Blackhawk Bancorp, Inc.

2014 Annual Report

Blackhawk Bank

The advice you need for the life you want.

OUR MISSION:

- To make every customer a customer for life.

OUR CORE VALUES:

- Be obsessed with your Client's success.
- Keep learning and teaching.
- Own it.
- Work smart, play hard.
- Communicate in ways that engage & inform.
- Give.
- Be grateful.

Financial Highlights

(Amounts in thousands, except share and per share data)

Years ended December 31,	2014	2013	2012	2011	2010
Interest income	$22,305	$22,693	$23,494	$24,822	$26,847
Interest expense	2,959	3,310	4,478	5,671	7,050
Net interest income	19,346	19,383	19,016	19,151	19,797
Provision for loan losses	2,285	4,140	5,620	4,803	4,544
Net interest income after provision for loan losses	17,061	15,243	13,396	14,348	15,253
Noninterest income	5,956	11,274	11,116	8,063	8,416
Noninterest expense	20,750	21,695	21,353	19,551	19,196
Income before income taxes	2,267	4,822	3,159	2,860	4,473
Income taxes	15	907	247	434	1,448
Net income before preferred stock dividends	2,252	3,915	2,912	2,426	3,025
Preferred stock dividends and warrant accretion	194	645	645	645	645
Net income available to common shareholders	$2,058	$3,270	$2,267	$1,781	$2,380
Basic earnings per common share	$0.92	$1.48	$1.03	$0.81	$1.10
Diluted earnings per common share	$0.92	$1.47	$1.03	$0.81	$1.10
Cash dividend declared per share	$0.06	$-	$-	$-	$-
Return on assets	0.38%	0.68%	0.52%	0.44%	0.56%
Return on common equity	5.05%	8.68%	6.37%	5.51%	8.25%
Total assets	$581,473	$583,440	$559,759	$558,987	$539,917
Securities	129,184	128,300	122,691	145,237	136,417
Total loans, net	391,448	383,456	362,486	331,075	332,134
Deposits	515,784	510,758	493,821	475,627	473,865
Borrowings	9,000	10,157	10,010	32,326	17,535
Subordinated debentures	11,255	11,255	4,958	4,958	4,958
Total stockholders' equity	42,036	48,302	47,824	44,036	40,468

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Dear Shareholders, Clients and Friends;

Rick Bastian
CEO &
Chairman of the Board

Dave Adkins
President &
Chief Operating Officer

As the year began we established aggressive goals for enhancing credit quality, improving the efficiency and effectiveness of delivering our services and converting targeted prospects to clients; in short, we aimed high. Great progress was made in a number of core earnings trends. Unfortunately, that positive trajectory was overshadowed by the 3rd quarter recognition of an impairment charge as a result of fraud on USDA securities. Todd James provides a more detailed financial analysis on pages 6 and 7 of this report. The impact of the fraud, while significant, was an isolated incident.

Excluding the after tax impairment charge, earnings per share improved more than 10% to $1.63 which would have been another record for the Company.

Both loans and deposits grew modestly during another year of historically low interest rates and anemic local economic growth. Key among the many positive trends seen in 2014 was our improved credit quality. This improvement allowed a 45% reduction in our provision for loan losses. Admittedly our strategy of working with business clients who were hurt by the recession extended the length of time we dealt with elevated nonperforming loans, but we believe that 'standing by' these survivors will be beneficial in the long run. Helping our clients regain momentum accomplishes three tactical moves: it gets them back on track to financial success, propels our franchise value by creating loyalty and advocacy, and helps the community as a whole.

Recognizing that a significant percentage of locally owned companies will likely change hands over the next 5-10 years as baby-boomer owners exit their business, leaders in the business banking division took action to develop comprehensive and specialized expertise in Succession Planning. We are now equipped to help family-owned and closely-held businesses create an exit strategy, succession plan, and build an advisory board; not only as a means to transition their business in the future, but also to help create a clear roadmap of how the business will operate to reach its goals. Our bankers work to help customers understand that executing a comprehensive succession plan will increase the value of their company, improve the chances that their business will remain locally owned and operated, and help ensure that they will continue to need the financial services of Blackhawk Bank.

The mega-banks that exited particular market segments for greener pastures during the great recession are now trying to buy their way back in to the local business market. Their hope is that prospects have short memories of what happened to many of their colleagues who, in their time of greatest need, were abandoned by those same big banks. In contrast, Blackhawk Bank was steadfast then, as we are now, in our commitment to stand by our clients, providing them with the tools they need to be successful.

We believe a large measure of our success lies in how we differentiate the Bank from our competition. We've invited experts to help businesses understand the impact of the Affordable Care Act. Our business banking associates have attended training to become proficient in topics related to efficiencies such as lean and quick response manufacturing. Doing so has helped them better understand the problems our clients face, and has prepared them to offer appropriate ideas and solutions. Helping our customers be more successful drives our success.

Supporting clients' ambitions is not limited to the business banking arena. Retail, investment and mortgage associates are well trained to work with clients to ensure the products and services we offer are truly a solution to a need. We don't apply an 'upsize the sale' system: our consultative approach has built trust and has worked very well. The average number of products and services our clients utilize has nearly tripled in the last few years.

The improvements we've experienced in core earnings are due in no small part to making our efficiency goals transparent across the entire organization. We examined how we deliver products and services to our clients, resulting in decisions to close the Capron, IL office, and restructure both retail and commercial staffing for improved effectiveness. These changes contributed to a 4% reduction in operating expenses as compared to 2013.

We have aligned resources and priorities, and developed greater accountability by sharing our strategic plan with all employees. To ensure that everyone is pulling in the same direction, every employee has an individual plan that aligns with the initiatives of their department and the Company. Employees focus their daily activities on taking great care of current clients, converting top prospects to clients, increasing profitability and reducing problem assets.

We look forward to continuing in 2015 the momentum we developed in our core earnings during 2014. We thank our employees for the exceptional effort, our board for their stewardship and our shareholders for their confidence in us.

Roger G. Bryden

John B. Clark

Merritt J. Mott

Blackhawk Bancorp's directors shoulder a great deal of responsibility and hold a position of trust. They're accountable to our shareholders, the Bank's clients, employees and the communities we serve for safeguarding their interests through lawful, informed, and able administration of our institution.

Our Board has been privileged to benefit from the skillful acumen of three of its directors who retired during 2014:

The late **Roger G. Bryden**, Beloit, WI:
President Bryden Motors, Inc.
From 2002 to 2014 Roger served the Company on committees including Trust and Investment, Nominating and Director Evaluation, and the Director's Loan Committee.

John B. Clark, Beloit, WI:
Retired Senior Vice President Wachovia Securities, Inc.
From 1980 to 2014 John served the Company on committees including Trust and Investment, Nominating and Director Evaluation, Audit and Compliance, Director's Loan Committee, Executive Committee, and the Compensation and Management Development Committee.

Merritt J. Mott, Rockford, IL:
Owner and CEO of Rockford Sanitary Systems, Inc.
From 2001 to 2014 Merritt served the Company on committees including Executive, Audit and Compliance, Nominating and Director Evaluation, and the Compensation and Management Development Committee.

With sincere appreciation and gratitude for their outstanding contributions and dedicated service,

R. Richard Bastian III, Chairman and CEO

Blackhawk Bancorp, Inc. Board of Directors

David K. Adkins, Beloit, WI
President, Chief Operating Officer
of Blackhawk Bancorp and the Bank

Eric Anderberg, Rockford, IL
Vice President/Secretary of Dial Machine, Inc.,
a family-owned contract machine shop

Thomas L. Barnes, Beloit, WI
Real Estate Asset Manager, ABC Supply Co., Inc.

R. Richard Bastian III, Beloit, WI
Chairman of the Board & Chief Executive Officer
of Blackhawk Bancorp and the Bank

Stephen P. Carter, Rockford, IL
Principal in Ingenium Aerospace LLC and serves as a director of Appvion, Inc., Paperweight Development Corp. and Hollister Incorporated

Steven A. Ceroni, Belvidere, IL
President & Owner, Ceroni Piping Co.

Prudence A. Harker, Beloit, WI
President of LifeCircle, LLC, and Investment Advisor Representative, AXA Advisors, LLC.

Diane M. Hendricks, Beloit, WI
Owner and Chairman, ABC Supply Co., Inc.

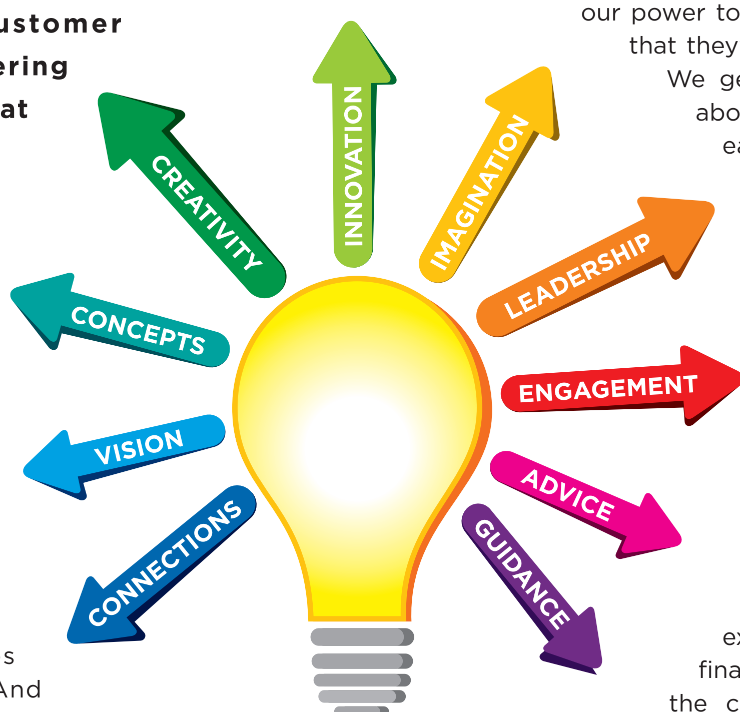
G. Curtis Lansbery, South Beloit, IL
President and Chief Executive Officer of
Global Specialty Solutions, Inc.

James D. Metz, Belvidere, IL
Treasurer for the Belvidere School District

Stephen R. Thomas, Poplar Grove, IL
President of Cirrus Trails, Inc., holding company for Poplar Grove Airmotive, Inc., and President of Emery Air, Inc.

It's more than selling financial services; it's creating engagement & value.

Achieving business success requires more than delivering a product or a service; it involves helping customers succeed by improving their performance, their bottom line, their sense of well-being. The more Blackhawk Bank can help its clients thrive, the stronger our partnerships become. Creating emotional customer engagement and delivering exceptional value is what we're in the financial services business to do.



Creating engagement

Customer engagement goes beyond merely satisfying customers. Engagement is based on confidence, integrity, pride, and passion. It's foundational to providing value because it establishes a partnership and requires a genuine connection. And connecting with clients is something we do really well.

The importance of doing more than just satisfying customers can't be overemphasized. We know that fully engaged customers trust us with more of their business, generate more revenue, and grow relationships – not just with them, but with new clients they refer into the fold. We know that success comes not from the number of customers we have, but from the depth of the relationships that we nurture.

Simply put, when we create an emotional connection with our customers, they grow and we grow.

Creating value

Our job is to provide value-added solutions for business owners that significantly improves their bottom line, and positively impacts the financial success of individuals and families that choose Blackhawk Bank.

Creating value means that we do everything in our power to demonstrate to a customer that they'll be better off choosing us. We genuinely engage in learning about them and by doing so, earn their trust. We listen for their expressions of joy and pain, both of which usually have a financial impact. We offer guidance that sees clients through the ups and downs of life. Against a proliferation of big-banks, we compete on reliable advice that helps people get ahead for the long haul, not on low price.

Beyond our doors, we extend thought leadership and financial education throughout the communities we serve – in places of commerce, schools, and at organizational meetings. Blackhawk bankers possess years of specialized education, experience and expert skills that they're happy to share.

For Business Owners

Creating value requires providing a meaningful change in a business customer's productivity or profitability, and long-term planning. Often, it comes from providing specific recommendations or other value-added solutions that:

- allow the customer to use its products and services more efficiently or effectively

- identify unseen product or service opportunities
- enhance the customer's standing in the marketplace and its potential for future growth
- have an effect on the customer's cost structure, through more effective supply chain management, inventory control, or process improvement
- secure a successful transition of company ownership from one generation to the next, or to a buyer

Value isn't just about 'sales and service'. It requires getting into the trenches with our business partners and their other partners - i.e. attorneys and accountants - to understand their goals and how we can support them. We work to gain in-depth knowledge of how their business operates and offer them new ideas and solutions.

Delivering value also means recognizing the importance of functional drivers such as quality, utility, service, and responsiveness. Those elements can be easily matched by competitors. To create value, we satisfy those functional requirements plus generate high levels of emotional engagement, and produce tangible, positive and lucrative change for our customers.

For Individuals and Families

In today's financial marketplace, value doesn't reside in products or services but rather in the manner in which customers acquire products and services. People want to be provided with valuable insights that they can't get elsewhere. They want to learn things they don't already know.

Our colleagues are energized by the knowledge that they're providing value to customers. They thrive knowing that each day's calendar is full of opportunities to help clients live a better financial life, and that the more they do for customers, the more they do for themselves.

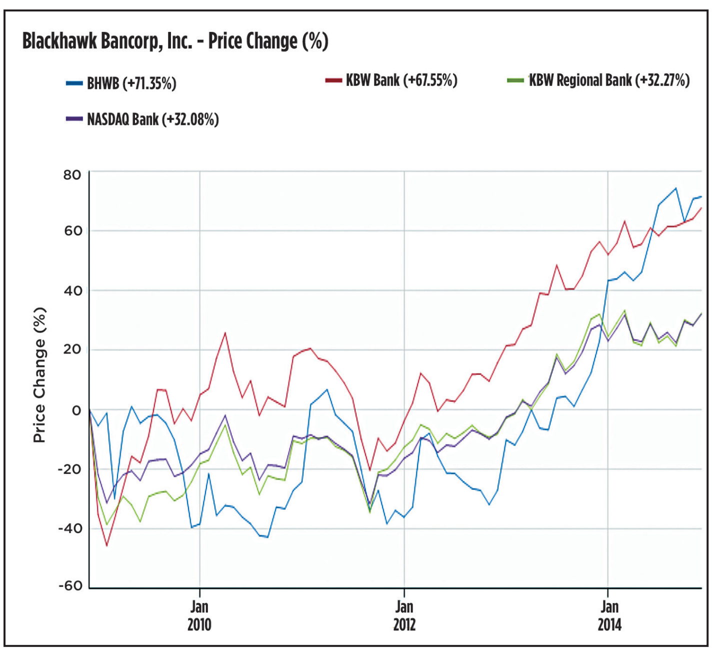
With so many institutions providing the same products and services, customers often perceive little or no real distinction between banks. Customers appreciate being able to have in-person conversations, and want expertise and advice on anything they see as complex: how to develop better credit, budgeting, assessing their current financial condition, mortgage and installment loans, investment products and retirement planning. While predictions are that by 2020, about two-thirds of all service-related transactions will likely be handled through online banking, banking centers will remain essential for face-to-face conversations between customers and their banker about financial decisions that significantly impact their life.

Relationship banking allows us to secure a greater wallet share, number of products and revenue per customer. Conversations based on needs and goals develop the tie to products and services that best overcome the customer's challenges and support their opportunities. Needs-based and value-added: it's the way we think and work. It's the way we secure the continued success of Blackhawk Bank for the benefit of our clients, our employees and our shareholders.

Dear Fellow Shareholders:

Bank stocks got hammered following the "Great Recession" that began in 2008, and Blackhawk's was no exception. Our common stock was trading at $8.90 per share at the end of 2008 and dropped 44% to $5.00 per share by mid-2010. This was a tough time for our shareholders as the Company also suspended the common stock dividend beginning in 2009. Suspending the dividend, accepting capital under the U.S. Government Troubled Asset Relief Program (TARP), and controlling growth were all part of our strategy to fortify the Company's balance sheet in the face of deteriorating asset quality and losses that were driven by a stagnant economy, the collapse of the housing market and declining real estate values. These actions were taken to preserve value for our shareholders ensuring that the Company would make it through the financial crisis without raising common equity at dilutive prices as many banks had to do to survive.

Now that the financial crisis is behind us, our shareholders are finally being rewarded with a stock price that began to recover in 2013 and reached $15.25 per share by the end of 2014, a 71.4% increase compared to the December 31, 2008 trading price. That increase, as indicated in the following chart, outperformed the KBW Bank, KBW Regional Bank and the NASDAQ Bank index increases of 57.6%, 32.3% and 32.1%, respectively, over the same time frame.



Source: SNL Financial LC

In 2014 Blackhawk continued to recover from the recession and grow recurring core earnings. The increase in core earnings reflects improvement in asset quality and our efforts to hold the line on operating expenses. We accomplished our goal of redeeming the TARP securities before the fifth anniversary of their issuance, avoiding a significant increase in the cost of that capital; and began to pay a small quarterly dividend to our common stockholders.

2014 Overall Results

While the Company's 2014 net income of $2.3 million was down by 42% compared to the $3.9 million earned in 2013, the underlying core earnings improved. The decrease in 2014 net income compared to 2013 was caused by large nonrecurring items in both years. In 2013 the Company realized $2.6 million in net gains on available-for-sale securities, compared to $0.5 million in 2014. The gains in the prior year were realized primarily on the sale of private label mortgage backed securities. These securities were sold to generate cash and capital to support the redemption of the Company's TARP securities, which occurred in April, 2014. The 2014 results include a $2.6 million securities fraud loss that, net of tax, reduced the 2014 diluted earnings per share by $0.71 to $0.92 compared to the $1.63 that would have otherwise been earned. The Company earned $1.47 per dilutive share in 2013, including the nonrecurring securities gains recorded that year.

The securities for which the Company incurred the fraud loss were repurchase agreements acquired through an investment advisor as safe short-term investments backed by loans and guarantees of United States Department of Agriculture (USDA). Blackhawk has a twelve year relationship with the advisor, a recognized leader in dealing with government guaranteed loans and securities, and has participated in similar arrangements over the entire term of the relationship. The fraudulent activity was committed by a USDA approved lender that delivered fraudulent loans and USDA guarantees on 25 loans totaling approximately $176 million. Blackhawk had a $5.5 million interest in the underlying loans and USDA guarantees. The amount of the loss was mitigated by recovery efforts that resulted in a court approved agreement identifying and seizing assets that are to be liquidated for the benefit of investors. The amount to ultimately be received from the seizure and liquidation of assets may be more or less than estimated, which could result in a recovery of the loss already recognized or additional loss in future periods. In addition to proceeds expected from the seizure and liquidation of assets from the perpetrators of the fraud, recovery is being sought from the USDA under the loan guarantees, a claim on Blackhawk's insurance policy, and the exercise of any other legal rights and remedies that may be available.

Net Interest Income

Net interest income for the year decreased to $19.35 million compared to $19.38 million in 2013. Average earning assets grew by $7.6 million compared to the prior year; however, the net interest margin decreased by six basis points to 3.67% compared to 3.73% in 2013. The decrease in net interest income and the net interest margin was largely due to $0.25 million of interest expense incurred on debt issued in conjunction with the redemption of the Company's TARP related preferred stock. While the issuance of new debt had an unfavorable impact on net interest income, it reduced the cost of the TARP preferred stock by $0.45 million, after tax, making that income available to our common shareholders.

We experienced growth in our core business in 2014 with average total loans increasing by $12.8 million, or 3%, and average total deposits increasing by $9.6 million, or 2%, over the prior year. The loan growth continues to be driven by our success in attracting new business banking customers. The deposit growth, as in the last several years, was in non-maturity core deposits, for which average total balances increased by $14.0 million. This was offset by a $4.4 million decrease in average time deposits.

Provision for Loan Losses and Credit Quality

The biggest contributor to improved core earnings in 2014 was the reduction in the provision for loan losses, which decreased by $1.8 million to $2.3 million compared to the 2013 provision of $4.1 million. This is a substantial improvement over the prior year, but the provision was still above what we would consider a normalized level. The economic recovery following the 2008 recession has been slow and uneven. Many customers have not fully recovered. Real estate values appear to have bottomed out, and have recovered only a fraction of the value that was lost. The Company charged off a net $2.8 million in loans in 2014, a 51% decrease compared to the $5.8 million of net charge-offs in 2013. Nonperforming assets continued to decline in 2014 with nonaccrual loans and other real estate owned dropping to $6.6 million, or 1.66% of total loans, at December 31, 2014 compared $8.1 million, or 2.10% of total loans, at December 31, 2013. We expect additional reductions in the provision for loan losses and net charge-offs in the future, but with this level of nonperforming assets we expect losses to continue to be somewhat elevated in 2015.

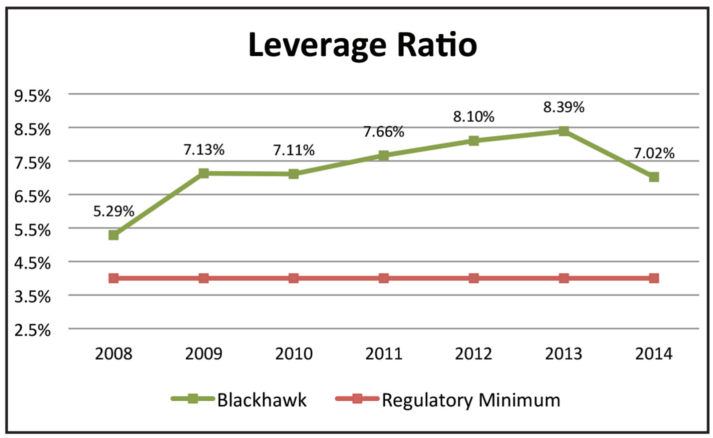
Non-Interest Income and Operating Expenses

Blackhawk has historically produced a very strong level of non-interest income. Our deposit base includes a large number of small accounts, which can be expensive to service, but generates a consistently high level of service fees and debit card interchange revenue. Despite growth in deposits, deposit service charges and debit card interchange fees were essentially flat compared to the prior year. Increased compliance requirements, restrictions related to overdraft fees and the widely publicized data breaches reported by large retailers create headwinds for growing activity in these areas. We have also developed a strong mortgage banking operation that has produced a lot of revenue over the last several years; however mortgage banking activity is a bit more volatile. Revenue from the sale and servicing of mortgage loans dropped to $2.1 million in 2014, compared to $3.0 million in 2013. The Company is increasing its market share of new purchase mortgages, but overall volume is heavily influenced by refinance activity, which is highly dependent on interest rates and home values.

We were able to achieve a $0.9 million, or 4%, reduction in operating expenses in 2014 to $20.8 million compared to $21.7 million in 2013. The expense reductions were almost across the board including decreases in salaries and benefits, occupancy and equipment and professional fees.

Capital

When the economic crisis began in 2008 we were aware of the importance of a strong capital position and what the regulatory expectations were. We knew that our capital level was marginal at the time and economic uncertainties could add regulatory pressure to raise capital. We elected to participate in the TARP Capital Purchase Program and accepted a $10 million capital injection from the U.S. Treasury in the form of preferred stock. This capital was relatively inexpensive compared to other very limited options available to community banks at the time. We accomplished our goal of redeeming these securities before the dividend was set to increase from 5% to 9%. Over the five years that these securities were outstanding the Company incurred a total cost of $3.3 million in dividends and amortization of up-front issuance expenses. The TARP capital qualified as tier 1 capital for regulatory purposes and created some breathing room for the Company during the financial crisis to generate and retain earnings to bolster the capital position. As the graph indicates the Company's regulatory tier 1 ratio at December 31, 2014 was 7.02%, after redemption of the TARP securities, which is 173 basis points higher than it was on December 31, 2008 before the TARP capital was accepted.



While our common shareholders were denied a dividend over most of this time period we were successful in avoiding the need for an expensive and dilutive common equity capital raise. While we are happy to be putting the TARP program behind us, it worked exactly as it was intended for Blackhawk Bancorp and our shareholders.

Todd James
Executive Vice President &
Chief Financial Officer

Consolidated Balance Sheets

December 31, 2014 and 2013

(Amounts in thousands, except share and per share data)

	2014	2013
Assets		
Cash and due from banks	$9,847	$11,350
Securities purchased under agreements to resell	-	21,064
Interest-bearing deposits in banks and other	11,744	2,078
Total cash and cash equivalents	21,591	34,492
Securities available-for-sale	129,184	127,985
Loans held for sale	1,537	1,161
Federal Home Loan Bank stock, at cost	2,266	2,266
Loans, less allowance for loan losses of $4,396 and $4,894 at December 31, 2014 and 2013, respectively	391,448	382,295
Premises and equipment, net	8,320	8,922
Goodwill	5,037	5,037
Mortgage servicing rights	2,640	3,066
Cash surrender value of bank-owned life insurance	9,602	9,311
Other assets	9,848	8,905
Total assets	$581,473	$583,440
Liabilities and Stockholders' Equity		
Liabilities		
Deposits:		
Noninterest-bearing	$99,068	$91,450
Interest-bearing	416,716	419,308
Total deposits	515,784	510,758
Subordinated debentures and notes (including $1,031 at fair value at December 31, 2014 and 2013)	11,255	11,255
Senior secured term note	9,000	-
FHLB advances (including $2,157 at fair value at December 31, 2013)	-	10,157
Other liabilities	3,398	2,968
Total liabilities	539,437	535,138
Stockholders' Equity		
Preferred stock, $0.01 par value, 1,000,000 shares authorized; 0 and 10,500 shares issued as of December 31, 2014 and 2013, respectively	-	10,483
Common stock, $0.01 par value, 10,000,000 shares authorized; 2,318,496 and 2,299,496 shares issued as of December 31, 2014 and 2013, respectively	23	23
Additional paid-in capital	9,960	9,768
Retained earnings	31,091	29,166
Treasury stock, 87,865 and 83,252 shares, at cost as of December 31, 2014 and 2013, respectively	(969)	(909)
Accumulated other comprehensive income (loss)	1,931	(229)
Total stockholders' equity	42,036	48,302
Total liabilities and stockholders' equity	$581,473	$583,440

Consolidated Statements of Income

Years Ended December 31, 2014 and 2013

(Amounts in thousands, except share and per share data)

	2014	2013
Interest Income:		
Interest and fees on loans	$18,711	$19,060
Interest and dividends on available-for-sale securities:		
Taxable	2,106	1,953
Tax-exempt	1,314	1,257
Interest on securities purchase under agreements to resell	156	364
Interest on other	18	59
Total interest income	22,305	22,693
Interest Expense:		
Interest on deposits	2,067	2,591
Interest on subordinated debentures and notes	609	513
Interest on senior secured term note	249	51
Interest on FHLB advances	34	155
Total interest expense	2,959	3,310
Net interest income before provision for loan losses	19,346	19,383
Provision for loan losses	2,285	4,140
Net interest income after provision for loan losses	17,061	15,243
Noninterest Income:		
Service charges on deposit accounts	2,832	2,820
Net gain on sale of loans	1,824	2,948
Net loan servicing income	236	13
Debit card interchange fees	2,223	2,230
Other-than-temporary loss:		
Total impairment loss	(170)	(232)
Loss recognized in other comprehensive income	-	86
Net impairment loss recognized in earnings	(170)	(146)
Net gains on sales of securities available-for-sale	640	2,732
Loss on repurchase agreement	(2,611)	-
Increase in cash surrender value of bank-owned life insurance	291	295
Other	691	382
Total noninterest income	5,956	11,274
Noninterest Expenses:		
Salaries and employee benefits	11,295	11,412
Occupancy and equipment	2,522	2,623
Data processing	2,344	2,346
FDIC assessment	448	767
Advertising and marketing	249	262
Professional fees	875	1,161
Office supplies	373	371
Telephone	386	367
Other	2,258	2,386
Total noninterest expenses	20,750	21,695
Income before income taxes	2,267	4,822
Provision for income taxes	15	907
Net income	$2,252	$3,915
Basic Earnings per Share	$0.92	$1.48
Diluted Earnings per Share	0.92	1.47

Consolidated Statements of Comprehensive Income

Years Ended December 31, 2014 and 2013

(Amounts in thousands, except share and per share data)

	2014	2013
Net income	$2,252	$3,915
Other comprehensive income (loss):		
Unrealized gains/(losses) on securities:		
Unrealized holding gains (losses) arising during the period	4,141	(2,720)
Reclassification adjustment for gains included in net income	(640)	(2,732)
	3,501	(5,452)
Tax effect	(1,341)	2,101
Net of tax	2,160	(3,351)
Unrealized gains/(losses) on securities for which a portion of an other-than temporary impairment has been recognized:		
Unrealized holding gains arising during the period	-	509
Tax effect	-	(199)
Net of tax	-	310
Total other comprehensive income (loss)	2,160	(3,041)
Total comprehensive income	$4,412	$874

Consolidated Statements of Changes in Stockholders' Equity

Years Ended December 31, 2014 and 2013

(Amounts in thousands, except share and per share data)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2012	$10,383	$23	$9,619	$25,896	$(909)	$2,812	$47,824
Net income				3,915			3,915
Other comprehensive loss						(3,041)	(3,041)
Accretion of preferred stock warrants	100			(100)			-
Cash dividends paid on preferred stock				(545)			(545)
Vesting of shares of restricted stock			83				83
Vesting of shares of restricted stock units			66				66
Balance, December 31, 2013	10,483	23	9,768	29,166	(909)	(229)	48,302
Net income				2,252			2,252
Other comprehensive income						2,160	2,160
Accretion of preferred stock warrants	17			(17)			-
Cash dividends paid on preferred stock				(177)			(177)
Redemption of preferred stock	(10,500)						(10,500)
Cash dividends paid on common stock				(133)			(133)
Purchase of treasury shares					(60)		(60)
Vesting of shares of restricted stock			126				126
Vesting of shares of restricted stock units			66				66
Balance, December 31, 2014	$-	$23	$9,960	$31,091	$(969)	$1,931	$42,036

Average Balance Sheet with Resultant Interest and Rates

Years Ended December 31, 2014 and 2013

(Yields on a tax-equivalent basis and amounts in thousands)

	Twelve months ended December 31, 2014			Twelve months ended December 31, 2013		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest Earning Assets:						
Interest-bearing deposits in banks	$3,245	$5	0.17%	$3,120	$7	0.23%
Federal funds sold & securities purchased under agreements to resell	11,536	156	1.35%	30,112	367	1.22%
Investment securities:						
Taxable investment securities	106,584	2,119	1.99%	95,545	2,002	2.09%
Tax-exempt investment securities	38,853	1,314	5.08%	36,561	1,257	5.17%
Total Investment securities	145,437	3,433	2.82%	132,106	3,259	2.95%
Loans	384,583	18,711	4.87%	371,827	19,060	5.13%
Total Earning Assets	$544,801	$22,305	4.22%	$537,165	$22,693	4.34%
Allowance for loan losses	(4,609)			(6,336)		
Cash and due from banks	12,981			13,051		
Other assets	34,103			36,232		
Total Assets	$587,276			$580,112		
Interest Bearing Liabilities:						
Interest bearing checking accounts	$162,483	$465	0.29%	$161,425	$667	0.41%
Savings and money market deposits	155,447	228	0.15%	148,800	229	0.15%
Time deposits	101,632	1,374	1.35%	106,121	1,695	1.60%
Total interest bearing deposits	419,562	2,067	0.49%	416,346	2,591	0.62%
Subordinated debentures and notes	14,852	609	5.44%	9,736	513	5.27%
Borrowings	11,199	283	1.91%	4,553	206	1.42%
Total Interest-Bearing Liabilities	$445,613	$2,959	0.66%	$440,635	$3,310	0.75%
Interest Rate Spread			3.56%			3.59%
Noninterest checking accounts	94,015			87,652		
Other liabilities	3,600			3,705		
Total liabilities	543,228			531,992		
Preferred Stock	3,278			10,430		
Common Stockholders' equity	40,770			37,690		
Total Stockholders' equity	44,048			48,120		
Total Liabilities and Stockholders' Equity	$587,276			$580,112		
Net Interest Income/Margin		$19,346	3.67%		$19,383	3.73%

Quarterly Financial Information

(Amounts in thousands, except share and per share data)

	2014				2013			
	4th Qtr	3rd Qtr	2nd Qtr	1st Qtr	4th Qtr	3rd Qtr	2nd Qtr	1st Qtr
Interest income	$5,619	$5,697	$5,500	$5,489	$5,778	$5,635	$5,649	$5,631
Interest expense	735	765	746	713	764	787	859	900
Net interest income	4,884	4,932	4,754	4,776	5,014	4,848	4,790	4,731
Provision for loan losses	516	577	681	511	600	480	1,980	1,080
Net interest income after provision for loan losses	4,368	4,355	4,073	4,265	4,414	4,368	2,810	3,651
Noninterest income	2,201	(191)	2,103	1,843	3,986	2,088	3,042	2,158
Noninterest expense	5,360	5,120	4,899	5,371	5,720	5,264	5,444	5,267
Income before income taxes	1,209	(956)	1,277	737	2,680	1,192	408	542
Income taxes	264	(581)	295	37	840	213	(105)	(41)
Net income before preferred stock dividends	945	(375)	982	700	1,840	979	513	583
Preferred stock dividends and warrant accretion	-	-	-	194	162	161	161	161
Net income available to common shareholders	$945	$(375)	$982	$506	$1,678	$818	$352	$422
Per share data:								
Basic earnings per common share	$0.42	$(0.17)	$0.42	$0.25	$0.76	$0.37	$0.16	$0.19
Nonperforming loans to total loans	1.43%	1.53%	1.38%	1.49%	1.63%	1.92%	1.68%	2.46%
Nonperforming assets to total loans	1.66%	1.79%	1.72%	1.89%	2.11%	2.68%	2.55%	3.07%
Allowance for loan losses to total loans	1.11%	1.12%	1.14%	1.26%	1.16%	1.58%	1.86%	1.77%
Allowance for loan losses to nonperforming loans	77%	73%	83%	85%	71%	82%	111%	72%
Total capital to risk-weighted assets								
Consolidated	11.93%	11.54%	12.04%	14.36%	13.88%	13.61%	13.84%	13.84%
Bank	13.70%	13.27%	13.93%	13.80%	13.52%	13.46%	13.64%	13.62%
Tier 1 capital to average assets								
Consolidated	7.00%	6.69%	6.80%	8.51%	8.39%	8.08%	7.96%	8.11%
Bank	9.40%	9.00%	9.19%	9.15%	9.14%	9.01%	8.86%	9.01%

The Consolidated Balance Sheets, Consolidated Statements of Income, Consolidated Statements of Comprehensive Income and Consolidated Statements of Changes in Stockholders' Equity contained in this annual report are based on the Company's 2014 audited Consolidated Financial Statements. The 2014 audited Consolidated Financial Statements and accompanying notes to Consolidated Financial Statements are available upon written request to:

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& Chairman of the Board

David K. Adkins,
President &
Chief Operating Officer

Todd J. James,
Executive Vice President &
Chief Financial Officer

Terri L. Burdick,
Senior Vice President
Administration, Operations &
Retail Banking

Todd L. Larson,
Senior Vice President,
Commercial Banking
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