   | 70,236                       | 8.0   | \$87,795   | 10.0 % |
| Tier 1 Capital (to Risk-Weighted Assets) |           |        |                              |       |  |        |
| Corporation                              | 122,473   | 13.9   | 35,205                       | 4.0   | N/A  | N/A    |
| Bank                                     | 121,495   | 13.8   | 35,118                       | 4.0   | 52,677   | 6.0    |
| Tier 1 Capital (to Average Assets)       |           |        |                              |       |  |        |
| Corporation                              | 122,473   | 9.4    | 52,316                       | 4.0   | N/A  | N/A    |
| Bank                                     | 121,495   | 9.3    | 52,300                       | 4.0   | 65,375   | 5.0    |
| As of December 31, 2013:                 |           |        |                              |       |  |        |
| Total Capital (to Risk-Weighted Assets)  |           |        |                              |       |  |        |
| Corporation                              | \$126,202 | 14.8 % | \$68,137                     | 8.0 % | N/A  | N/A    |
| Bank                                     | 100,538   | 14.5   | 55,400                       | 8.0   | \$69,250   | 10.0 % |
| CVB                                      | 20,632    | 13.0   | 12,710                       | 8.0   | 15,888   | 10.0   |
| Tier 1 Capital (to Risk-Weighted Assets) |           |        |                              |       |  |        |
| Corporation                              | 115,257   | 13.5   | 34,069                       | 4.0   | N/A  | N/A    |
| Bank                                     | 91,559    | 13.2   | 27,700                       | 4.0   | 41,550   | 6.0    |
| CVB                                      | 20,597    | 13.0   | 6,355                        | 4.0   | 9,533  | 6.0    |
| Tier 1 Capital (to Average Assets)       |           |        |                              |       |  |        |
| Corporation                              | 115,257   | 8.9    | 51,664                       | 4.0   | N/A  | N/A    |
| Bank                                     | 91,559    | 9.4    | 38,964                       | 4.0   | 48,706   | 5.0    |
| CVB                                      | 20,597    | 6.2    | 13,332                       | 4.0   | 16,644   | 5.0    |

The Corporation's Tier 1 Capital and Total Capital presented in Table 14 include \$25.0 million of trust preferred securities. Under the changes to the regulatory capital framework that were approved on July 9, 2013 by the federal banking agencies (the Basel III Final Rule), the Corporation's trust preferred securities will continue to be included in Tier 1 Capital and Total Capital until they mature, pursuant to a "grandfathering" provision that exempts the Corporation's trust preferred securities from the more stringent regulatory capital treatment contained in the Basel III Final Rule for trust preferred securities. In addition to "grandfathering" certain previously outstanding trust preferred securities for community banks, the Basel III Final Rule introduces a new Common Equity Tier 1 Capital measure, increases the applicable minimum regulatory capital levels and certain prompt corrective action capital levels, and establishes a capital conservation buffer and new risk weights for certain types of assets. The Basel III Final Rule is effective for community banks on January 1, 2015 and has a transition period applicable to certain regulatory capital changes until January 1, 2019.

The Corporation's capital resources may be further affected by the Corporation's share repurchase program, which was authorized by the Corporation's Board of Directors during the second quarter of 2014. Under this program the Corporation is authorized to purchase up to \$5.0 million of its common stock. Repurchases under the program may be made through privately negotiated transactions or open market transactions, and shares repurchased will be returned to the status of authorized and unissued shares of common stock. The timing, number and purchase price of shares repurchased under the program, if any, will be determined by management in its discretion and will depend on a number of factors, including the market price of the shares, general market and economic conditions, applicable legal requirements and other conditions, and there is no assurance that the Corporation will purchase any shares under the program. The share repurchase program is authorized through May 2015.

### **Effects of Inflation and Changing Prices**

The Corporation's financial statements included herein have been prepared in accordance with accounting principles generally accepted in the United States (GAAP). GAAP presently requires the Corporation to measure financial position and operating results primarily in terms of historic dollars. Changes in the relative value of money due to inflation or recession are generally not considered. The primary effect of inflation on the operations of the Corporation is reflected in increased operating costs. In management's opinion, changes in interest rates affect the financial condition of a financial institution to a far greater degree than changes in the inflation rate. While interest rates are greatly influenced by changes in the inflation rate, they do not necessarily change at the same rate or in the same magnitude as the inflation rate. Interest rates are highly sensitive to many factors that are beyond the control of the Corporation, including changes in the expected rate of inflation, the influence of general and local economic conditions and the monetary and fiscal policies of the United States government, its agencies and various other governmental regulatory authorities.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

There have been no significant changes from the quantitative and qualitative disclosures about market risk made in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013.

### **ITEM 4. CONTROLS AND PROCEDURES**

The Corporation's management, including the Corporation's Chief Executive Officer and the Chief Financial Officer, has evaluated the effectiveness of the Corporation's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that the Corporation's disclosure controls and procedures were effective as of June 30, 2014 to ensure that information required to be disclosed by the Corporation in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms and that such



information is accumulated and communicated to the Corporation's management, including the Corporation's Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that the Corporation's disclosure controls and procedures will detect or uncover every situation involving the failure of persons within the Corporation or its subsidiary to disclose material information required to be set forth in the Corporation's periodic reports.

Management of the Corporation is also responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act). There were no changes in the Corporation's internal control over financial reporting during the Corporation's second quarter ended June 30, 2014 that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

## **PART II - OTHER INFORMATION**

### **ITEM 1A. RISK FACTORS**

Other than as disclosed in this Item 1A, "Risk Factors," there have been no material changes in the risk factors faced by the Corporation from those disclosed in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013.

### **ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

#### **Issuer Purchases of Equity Securities**

There were no purchases of the Corporation's Common Stock during the three months ended June 30, 2014.

**ITEM 6. EXHIBITS**

- 2.1 Agreement and Plan of Merger dated as of June 10, 2013 by and among C&F Financial Corporation, Special Purpose Sub, Inc. and Central Virginia Bankshares, Inc. (incorporated by reference to Exhibit 2.1 to Form 8-K filed June 14, 2013)
- 3.1 Articles of Incorporation of C&F Financial Corporation (incorporated by reference to Exhibit 3.1 to Form 10-KSB filed March 29, 1996)
- 3.1.1 Amendment to Articles of Incorporation of C&F Financial Corporation establishing Series A Preferred Stock, effective January 8, 2009 (incorporated by reference to Exhibit 3.1.1 to Form 8-K filed January 14, 2009)
- 3.2 Amended and Restated Bylaws of C&F Financial Corporation, as adopted October 16, 2007 (incorporated by reference to Exhibit 3.2 to Form 8-K filed October 22, 2007)
- 31.1 Certification of CEO pursuant to Rule 13a-14(a)
- 31.2 Certification of CFO pursuant to Rule 13a-14(a)
- 32 Certification of CEO/CFO pursuant to 18 U.S.C. Section 1350
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CALXBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LABXBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Presentation Linkbase Document

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.

C&F FINANCIAL CORPORATION  
(Registrant)

Date August 11, 2014 /s/ Larry G. Dillon  
Larry G. Dillon  
Chairman, President and Chief Executive Officer

(Principal Executive Officer)

Date August 11, 2014 /s/ Thomas F. Cherry  
Thomas F. Cherry  
Executive Vice President,

Chief Financial Officer and Secretary

(Principal Financial and Accounting Officer)