

HMN FINANCIAL INC
Form 10-Q
August 05, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2015

OR

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

For the transition period from _____ to _____

Commission File Number 0-24100

HMN FINANCIAL, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or organization)

41-1777397
(I.R.S. Employer Identification No.)

1016 Civic Center Drive N.W., Rochester, MN
(Address of principal executive offices)

55901
(Zip Code)

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Registrant's telephone number, including area code: (507) 535-1200

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 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 Smaller reporting company
(Do not check if a 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

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

Class	Outstanding at July 20, 2015
Common stock, \$0.01 par value	4,482,893

HMN FINANCIAL, INC.

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Part I – FINANCIAL INFORMATION**Item 1: Financial Statements****HMN FINANCIAL, INC. AND SUBSIDIARIES
Consolidated Balance Sheets**

<i>(Dollars in thousands)</i>	June 30, 2015 (unaudited)	December 31, 2014
Assets		
Cash and cash equivalents	\$ 39,557	46,634
Securities available for sale:		
Mortgage-backed and related securities (amortized cost \$2,021 and \$2,755)	2,115	2,909
Other marketable securities (amortized cost \$123,773 and \$135,772)	123,326	134,925
	125,441	137,834
Loans held for sale	5,968	2,076
Loans receivable, net	368,110	365,113
Accrued interest receivable	1,779	1,713
Real estate, net	2,730	3,103
Federal Home Loan Bank stock, at cost	691	777
Mortgage servicing rights, net	1,451	1,507
Premises and equipment, net	7,007	6,982
Prepaid expenses and other assets	872	1,157
Deferred tax asset, net	10,395	10,530
Total assets	\$ 564,001	577,426
Liabilities and Stockholders' Equity		
Deposits	\$ 481,476	496,750
Other borrowings	10,000	0
Accrued interest payable	243	93
Customer escrows	771	788
Accrued expenses and other liabilities	4,017	3,782
Total liabilities	496,507	501,413
Commitments and contingencies		
Stockholders' equity:		
Serial preferred stock (\$.01 par value): authorized 500,000 shares; issued shares 0 and 10,000	0	10,000
Common stock (\$.01 par value): authorized 16,000,000; issued shares 9,128,662	91	91
Additional paid-in capital	50,242	50,207
Retained earnings, subject to certain restrictions	78,626	77,805
Accumulated other comprehensive loss, net of tax	(212)	(418)
Unearned employee stock ownership plan shares	(2,514)	(2,610)
Treasury stock, at cost 4,645,769 and 4,658,323 shares	(58,739)	(59,062)

Total stockholders' equity	67,494	76,013
Total liabilities and stockholders' equity	\$ 564,001	577,426

See accompanying notes to consolidated financial statements.

HMN FINANCIAL, INC. AND SUBSIDIARIES**Consolidated Statements of Comprehensive Income**

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
(Dollars in thousands, except per share data)				
Interest income:				
Loans receivable	\$4,537	4,659	8,891	9,729
Securities available for sale:				
Mortgage-backed and related	24	43	52	93
Other marketable	501	257	987	511
Cash equivalents	7	60	22	112
Other	1	1	2	2
Total interest income	5,070	5,020	9,954	10,447
Interest expense:				
Deposits	226	306	474	640
Federal Home Loan Bank advances	1	0	1	0
Other borrowings	164	0	242	0
Total interest expense	391	306	717	640
Net interest income	4,679	4,714	9,237	9,807
Provision for loan losses	(183)	(2,178)	(183)	(3,788)
Net interest income after provision for loan losses	4,862	6,892	9,420	13,595
Non-interest income:				
Fees and service charges	844	901	1,626	1,724
Mortgage servicing fees	257	263	516	524
Gain on sales of loans	530	330	815	676
Other	236	228	504	486
Total non-interest income	1,867	1,722	3,461	3,410
Non-interest expense:				
Compensation and benefits	3,540	3,273	6,986	6,751
Losses (gains) on real estate owned	65	(1,120)	(47)	(1,052)
Occupancy	926	876	1,805	1,758
Deposit	74	97	144	254
Data processing	268	249	499	495
Other	927	1,089	1,844	1,955
Total non-interest expense	5,800	4,464	11,231	10,161
Income before income tax expense	929	4,150	1,650	6,844
Income tax expense	344	1,620	604	2,682
Net income	585	2,530	1,046	4,162

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Preferred stock dividends	0	(524)	(108)	(1,057)
Net income available to common shareholders	585	2,006	938	3,105
Other comprehensive (loss) income, net of tax	(189)	192	206	372
Comprehensive income available to common shareholders	\$396	2,198	1,144	3,477
Basic earnings per common share	\$0.14	0.50	0.23	0.77
Diluted earnings per common share	\$0.13	0.44	0.20	0.68

See accompanying notes to consolidated financial statements.

HMN FINANCIAL, INC. AND SUBSIDIARIES**Consolidated Statement of Stockholders' Equity****For the Six-Month Period Ended June 30, 2015**

(unaudited)

<i>(Dollars in thousands)</i>	Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income/(Loss)	Unearned Employee Stock Ownership Plan Shares	Treasury Stock	Total Stock- Holders' Equity
Balance, December 31, 2014	\$ 10,000	91	50,207	77,805	(418)	(2,610)	(59,062)	76,013
Net income				1,046				1,046
Other comprehensive income					206			206
Redemption of preferred stock	(10,000)							(10,000)
Restricted stock awards			(332)				332	0
Forfeiture of restricted stock awards			9				(9)	0
Amortization of restricted stock awards			327					327
Preferred stock dividends				(225)				(225)
Earned employee stock ownership plan shares			31			96		127
Balance, June 30, 2015	0	91	50,242	78,626	(212)	(2,514)	(58,739)	67,494

See accompanying notes to consolidated financial statements.

HMN FINANCIAL, INC. AND SUBSIDIARIES**Consolidated Statements of Cash Flows**

(unaudited)

	Six Months Ended	
	June 30,	
	2015	2014
<i>(Dollars in thousands)</i>		
Cash flows from operating activities:		
Net income	\$1,046	4,162
Adjustments to reconcile net income to cash provided by operating activities:		
Provision for loan losses	(183)	(3,788)
Depreciation	333	271
Amortization of (discounts) premiums, net	(2)	8
Amortization of deferred loan fees	(207)	(119)
Amortization of mortgage servicing rights	275	249
Capitalized mortgage servicing rights	(219)	(112)
Gain on sales of real estate owned	(47)	(1,052)
Gain on sales of loans	(815)	(676)
Proceeds from sale of loans held for sale	30,873	23,098
Disbursements on loans held for sale	(31,660)	(17,436)
Amortization of restricted stock awards	327	112
Amortization of unearned ESOP shares	96	97
Earned employee stock ownership shares priced above original cost	31	22
(Increase) decrease in accrued interest receivable	(66)	211
Increase (decrease) in accrued interest payable	150	(43)
Decrease in other assets	290	132
Increase in other liabilities	273	2,534
Other, net	15	305
	510	7,975
Net cash provided by operating activities		
Cash flows from investing activities:		
Principal collected on securities available for sale	736	1,253
Proceeds collected on maturities of securities available for sale	76,070	30,000
Purchases of securities available for sale	(64,070)	(50,000)
Purchase of Federal Home Loan Bank Stock	(119)	0
Redemption of Federal Home Loan Bank Stock	205	7
Proceeds from sales of real estate and premises	385	4,305
Net (increase) decrease in loans receivable	(4,920)	13,448
Purchases of premises and equipment	(358)	(414)
	7,929	(1,401)
Net cash provided (used) by investing activities		
Cash flows from financing activities:		
Decrease in deposits	(15,274)	(31,080)
Redemption of preferred stock	(10,000)	(10,000)
Dividends to preferred stockholders	(225)	(5,244)

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Proceeds from borrowings	41,000	0
Repayment of borrowings	(31,000)	0
(Decrease) increase in customer escrows	(17)	266
Net cash used by financing activities	(15,516)	(46,058)
Decrease in cash and cash equivalents	(7,077)	(39,484)
Cash and cash equivalents, beginning of period	46,634	120,686
Cash and cash equivalents, end of period	\$39,557	81,202
Supplemental cash flow disclosures:		
Cash paid for interest	\$567	683
Cash paid for income taxes	135	0
Supplemental noncash flow disclosures:		
Transfer of loans to real estate	0	112
Loans transferred to loans held for sale	2,313	7,296

See accompanying notes to consolidated financial statements.

HMN FINANCIAL, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(unaudited)

(1) *HMN Financial, Inc.*

HMN Financial, Inc. (HMN or the Company) is a stock savings bank holding company that owns 100 percent of Home Federal Savings Bank (the Bank). The Bank has a community banking philosophy and operates retail banking and loan production facilities in Minnesota, Iowa, and Wisconsin. The Bank has two wholly owned subsidiaries, Osterud Insurance Agency, Inc. (OIA), which offers financial planning products and services, and HFSB Property Holdings, LLC (HPH), which acts as an intermediary for the Bank in holding and operating certain foreclosed properties.

The consolidated financial statements included herein are for HMN, the Bank, OIA and HPH. All significant intercompany accounts and transactions have been eliminated in consolidation.

(2) *Basis of Preparation*

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-Q and, therefore, do not include all disclosures necessary for a complete presentation of the consolidated balance sheets, consolidated statements of comprehensive income, consolidated statement of stockholders' equity and consolidated statements of cash flows in conformity with U.S. generally accepted accounting principles. However, all normal recurring adjustments which are, in the opinion of management, necessary for the fair presentation of the interim financial statements have been included. The results of operations for the six-month period ended June 30, 2015 are not necessarily indicative of the results which may be expected for the entire year.

(3) *Derivative Instruments and Hedging Activities*

The Company had commitments outstanding to extend credit to future borrowers that had not closed prior to the end of the quarter. The Company intends to sell these commitments, which are referred to as its mortgage pipeline. As commitments to originate loans enter the mortgage pipeline, the Company generally enters into commitments to sell the mortgage pipeline into the secondary market on a firm commitment or best efforts basis. The commitments to originate or sell loans on a firm commitment basis are derivatives and are recorded at market value. As a result of marking these derivatives to market and the related firm commitments to sell for the period ended June 30, 2015, the Company recorded an increase in other assets of \$5,000, a decrease in other liabilities of \$7,000 and a gain included in the gain on sales of loans of \$12,000. As a result of marking these derivatives to market for the period ended June 30,

2014, the Company recorded an increase in other assets of \$26,000, an increase in other liabilities of \$13,000 and a gain included in the gain on sales of loans of \$13,000.

The current commitments to sell loans held for sale are derivatives that do not qualify for hedge accounting. As a result, these derivatives are marked to market and the related loans held for sale are recorded at the lower-of-cost-or-market. The Company recorded a decrease in other liabilities of \$8,000 and a gain included in the gain on sales of loans of \$8,000 for the period ended June 30, 2015. The Company recorded an increase in other liabilities of \$64,000 and a loss included in the gain on sales of loans of \$64,000 for the period ended June 30, 2014.

(4) Fair Value Measurements

Accounting Standards Codification (ASC) 820, *Fair Value Measurements*, establishes a framework for measuring the fair value of assets and liabilities using a hierarchy system consisting of three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1 - Valuation is based upon quoted prices for identical instruments traded in active markets that the Company has the ability to access.

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 significant assumptions are observable in the market.

Level 3 – Valuation is generated from model-based techniques that use significant assumptions not observable in the market and are used only to the extent that observable inputs are not available. These unobservable assumptions reflect our own estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

The following table summarizes the assets and liabilities of the Company for which fair values are determined on a recurring basis as of June 30, 2015 and December 31, 2014.

<i>(Dollars in thousands)</i>	Carrying value at June 30, 2015			
	Total	Level 1	Level 2	Level 3
Securities available for sale	\$ 125,441	0	125,441	0
Mortgage loan commitments	22	0	22	0
Total	\$ 125,463	0	125,463	0

<i>(Dollars in thousands)</i>	Carrying value at December 31, 2014			
	Total	Level 1	Level 2	Level 3
Securities available for sale	\$ 137,834	0	137,834	0
Mortgage loan commitments	16	0	16	0
Total	\$ 137,850	0	137,850	0

There were no transfers between Levels 1, 2, or 3 during the three or six month periods ended June 30, 2015.

The Company may also be required, from time to time, to measure certain other financial assets at fair value on a nonrecurring basis in accordance with generally accepted accounting principles. These adjustments to fair value usually result from the application of the lower-of-cost-or-market accounting or write-downs of individual assets. For assets measured at fair value on a nonrecurring basis in the second quarter of 2015 that were still held at June 30, 2015, the following table provides the level of valuation assumptions used to determine each adjustment and the carrying value of the related individual assets or portfolios at June 30, 2015 and December 31, 2014.

<i>(Dollars in thousands)</i>	Carrying value at June 30, 2015					
	Total	Level 1	Level 2	Level 3	Three months ended	Six months ended

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					June 30, 2015	June 30, 2015
					Total (Losses)	Total (Losses)
Loans held for sale	\$5,968	0	5,968	0	(11)	(8)
Mortgage servicing rights	1,451	0	1,451	0	0	0
Loans ⁽¹⁾	11,225	0	11,225	0	(199)	(242)
Real estate, net ⁽²⁾	2,730	0	2,730	0	(121)	(121)
Total	\$21,374	0	21,374	0	(331)	(371)

Carrying value at December 31,
2014

					Year ended
<i>(Dollars in thousands)</i>	Total	Level 1	Level 2	Level 3	December 31, 2014 Total Gains (Losses)
Loans held for sale	\$2,076	0	2,076	0	(1)
Mortgage servicing rights, net	1,507	0	1,507	0	0
Loans ⁽¹⁾	11,882	0	11,882	0	532
Real estate, net ⁽²⁾	3,103	0	3,103	0	(134)
Total	\$18,568	0	18,568	0	397

(1) Represents carrying value and related write-downs of loans for which adjustments are based on the appraised value of the collateral. The carrying value of loans fully charged-off is zero.

(2) Represents the fair value and related losses of foreclosed real estate and other collateral owned that were measured at fair value subsequent to their initial classification as foreclosed assets.

(5) Fair Value of Financial Instruments

Generally accepted accounting principles require interim reporting period disclosure about the fair value of financial instruments, including assets, liabilities and off-balance sheet items for which it is practicable to estimate fair value. The fair value hierarchy level for each asset and liability, as defined in note 4, have been included in the following table for June 30, 2015. The fair value estimates are made based upon relevant market information, if available, and upon the characteristics of the financial instruments themselves. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based upon judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. The estimated fair value of the Company's financial instruments as of June 30, 2015 and December 31, 2014 are shown below.

	June 30, 2015			December 31, 2014					
	Carrying amount	Estimated fair value	Fair value hierarchy	Contract amount	Carrying amount	Estimated fair value	Fair value hierarchy		
<i>(Dollars in thousands)</i>			Level 1	Level 2	Level 3		Level 1	Level 2	Level 3
Financial assets:									
Cash and cash equivalents	\$39,557	39,557	39,557				46,634	46,634	46,634
Securities available for sale	125,441	125,441		125,441			137,834	137,834	137,834
Loans held for sale	5,968	5,968		5,968			2,076	2,076	2,076
Loans receivable, net	368,110	366,294		366,294					