

HORIZON BANCORP /IN/  
Form 10-Q  
May 10, 2012  
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**United States**  
**SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 10-Q**

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

**For the quarterly period ended March 31, 2012**

**Commission file number 0-10792**

**HORIZON BANCORP**

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

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**Indiana**  
(State or other jurisdiction of  
incorporation or organization)

**35-1562417**  
(I.R.S. Employer  
Identification No.)

**515 Franklin Square, Michigan City, Indiana**  
(Address of principal executive offices)

**46360**  
(Zip Code)

**(219) 879-0211**

**Registrant's telephone number, including area code:**

N/A

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

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

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. (Check One):

Large Accelerated Filer  Accelerated Filer

Non-accelerated Filer  (Do not check if 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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 4,997,017 shares of Common Stock, no par value, at May 10, 2012.

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**HORIZON BANCORP**

**FORM 10-Q**

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**Table of Contents****PART 1 FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****HORIZON BANCORP AND SUBSIDIARIES****Condensed Consolidated Balance Sheets**

(Dollar Amounts in Thousands)

	March 31 2012 (Unaudited)	December 31 2011
<b>Assets</b>		
Cash and due from banks	\$ 19,049	\$ 20,447
Investment securities, available for sale	433,501	431,045
Investment securities, held to maturity	7,100	7,100
Loans held for sale	10,202	14,090
Loans, net of allowance for loan losses of \$19,412 and \$18,882	969,141	964,311
Premises and equipment	35,775	34,665
Federal Reserve and Federal Home Loan Bank stock	12,390	12,390
Goodwill	5,910	5,910
Other intangible assets	2,182	2,292
Interest receivable	6,798	6,671
Cash value life insurance	30,415	30,190
Other assets	14,368	18,051
<b>Total assets</b>	<b>\$ 1,546,831</b>	<b>\$ 1,547,162</b>
<b>Liabilities</b>		
Deposits		
Non-interest bearing	\$ 138,618	\$ 130,673
Interest bearing	926,003	879,192
<b>Total deposits</b>	<b>1,064,621</b>	<b>1,009,865</b>
Borrowings	310,889	370,111
Subordinated debentures	30,699	30,676
Interest payable	555	596
Other liabilities	13,829	14,449
<b>Total liabilities</b>	<b>1,420,593</b>	<b>1,425,697</b>
<b>Commitments and contingent liabilities</b>		
<b>Stockholders Equity</b>		
Preferred stock, \$.01 par value, \$1,000 liquidation value		
Authorized, 1,000,000 Series B shares		
Issued 12,500 and 12,500 shares	12,500	12,500
Common stock, \$.3333 stated value		
Authorized, 22,500,000 shares		
Issued, 4,994,017 and 4,967,196 shares		
Outstanding, 4,954,347 and 4,947,696 shares	1,126	1,126
Additional paid-in capital	10,641	10,610
Retained earnings	93,198	89,387
Accumulated other comprehensive income	8,773	7,842

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Total stockholders' equity	<b>126,238</b>	121,465
Total liabilities and stockholders' equity	<b>\$ 1,546,831</b>	\$ 1,547,162

See notes to condensed consolidated financial statements

**Table of Contents****HORIZON BANCORP AND SUBSIDIARIES****Condensed Consolidated Statements of Income**

(Dollar Amounts in Thousands, Except Per Share Data)

	<b>Three Months Ended March 31</b>	
	<b>2012</b>	<b>2011</b>
	<b>(Unaudited)</b>	<b>(Unaudited)</b>
<b>Interest Income</b>		
Loans receivable	\$ 13,532	\$ 11,888
Investment securities		
Taxable	2,314	2,500
Tax exempt	980	1,043
Total interest income	16,826	15,431
<b>Interest Expense</b>		
Deposits	1,639	2,337
Borrowed funds	1,519	1,577
Subordinated debentures	470	450
Total interest expense	3,628	4,364
<b>Net Interest Income</b>	<b>13,198</b>	<b>11,067</b>
Provision for loan losses	559	1,548
<b>Net Interest Income after Provision for Loan Losses</b>	<b>12,639</b>	<b>9,519</b>
<b>Other Income</b>		
Service charges on deposit accounts	712	795
Wire transfer fees	182	108
Interchange fees	628	545
Fiduciary activities	975	963
Gain on sale of securities		274
Gain on sale of mortgage loans	2,274	533
Mortgage servicing income net of impairment	90	764
Increase in cash surrender value of bank owned life insurance	225	205
Other income	56	127
Total other income	5,142	4,314
<b>Other Expenses</b>		
Salaries and employee benefits	5,963	5,361
Net occupancy expenses	1,054	1,081
Data processing	526	407
Professional fees	534	349
Outside services and consultants	471	381
Loan expense	702	762
FDIC insurance expense	257	387
Other losses	30	31
Other expenses	1,623	1,499

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Total other expenses	<b>11,160</b>	10,258
<b>Income Before Income Tax</b>	<b>6,621</b>	3,575
Income tax expense	<b>2,008</b>	810
<b>Net Income</b>	<b>4,613</b>	2,765
Preferred stock dividend and discount accretion	<b>(156)</b>	(276)
<b>Net Income Available to Common Shareholders</b>	<b>\$ 4,457</b>	\$ 2,489
<b>Basic Earnings Per Share</b>	<b>\$ 0.90</b>	\$ 0.51
<b>Diluted Earnings Per Share</b>	<b>0.88</b>	0.49

See notes to condensed consolidated financial statements

**Table of Contents****HORIZON BANCORP AND SUBSIDIARIES****Condensed Consolidated Statements of Comprehensive Income**

(Dollar Amounts in Thousands)

	<b>Three Months Ended March 31 2012 (Unaudited)</b>	<b>2011 (Unaudited)</b>
<b>Net Income</b>	<b>\$ 4,613</b>	<b>\$ 2,765</b>
<b>Other Comprehensive Income</b>		
Change in fair value of derivative instruments, net of taxes		
of \$198 and \$670, for 2012 and 2011, respectively	<b>367</b>	1,245
Unrealized appreciation on available-for-sale securities, net of taxes of \$303 and \$158, for 2012 and 2011, respectively	<b>564</b>	293
Less: reclassification adjustment for realized gains included in net income, net of taxes of \$0 and \$96, for 2012 and 2011, respectively		178
	<b>931</b>	1,716
<b>Comprehensive Income</b>	<b>\$ 5,544</b>	<b>\$ 4,481</b>

See notes to condensed consolidated financial statements



**Table of Contents****HORIZON BANCORP AND SUBSIDIARIES****Condensed Consolidated Statement of Stockholders' Equity****(Unaudited)**

(Table Dollar Amounts in Thousands, Except Per Share Data)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
<b>Balances, January 1, 2012</b>	<b>\$ 12,500</b>	<b>\$ 1,126</b>	<b>\$ 10,610</b>	<b>\$ 89,387</b>	<b>\$ 7,842</b>	<b>\$ 121,465</b>
Net income				4,613		4,613
Other comprehensive income, net of tax					931	
Amortization of unearned compensation			23			23
Stock option expense			8			8
Cash dividends on preferred stock (5.00%)				(156)		(156)
Cash dividends on common stock (\$.13 per share)				(646)		(646)
<b>Balances, March 31, 2012</b>	<b>\$ 12,500</b>	<b>\$ 1,126</b>	<b>\$ 10,641</b>	<b>\$ 93,198</b>	<b>\$ 8,773</b>	<b>\$ 126,238</b>

See notes to condensed consolidated financial statements

**Table of Contents****HORIZON BANCORP AND SUBSIDIARIES****Condensed Consolidated Statements of Cash Flows**

(Dollar Amounts in Thousands)

	<b>Three Months Ended March 31</b>	
	<b>2012</b>	<b>2011</b>
	<b>(Unaudited)</b>	<b>(Unaudited)</b>
<b>Operating Activities</b>		
Net income	\$ 4,613	\$ 2,765
Items not requiring (providing) cash		
Provision for loan losses	559	1,548
Depreciation and amortization	646	604
Share based compensation	8	10
Mortgage servicing rights impairment (recovery)	7	(701)
Premium amortization on securities available for sale, net	700	522
Gain on sale of investment securities		(274)
Gain on sale of mortgage loans	(2,274)	(533)
Proceeds from sales of loans	82,619	64,764
Loans originated for sale	(80,345)	(64,231)
Change in cash surrender value of life insurance	(225)	(205)
(Gain) loss on sale of other real estate owned	21	(30)
Net change in		
Interest receivable	(127)	(114)
Interest payable	(41)	5
Other assets	1,415	1,401
Other liabilities	(179)	(1,159)
Net cash provided by operating activities	7,397	4,372
<b>Investing Activities</b>		
Purchases of securities available for sale	(22,581)	(76,429)
Proceeds from sales, maturities, calls, and principal repayments of securities available for sale	20,294	25,358
Purchase of securities held to maturity		(2,437)
Proceeds from maturities of securities held to maturity		1,400
Net change in loans	(2,102)	84,163
Proceeds on the sale of OREO and repossessed assets	2,461	1,469
Purchases of premises and equipment	(1,622)	(990)
Net cash provided (used in) by investing activities	(3,550)	32,534
<b>Financing Activities</b>		
Net change in		
Deposits	54,756	15,911
Borrowings	(59,199)	(36,360)
Proceeds from issuance of stock		56
Tax benefit from issuance of stock		8
Dividends paid on common shares	(646)	(560)
Dividends paid on preferred shares	(156)	(235)
Net cash used in financing activities	(5,245)	(21,180)
<b>Net Change in Cash and Cash Equivalent</b>	<b>(1,398)</b>	<b>15,726</b>

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<b>Cash and Cash Equivalents, Beginning of Period</b>	<b>20,447</b>	15,683
<b>Cash and Cash Equivalents, End of Period</b>	<b>\$ 19,049</b>	\$ 31,409
<b>Additional Cash Flows Information</b>		
Interest paid	<b>\$ 3,669</b>	\$ 4,358
Income taxes paid	<b>900</b>	
Transfer of loans to other real estate owned	<b>527</b>	1,095
See notes to condensed consolidated financial statements		

**Table of Contents****HORIZON BANCORP AND SUBSIDIARIES****Notes to Condensed Consolidated Financial Statements**

(Table Dollar Amounts in Thousands, Except Per Share Data)

**Note 1 Accounting Policies**

The accompanying condensed consolidated financial statements include the accounts of Horizon Bancorp ( Horizon or the Company ) and its wholly-owned subsidiaries, including Horizon Bank, N.A. ( Bank ). All inter-company balances and transactions have been eliminated. The results of operations for the periods ended March 31, 2012 and March 31, 2011 are not necessarily indicative of the operating results for the full year of 2012 or 2011. The accompanying unaudited condensed consolidated financial statements reflect all adjustments that are, in the opinion of Horizon's management, necessary to fairly present the financial position, results of operations and cash flows of Horizon for the periods presented. Those adjustments consist only of normal recurring adjustments.

Certain information and note disclosures normally included in Horizon's annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in Horizon's Annual Report on Form 10-K for 2011 filed with the Securities and Exchange Commission on March 12, 2012. The consolidated condensed balance sheet of Horizon as of December 31, 2011 has been derived from the audited balance sheet of Horizon as of that date.

Basic earnings per share is computed by dividing net income available to common shareholders (net income less dividend requirements for preferred stock and accretion of preferred stock discount) by the weighted-average number of common shares outstanding. Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. The following table shows computation of basic and diluted earnings per share.

	Three months ended	
	March 31	
	2012 (Unaudited)	2011 (Unaudited)
<b>Basic earnings per share</b>		
Net income	\$ 4,613	\$ 2,765
Less: Preferred stock dividends and accretion of discount	156	276
Net income available to common shareholders	\$ 4,457	\$ 2,489
Weighted average common shares outstanding <sup>(1)</sup>	4,948,573	4,924,715
<b>Basic earnings per share</b>	<b>\$ 0.90</b>	<b>\$ 0.51</b>
<b>Diluted earnings per share</b>		
Net income available to common shareholders	\$ 4,457	\$ 2,489
Weighted average common shares outstanding <sup>(1)</sup>	4,948,573	4,924,715
Effect of dilutive securities:		
Warrants	106,438	115,887
Restricted stock	971	22,217
Stock options	9,678	11,945
Weighted average shares outstanding	5,065,660	5,074,763
<b>Diluted earnings per share</b>	<b>\$ 0.88</b>	<b>\$ 0.49</b>

<sup>(1)</sup> Adjusted for 3:2 stock split on December 9, 2011

**Table of Contents****HORIZON BANCORP AND SUBSIDIARIES****Notes to Condensed Consolidated Financial Statements**

(Table Dollar Amounts in Thousands, Except Per Share Data)

At March 31, 2012 and 2011, there were 31,500 shares and 39,176 shares that were not included in the computation of diluted earnings per share because they were non-dilutive.

Horizon has share-based employee compensation plans, which are described in the notes to the financial statements included in the December 31, 2011 Annual Report on Form 10-K.

**Reclassifications**

Certain reclassifications have been made to the 2011 consolidated financial statements to be comparable to 2012. These reclassifications had no effect on net income.

**Note 2 Securities**

The fair value of securities is as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>March 31, 2012</b>				
<b>Available for sale</b>				
U.S. Treasury and federal agencies	\$ 18,365	\$ 293	\$ (1)	\$ 18,657
State and municipal	134,661	9,195	(82)	143,774
Federal agency collateralized mortgage obligations	84,458	2,233	(1)	86,690
Federal agency mortgage-backed pools	174,909	6,095	(21)	180,983
Private labeled mortgage-backed pools	3,247	113		3,360
Corporate notes	32	5		37
Total available for sale investment securities	\$ 415,672	\$ 17,934	\$ (105)	\$ 433,501
<b>Held to maturity, State and Municipal</b>	<b>\$ 7,100</b>	<b>\$</b>	<b>\$</b>	<b>\$ 7,100</b>
<b>December 31, 2011</b>				
<b>Available for sale</b>				
U.S. Treasury and federal agencies	\$ 12,693	\$ 329	\$	\$ 13,022
State and municipal	135,011	8,950	(71)	143,890
Federal agency collateralized mortgage obligations	89,016	2,106		91,122
Federal agency mortgage-backed pools	173,797	5,669	(115)	179,351
Private labeled mortgage-backed pools	3,518	118		3,636
Corporate notes	32		(8)	24
Total available for sale investment securities	\$ 414,067	\$ 17,172	\$ (194)	\$ 431,045

<b>Held to maturity, State and Municipal</b>	\$ 7,100	\$ 34	\$	\$ 7,134
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Based on evaluation of available evidence, including recent changes in market interest rates, credit rating information, and information obtained from regulatory filings, management believes the declines in fair value for these securities are temporary. While these securities are held in the available for sale portfolio, Horizon intends, and has the ability, to hold them until the earlier of a recovery in fair value or maturity.

Should the impairment of any of these securities become other than temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income in the period the other-than-temporary impairment is identified. At March 31, 2012, no individual investment security had an unrealized loss that was determined to be other-than-temporary.

The unrealized losses on the Company's investments in United States Department of the Treasury ( U.S. Treasury ) and federal agencies, securities of state and municipal governmental agencies, and federal agency mortgage-backed pools were caused by interest rate volatility and not a decline in credit quality. The

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(Table Dollar Amounts in Thousands, Except Per Share Data)

contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. The Company expects to recover the amortized cost basis over the term of the securities. Because the Company does not intend to sell the investments and it is not likely that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be at maturity, the Company did not consider those investments to be other-than-temporarily impaired at March 31, 2012.

The amortized cost and fair value of securities available for sale and held to maturity at March 31, 2012 and December 31, 2011, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	March 31, 2012		December 31, 2011	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
<b>Available for sale</b>				
Within one year	\$ 936	\$ 941	\$ 931	\$ 940
One to five years	32,713	33,847	30,796	31,910
Five to ten years	59,524	63,509	51,476	55,053
After ten years	59,885	64,171	64,533	69,033
	153,058	162,468	147,736	156,936
Federal agency collateralized mortgage obligations	84,458	86,690	89,016	91,122
Federal agency mortgage-backed pools	174,909	180,983	173,797	179,351
Private labeled mortgage-backed pools	3,247	3,360	3,518	3,636
Total available for sale investment securities	\$ 415,672	\$ 433,501	\$ 414,067	\$ 431,045
<b>Held to maturity</b>				
Within one year	\$ 7,100	\$ 7,100	\$ 7,100	\$ 7,134
One to five years				
Total held to maturity investment securities	\$ 7,100	\$ 7,100	\$ 7,100	\$ 7,134

The following table shows the gross unrealized losses and the fair value of the Company's investments, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position.

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>March 31, 2012</b>						
U.S. Treasury and federal agencies	\$ 2,984	\$ (1)	\$	\$	\$ 2,984	\$ (1)
State and municipal	2,323	(82)			2,323	(82)
Federal agency collateralized mortgage obligations	2,595	(1)			2,595	(1)
Federal agency mortgage-backed pools	7,248	(21)	20		7,268	(21)
Total temporarily impaired securities	\$ 15,150	\$ (105)	\$ 20	\$	\$ 15,170	\$ (105)



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	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>December 31, 2011</b>						
State and municipal	\$ 1,550	\$ (44)	\$ 1,948	\$ (27)	\$ 3,498	\$ (71)
Federal agency mortgage-backed pools	23,442	(115)	23		23,465	(115)
Corporate notes	24	(8)			24	(8)
 Total temporarily impaired securities	 \$ 25,016	 \$ (167)	 \$ 1,971	 \$ (27)	 \$ 26,987	 \$ (194)

**Table of Contents****HORIZON BANCORP AND SUBSIDIARIES****Notes to Condensed Consolidated Financial Statements**

(Table Dollar Amounts in Thousands, Except Per Share Data)

	<b>Three months ended March 31</b>	
	<b>2012</b>	<b>2011</b>
<b>Sales of securities available for sale (Unaudited)</b>		
Proceeds	\$	\$ 9,274
Gross gains		274
Gross losses		

**Note 3 Loans**

	<b>March 31</b>	<b>December 31</b>
	<b>2012</b>	<b>2011</b>
<b>Commercial</b>		
Working capital and equipment	<b>\$ 164,199</b>	\$ 170,325
Real estate, including agriculture	<b>176,889</b>	172,910
Tax exempt	<b>3,539</b>	3,818
Other	<b>5,836</b>	5,323
Total	<b>350,463</b>	352,376
<b>Real estate</b>		
1-4 family	<b>151,497</b>	153,039
Other	<b>4,053</b>	4,102
Total	<b>155,550</b>	157,141
<b>Consumer</b>		
Auto	<b>138,682</b>	134,686
Recreation	<b>4,808</b>	4,737
Real estate/home improvement	<b>27,865</b>	27,729
Home equity	<b>92,495</b>	92,249
Unsecured	<b>3,039</b>	3,183
Other	<b>2,499</b>	2,793
Total	<b>269,388</b>	265,377
Mortgage warehouse	<b>213,152</b>	208,299
Total	<b>213,152</b>	208,299
Total loans	<b>988,553</b>	983,193
Allowance for loan losses	<b>(19,412)</b>	(18,882)
Loans, net	<b>\$ 969,141</b>	\$ 964,311

**Commercial**

Commercial loans are primarily based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most

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commercial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial real estate loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally dependent on the successful operation of the property securing the loan or the

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**HORIZON BANCORP AND SUBSIDIARIES**

**Notes to Condensed Consolidated Financial Statements**

(Table Dollar Amounts in Thousands, Except Per Share Data)

business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing the Company's commercial real estate portfolio are diverse in terms of property type, which are monitored for concentrations of credit. Management monitors and evaluates commercial real estate loans based on collateral, cash flow and risk grade criteria. As a general rule, the Company avoids financing single purpose projects unless other underwriting factors are present to help mitigate risk. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans.

**Real Estate and Consumer**

With respect to residential loans that are secured by 1-4 family residences and are generally owner occupied, the Company generally establishes a maximum loan-to-value ratio and requires private mortgage insurance if that ratio is exceeded. Home equity loans are typically secured by a subordinate interest in 1-4 family residences, and consumer loans are secured by consumer assets such as automobiles or recreational vehicles. Some consumer loans are unsecured such as small installment loans and certain lines of credit. Repayment of these loans is primarily dependent on the personal income of the borrowers, which can be impacted by economic conditions in their market areas such as unemployment levels. Repayment can also be impacted by changes in property values on residential properties. Risk is mitigated by the fact that the loans are of smaller individual amounts and spread over a large number of borrowers.

**Mortgage Warehousing**

Horizon's mortgage warehouse lending has specific mortgage companies as customers of Horizon Bank. Individual mortgage loans originated by these mortgage companies are funded as a secured borrowing with pledge of collateral under Horizon's agreement with the mortgage company. Each individual mortgage is assigned to Horizon until the loan is sold to the secondary market by the mortgage company. In addition, Horizon takes possession of each original note and forwards such note to the end investor once the mortgage company has sold the loan. At the time a loan is transferred to the secondary market, the mortgage company repurchases the loan under its option within the agreement. Due to the repurchase feature contained in the agreement, the transaction does not qualify as a sale and therefore is accounted for as a secured borrowing with pledge of collateral pursuant to the agreement with the mortgage company. When the individual loan is sold to the end investor by the mortgage company the proceeds from the sale of the loan are received by Horizon and used to pay off the loan balance with Horizon along with any accrued interest and any related fees. The remaining balance from the sale is forwarded to the mortgage company. These individual loans typically are sold by the mortgage company within 30 days and are seldom held more than 90 days. Interest income is accrued during this period and collected at the time each loan is sold. Fee income for each loan sold is collected when the loan is sold and no costs are deferred due to the term between each loan funding and related payoff is typically less than 30 days.

Based on the agreements with each mortgage company, at any time a mortgage company can repurchase from Horizon their outstanding loan balance on an individual mortgage and regain possession of the original note. Horizon also has the option to request that the mortgage company repurchase an individual mortgage. Should this occur, Horizon would return the original note and reassign the assignment of the mortgage to the mortgage company. Also, in the event that the end investor would not be able to honor the sales commitment and the mortgage company would not be able to repurchase its loan on an individual mortgage, Horizon would be able to exercise its rights under the agreement.

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(Table Dollar Amounts in Thousands, Except Per Share Data)

The following table shows the recorded investment of individual loan categories.

<b>March 31, 2012</b>	<b>Loan Balance</b>	<b>Interest Due</b>	<b>Deferred Fees/(Costs)</b>	<b>Recorded Investment</b>
Owner occupied real estate	\$ 129,530	\$ 409	\$ 26	\$ 129,965
Non owner occupied real estate	150,861	395	99	151,355
Residential spec homes	2,834	7		2,841
Development & spec land loans	7,366	15		7,381
Commercial and industrial	59,744	198	3	59,945
<b>Total commercial</b>	<b>350,335</b>	<b>1,024</b>	<b>128</b>	<b>351,487</b>
Residential mortgage	148,073	569	68	148,710
Residential construction	7,409	11		7,420
Mortgage warehouse	213,152	427		213,579
<b>Total real estate</b>	<b>368,634</b>	<b>1,007</b>	<b>68</b>	<b>369,709</b>
Direct installment	24,735	86	(346)	24,475
Direct installment purchased	863			863
Indirect installment	131,461	403		131,864
Home equity	113,420	524	(745)	113,199
<b>Total consumer</b>	<b>270,479</b>	<b>1,013</b>	<b>(1,091)</b>	<b>270,401</b>
<b>Total loans</b>	<b>989,448</b>	<b>3,044</b>	<b>(895)</b>	<b>991,597</b>
Allowance for loan losses	(19,412)			(19,412)
<b>Net loans</b>	<b>\$ 970,036</b>	<b>\$ 3,044</b>	<b>\$ (895)</b>	<b>\$ 972,185</b>

<b>December 31, 2011</b>	<b>Loan Balance</b>	<b>Interest Due</b>	<b>Deferred Fees/(Costs)</b>	<b>Recorded Investment</b>
Owner occupied real estate	\$ 131,893	\$ 383	\$ 30	\$ 132,306
Non owner occupied real estate	142,269	360	94	142,723
Residential spec homes	3,574	6		3,580
Development & spec land loans	8,739	16		8,755
Commercial and industrial	65,774	169	3	65,946
<b>Total commercial</b>	<b>352,249</b>	<b>934</b>	<b>127</b>	<b>353,310</b>
Residential mortgage	150,893	513	68	151,474
Residential construction	6,181	8		6,189
Mortgage warehouse	208,299	427		208,726

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Total real estate	365,373	948	68	366,389
Direct installment	24,252	94	(360)	23,986
Direct installment purchased	981			981
Indirect installment	127,751	420	(56)	128,115
Home equity	113,561	559	(752)	113,368
<b>Total consumer</b>	<b>266,545</b>	<b>1,073</b>	<b>(1,168)</b>	<b>266,450</b>
<b>Total loans</b>	<b>984,167</b>	<b>2,955</b>	<b>(973)</b>	<b>986,149</b>
Allowance for loan losses	(18,882)			(18,882)
<b>Net loans</b>	<b>\$ 965,285</b>	<b>\$ 2,955</b>	<b>\$ (973)</b>	<b>\$ 967,267</b>

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**Note 4 Allowance for Loan Losses**

The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Company over the prior one to five years. Management believes the two-year historical loss experience methodology is appropriate in the current economic environment, as it captures loss rates that are comparable to the current period being analyzed.

	<b>Three Months Ended</b>	
	<b>March 31 2012 (Unaudited)</b>	<b>March 31 2011 (Unaudited)</b>
<b>Balance at beginning of the period</b>	\$ 18,882	\$ 19,064
<b>Loans charged-off:</b>		
<b>Commercial</b>		
Owner occupied real estate		11
Non owner occupied real estate		
Residential development		
Development & Spec Land Loans		
Commercial and industrial		50
<b>Total commercial</b>		61
<b>Real estate</b>		
Residential mortgage	89	82
Residential construction		
Mortgage warehouse		
<b>Total real estate</b>	89	82
<b>Consumer</b>		
Direct Installment	113	185
Direct Installment Purchased		
Indirect Installment	338	455
Home Equity	133	977
<b>Total consumer</b>	584	1,617
<b>Total loans charged-off</b>	673	1,760
<b>Recoveries of loans previously charged-off:</b>		
<b>Commercial</b>		
Owner occupied real estate	300	
Non owner occupied real estate	7	
Residential development		
Development & Spec Land Loans		
Commercial and industrial	25	2
<b>Total commercial</b>	332	2
<b>Real estate</b>		

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Residential mortgage	30	
Residential construction		
Mortgage warehouse		
<b>Total real estate</b>	30	
<b>Consumer</b>		
Direct Installment	15	48
Direct Installment Purchased		
Indirect Installment	201	169
Home Equity	66	19
<b>Total consumer</b>	282	236
<b>Total loan recoveries</b>	644	238
<b>Net loans charged-off</b>	29	1,522
Provision charged to operating expense		
<b>Commercial</b>	86	1,114
<b>Real estate</b>	611	47
<b>Consumer</b>	(138)	387
<b>Total provision charged to operating expense</b>	559	1,548
<b>Balance at the end of the period</b>	\$ 19,412	\$ 19,090



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Management's general practice is to proactively charge down loans individually evaluated for impairment to the fair value of the underlying collateral.

Consistent with regulatory guidance, charge-offs on all loan segments are taken when specific loans, or portions thereof, are considered uncollectible. The Company's policy is to promptly charge these loans off in the period the uncollectible loss is reasonably determined.

For all loan portfolio segments except 1-4 family residential properties and consumer, the Company promptly charges-off loans, or portions thereof, when available information confirms that specific loans are uncollectible based on information that includes, but is not limited to, (1) the deteriorating financial condition of the borrower, (2) declining collateral values, and/or (3) legal action, including bankruptcy, that impairs the borrower's ability to adequately meet its obligations. For impaired loans that are considered to be solely collateral dependent, a partial charge-off is recorded when a loss has been confirmed by an updated appraisal or other appropriate valuation of the collateral.

The Company charges-off 1-4 family residential and consumer loans, or portions thereof, when the Company reasonably determines the amount of the loss. The Company adheres to timeframes established by applicable regulatory guidance which provides for the charge-down or specific allocation of 1-4 family first and junior lien mortgages to the net realizable value less costs to sell when the value is known but no later than when a loan is 180 days past due, charge-off of unsecured open-end loans when the loan is 90 days past due, and charge down to the net realizable value when other secured loans are 90 days past due. Loans at these respective delinquency thresholds for which the Company can clearly document that the loan is both well-secured and in the process of collection, such that collection will occur regardless of delinquency status, need not be charged off.

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment analysis:

	Commercial	Real Estate	Mortgage Warehousing	Consumer	Total
<b>March 31, 2012</b>					
<b>Allowance For Loan Losses</b>					
<b>Ending allowance balance attributable to loans:</b>					
Individually evaluated for impairment	\$ 2,833	\$	\$	\$	\$ 2,833
Collectively evaluated for impairment	5,602	3,025	1,694	6,258	16,579
<b>Total ending allowance balance</b>	<b>\$ 8,435</b>	<b>\$ 3,025</b>	<b>\$ 1,694</b>	<b>\$ 6,258</b>	<b>\$ 19,412</b>
<b>Loans:</b>					
Individually evaluated for impairment	\$ 9,035	\$	\$	\$	\$ 9,035
Collectively evaluated for impairment	342,452	156,130	213,579	270,401	982,562
<b>Total ending loans balance</b>	<b>\$ 351,487</b>	<b>\$ 156,130</b>	<b>\$ 213,579</b>	<b>\$ 270,401</b>	<b>\$ 991,597</b>
<b>December 31, 2011</b>					
<b>Allowance For Loan Losses</b>					
<b>Ending allowance balance attributable to loans:</b>					
Individually evaluated for impairment	\$ 2,136	\$	\$	\$	\$ 2,136

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Collectively evaluated for impairment	5,881	2,472	1,695	6,698	16,746
<b>Total ending allowance balance</b>	<b>\$ 8,017</b>	<b>\$ 2,472</b>	<b>\$ 1,695</b>	<b>\$ 6,698</b>	<b>\$ 18,882</b>
<b>Loans:</b>					
Individually evaluated for impairment	\$ 7,960	\$	\$	\$	\$ 7,960
Collectively evaluated for impairment	345,350	157,663	208,726	266,450	978,189
<b>Total ending loans balance</b>	<b>\$ 353,310</b>	<b>\$ 157,663</b>	<b>\$ 208,726</b>	<b>\$ 266,450</b>	<b>\$ 986,149</b>

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**Note 5 Non-performing Loans and Impaired Loans**

The following table presents the nonaccrual, loans past due over 90 days still on accrual, and troubled debt restructured ( TDR s ) by class of loans:

March 31, 2012	Nonaccrual	Loans Past Due Over 90 Days Still Accruing	Non Performing TDR s	Performing TDR s	Total Non-Performing Loans
<b>Commercial</b>					
Owner occupied real estate	\$ 2,359	\$		\$	\$ 2,359
Non owner occupied real estate	4,033		152	(0)	4,185
Residential development					
Development & Spec Land Loans	805				805
Commercial and industrial	808		878	0	1,686
<b>Total commercial</b>	<b>8,005</b>		<b>1,030</b>	<b>0</b>	<b>9,035</b>
<b>Real estate</b>					
Residential mortgage	4,853		1,331	2,047	8,231
Residential construction	144			292	436
Mortgage warehouse					
<b>Total real estate</b>	<b>4,997</b>		<b>1,331</b>	<b>2,339</b>	<b>8,667</b>
<b>Consumer</b>					
Direct Installment	157		24	0	181
Direct Installment Purchased		9			9
Indirect Installment	755	19			774
Home Equity	1,536		53	849	2,438
<b>Total Consumer</b>	<b>2,448</b>	<b>28</b>	<b>78</b>	<b>849</b>	<b>3,402</b>
<b>Total</b>	<b>\$ 15,450</b>	<b>\$ 28</b>	<b>\$ 2,439</b>	<b>\$ 3,188</b>	<b>\$ 21,104</b>

December 31, 2011	Nonaccrual	Loans Past Due Over 90 Days Still Accruing	Non Performing TDR s	Performing TDR s	Total Non-Performing Loans
<b>Commercial</b>					
Owner occupied real estate	\$ 2,515	\$	\$	\$	\$ 2,515
Non owner occupied real estate	3,970		152		4,122

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Residential development					
Development & Spec Land Loans	90				90
Commercial and industrial	330		901		1,231
<b>Total commercial</b>	<b>6,905</b>		<b>1,053</b>		<b>7,958</b>
<b>Real estate</b>					
Residential mortgage	4,550		1,120	2,389	8,059
Residential construction	144			293	437
Mortgage warehouse					
<b>Total real estate</b>	<b>4,694</b>		<b>1,120</b>	<b>2,682</b>	<b>8,496</b>
<b>Consumer</b>					
Direct Installment	256	1			257
Direct Installment Purchased		4			4
Indirect Installment	926	29			955
Home Equity	1,587	3	25	858	2,473
<b>Total Consumer</b>	<b>2,769</b>	<b>37</b>	<b>25</b>	<b>858</b>	<b>3,689</b>
<b>Total</b>	<b>\$ 14,368</b>	<b>\$ 37</b>	<b>\$ 2,198</b>	<b>\$ 3,540</b>	<b>\$ 20,143</b>

From time to time, the Bank obtains information that may lead management to believe that the collection of payments may be doubtful on a particular loan. In recognition of this, it is management's policy to convert

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the loan from an earning asset to a non-accruing loan. The entire balance of a loan is considered delinquent if the minimum payment contractually required to be made is not received by the specified due date. Further, it is management's policy to place a loan on a non-accrual status when delinquent in excess of 90 days or have had the accrual of interest discontinued by management. The officer responsible for the loan and the Chief Operating Officer or the senior collection officer must review all loans placed on non-accrual status. Subsequent payments on non-accrual loans are recorded as a reduction of principal, and interest income is recorded only after principal recovery is reasonably assured. Nonaccrual loans are returned to accrual status when, in the opinion of management, the financial position of the borrower indicates there is no longer any reasonable doubt as to the timely collection of interest or principal. The Company requires a period of satisfactory performance of not less than six months before returning a nonaccrual loan to accrual status.

A loan becomes impaired when, based on current information, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. When a loan is classified as impaired, the degree of impairment must be recognized by estimating future cash flows from the debtor. The present value of these cash flows is computed at a discount rate based on the interest rate contained in the loan agreement. However, if a particular loan has a determinable market value for its collateral, the creditor may use that value. Also, if the loan is secured and considered collateral dependent, the creditor may use the fair value of the collateral. Interest income on loans individually classified as impaired is recognized on a cash basis after all past due and current principal payments have been made.

Smaller-balance, homogeneous loans are evaluated for impairment in total. Such loans include residential first mortgage loans secured by 1-4 family residences, residential construction loans, automobile, home equity, second mortgage loans and mortgage warehouse loans. Commercial loans and mortgage loans secured by other properties are evaluated individually for impairment. When analysis of borrower operating results and financial condition indicate that underlying cash flows of a borrower's business are not adequate to meet its debt service requirements, the loan is evaluated for impairment. Often this is associated with a delay or shortfall in payments of 30 days or more. Loans are generally moved to non-accrual status when 90 days or more past due. These loans are often considered impaired. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

Loans for which it is probable that the Company will not collect all principal and interest due according to contractual terms, including TDRs, are measured for impairment. Allowable methods for determining the amount of impairment include estimating fair value using the fair value of the collateral for collateral-dependent loans.

The Company's TDRs are considered impaired loans and included in the allowance methodology using the guidance for impaired loans. At March 31, 2012, the type of concessions the Company has made on restructured loans has been temporary rate reductions and/or reductions in monthly payments. Any modification to a loan that is a concession and is not in the normal course of lending is considered a restructured loan. A restructured loan is returned to accruing status after six consecutive payments but is still reported as TDR unless the loan bears interest at a market rate. As of March 31, 2012, the Company had \$5.6 million in TDRs and \$3.4 million were performing according to the restructured terms. The financial statement impact of non-performing TDRs was not material for the three months ending March 31, 2012. There was \$840,000 of specific reserves allocated to TDRs at March 31, 2012 based on the collateral deficiencies.

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Loans classified as troubled debt restructuring during the *three months ended* March 31, 2012 and 2011, segregated by class, are shown in the table below.

	March 31, 2012		March 31, 2011	
	Number of Defaults	Unpaid Principal Balance	Number of Defaults	Unpaid Principal Balance
<b>Commercial</b>				
Owner occupied real estate		\$		\$
Non owner occupied real estate				
Residential development				
Development & Spec Land Loans				
Commercial and industrial				
<b>Total commercial</b>				
<b>Real estate</b>				
Residential mortgage	1	121	2	342
Residential construction				
Mortgage warehouse				
<b>Total real estate</b>	1	121	2	342
<b>Consumer</b>				
Direct Installment				
Direct Installment Purchased				
Indirect Installment				
Home Equity	1	53	1	9
<b>Total Consumer</b>	1	53	1	9
<b>Total</b>	2	\$ 174	3	\$ 351

Troubled debt restructured loans which had payment defaults during the *three months ended* March 31, 2012 and 2011, segregated by class, are shown in the table below. Default occurs when a loan is 90 days or more past due or transferred to nonaccrual.

	March 31, 2012		March 31, 2011	
	Number of Defaults	Unpaid Principal Balance	Number of Defaults	Unpaid Principal Balance
<b>Commercial</b>				
Owner occupied real estate		\$		\$
Non owner occupied real estate				
Residential development				

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Development & Spec Land Loans				
Commercial and industrial				
<b>Total commercial</b>				
<b>Real estate</b>				
Residential mortgage	2	232	1	459
Residential construction			1	293
Mortgage warehouse				
<b>Total real estate</b>	2	232	2	752
<b>Consumer</b>				
Direct Installment				
Direct Installment Purchased				
Indirect Installment				
Home Equity	1	53		
<b>Total Consumer</b>	1	53		
<b>Total</b>	3	\$ 285	2	\$ 752

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The following table presents commercial loans individually evaluated for impairment by class of loans:

	Unpaid Principal Balance	Recorded Investment	Allowance For Loan Loss Allocated	Three Months Ending Average Balance in Impaired Loans	Cash/Accrual Interest Income Recognized
<b>March 31, 2012</b>					
<b>With no recorded allowance</b>					
<b>Commercial</b>					
Owner occupied real estate	\$ 723	\$ 723	\$	\$ 503	\$ 3
Non owner occupied real estate	972	974		973	
Residential development					
Development & Spec Land Loans	90	90		90	
Commercial and industrial	338	338		240	1
<b>Total commercial</b>	<b>2,123</b>	<b>2,125</b>		<b>1,806</b>	<b>4</b>
<b>With an allowance recorded</b>					
<b>Commercial</b>					
Owner occupied real estate	1,636	1,636	595	1,783	1
Non owner occupied real estate	3,213	3,213	1,105	3,186	2
Residential development					
Development & Spec Land Loans	715	715	470	237	6
Commercial and industrial	1,348	1,348	663	1,130	4
<b>Total commercial</b>	<b>6,912</b>	<b>6,912</b>	<b>2,833</b>	<b>6,336</b>	<b>13</b>
<b>Total</b>	<b>\$ 9,035</b>	<b>\$ 9,037</b>	<b>\$ 2,833</b>	<b>\$ 8,142</b>	<b>\$ 17</b>

	Unpaid Principal Balance	Recorded Investment	Allowance For Loan Loss Allocated	Three Months Ending Average Balance in Impaired Loans	Cash/Accrual Interest Income Recognized
<b>March 31, 2011</b>					
<b>With no recorded allowance</b>					
<b>Commercial</b>					
Owner occupied real estate	\$ 1,003	\$ 1,006	\$	\$ 818	\$ 1
Non owner occupied real estate	1,254	1,254		1,037	4
Residential development	16	16		16	
Development & Spec Land Loans	124	124		83	
Commercial and industrial	191	191		154	
<b>Total commercial</b>	<b>2,588</b>	<b>2,591</b>		<b>2,107</b>	<b>5</b>
<b>With an allowance recorded</b>					



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**Commercial**

Owner occupied real estate	1,538	1,537	585	1,141	
Non owner occupied real estate	4,849	4,888	665	4,884	
<b>Residential development</b>					
Development & Spec Land Loans	250	250	125	250	
Commercial and industrial	251	251	115	251	1
<b>Total commercial</b>	6,888	6,926	1,490	6,526	1
<b>Total</b>	\$ 9,476	\$ 9,517	\$ 1,490	\$ 8,633	\$ 6

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The following table presents the payment status by class of loans:

March 31, 2012	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater than 90 Days Past Due	Total Past Due	Loans Not Past Due	Total
<b>Commercial</b>						
Owner occupied real estate	\$ 285	\$ 30	\$	\$ 315	\$ 129,215	\$ 129,530
Non owner occupied real estate		97		97	150,764	150,861
Residential development					2,834	2,834
Development & Spec Land Loans					7,366	7,366
Commercial and industrial	1			1	59,743	59,744
<b>Total commercial</b>	<b>286</b>	<b>127</b>		<b>413</b>	<b>349,922</b>	<b>350,335</b>
<b>Real estate</b>						
Residential mortgage	213	254		467	147,606	148,073
Residential construction	292			292	7,117	7,409
Mortgage warehouse					213,152	213,152
<b>Total real estate</b>	<b>505</b>	<b>254</b>		<b>759</b>	<b>367,875</b>	<b>368,634</b>
<b>Consumer</b>						
Direct Installment	137	17		154	24,581	24,735
Direct Installment Purchased	4	8	9	21	842	863
Indirect Installment	816	87	19	922	130,539	131,461
Home Equity	655	36		691	112,729	113,420
<b>Total consumer</b>	<b>1,612</b>	<b>148</b>	<b>28</b>	<b>1,788</b>	<b>268,691</b>	<b>270,479</b>
<b>Total</b>	<b>\$ 2,403</b>	<b>\$ 529</b>	<b>\$ 28</b>	<b>\$ 2,960</b>	<b>\$ 986,488</b>	<b>\$ 989,448</b>

December 31, 2011	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater than 90 Days Past Due	Total Past Due	Loans Not Past Due	Total
<b>Commercial</b>						
Owner occupied real estate	\$ 89	\$ 168	\$	\$ 257	\$ 131,636	\$ 131,893
Non owner occupied real estate	228			228	142,041	142,269
Residential development					3,574	3,574
Development & Spec Land Loans					8,739	8,739
Commercial and industrial	34	22		56	65,718	65,774
<b>Total commercial</b>	<b>351</b>	<b>190</b>		<b>541</b>	<b>351,708</b>	<b>352,249</b>
<b>Real estate</b>						

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Residential mortgage	411			411	150,482	150,893
Residential construction					6,181	6,181
Mortgage warehouse					208,299	208,299
<b>Total real estate</b>	<b>411</b>			<b>411</b>	<b>364,962</b>	<b>365,373</b>
<b>Consumer</b>						
Direct Installment	164	22	1	187	24,065	24,252
Direct Installment Purchased	7	14	4	25	956	981
Indirect Installment	1,333	335	29	1,697	126,054	127,751
Home Equity	363	92	3	458	113,103	113,561
<b>Total consumer</b>	<b>1,867</b>	<b>463</b>	<b>37</b>	<b>2,367</b>	<b>264,178</b>	<b>266,545</b>
<b>Total</b>	<b>\$ 2,629</b>	<b>\$ 653</b>	<b>\$ 37</b>	<b>\$ 3,319</b>	<b>\$ 980,848</b>	<b>\$ 984,167</b>

The entire balance of a loan is considered delinquent if the minimum payment contractually required to be made is not received by the specified due date.

Horizon Bank's processes for determining credit quality differ slightly depending on whether a new loan or a renewed loan is being underwritten, or whether an existing loan is re-evaluated for credit quality. The latter usually occurs upon receipt of current financial information or other pertinent data that would trigger a change in the loan grade.

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For new and renewed commercial loans, the Bank's Credit Department, which acts independently of the loan officer, assigns the credit quality grade to the loan. Loan grades for loans with an aggregate credit exposure of \$500,000 or greater are validated by the Loan Committee, which is chaired by the Chief Operating Officer (COO).

Commercial loan officers are responsible for reviewing their loan portfolios and report any adverse material change to the COO or Loan Committee. When circumstances warrant a change in the credit quality grade, loan officers are required to notify the COO and the Credit Department of the change in the loan grade. Downgrades are accepted immediately by the COO however, lenders must present their factual information to either the Loan Committee or the COO when recommending an upgrade.

The COO meets weekly with loan officers to discuss the status of past-due loans and classified loans. These meetings are also designed to give the loan officers an opportunity to identify an existing loan that should be downgraded to a classified grade.

Monthly, Senior Management attends the Watch Committee, which reviews all of the past due, classified, and impaired loans and the relative trends of these assets. This committee also reviews the actions taken by management regarding foreclosure mitigation, loan extensions, troubled debt restructures, and collateral repossessions. The information reviewed in this meeting acts as a precursor for developing Management's analysis of the adequacy of the Allowance for Loan and Lease Losses.

For real estate and consumer loans, Horizon uses a grading system based on delinquency. Loans that are 90 days or more past due, on non-accrual, or a troubled debt restructure are graded Substandard. After being 90 days delinquent a loan is charged off unless it is well secured and in the process of collection. If the latter case exists, the loan is placed on non-accrual. Occasionally a mortgage loan may be graded as Special Mention. When this situation arises, it is because the characteristics of the loan and the borrower fit the definition of a Risk Grade 5 described below, which is normally used for grading commercial loans. Loans not graded Substandard are considered Pass.

Horizon Bank employs an eight-grade rating system to determine the credit quality of commercial loans. The first four grades represent acceptable quality, and the last four grades mirror the criticized and classified grades used by the bank regulatory agencies (special mention, substandard, doubtful, and loss). The loan grade definitions are detailed below.

**Risk Grade 1: Excellent (Pass)**

Loans secured by liquid collateral, such as certificates of deposit, reputable bank letters of credit, or other cash equivalents; loans that are guaranteed or otherwise backed by the full faith and credit of the United States government or an agency thereof, such as the Small Business Administration; or loans to any publicly held company with a current long-term debt rating of A or better.

**Risk Grade 2: Good (Pass)**

Loans to businesses that have strong financial statements containing an unqualified opinion from a CPA firm and at least three consecutive years of profits; loans supported by unaudited financial statements containing strong balance sheets, five consecutive years of profits, a five-year satisfactory relationship with the Bank, and key balance sheet and income statement trends that are either stable or positive; loans secured by publicly traded marketable securities where there is no impediment to liquidation; loans to individuals backed by liquid personal assets and unblemished credit history; or loans to publicly held companies with current long-term debt ratings of Baa or better.

**Risk Grade 3: Satisfactory (Pass)**

Loans supported by financial statements (audited or unaudited) that indicate average or slightly below average risk and having some deficiency or vulnerability to changing economic conditions; loans with some weakness but offsetting features of other support are readily available; loans

that are meeting the terms of repayment, but which may be susceptible to deterioration if adverse factors are encountered.

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Loans may be graded Satisfactory when there is no recent information on which to base a current risk evaluation and the following conditions apply:

At inception, the loan was properly underwritten, did not possess an unwarranted level of credit risk, and the loan met the above criteria for a risk grade of Excellent, Good, or Satisfactory;

At inception, the loan was secured with collateral possessing a loan value adequate to protect the Bank from loss.

The loan has exhibited two or more years of satisfactory repayment with a reasonable reduction of the principal balance.

During the period that the loan has been outstanding, there has been no evidence of any credit weakness. Some examples of weakness include slow payment, lack of cooperation by the borrower, breach of loan covenants, or the borrower is in an industry known to be experiencing problems. If any of these credit weaknesses is observed, a lower risk grade may be warranted.

**Risk Grade 4: Satisfactory/Monitored (Pass)**

Loans in this category are considered to be of acceptable credit quality, but contain greater credit risk than Satisfactory loans due to weak balance sheets, marginal earnings or cash flow, lack of financial information, weakening markets, insufficient or questionable collateral coverage or other uncertainties. These loans warrant a higher than average level of monitoring to ensure that weaknesses do not advance. The level of risk in a Satisfactory/Monitored loan is within acceptable underwriting guidelines so long as the loan is given the proper level of management supervision. Loans that normally fall into this grade include construction of commercial real estate buildings, land development and subdivisions, and rental properties that have not attained stabilization.

**Risk Grade 5: Special Mention**

Loans which possess some credit deficiency or potential weakness which deserves close attention. Such loans pose an unwarranted financial risk that, if not corrected, could weaken the loan by adversely impacting the future repayment ability of the borrower. The key distinctions of a Special Mention classification are that (1) it is indicative of an unwarranted level of risk and (2) weaknesses are considered potential, not defined, impairments to the primary source of repayment. These loans may be to borrowers with adverse trends in financial performance, collateral value and/or marketability, or balance sheet strength.

**Risk Grade 6: Substandard**

One or more of the following characteristics may be exhibited in loans classified Substandard:

Loans which possess a defined credit weakness. The likelihood that a loan will be paid from the primary source of repayment is uncertain. Financial deterioration is under way and very close attention is warranted to ensure that the loan is collected without loss.

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Loans are inadequately protected by the current net worth and paying capacity of the obligor.

The primary source of repayment is gone, and the Bank is forced to rely on a secondary source of repayment, such as collateral liquidation or guarantees.

Loans have a distinct possibility that the Bank will sustain some loss if deficiencies are not corrected.

Unusual courses of action are needed to maintain a high probability of repayment.

The borrower is not generating enough cash flow to repay loan principal; however, it continues to make interest payments.

The lender is forced into a subordinated or unsecured position due to flaws in documentation.

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Loans have been restructured so that payment schedules, terms, and collateral represent concessions to the borrower when compared to the normal loan terms.

The lender is seriously contemplating foreclosure or legal action due to the apparent deterioration in the loan.

There is a significant deterioration in market conditions to which the borrower is highly vulnerable.

**Risk Grade 7: Doubtful**

One or more of the following characteristics may be present in loans classified Doubtful:

Loans have all of the weaknesses of those classified as Substandard. However, based on existing conditions, these weaknesses make full collection of principal highly improbable.

The primary source of repayment is gone, and there is considerable doubt as to the quality of the secondary source of repayment.

The possibility of loss is high but because of certain important pending factors which may strengthen the loan, loss classification is deferred until the exact status of repayment is known.

**Risk Grade 8: Loss**

Loans are considered uncollectible and of such little value that continuing to carry them as assets is not feasible. Loans will be classified Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.



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March 31, 2012	Pass	Special Mention	Substandard	Doubtful	Total
<b>Commercial</b>					
Owner occupied real estate	\$ 111,070	\$ 5,936	\$ 12,524	\$	\$ 129,530
Non owner occupied real estate	125,077	12,740	13,044		150,861
Residential development	974	527	1,333		2,834
Development & Spec Land Loans	3,624	939	2,803		7,366
Commercial and industrial	52,043	2,831	4,870		59,744
<b>Total commercial</b>	<b>292,788</b>	<b>22,973</b>	<b>34,574</b>		<b>350,335</b>
<b>Real estate</b>					
Residential mortgage	139,842		8,231		148,073
Residential construction	6,973		436		7,409
Mortgage warehouse	213,152				213,152
<b>Total real estate</b>	<b>359,967</b>		<b>8,667</b>		<b>368,634</b>
<b>Consumer</b>					
Direct Installment	24,554		181		24,735
Direct Installment Purchased	854		9		863
Indirect Installment	130,687		774		131,461
Home Equity	110,982		2,438		113,420
<b>Total Consumer</b>	<b>267,077</b>		<b>3,402</b>		<b>270,479</b>
<b>Total</b>	<b>\$ 919,832</b>	<b>\$ 22,973</b>	<b>\$ 46,643</b>	<b>\$</b>	<b>\$ 989,448</b>

December 31, 2011	Pass	Special Mention	Substandard	Doubtful	Total
<b>Commercial</b>					
Owner occupied real estate	\$ 107,155	\$ 4,101	\$ 20,637	\$	\$ 131,893
Non owner occupied real estate	118,446	11,423	12,400		142,269
Residential development	1,677	529	1,368		3,574
Development & Spec Land Loans	3,778	860	4,101		8,739
Commercial and industrial	55,964	3,012	6,798		65,774
<b>Total commercial</b>	<b>287,020</b>	<b>19,925</b>	<b>45,304</b>		<b>352,249</b>
<b>Real estate</b>					
Residential mortgage	142,834		8,059		150,893
Residential construction	5,744		437		6,181
Mortgage warehouse	208,299				208,299
<b>Total real estate</b>	<b>356,877</b>		<b>8,496</b>		<b>365,373</b>
<b>Consumer</b>					
Direct Installment	23,995		257		24,252
Direct Installment Purchased	977		4		981
Indirect Installment	126,796		955		127,751

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Home Equity	111,088	2,473	113,561	
<b>Total Consumer</b>	262,856	3,689	266,545	
<b>Total</b>	\$ 906,753	\$ 19,925	\$ 57,489	\$ 984,167

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**Note 6 Derivative financial instruments**

***Cash Flow Hedges***

As a strategy to maintain acceptable levels of exposure to the risk of changes in future cash flow due to interest rate fluctuations, the Company entered into interest rate swap agreements for a portion of its floating rate debt. The agreements provide for the Company to receive interest from the counterparty at three month LIBOR and to pay interest to the counterparty at a weighted average fixed rate of 5.63% on a notional amount of \$30.5 million at March 31, 2012. Under these agreements, the Company pays or receives the net interest amount monthly, with the monthly settlements included in interest expense.

Management has designated the interest rate swap agreement as a cash flow hedging instrument. For derivative instruments that are designated and qualify as a cash flow hedge, the effective portion of the gain or loss on the derivative is reported as a component of the other comprehensive income and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Gains and losses on the derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings. At March 31, 2012, the Company's cash flow hedge was effective and is not expected to have a significant impact on the Company's net income over the next 12 months.

***Fair Value Hedges***

Fair value hedges are intended to reduce the interest rate risk associated with the underlying hedged item. The Company enters into fixed rate loan agreements as part of its lending activities. To mitigate the risk of changes in fair value based on fluctuations in interest rates, the Company has entered into interest rate swap agreements on individual loans, converting the fixed rate loans to a variable rate. For derivative instruments that are designated and qualify as a fair value hedge, the gain or loss on the derivative as well as the offsetting gain or loss on the hedged item attributable to the hedged risk are recognized in current earnings. At March 31, 2012, the Company's fair value hedges were effective and are not expected to have a significant impact on the Company's net income over the next 12 months.

The change in fair value of both the hedge instruments and the underlying loan agreements are recorded as gains or losses in interest income. The fair value hedges are considered to be highly effective, and any hedge ineffectiveness was deemed not material. The notional amounts of the loan agreements being hedged were \$47.6 million at March 31, 2012.

***Other Derivative Instruments***

The Company enters into non-hedging derivatives in the form of mortgage loan forward sale commitments with investors and commitments to originate mortgage loans as part of its mortgage banking business. At March 31, 2012, the Company's fair value of these derivatives was recorded and over the next 12 months is not expected to have a significant impact on the Company's net income.

The change in fair value of both the forward sale commitments and commitments to originate mortgage loans were recorded and the net gains or losses included in the Company's gain on sale of loans.

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The following tables summarize the fair value of derivative financial instruments utilized by Horizon Bancorp:

Derivatives designated as hedging instruments (Unaudited)	Asset Derivative March 31, 2012		Liability Derivatives March 31, 2012	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Interest rate contracts	Loans	\$ 643	Other liabilities	\$ 2,113
Interest rate contracts	Other Assets	1,470	Other liabilities	4,351
<b>Total derivatives designated as hedging instruments</b>		<b>2,113</b>		<b>6,464</b>
<b>Derivatives not designated as hedging instruments</b>				
Mortgage loan contracts	Other assets	510	Other liabilities	71
<b>Total derivatives not designated as hedging instruments</b>		<b>510</b>		<b>71</b>
<b>Total derivatives</b>		<b>\$ 2,623</b>		<b>\$ 6,535</b>

Derivatives designated as hedging instruments (Unaudited)	Asset Derivative December 31, 2011		Liability Derivatives December 31, 2011	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Interest rate contracts	Loans	\$ 754	Other liabilities	\$ 2,187
Interest rate contracts	Other Assets	1,433	Other liabilities	4,914
<b>Total derivatives designated as hedging instruments</b>		<b>2,187</b>		<b>7,101</b>
<b>Derivatives not designated as hedging instruments</b>				
Mortgage loan contracts	Other assets	662	Other liabilities	
<b>Total derivatives not designated as hedging instruments</b>		<b>662</b>		
<b>Total derivatives</b>		<b>\$ 2,849</b>		<b>\$ 7,101</b>

The effect of the derivative instruments on the consolidated statement of income for the three-month periods ending is as follows:

Derivative in cash flow	Comprehensive Income on Derivative (Effective Portion) Three Months Ended March 31	
	2012 (Unaudited)	2011 (Unaudited)

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### hedging relationship

Interest rate contracts

\$ 367

\$ 293

FASB Accounting Standards Codification ( ASC ) Topic 820-10-20 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Topic 820-10-55 establishes a fair value hierarchy that emphasizes the use of observable inputs and minimizes the use of unobservable inputs when measuring fair value.

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Derivative in fair value	Location of gain (loss)	Amount of Gain (Loss) Recognized on Derivative	
		Three Months Ended March 31	
hedging relationship	recognized on derivative	2012 (Unaudited)	2011 (Unaudited)
Interest rate contracts	Interest income - loans	\$ (74)	\$ (410)
Interest rate contracts	Interest income - loans	\$ 74	410
<b>Total</b>		\$	\$

Derivative not designated as	Location of gain (loss)	Amount of Gain (Loss) Recognized on Derivative	
		Three Months Ended March 31	
hedging relationship	recognized on derivative	2012 (Unaudited)	2011 (Unaudited)
Mortgage contracts	Other income - gain on sale of loans	\$ (223)	\$ 634

**Note 7 Disclosures about fair value of assets and liabilities**

The Fair Value Measurements topic of the FASB ASC defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. There are three levels of inputs that may be used to measure fair value:

**Level 1** Quoted prices in active markets for identical assets or liabilities

**Level 2** Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities

**Level 3** Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities

Following is a description of the valuation methodologies used for instruments measured at fair value on a recurring basis and recognized in the accompanying financial statements, as well as the general classification of such instruments pursuant to the valuation hierarchy. There have been no significant changes in the valuation techniques during the period ended March 31, 2012. For assets classified within Level 3 of the fair value hierarchy, the process used to develop the reported fair value is described below.

**Available for sale securities**

When quoted market prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics or discounted cash flows. Level 2 securities include U.S. Treasury and federal agency securities, state and municipal securities, federal agency mortgage obligations and mortgage-backed pools, and corporate notes. Level 2 securities are valued by a third party pricing service commonly used in the banking industry utilizing observable inputs. Observable inputs include dealer quotes, market spreads, cash flow analysis, the U.S. Treasury yield curve, trade execution data, market consensus prepayment spreads and available credit information and the bond's terms and conditions. The pricing provider utilizes evaluated pricing models that vary based on asset class. These models incorporate available market information including quoted prices of securities with similar characteristics and, because many fixed-income securities do not trade on a daily basis, apply available information through processes such as benchmark curves, benchmarking of like securities, sector grouping, and matrix pricing. In addition, model processes, such as an option adjusted spread model is used to develop prepayment and interest rate scenarios for securities with prepayment features.



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***Hedged loans***

Certain fixed rate loans have been converted to variable rate loans by entering into interest rate swap agreements. The fair value of those fixed rate loans is based on discounting the estimated cash flows using interest rates determined by the respective interest rate swap agreement. Loans are classified within Level 2 of the valuation hierarchy based on the unobservable inputs used.

***Interest rate swap agreements***

The fair value of the Company's interest rate swap agreements is estimated by a third party using inputs that are primarily unobservable including a yield curve, adjusted for liquidity and credit risk, contracted terms and discounted cash flow analysis, therefore, are classified within Level 2 of the valuation hierarchy.

The following table presents the fair value measurements of assets and liabilities recognized in the accompanying financial statements measured at fair value on a recurring basis and the level within the FASB ASC fair value hierarchy in which the fair value measurements fall at the following:

	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>March 31, 2012</b>				
Available-for-sale securities				
U.S. Treasury and federal agencies	\$ 18,657	\$	\$ 18,657	\$
State and municipal	143,774		143,774	
Federal agency collateralized mortgage obligations	86,690		86,690	
Federal agency mortgage-backed pools	180,983		180,983	
Private labeled mortgage-backed pools	3,360		3,360	
Corporate notes	37		37	
Total available-for-sale securities	433,501		433,501	
Hedged loans	59,911		59,911	
Forward sale commitments	510		510	
Interest rate swap agreements	(6,464)		(6,464)	
Commitments to originate loans	(71)		(71)	
<b>December 31, 2011</b>				
Available-for-sale securities				
U.S. Treasury and federal agencies	\$ 13,022	\$	\$ 13,022	\$
State and municipal	143,890		143,890	
Federal agency collateralized mortgage obligations	91,122		91,122	
Federal agency mortgage-backed pools	179,351		179,351	
Private labeled mortgage-backed pools	3,636		3,636	
Corporate notes	24		24	



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Total available-for-sale securities	431,045	431,045
Hedged loans	54,362	54,362
Forward sale commitments	662	662
Interest rate swap agreements	(7,102)	(7,101)
Commitments to originate loans		

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*Transfers between Levels*

Transfers between Levels 1, 2 and 3 and the reasons for those transfers are as follows:

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Reason for Transfer
Transfers to level:				
Hedged loans	\$	\$ 59,911	\$	(a)
Forward sale commitments		510		(b)
Interest rate swap agreements		(6,464)		(a)
Commitments to originate loans		(71)		(b)
Total transfers to level	\$	\$ 53,886	\$	

- (a) Valuation determined by widely accepted valuation techniques including discounted cash flow analysis on expected cash flows of each derivative an observable market rate inputs such as yield curves and contractual terms on each instrument.
- (b) Valuation determined by quoted prices for similar loans in the secondary market with an expected fallout rate (interest rate locked pipeline loans not expected to close). Fallout rate is not considered a significant input to the fair value in its entirety.

The following is a reconciliation of the beginning and ending balances of recurring fair value measurements recognized in the accompanying condensed consolidated balance sheet using significant unobservable (Level 3) inputs (Unaudited):

	Hedged Loans	Forward Sale Commitments	Interest Rate Swaps	Commitments to Originate Loans
<b>Beginning balance December 31, 2011</b>	\$ 54,362	\$ 662	\$ (7,101)	\$
Total realized and unrealized gains and losses				
Included in net income	(74)	(152)	74	(71)
Included in other comprehensive income, gross			563	
Purchases, issuances, and settlements	6,114			
Principal payments	(491)			
Transfers out to Level 2	(59,911)	(510)	6,464	71

**Ending balance March 31, 2012**

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	Hedged Loans	Forward Sale Commitments	Interest Rate Swaps	Commitments to Originate Loans
<b>Beginning balance December 31, 2010</b>	\$ 50,088	\$ 407	\$ (3,415)	\$
Total realized and unrealized gains and losses				
Included in net income	(410)	(126)	410	(56)
Included in other comprehensive income, gross			451	
Purchases, issuances, and settlements	(915)			
Principal payments	(352)			
<b>Ending balance March 31, 2011</b>	48,411	281	(2,554)	(56)

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Realized gains and losses included in net income for the periods are reported in the condensed consolidated statements of income as follows:

Non Interest Income	Three Months Ended March 31	
	2012 (Unaudited)	2011 (Unaudited)
<b>Total gains and losses from:</b>		
Hedged loans	\$ (74)	\$ (410)
Fair value interest rate swap agreements	74	410
Derivative loan commitments	(223)	634
	\$ (223)	\$ 634

Certain other assets are measured at fair value on a nonrecurring basis in the ordinary course of business and are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment):

	Fair Value	Quoted Prices in	Significant Other	Significant
		Active Markets for	Observable	Unobservable
		Identical	Inputs	Inputs
		Assets	(Level 2)	(Level 3)
		(Level 1)		
<b>March 31, 2012</b>				
Impaired loans	\$ 6,202	\$	\$	\$ 6,202
Mortgage servicing rights	4,377			4,377
<b>December 31, 2011</b>				
Impaired loans	\$ 5,822	\$	\$	\$ 5,822
Mortgage servicing rights	4,193			4,193

**Impaired (collateral dependent):** Fair value adjustments for impaired and non-accrual loans typically occur when there is evidence of impairment. Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. The Company measures fair value based on the value of the collateral securing the loans. Collateral may be in the form of real estate or personal property, including equipment and inventory. The value of the collateral is determined based on internal estimates as well as third-party appraisals or non-binding broker quotes. These measurements were classified as Level 3. The fair value of the Company's other real estate owned is determined using Level 3 inputs, which include current and prior appraisals net of estimated costs to sell. Fair value adjustments on impaired loans were \$2.8 million at March 31, 2012 and \$2.1 million at December 31, 2012.

**Mortgage Servicing Rights (MSRs):** MSRs do not trade in an active market with readily observable prices. Accordingly, the fair value of these assets is classified as Level 3. The Company determines the fair value of MSRs using an income approach model based upon the Company's month-end interest rate curve and prepayment assumptions. The model utilizes assumptions to estimate future net servicing income cash flows, including estimates of time decay, payoffs and changes in valuation inputs and assumptions. The Company reviews the valuation assumptions against this market data for reasonableness and adjusts the assumptions if deemed appropriate.



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**Note 8 Fair Value of Financial Instruments**

The estimated fair value amounts of the Company's financial instruments were determined using available market information, current pricing information applicable to Horizon and various valuation methodologies. Where market quotations were not available, considerable management judgment was involved in the determination of estimated fair values. Therefore, the estimated fair value of financial instruments shown below may not be representative of the amounts at which they could be exchanged in a current or future transaction. Due to the inherent uncertainties of expected cash flows of financial instruments, the use of alternate valuation assumptions and methods could have a significant effect on the estimated fair value amounts.

The estimated fair values of financial instruments, as shown below, are not intended to reflect the estimated liquidation or market value of Horizon taken as a whole. The disclosed fair value estimates are limited to Horizon's significant financial instruments at March 31, 2012 and December 31, 2011. These include financial instruments recognized as assets and liabilities on the consolidated balance sheet as well as certain off-balance sheet financial instruments. The estimated fair values shown below do not include any valuation of assets and liabilities, which are not financial instruments as defined by the FASB ASC fair value hierarchy.

The following methods and assumptions were used to estimate the fair value of each class of financial instrument:

**Cash and Due from Banks** The carrying amounts approximate fair value.

**Held-to-Maturity Securities** For debt securities held to maturity, fair values are based on quoted market prices or dealer quotes. For those securities where a quoted market price is not available, carrying amount is a reasonable estimate of fair value based upon comparison with similar securities.

**Loans Held for Sale** The carrying amounts approximate fair value.

**Net Loans** The fair value of portfolio loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. The carrying amounts of loans held for sale approximate fair value.

**FHLB and FRB Stock** Fair value of FHLB and FRB stock is based on the price at which it may be resold to the FHLB and FRB.

**Interest Receivable/Payable** The carrying amounts approximate fair value.

**Deposits** The fair value of demand deposits, savings accounts, interest-bearing checking accounts and money market deposits is the amount payable on demand at the reporting date. The fair value of fixed maturity certificates of deposit is estimated by discounting the future cash flows using rates currently offered for deposits of similar remaining maturity.

**Borrowings** Rates currently available to Horizon for debt with similar terms and remaining maturities are used to estimate fair values of existing borrowings.

**Subordinated Debentures** Rates currently available for debentures with similar terms and remaining maturities are used to estimate fair values of existing debentures.

**Commitments to Extend Credit and Standby Letter of Credit** The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the



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(Table Dollar Amounts in Thousands, Except Per Share Data)

committed rates. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. Due to the short-term nature of these agreements, carrying amounts approximate fair value.

The following table presents estimated fair values of the Company's financial instruments and the level within the fair value hierarchy in which the fair value measurements fall (unaudited).

	March 31, 2012			
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Cash and due from banks	\$ 19,049	\$ 19,049	\$	\$
Investment securities held to maturity	7,100		7,100	
Loans held for sale	10,202			10,202
Loans, net	969,141			983,862
Stock in FHLB and FRB	12,390		12,390	
Interest receivable	6,798		6,798	
<b>Liabilities</b>				
Non-interest bearing deposits	\$ 138,618	\$ 138,618	\$	\$
Interest-bearing deposits	926,003		918,614	
Borrowings	310,889		344,188	
Subordinated debentures	30,699		30,344	
Interest payable	555		555	

	December 31, 2011			
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Cash and due from banks	\$ 20,447	\$ 20,447	\$	\$
Investment securities held to maturity	7,100		7,134	
Loans held for sale	14,090			14,090
Loans, net	964,311			979,401
Stock in FHLB and FRB	12,390		12,390	
Interest receivable	6,671		6,671	
<b>Liabilities</b>				
Non-interest bearing deposits	\$ 130,673	\$ 130,673	\$	\$
Interest-bearing deposits	879,192		874,160	



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Borrowings	370,111	398,789
Subordinated debentures	30,676	30,083
Interest payable	596	596

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(Table Dollar Amounts in Thousands, Except Per Share Data)

**Note 9 Other Comprehensive Income**

	Three Months Ended	
	March 31 2012 (Unaudited)	March 31 2011 (Unaudited)
Unrealized gains on securities:		
Unrealized holding gains arising during the period	\$ 867	\$ 725
Less: reclassification adjustment for gains realized in net income		274
	867	451
Unrealized gain on derivative instruments	565	2,189
Net unrealized gains	1,432	2,640
Tax expense (benefit)	(501)	(924)
Other comprehensive income	\$ 931	\$ 1,716
	March 31 2012	December 31 2011
Unrealized gain on securities available for sale	\$ 17,829	\$ 16,978
Unrealized gain (loss) on derivative instruments	(4,351)	(4,914)
Tax effect	(4,705)	(4,222)
Total accumulated other comprehensive income	\$ 8,773	\$ 7,842

**Note 10 Future accounting matters**

**Offsetting Assets and Liabilities:** In December 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-11 *Balance Sheet (Topic 210) Disclosures about Offsetting Assets and Liabilities*. ASU 2011-11 requires an entity to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. ASU 2011-11 is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. Retrospective disclosure is required for all comparative periods presented. The Company is assessing the impact of ASU 2011-11 on its disclosures.

**Goodwill:** In September 2011, the FASB issued ASU No. 2011-08 *Intangibles - Goodwill and Other (Topic 350) Testing Goodwill for Impairment*. ASU 2011-08 allows an entity the option to make a qualitative evaluation about the likelihood of goodwill impairment to determine whether it should calculate the fair value of the reporting unit. ASU 2011-08 was effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption was permitted. The Company does not expect an impact on its financial condition or results of operations.

**Comprehensive Income:** In June 2011, the FASB issued ASU No. 2011-05 *Comprehensive Income (Topic 220) Presentation of Comprehensive Income*. ASU 2011-05 requires that all nonowner changes in stockholders' equity be presented either in a single continuous

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statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. In December 2011, FASB issued ASU No. 2011-12 which defers the effective date of the requirement in ASU 2011-05 to present items that are reclassified from accumulated other comprehensive income to net income alongside their respective components of net income and other comprehensive income. ASU 2011-05 was effective retrospectively for fiscal years, and interim periods within those years, beginning after December 15, 2011. The effect of applying this standard is reflected in the Condensed Consolidated Statement of Comprehensive Income.

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**Fair Value Measurements:** In May 2011, the FASB issued ASU No. 2011-04 *Fair Value Measurement (Topic 820) Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. ASU 2011-04 changed the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. Consequently, the amendments in this update result in common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs (International Financial Reporting Standards). ASU 2011-04 was effective prospectively during interim and annual periods beginning on or after December 15, 2011. Early application by public entities was not permitted. The effect of applying this standard is included in Note 7.

**Transfers and Servicing:** In April 2011, the FASB issued ASU No. 2011-03 *Transfers and Servicing (Topic 860) Reconsideration of Effective Control for Repurchase Agreement*. ASU 2011-03 removed from the assessment of effective control the criterion relating to the transferor's ability to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee. ASU 2011-03 was effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occurred on or after the effective date. Early adoption was not permitted. ASU 2011-03 did not have an impact on the Company's financial condition, results of operations, or disclosures.

**Note 11 Business Combination**

On February 9, 2012, Horizon entered into an Agreement and Plan of Merger (the *Merger Agreement*) providing for Horizon's acquisition of Heartland Bancshares, Inc., an Indiana corporation (Heartland). Pursuant to the Merger Agreement, Heartland will merge with and into Horizon, with Horizon surviving the merger (the *Merger*), and Heartland Community Bank, an Indiana-chartered commercial bank and wholly owned subsidiary of Heartland, will merge with and into a wholly owned subsidiary of Horizon, Horizon Bank, N.A. (Horizon Bank), with Horizon Bank as the surviving bank.

The boards of directors of each of Horizon and Heartland have approved the Merger and the Merger Agreement. Subject to the approval of the Merger by Heartland's shareholders, regulatory approvals and other closing conditions, the parties anticipate completing the Merger at the end of the second quarter or beginning of the third quarter of 2012.

In connection with the Merger, each Heartland shareholder will receive 0.54 shares of Horizon common stock (the *Exchange Ratio*) for each share of Heartland common stock owned by them, subject to adjustment as described below. Based on Horizon's February 8, 2012 closing price of \$18.00 per share as reported on the NASDAQ Global Market, the transaction value is estimated at \$14.0 million.

The Exchange Ratio may be adjusted in the manner prescribed in the Merger Agreement based upon (i) Heartland's consolidated shareholder's equity as of the end of the month prior to closing of the Merger, (ii) the closing of certain commercial loans prior to the closing of the Merger, (iii) a significant decrease in Horizon's common stock price, and (iv) certain other circumstances specified by the Merger Agreement.

The Merger Agreement also provides that prior to the merger Horizon will fund the purchase by either Horizon or Heartland of the shares of preferred stock with an aggregate liquidation value of \$7.248 million that Heartland issued to the U.S. Treasury pursuant to the TARP Capital Purchase Program. The Merger Agreement contains other customary representations, warranties, and covenants of Horizon and Heartland.

Subject to certain terms and conditions, the board of directors of Heartland has agreed to recommend the approval and adoption of the Merger Agreement to the Heartland shareholders and will solicit proxies voting in favor of the Merger from Heartland's shareholders.

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The Merger Agreement also provides for certain termination rights for both Horizon and Heartland, and further provides that upon termination of the Merger Agreement under certain circumstances, Heartland will be obligated to pay Horizon a termination fee.

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

***Forward Looking Statements***

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, with respect to Horizon Bancorp ( Horizon or the Company ) and Horizon Bank, N.A. (the Bank ). Horizon intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Reform Act of 1995, and is including this statement for the purposes of these safe harbor provisions. Statements in this report should be considered in conjunction with the other information available about Horizon, including the information in the other filings we make with the Securities and Exchange Commission. The forward-looking statements are based on management's expectations and are subject to a number of risks and uncertainties. We have tried, wherever possible, to identify such statements by using words such as anticipate, expect, estimate, project, intend, plan, believe, could, will and similar expressions in connection with our discussion of future operating or financial performance. Although management believes that the expectations reflected in such forward-looking statements are reasonable, actual results may differ materially from those expressed or implied in such statements.

Actual results may differ materially, and adversely or positively, from the expectations of the Company that are expressed or implied by any forward-looking statement. Risks, uncertainties, and factors that could cause the Company's actual results to vary materially from those expressed or implied by any forward-looking statement include but not limited to:

the use of proceeds of future offerings of securities;

the unknown future direction of interest rates and the timing and magnitude of any changes in interest rates;

changes in competitive conditions;

the introduction, withdrawal, success and timing of asset/liability management strategies or of mergers and acquisitions and other business initiatives and strategies;

changes in customer borrowing, repayment, investment and deposit practices;

changes in fiscal, monetary and tax policies;

changes in financial and capital markets;

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deterioration in general economic conditions, either nationally or locally, resulting in, among other things, credit quality deterioration;

capital management activities, including possible future sales of new securities, or possible repurchases or redemptions by the Company of outstanding debt or equity securities;

risks of expansion through acquisitions and mergers, such as unexpected credit quality problems of the acquired loans or other assets, unexpected attrition of the customer base of the acquired institution or branches, and difficulties in integration of the acquired operations;

factors that may cause the Company to incur impairment charges on its investment securities;

the impact, extent and timing of technological changes

electronic, cyber and physical security breaches;

claims and litigation liabilities, including related costs, expenses, settlements and judgments, or the outcome of matters before regulatory agencies, whether pending or commencing in the future;

actions of the Federal Reserve Board;

changes in accounting principles and interpretations;

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potential increases of federal deposit insurance premium expense, and possible future special assessments of FDIC premiums, either industry wide or specific to the Company's banking subsidiary;

actions of the regulatory authorities under the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Federal Deposit Insurance Act and other possible legislative and regulatory actions and reforms;

the continued availability of earnings and excess capital sufficient for the lawful and prudent declaration and payment of cash dividends; and

other factors and risks described under the caption "Risk Factors" in this report and in any of our subsequent reports that we have made or make with the Securities and Exchange Commission ("SEC").

Because such forward-looking statements are subject to risks and uncertainties, actual results may differ materially from those expressed or implied by such statements. The foregoing list of important factors is not exclusive and you are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this document or, in the case of documents incorporated by reference, the dates of those documents. We do not undertake to update any forward-looking statements, whether written or oral, that may be made from time to time by or on behalf of us. For a detailed discussion of the risks and uncertainties that may cause our actual results or performance to differ materially from the results or performance expressed or implied by forward-looking statements, see "Risk Factors" in Item 1A of Part I of our 2011 Annual Report on Form 10-K and in the subsequent reports we file with the SEC.

***Overview***

Horizon is a registered bank holding company incorporated in Indiana and headquartered in Michigan City, Indiana. Horizon provides a broad range of banking services in Northwestern Indiana and Southwestern Michigan through its bank subsidiary. Horizon operates as a single segment, which is commercial banking. Horizon's Common Stock is traded on the NASDAQ Global Market under the symbol HBNC. The Bank was chartered as a national banking association in 1873 and has operated continuously since that time. The Bank is a full-service commercial bank offering commercial and retail banking services, corporate and individual trust and agency services, and other services incident to banking.

Horizon continues to operate in a challenging economic and banking environment. Within the Company's primary market areas of Northwest Indiana and Southwest Michigan, unemployment rates increased during 2009 and have remained at high levels during 2010, 2011 and through the first three months of 2012. This rise in unemployment has been driven by multiple factors including slowdowns in the steel and recreational vehicle industries as well as a continued lower activity in the housing industry. The Company's higher than historical levels of non-performing loans at March 31, 2012 and over the past two years can be attributed to the continued slow economy and continued high local unemployment, which have resulted in lower business revenues and increased bankruptcies. Despite these economic factors, Horizon continued to post record positive results through the first three months of 2012.

Following are some highlights of Horizon's financial performance through the first quarter of 2012:

First quarter 2012 net income was \$4.6 million or \$.88 diluted earnings per share, a 79% increase in diluted earnings per share compared to the same period in 2011 and a 29% increase compared to the most recent linked quarter. In addition, this represents the highest quarterly net income and diluted earnings per share in the Company's history.



Total loans increased \$5.4 million during the quarter and \$179.0 million over the previous twelve months to \$988.6 million at March 31, 2012.

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Net interest income, after provisions for loan losses, for the first three months of 2012 was \$12.6 million compared with \$9.5 million for the same period in the prior year.

The provision for loan losses decreased to \$559,000 for the first three months of 2012 compared to \$1.5 million for the same period in 2011 and \$838,000 for the most recent linked quarter.

Net charge-offs for the first three months of 2012 were \$29,000 compared to \$1.5 million for the same period in 2011 and \$1.1 million for the most recent linked quarter.

Return on average assets was 1.23% for the first quarter of 2012.

Return on average common equity was 15.90% for the first quarter of 2012.

Announced the definitive agreement to acquire Heartland Bancshares, Inc ( Heartland ) based in Franklin, Indiana.

The Company increased its quarterly cash dividend in the first quarter of 2012 to \$.13 and paid its 105<sup>th</sup> consecutive quarterly dividend to shareholders.

Horizon's tangible book value per share rose to \$21.35 compared with \$18.11 at March 31, 2011.

Horizon Bank's capital ratios, including Tier 1 Capital to total risk weighted assets of 11.77% as of March 31, 2012, continue to be well above the regulatory standards for well-capitalized banks.

***Critical Accounting Policies***

The notes to the consolidated financial statements included in Item 8 of the Company's Annual Report on Form 10-K for 2011 contain a summary of the Company's significant accounting policies. Certain of these policies are important to the portrayal of the Company's financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. Management has identified the allowance for loan losses, intangible assets, mortgage servicing rights and hedge accounting as critical accounting policies.

**Allowance for Loan Losses**

An allowance for loan losses is maintained to absorb probable incurred loan losses inherent in the loan portfolio. The determination of the allowance for loan losses is a critical accounting policy that involves management's ongoing quarterly assessments of the probable incurred losses inherent in the loan portfolio. The identification of loans that have probable incurred losses is subjective; therefore, a general reserve is

maintained to cover all probable losses within the entire loan portfolio. Horizon utilizes a loan grading system that helps identify, monitor and address asset quality problems in an adequate and timely manner. Each quarter, various factors affecting the quality of the loan portfolio are reviewed. Large credits are reviewed on an individual basis for loss potential. Other loans are reviewed as a group based upon previous trends of loss experience. Horizon also reviews the current and anticipated economic conditions of its lending market as well as transaction risk to determine the effect they may have on the loss experience of the loan portfolio.

Goodwill and Intangible Assets

Management believes that the accounting for goodwill and other intangible assets also involves a higher degree of judgment than most other significant accounting policies. FASB ASC 350-10 establishes standards for the amortization of acquired intangible assets and impairment assessment of goodwill. At March 31, 2012, Horizon had core deposit intangibles of \$2.2 million subject to amortization and \$5.9 million of goodwill, which is not subject to amortization. Goodwill arising from business combinations represents the value attributable to unidentifiable intangible assets in the business acquired. Horizon's goodwill relates to the value inherent in the banking industry and that value is dependent upon the ability of Horizon to provide quality, cost effective banking services in a competitive marketplace. The goodwill value is supported by revenue that is in part driven by the volume of business transacted. A decrease in earnings resulting from a decline in the customer base or the inability to deliver cost effective services over sustained periods can lead to impairment of goodwill that could adversely affect earnings in future periods. FASB ASC 350-10 requires

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an annual evaluation of goodwill for impairment. The evaluation of goodwill for impairment requires the use of estimates and assumptions. Market price at the close of business on March 31, 2012 was \$18.50 per share compared to a book value of \$22.99 per common share. Horizon reported record earnings for the twelfth consecutive year in 2011 and the first three months of 2012 were the highest first three months of net income in the Company's history, therefore, the Company believes the below book market price relates to an overall decline in the financial industry sector and is not specific to Horizon.

The financial markets are currently reflecting significantly lower valuations for the stocks of financial institutions, when compared to historic valuation metrics, largely driven by the constriction in available credit and losses suffered related to residential mortgage markets. The Company's stock activity, as well as the price, has been affected by the economic conditions affecting the banking industry. Management believes this downturn has impacted the Company's stock and has concluded that the recent stock price is not indicative or reflective of fair value (per ASC Topic 820 Fair Value).

Horizon has concluded that, based on its own internal evaluation the recorded, value of goodwill is not impaired.

**Mortgage Servicing Rights**

Servicing assets are recognized as separate assets when rights are acquired through purchase or through the sale of financial assets on a servicing-retained basis. Capitalized servicing rights are amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Servicing assets are evaluated regularly for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying servicing rights by predominant characteristics, such as interest rates, original loan terms and whether the loans are fixed or adjustable rate mortgages. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. When the book value of an individual stratum exceeds its fair value, an impairment reserve is recognized so that each individual stratum is carried at the lower of its amortized book value or fair value. In periods of falling market interest rates, accelerated loan prepayment can adversely affect the fair value of these mortgage-servicing rights relative to their book value. In the event that the fair value of these assets was to increase in the future, Horizon can recognize the increased fair value to the extent of the impairment allowance but cannot recognize an asset in excess of its amortized book value. Future changes in management's assessment of the impairment of these servicing assets, as a result of changes in observable market data relating to market interest rates, loan prepayment speeds, and other factors, could impact Horizon's financial condition and results of operations either positively or negatively.

Generally, when market interest rates decline and other factors favorable to prepayments occur, there is a corresponding increase in prepayments as customers refinance existing mortgages under more favorable interest rate terms. When a mortgage loan is prepaid, the anticipated cash flows associated with servicing that loan are terminated, resulting in a reduction of the fair value of the capitalized mortgage servicing rights. To the extent that actual borrower prepayments do not react as anticipated by the prepayment model (i.e., the historical data observed in the model does not correspond to actual market activity), it is possible that the prepayment model could fail to accurately predict mortgage prepayments and could result in significant earnings volatility. To estimate prepayment speeds, Horizon utilizes a third-party prepayment model, which is based upon statistically derived data linked to certain key principal indicators involving historical borrower prepayment activity associated with mortgage loans in the secondary market, current market interest rates and other factors, including Horizon's own historical prepayment experience. For purposes of model valuation, estimates are made for each product type within the mortgage servicing rights portfolio on a monthly basis. In addition, on a quarterly basis Horizon engages a third party to independently test the value of its servicing asset.

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**Derivative Instruments**

As part of the Company's asset/liability management program, Horizon utilizes, from time-to-time, interest rate floors, caps or swaps to reduce the Company's sensitivity to interest rate fluctuations. These are derivative instruments, which are recorded as assets or liabilities in the consolidated balance sheets at fair value. Changes in the fair values of derivatives are reported in the consolidated income statements or other comprehensive income (OCI) depending on the use of the derivative and whether the instrument qualifies for hedge accounting. The key criterion for the hedge accounting is that the hedged relationship must be highly effective in achieving offsetting changes in those cash flows that are attributable to the hedged risk, both at inception of the hedge and on an ongoing basis.

Horizon's accounting policies related to derivatives reflect the guidance in FASB ASC 815-10. Derivatives that qualify for the hedge accounting treatment are designated as either: a hedge of the fair value of the recognized asset or liability or of an unrecognized firm commitment (a fair value hedge) or a hedge of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability (a cash flow hedge). For fair value hedges, the cumulative change in fair value of both the hedge instruments and the underlying loans is recorded in non-interest income. For cash flow hedges, changes in the fair values of the derivative instruments are reported in OCI to the extent the hedge is effective. The gains and losses on derivative instruments that are reported in OCI are reflected in the consolidated income statement in the periods in which the results of operations are impacted by the variability of the cash flows of the hedged item. Generally, net interest income is increased or decreased by amounts receivable or payable with respect to the derivatives, which qualify for hedge accounting. At inception of the hedge, Horizon establishes the method it uses for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. The ineffective portion of the hedge, if any, is recognized currently in the consolidated statements of income. Horizon excludes the time value expiration of the hedge when measuring ineffectiveness.

**Valuation Measurements**

Valuation methodologies often involve a significant degree of judgment, particularly when there are no observable active markets for the items being valued. Investment securities, residential mortgage loans held for sale and derivatives are carried at fair value, as defined in FASB ASC 820, which requires key judgments affecting how fair value for such assets and liabilities is determined. In addition, the outcomes of valuations have a direct bearing on the carrying amounts of goodwill, mortgage servicing rights, and pension and other post-retirement benefit obligations. To determine the values of these assets and liabilities, as well as the extent, to which related assets may be impaired, management makes assumptions and estimates related to discount rates, asset returns, prepayment speeds and other factors. The use of different discount rates or other valuation assumptions could produce significantly different results, which could affect Horizon's results of operations.

**Financial Condition**

On March 31, 2012, Horizon's total assets were \$1.5 billion, primarily unchanged from December 31, 2011.

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Investment securities were comprised of the following as of:

	March 31, 2012		December 31, 2011	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
<b>Available for sale</b>				
U.S. Treasury and federal agencies	\$ 18,365	\$ 18,657	\$ 12,693	\$ 13,022
State and municipal	134,661	143,774	135,011	143,890
Federal agency collateralized mortgage obligations	84,458	86,690	89,016	91,122
Federal agency mortgage-backed pools	174,909	180,983	173,797	179,351
Private labeled mortgage-backed pools	3,247	3,360	3,518	3,636
Corporate notes	32	37	32	24
Total available for sale investment securities	\$ 415,672	\$ 433,501	\$ 414,067	\$ 431,045
<b>Held to maturity, State and Municipal</b>	\$ 7,100	\$ 7,100	\$ 7,100	\$ 7,134

Investment securities increased by approximately \$2.5 million compared to the end of 2011. This growth was the result of the Company deploying excess cash that was held during the first three months in cash and due from banks into investment securities.

Net loans increased \$4.8 million since December 31, 2011. This increase was the result of an increase in consumer and mortgage warehouse loans of \$4.0 million and \$4.9 million, respectively. These increases were offset by a decrease in commercial and real estate loans of \$1.9 million and \$1.6 million, respectively. The increase in consumer loans is the direct result of increased calling efforts and market expansion allowing opportunities to increase Horizon's market share within the Company's footprint. Mortgage warehouse loans increased as a result of market expansion and refinancing activity. Horizon's commercial loans decreased during the first three months of 2012 as new loan production has not completely replaced all of the loan run-off from scheduled amortization and pay-offs along with exiting several substandard relationships.

Other assets decreased \$3.7 million during the first three months of 2012 primarily due to a \$2.0 million decrease in OREO.

Total deposits increased \$54.8 million during the first three months of 2012 primarily due to municipal deposit growth.

The Company's borrowings decreased \$59.2 million since December 31, 2011. At March 31, 2012 the Company had \$106.0 million in short-term funds borrowed compared to \$157.0 million at December 31, 2011. The Company uses short-term borrowings to fund the increase in mortgage warehouse lending when it is determined that the loan demand may fluctuate as a result of refinancing activity. In addition, the current Company's balance sheet strategy is to utilize a reasonable level of short-term borrowing during extended low rate environments in addition to what is needed for the fluctuations in mortgage warehouse lending.

Stockholders' equity totaled \$126.2 million at March 31, 2012 compared to \$121.5 million at December 31, 2011. The increase in stockholders' equity during the period was the result of generating net income and an increase in accumulated other comprehensive income, net of dividends declared. At March 31, 2012, the ratio of average stockholders' equity to average assets was 8.33% compared to 7.96% for December 31, 2011. Book value per common share at March 31, 2012 increased to \$22.99 compared to \$22.02 at December 31, 2011.



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***Results of Operations***

**Overview**

Consolidated net income for the three-month period ended March 31, 2012 was \$4.6 million, an increase of 66.8% from the \$2.8 million for the same period in 2011. Earnings per common share for the three months ended March 31, 2012 increased to \$0.90 basic and \$0.88 diluted, compared to \$0.51 basic and \$0.49 diluted for the same three-month period in 2011. Dividends paid on preferred shares reduced diluted earnings per share by \$0.03 and \$0.08 per share for the three-month periods ended March 31, 2012 and 2011, respectively.

**Net Interest Income**

The largest component of net income is net interest income. Net interest income is the difference between interest income, principally from loans and investment securities, and interest expense, principally on deposits and borrowings. Changes in the net interest income are the result of changes in volume and the net interest spread which affects the net interest margin. Volume refers to the average dollar levels of interest-earning assets and interest-bearing liabilities. Net interest spread refers to the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities. Net interest margin refers to net interest income divided by average interest-earning assets and is influenced by the level and relative mix of interest-earning assets and interest-bearing liabilities.

The reduction in interest rates has influenced the cost of the Company's interest bearing liabilities more significantly than the reduction in the yields received on the Company's interest earning assets, resulting in an increase of the net interest margin. Management believes that the current level of interest rates is driven by external factors and therefore impacts the results of the Company's net interest margin. Management does not expect a significant rise in interest rates in the short term, but an increase in rates is expected at some time in the future due to the current historically low interest rate environment.

Net interest income during the three months ended March 31, 2012 was \$13.2 million, an increase of \$2.1 million over the \$11.1 million earned during the same period in 2011. Yields on the Company's interest-earning assets decreased by 2 basis points to 4.91% from 4.93% for the three months ended March 31, 2012 and 2011, respectively. Interest income increased \$1.4 million from \$15.4 million for the three months ended March 31, 2011 to \$16.8 million for the same period in 2012. This increase was primarily due to an increase in interest earning assets offset slightly from the yield on new and repriced earning assets. However, the asset yields on loans receivable has not declined at the same pace as some market indices partially due to interest rate floors that are in place on approximately \$387.1 million of the Company's \$520.5 million of adjustable rate loans.

Rates paid on interest-bearing liabilities decreased by 34 basis points for the three months ended March 31, 2012 compared to the same period in 2011 due to the lower interest rate environment. Interest expense decreased \$736,000 from \$4.4 million for the three-months ended March 31, 2011 to \$3.6 million for the same period in 2012. This decrease was due to the lower rates being paid on the Company's interest bearing liabilities. Due to a more significant decrease in the rates paid on the Company's interest-bearing liabilities compared to the decrease in yields received on the Company's interest-earning assets the net interest margin increased 30 basis points from 3.57% for the three months ended March 31, 2011 to 3.87% for the same period in 2012.



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**Management's Discussion and Analysis of Financial Condition**

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**For the Three Months Ended March 31, 2012**

The following are the average balance sheets for the three months ending:

	Three Months Ended March 31, 2012		Three Months Ended March 31, 2011	
	Average Balance	Interest	Average Balance	Average Interest
		Rate		Rate
<b>ASSETS</b>				
Interest-earning assets				