HAIN CELESTIAL GROUP INC
Form 10-Q
February 09, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)
ý Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended December 31, 2015

¨ Transition Report pursuant to Section 13 or 15(d) of The Securities Exchange Act of 1934
for the transition period from to .
Commission File No. 0-22818

THE HAIN CELESTIAL GROUP, INC.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	22-3240619 (I.R.S. Employer Identification No.)
1111 Marcus Avenue Lake Success, New York (Address of principal executive offices)	11042 (Zip Code)

Registrant’s telephone number, including area code: (516) 587-5000

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes ý 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 (section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ý 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 definitions of “accelerated filer,” “large accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	ý	Accelerated filer	¨
Non-accelerated filer	¨	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).
Yes ¨ No ý

As of February 2, 2016 there were 103,101,441 shares outstanding of the registrant’s Common Stock, par value $.01 per share.

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PART I - FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

THE HAIN CELESTIAL GROUP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2015 AND JUNE 30, 2015
(In thousands, except share amounts)

	December 31, 2015 (Unaudited)	June 30, 2015 (Note)
ASSETS		
Current assets:		
Cash and cash equivalents	$177,100	$166,922
Accounts receivable, less allowance for doubtful accounts of $1,188 and $896	350,408	320,197
Inventories	403,318	382,211
Deferred income taxes	21,027	20,758
Prepaid expenses and other current assets	49,513	42,931
Total current assets	1,001,366	933,019
Property, plant and equipment, net	382,830	344,262
Goodwill	1,219,725	1,136,079
Trademarks and other intangible assets, net	659,267	647,754
Investments and joint ventures	20,214	2,305
Other assets	33,458	33,851
Total assets	$3,316,860	$3,097,270
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Current liabilities:		
Accounts payable	$280,042	$251,999
Accrued expenses and other current liabilities	89,965	79,167
Current portion of long-term debt	41,552	31,275
Total current liabilities	411,559	362,441
Long-term debt, less current portion	940,462	812,608
Deferred income taxes	145,984	145,297
Other noncurrent liabilities	4,830	5,237
Total liabilities	1,502,835	1,325,583
Stockholders’ equity:		
Preferred stock - $.01 par value, authorized 5,000,000 shares, no shares issued	—	—
Common stock - $.01 par value, authorized 150,000,000 shares, issued 106,548,957 and 105,840,586 shares	1,066	1,058
Additional paid-in capital	1,103,357	1,073,671
Retained earnings	885,763	797,514
Accumulated other comprehensive loss	(107,577)	(42,406)
	1,882,609	1,829,837
Less: 3,447,946 and 3,229,342 shares of treasury stock, at cost	(68,584)	(58,150)
Total stockholders’ equity	1,814,025	1,771,687
Total liabilities and stockholders’ equity	$3,316,860	$3,097,270

Note: The balance sheet at June 30, 2015 has been derived from the audited financial statements at that date. See notes to condensed consolidated financial statements.

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THE HAIN CELESTIAL GROUP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)
FOR THE THREE AND SIX MONTHS ENDED DECEMBER 31, 2015 AND 2014
(In thousands, except per share amounts)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2015	2014	2015	2014
Net sales	$752,589	$696,383	$1,439,777	$1,327,640
Cost of sales	575,026	529,056	1,110,167	1,034,469
Gross profit	177,563	167,327	329,610	293,171
Selling, general and administrative expenses	82,607	88,621	168,861	179,544
Amortization of acquired intangibles	4,736	4,303	9,408	8,813
Acquisition related expenses, restructuring and integration charges, net	2,498	391	6,151	1,975
Operating income	87,722	74,012	145,190	102,839
Interest and other expenses, net	9,365	8,814	21,233	12,740
Income before income taxes and equity in earnings of equity-method investees	78,357	65,198	123,957	90,099
Provision for income taxes	21,379	20,931	35,761	26,997
Equity in net loss (income) of equity-method investees	31	(308)	(53)	(328)
Net income	$56,947	$44,575	$88,249	$63,430
Net income per common share:				
Basic	$0.55	$0.44	$0.86	$0.63
Diluted	$0.55	$0.43	$0.85	$0.62
Weighted average common shares outstanding:				
Basic	103,017	101,267	102,912	100,975
Diluted	104,161	103,226	104,209	102,941

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THE HAIN CELESTIAL GROUP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)
FOR THE THREE AND SIX MONTHS ENDED DECEMBER 31, 2015 AND 2014
(In thousands)

	Three Months Ended December 31, 2015			December 31, 2014		
	Pre-tax amount	Tax (expense) benefit	After-tax amount	Pre-tax amount	Tax (expense) benefit	After-tax amount
Net income			$56,947			$44,575
Other comprehensive income (loss):						
Foreign currency translation adjustments	$(25,791)	$—	(25,791)	$(51,656)	$1,289	(50,367)
Change in deferred gains (losses) on cash flow hedging instruments	(418)	122	(296)	(100)	913	813
Change in unrealized gain on available for sale investment	39	(15)	24	(492)	192	(300)
Total other comprehensive income (loss)	$(26,170)	$107	$(26,063)	$(52,248)	$2,394	$(49,854)
Total comprehensive (loss) income			$30,884			$(5,279)

	Six Months Ended December 31, 2015			December 31, 2014		
	Pre-tax amount	Tax (expense) benefit	After-tax amount	Pre-tax amount	Tax (expense) benefit	After-tax amount
Net income			$88,249			$63,430
Other comprehensive income (loss):						
Foreign currency translation adjustments	$(66,084)	$—	(66,084)	$(112,698)	$2,729	(109,969)
Change in deferred gains (losses) on cash flow hedging instruments	1,322	(277)	1,045	2,305	(526)	1,779
Change in unrealized gain on available for sale investment	(216)	84	(132)	(1,343)	455	(888)
Total other comprehensive income (loss)	$(64,978)	$(193)	$(65,171)	$(111,736)	$2,658	$(109,078)
Total comprehensive (loss) income			$23,078			$(45,648)

See notes to condensed consolidated financial statements.

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THE HAIN CELESTIAL GROUP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)
FOR THE SIX MONTHS ENDED DECEMBER 31, 2015
(In thousands, except per share and share amounts)

	Common Stock		Additional				Accumulated Other	
		Amount	Paid-in	Retained	Treasury Stock		Comprehensive	
	Shares	at $.01	Capital	Earnings	Shares	Amount	Income (Loss)	Total
Balance at June 30, 2015	105,840,586	$1,058	$1,073,671	$797,514	3,229,342	$(58,150)	$ (42,406)	$1,771,687
Net income				88,249				88,249
Other comprehensive income							(65,171)	(65,171)
Issuance of common stock pursuant to stock based compensation plans	468,164	5	4,395					4,400
Issuance of common stock in connection with acquisitions	240,207	3	16,305					16,308
Stock based compensation income tax effects			1,757					1,757
Shares withheld for payment of employee payroll taxes due on shares issued under stock based compensation plans					218,604	(10,434)		(10,434)
Stock based compensation charge			7,229					7,229
Balance at December 31, 2015	106,548,957	1,066	1,103,357	885,763	3,447,946	(68,584)	(107,577)	1,814,025

See notes to condensed consolidated financial statements.

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THE HAIN CELESTIAL GROUP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
FOR THE SIX MONTHS ENDED DECEMBER 31, 2015 AND 2014
(In thousands)

	Six Months Ended December 31,	
	2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$88,249	$63,430
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	31,409	28,902
Deferred income taxes	(8,693)	(5,044)
Equity in net income of equity-method investees	(53)	(328)
Stock based compensation	7,229	5,999
Tax (deficiency) benefit from stock based compensation	(258)	2,131
Contingent consideration expense	—	280
Gain on pre-existing ownership interest in Hain Pure Protein Corporation	—	(5,334)
Other non-cash items including unrealized currency (gains)/losses, net	7,812	(2,811)
Increase (decrease) in cash attributable to changes in operating assets and liabilities, net of amounts applicable to acquisitions:		
Accounts receivable	(17,231)	(41,559)
Inventories	(20,891)	(26,244)
Other current assets	5,336	(1,228)
Other assets and liabilities	2,187	(5,254)
Accounts payable and accrued expenses	4,548	41,311
Net cash provided by operating activities	99,644	54,251
CASH FLOWS FROM INVESTING ACTIVITIES		
Acquisitions of businesses, net of cash acquired and working capital settlements	(157,864)	(17,935)
Purchases of property and equipment	(41,177)	(25,766)
Proceeds from sale of investment	—	1,287
Proceeds from disposals of property and equipment	—	1,697
Net cash used in investing activities	(199,041)	(40,717)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from exercises of stock options	—	9,728
Borrowings under bank revolving credit facility, net	121,969	21,500
Borrowings (repayments) of other debt, net	780	(23,411)
Excess tax benefits from stock based compensation	2,016	13,615
Acquisition related contingent consideration	—	(3,217)
Shares withheld for payment of employee payroll taxes	(10,434)	(12,174)
Net cash provided by financing activities	114,331	6,041
Effect of exchange rate changes on cash	(4,756)	(8,099)
Net increase in cash and cash equivalents	10,178	11,476
Cash and cash equivalents at beginning of period	166,922	123,751
Cash and cash equivalents at end of period	$177,100	$135,227

See notes to condensed consolidated financial statements.

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THE HAIN CELESTIAL GROUP, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. BUSINESS

The Hain Celestial Group, Inc., a Delaware corporation, and its subsidiaries (collectively, the "Company") manufacture, market, distribute and sell organic and natural products under brand names which are sold as "better-for-you" products, providing consumers with the opportunity to lead A Healthier Way of Life™. The Company is a leader in many organic and natural products categories, with many recognized brands in the various market categories they serve. The brand names include Almond Dream®, Arrowhead Mills®, Bearitos®, BluePrint®, Celestial Seasonings®, Cully & Sully®, Danival®, DeBoles®, Earth's Best®, Ella's Kitchen®, Empire®, Europe's Best®, Farmhouse Fare®, Frank Cooper's®, FreeBird®, Gale's®, Garden of Eatin'®, GG UniqueFiber™, Hain Pure Foods®, Hartley's®, Health Valley®, Imagine®, Johnson's Juice Co.®, Joya®, Kosher Valley®, Lima®, Linda McCartney® (under license), MaraNatha®, Natumi®, New Covent Garden Soup Co.®, Plainville Farms®, Rice Dream®, Robertson's®, Rudi's Gluten-Free Bakery®, Rudi's Organic Bakery®, Sensible Portions®, Spectrum®, Spectrum Essentials®, Soy Dream®, Sun-Pat®, SunSpire®, Terra®, The Greek Gods®, Tilda®, Walnut Acres®, WestSoy® and Yves Veggie Cuisine®. Our personal care products are marketed under the Alba Botanica®, Avalon Organics®, Earth's Best®, JASON®, Live Clean® and Queen Helene® brands.

On October 27, 2015, the Company acquired a 15.2% interest in Chop't Creative Salad Company LLC ("Chop't"). The Company's current ownership percentage may be diluted in the future to 12% pending the distribution of additional ownership shares. Chop't develops and operates fast-casual, fresh salad restaurants in the Northeast and Mid-Atlantic United States. Chop't markets and sells certain of the Company's branded products and provides consumer insight and feedback. The Company also has an investment in a joint venture in Hong Kong with Hutchison China Meditech Ltd. ("Chi-Med"), a majority owned subsidiary of CK Hutchison Holdings Limited, a company listed on the Hong Kong Stock Exchange, to market and distribute certain of the Company's brands in China and other markets (see Note 12).

The Company's operations are managed in five operating segments: United States, United Kingdom, Hain Pure Protein, Canada and Europe. Refer to Note 15 for additional information and selected financial information for the reportable segments.

2. BASIS OF PRESENTATION

The Company's condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States ("U.S. GAAP"). The amounts as of and for the periods ended June 30, 2015 are derived from the Company's audited annual financial statements. The consolidated financial statements reflect all normal recurring adjustments which, in management's opinion, are necessary for a fair presentation for interim periods. Operating results for the three and six months ended December 31, 2015 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2016. Please refer to the notes to the consolidated financial statements as of June 30, 2015 and for the fiscal year then ended included in the Company's Annual Report on Form 10-K for information not included in these condensed notes.

All amounts in the condensed consolidated financial statements, notes and tables have been rounded to the nearest thousand, except share and per share amounts, unless otherwise indicated.

Newly Adopted Accounting Pronouncements

In September 2015, the FASB issued ASU No. 2015-16, Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments. ASU No. 2015-16 requires that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. ASU No. 2015-16 is effective for annual reporting periods beginning after December 15, 2015 and for interim periods within such annual period. Early application is permitted for any interim and annual financial statements that have not yet been made available for issuance. The Company has elected to early adopt the provisions of ASU No. 2015-16 at the beginning of fiscal 2016. The adoption of the new guidance did not materially impact the Company’s consolidated financial position or results of operations.

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In April 2015, the FASB issued ASU No. 2015-03, Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. The amendments in ASU No. 2015-03 require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability. The recognition and measurement guidance for debt issuance costs are not affected by the amendments. ASU No. 2015-03 must be applied retrospectively and is effective for interim and annual periods beginning after December 15, 2015, with early adoption permitted. In August 2015, the FASB issued ASU No. 2015-15, Interest - Imputation of Interest (Subtopic 835-30): Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements. ASU No. 2015-15 states that for debt issuance costs related to line-of-credit arrangements, the SEC staff would not object to an entity deferring and presenting such costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. The Company has elected to early adopt the provisions of ASU Nos. 2015-03 and 2015-15 at the beginning of fiscal 2016. The adoption of the new guidance did not materially impact the Company’s consolidated financial position or results of operations.

Recently Issued Accounting Pronouncements Not Yet Effective

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01 requires that most equity investments be measured at fair value, with subsequent changes in fair value recognized in net income. The pronouncement also impacts financial liabilities under the fair value option and the presentation and disclosure requirements for financial instruments. ASU 2016-01 is effective for annual reporting periods beginning after December 15, 2017, and interim periods within those annual periods. The Company is currently evaluating the potential effects of adopting the provisions of ASU No. 2016-01.

In November 2015, the FASB issued ASU No. 2015-17, Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes. ASU No. 2015-17 requires that deferred tax assets and liabilities be classified as noncurrent on the balance sheet. ASU 2015-17 is effective for annual reporting periods beginning after December 15, 2016, and interim periods within those annual periods, with early adoption permitted. The Company intends to adopt this new guidance in the fourth quarter of fiscal 2016. The adoption of this guidance will impact the balance sheet classification of such assets and liabilities.

In July 2015, the FASB issued ASU No. 2015-11, Inventory (Topic 330): Simplifying the Measurement of Inventory. ASU No. 2015-11 requires inventory measured using any method other than last-in, first out or the retail inventory method to be subsequently measured at the lower of cost or net realizable value, rather than at the lower of cost or market. ASU No. 2015-11 is effective for annual reporting periods beginning after December 15, 2016 and for interim periods within such annual period. Early application is permitted. The Company is currently evaluating the potential effects of adopting the provisions of ASU No. 2015-11.

In June 2014, the FASB issued ASU No. 2014-12, Compensation - Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period. ASU No. 2014-12 requires that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. As such, the performance target should not be reflected in estimating the grant date fair value of the award. ASU No. 2014-12 is effective for annual periods beginning after December 15, 2015 and for interim periods within such annual period, with early adoption permitted. The Company is currently evaluating the potential effects of adopting the provisions of ASU No. 2014-12.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). ASU No. 2014-09 supersedes the revenue recognition requirements in Topic 605, Revenue Recognition, and most industry-specific guidance throughout the Industry Topics of the Codification. Additionally, ASU No. 2014-09 supersedes some cost guidance included in Subtopic 605-35, Revenue Recognition-Construction-Type and Production-Type Contracts. Under ASU No. 2014-09, an entity should recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU No. 2014-09 also requires additional disclosure about the nature, amount, timing, and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. ASU No. 2014-09 is effective for annual reporting periods beginning after December 15, 2017 and for interim periods within such annual period, with early application prohibited for annual reporting periods beginning after December 15, 2016. ASU No. 2014-09 allows for either full retrospective or modified retrospective adoption. The Company is evaluating the transition method that will be elected and the potential effects of adopting the provisions of ASU No. 2014-09.

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3. EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2015	2014	2015	$

514

$
2,045

Gross losses realized
544

1,627

Net (loss) gain realized
$
(30
)
$
418

The cost of investment securities sold, and any resulting gain or loss, was based on the specific identification method and recognized as of the trade date.

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The following table presents a summary of available-for-sale investment securities that had an unrealized loss:

(Dollars in thousands)	Less than 12 Months Fair Value	Unrealized Loss	No. of Securities	12 Months or More Fair Value	Unrealized Loss	No. of Securities	Total Fair Value	Unrealized Loss
March 31, 2014								
Obligations of:								
U.S. Treasury and government agencies	$—	$—	—	$—	$—	—	$—	$—
U.S. government sponsored agencies	—	—	—	—	—	—	—	—
States and political subdivisions	12,445	251	18	5,440	260	9	17,885	511
Residential mortgage-backed securities	279,545	9,400	60	83,715	5,342	26	363,260	14,742
Commercial mortgage-backed securities	19,556	696	4	7,194	439	2	26,750	1,135
Bank-issued trust preferred securities	2,103	7	1	3,485	513	4	5,588	520
Equity securities	—	—	—	90	85	1	90	85
Total	$313,649	$10,354	83	$99,924	$6,639	42	$413,573	$16,993
December 31, 2013								
Obligations of:								
U.S. Treasury and government agencies	$—	$—	—	$—	$—	—	$—	$—
U.S. government sponsored agencies	—	—	—	—	—	—	—	—
States and political subdivisions	15,848	659	22	6,180	368	10	22,028	1,027
Residential mortgage-backed securities	310,315	16,709	75	57,440	5,811	20	367,755	22,520
Commercial mortgage-backed securities	19,560	779	4	7,205	447	2	26,765	1,226
Bank-issued trust preferred securities	2,013	90	1	4,803	589	4	6,816	679
Equity securities	—	—	—	97	86	2	97	86
Total	$347,736	$18,237	102	$75,725	$7,301	38	$423,461	$25,538

Management systematically evaluates available-for-sale investment securities for other-than-temporary declines in fair value on a quarterly basis. At March 31, 2014, management concluded no individual securities were other-than-temporarily impaired since Peoples did not have the intent to sell nor was it more likely than not that Peoples would be required to sell any of the securities with an unrealized loss prior to recovery. Further, the unrealized losses at both March 31, 2014 and December 31, 2013, were largely attributable to changes in market interest rates and spreads since the securities were purchased.

At March 31, 2014, approximately 98% of the mortgage-backed securities that had been at an unrealized loss position for twelve months or more were issued by U.S. government sponsored agencies. The remaining 2%, or four positions, consisted of privately issued mortgage-backed securities with all of the underlying mortgages originated prior to 2004. Two of the four positions had a fair value less than 90% of their book value, with an aggregate book and fair value of $0.9 million and $0.6 million, respectively. Management has analyzed the underlying credit quality of these securities and concluded the unrealized losses were primarily attributable to the floating rate nature of these investments and the low number of loans remaining in these securities.

Furthermore, the four bank-issued trust preferred securities that had been in an unrealized loss position for twelve months or more at March 31, 2014 were primarily attributable to the floating nature of those investments, the current interest rate environment and spreads within that sector.

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The table below presents the amortized cost, fair value and weighted-average yield of available-for-sale securities by contractual maturity at March 31, 2014. The average yields are based on the amortized cost. In some cases, the issuers may have the right to call or prepay obligations without call or prepayment penalties prior to the contractual maturity date. Rates are calculated on a fully tax-equivalent basis using a 35% federal income tax rate.

(Dollars in thousands)	Within 1 Year	1 to 5 Years	5 to 10 Years	Over 10 Years	Total
Amortized cost					
Obligations of:					
U.S. Treasury and government agencies	$—	$19	$—	$—	$19
U.S. government sponsored agencies	287	—	—	—	287
States and political subdivisions	350	4,232	20,099	25,684	50,365
Residential mortgage-backed securities	18	7,384	35,814	466,856	510,072
Commercial mortgage-backed securities	—	—	23,120	4,765	27,885
Bank-issued trust preferred securities	—	—	—	8,513	8,513
Equity securities					1,304
Total available-for-sale securities	$655	$11,635	$79,033	$505,818	$598,445
Fair value					
Obligations of:					
U.S. Treasury and government agencies	$—	$19	$—	$—	$19
U.S. government sponsored agencies	295	—	—	—	295
States and political subdivisions	355	4,483	20,703	26,127	51,668
Residential mortgage-backed securities	18	7,574	34,897	458,027	500,516
Commercial mortgage-backed securities	—	—	22,063	4,687	26,750
Bank-issued trust preferred securities	—	—	—	7,995	7,995
Equity securities					4,854
Total available-for-sale securities	$668	$12,076	$77,663	$496,836	$592,097
Total average yield	4.14%	4.78%	2.86%	2.74%	2.81%

Held-to-Maturity

The following table summarizes Peoples' held-to-maturity investment securities:

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
March 31, 2014				
Obligations of:				
States and political subdivisions	$3,848	$200	$(11)	$4,037
Residential mortgage-backed securities	37,151	50	(1,171)	36,030
Commercial mortgage-backed securities	7,804	—	(272)	7,532
Total held-to-maturity securities	$48,803	$250	$(1,454)	$47,599
December 31, 2013				
Obligations of:				
States and political subdivisions	$3,850	$91	$(12)	$3,929
Residential mortgage-backed securities	37,536	35	(3,041)	34,530
Commercial mortgage-backed securities	7,836	2	(203)	7,635
Total held-to-maturity securities	$49,222	$128	$(3,256)	$46,094

There were no gross gains or gross losses realized by Peoples from sales of held-to-maturity securities for the three months ended March 31, 2014 and 2013.

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The following table presents a summary of held-to-maturity investment securities that had an unrealized loss:

(Dollars in thousands)	Less than 12 Months Fair Value	Unrealized Loss	No. of Securities	12 Months or More Fair Value	Unrealized Loss	No. of Securities	Total Fair Value	Unrealized Loss
March 31, 2014								
Obligations of:								
States and political subdivisions	$322	$11	1	$—	$—	—	$322	$11
Residential mortgage-backed securities	23,392	542	6	10,624	629	2	34,016	1,171
Commercial mortgage-backed securities	7,532	272	2	—	—	—	7,532	272
Total	$31,246	$825	9	$10,624	$629	2	$41,870	$1,454
December 31, 2013								
Obligations of:								
States and political subdivisions	$321	$12	1	$—	$—	—	$321	$12
Residential mortgage-backed securities	$31,341	$2,908	7	$1,181	$133	1	$32,522	$3,041
Commercial mortgage-backed securities	6,547	203	1	—	—	—	6,547	203
Total	$38,209	$3,123	9	$1,181	$133	1	$39,390	$3,256

The table below presents the amortized cost, fair value and weighted-average yield of held-to-maturity securities by contractual maturity at March 31, 2014. The average yields are based on the amortized cost. In some cases, the issuers may have the right to call or prepay obligations without call or prepayment penalties prior to the contractual maturity date. Rates are calculated on a fully tax-equivalent basis using a 35% federal income tax rate.

(Dollars in thousands)	Within 1 Year	1 to 5 Years	5 to 10 Years	Over 10 Years	Total
Amortized cost					
Obligations of:					
States and political subdivisions	$—	$—	$333	$3,515	$3,848
Residential mortgage-backed securities	—	—	522	36,629	37,151
Commercial mortgage-backed securities	—	—	—	7,804	7,804
Total held-to-maturity securities	$—	$—	$855	$47,948	$48,803
Fair value					
Obligations of:					
States and political subdivisions	$—	$—	$322	$3,715	$4,037
Residential mortgage-backed securities	—	—	504	35,526	36,030
Commercial mortgage-backed securities	—	—	—	7,532	7,532
Total held-to-maturity securities	$—	$—	$826	$46,773	$47,599
Total average yield	—%	—%	2.60%	2.74%	2.74%

Pledged Securities

Peoples had pledged available-for-sale investment securities with carrying values of $326.0 million and $303.8 million at March 31, 2014 and December 31, 2013, respectively, to secure public and trust department deposits and repurchase agreements in accordance with federal and state requirements. Additionally, Peoples had pledged held-to-maturity investment securities with carrying values of $23.2 million and $21.4 million at March 31, 2014 and December 31, 2013, respectively, to secure public and trust department deposits and repurchase agreements in accordance with federal and state requirements. Peoples also pledged available-for-sale investment securities with carrying values of $15.6 million and $16.2 million at March 31, 2014 and December 31, 2013, respectively, and held-to-maturity securities with carrying values of $25.6 million and $25.9 million at March 31, 2014 and December 31, 2013, respectively, to secure additional borrowing capacity at the Federal Home Loan Bank of Cincinnati ("FHLB") and the Federal Reserve Bank of Cleveland ("FRB").

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Note 4. Loans

Peoples' loan portfolio consists of various types of loans originated primarily as a result of lending opportunities within Peoples' primary market areas of northeastern, central and southeastern Ohio, west central West Virginia, and northeastern Kentucky. The major classifications of loan balances, excluding loans held for sale, were as follows:

(Dollars in thousands)	March 31, 2014	December 31, 2013
Commercial real estate, construction	$55,935	$47,539
Commercial real estate, other	458,580	450,170
Commercial real estate	514,515	497,709
Commercial and industrial	233,329	232,754
Residential real estate	268,794	268,617
Home equity lines of credit	60,319	60,076
Consumer	143,541	135,018
Deposit account overdrafts	6,008	2,060
Total loans	$1,226,506	$1,196,234

Peoples has acquired various loans through business combinations for which there was, at acquisition, evidence of deterioration of credit quality since origination and for which it was probable that all contractually required payments would not be collected. The carrying amounts of these loans included in the loan balances above are summarized as follows:

(Dollars in thousands)	March 31, 2014	December 31, 2013
Commercial real estate	$937	$963
Commercial and industrial	63	78
Residential real estate	1,183	1,236
Consumer	—	—
Total outstanding balance	$2,183	$2,277
Net carrying amount	$1,781	$1,875

Changes in the accretable yield for the three months ended March 31, 2014 were as follows:

(Dollars in thousands)	Accretable Yield	
Balance, December 31, 2013	$1,654	
Accretion	(268	)
Balance, March 31, 2014	$1,386	

Peoples has pledged certain loans secured by 1-4 family and multifamily residential mortgages under a blanket collateral agreement to secure borrowings from the FHLB. The amount of such pledged loans totaled $264.4 million and $259.1 million at March 31, 2014 and December 31, 2013, respectively. Peoples also had pledged commercial loans to secure borrowings with the FRB. The outstanding balances of these loans totaled $107.6 million and $113.0 million at March 31, 2014 and December 31, 2013, respectively.

Nonaccrual and Past Due Loans

A loan is considered past due if any required principal and interest payments have not been received as of the date such payments were required to be made under the terms of the loan agreement. A loan may be placed on nonaccrual status regardless of whether or not such loan is considered past due. The recorded investments in loans on nonaccrual status and accruing loans delinquent for 90 days or more were as follows:

	Nonaccrual Loans		Accruing Loans 90+ Days Past Due	
(Dollars in thousands)	March 31, 2014	December 31, 2013	March 31, 2014	December 31, 2013
Commercial real estate, construction	$96	$96	$—	$—
Commercial real estate, other	3,810	3,717	—	—

Commercial real estate	3,906	3,813	—	—
Commercial and industrial	640	708	—	—
Residential real estate	3,931	3,215	29	37
Home equity lines of credit	329	87	129	873
Consumer	—	58	1	—
Total	$8,806	$7,881	$159	$910

The following table presents the aging of the recorded investment in past due loans and leases:

	Loans Past Due				Current	Total
(Dollars in thousands)	30 - 59 days	60 - 89 days	90 + Days	Total	Loans	Loans
March 31, 2014						
Commercial real estate, construction	$98	$—	$96	$194	$55,741	$55,935
Commercial real estate, other	1,342	568	1,242	3,152	455,428	458,580
Commercial real estate	1,440	568	1,338	3,346	511,169	514,515
Commercial and industrial	1,387	15	556	1,958	231,371	233,329
Residential real estate	3,926	736	2,049	6,711	262,083	268,794
Home equity lines of credit	200	15	205	420	59,899	60,319
Consumer	468	134	1	603	142,938	143,541
Deposit account overdrafts	30	—	—	30	5,978	6,008
Total	$7,451	$1,468	$4,149	$13,068	$1,213,438	$1,226,506
December 31, 2013						
Commercial real estate, construction	$1,340	$—	$—	$1,340	$46,199	$47,539
Commercial real estate, other	432	679	1,249	2,360	447,810	450,170
Commercial real estate	1,772	679	1,249	3,700	494,009	497,709
Commercial and industrial	171	90	127	388	232,366	232,754
Residential real estate	5,445	1,509	1,452	8,406	260,211	268,617
Home equity lines of credit	254	65	929	1,248	58,828	60,076
Consumer	976	165	58	1,199	133,819	135,018
Deposit account overdrafts	47	—	—	47	2,013	2,060
Total	$8,665	$2,508	$3,815	$14,988	$1,181,246	$1,196,234

Credit Quality Indicators

As discussed in Note 1 of the Notes to the Consolidated Financial Statements included in Peoples' 2013 Form 10-K, Peoples categorizes the majority of its loans into risk categories based upon an established risk grading matrix using a scale of 1 to 8. A description of the general characteristics of the risk grades used by Peoples is as follows:

"Pass" (grades 1 through 4): Loans in this risk category involve borrowers of acceptable-to-strong credit quality and risk who have the apparent ability to satisfy their loan obligations. Loans in this risk grade would possess sufficient mitigating factors, such as adequate collateral or strong guarantors possessing the capacity to repay the debt if required, for any weakness that may exist.

"Watch" (grade 5): Loans in this risk grade are the equivalent of the regulatory definition of "Other Assets Especially Mentioned" classification. Loans in this category possess some credit deficiency or potential weakness, which requires a high level of management attention. Potential weaknesses include declining trends in operating earnings and cash flows and /or reliance on the secondary source of repayment. If left uncorrected, these potential weaknesses may result in noticeable deterioration of the repayment prospects for the asset or in Peoples' credit position.

"Substandard" (grade 6): Loans in this risk grade are inadequately protected by the borrower's current financial condition and payment capability or of the collateral pledged, if any. Loans so classified have one or more well-defined weaknesses that jeopardize the orderly repayment of debt. They are characterized by the distinct possibility that Peoples will sustain some loss if the deficiencies are not corrected.

"Doubtful" (grade 7): Loans in this risk grade have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or orderly repayment in full, on the basis of current existing facts, conditions and values, highly questionable and improbable. Possibility of loss is extremely high, but because of certain important and reasonably specific factors that may work to the advantage and strengthening of the exposure, its classification as an estimate loss is deferred until its more exact status may be determined.

"Loss" (grade 8): Loans in this risk grade are considered to be non-collectible and of such little value that their continuance as bankable assets is not warranted. This does not mean the loan has absolutely no recovery value, but rather it is neither practical nor desirable to defer writing off the loan, even though partial recovery may be obtained in the future. Charge-offs against the allowance for loan losses are taken in the period in which the loan becomes uncollectible. Consequently, Peoples typically does not maintain a recorded investment in loans within this category.
Consumer loans and other smaller-balance loans are evaluated and categorized as "substandard", "doubtful" or "loss" based upon the regulatory definition of these classes and consistent with regulatory requirements. All other loans not evaluated individually nor meeting the regulatory conditions to be categorized as described above would be considered as being "not rated".
The following table summarizes the risk category of Peoples' loan portfolio based upon the most recent analysis performed:

(Dollars in thousands)	Pass Rated (Grades 1 - 4)	Watch (Grade 5)	Substandard (Grade 6)	Doubtful (Grade 7)	Not Rated	Total Loans
March 31, 2014						
Commercial real estate, construction	$52,531	$—	$67	$—	$3,337	$55,935
Commercial real estate, other	436,597	9,387	11,804	—	792	458,580
Commercial real estate	489,128	9,387	11,871	—	4,129	514,515
Commercial and industrial	212,903	10,082	9,851	493	—	233,329
Residential real estate	25,847	2,640	7,541	—	232,766	268,794
Home equity lines of credit	837	—	1,187	—	58,295	60,319
Consumer	65	4	20	—	143,452	143,541
Deposit account overdrafts	—	—	—	—	6,008	6,008
Total	$728,780	$22,113	$30,470	$493	$444,650	$1,226,506
December 31, 2013						
Commercial real estate, construction	$43,407	$148	$68	$—	$3,916	$47,539
Commercial real estate, other	423,313	13,433	12,921	—	503	450,170
Commercial real estate	466,720	13,581	12,989	—	4,419	497,709
Commercial and industrial	212,193	6,013	14,006	542	—	232,754
Residential real estate	26,822	2,787	8,094	4	230,910	268,617
Home equity lines of credit	844	—	1,014	—	58,218	60,076
Consumer	50	5	24	—	134,939	135,018
Deposit account overdrafts	—	—	—	—	2,060	2,060
Total	$706,629	$22,386	$36,127	$546	$430,546	$1,196,234

Impaired Loans
The following tables summarize loans classified as impaired:

(Dollars in thousands)	Unpaid Principal Balance	Recorded Investment With Allowance	Recorded Investment Without Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
March 31, 2014							
Commercial real estate, construction	$—	$—	$—	$—	$—	$—	$—
Commercial real estate, other	5,570	1,132	2,321	3,453	111	3,166	4
Commercial real estate	5,570	$1,132	$2,321	$3,453	$111	$3,166	$4
Commercial and industrial	527	526	—	526	526	550	—
Residential real estate	3,538	—	3,310	3,310	—	3,090	33
Home equity lines of credit	519	—	519	519	—	410	4
Consumer	153	—	153	153	—	128	2
Total	$10,307	$1,658	$6,303	$7,961	$637	$7,344	$43
December 31, 2013							

Commercial real estate, construction	$—	$—	$—	$—	$—	$—	$—
Commercial real estate, other	4,970	1,150	1,729	2,879	83	4,586	6
Commercial real estate	4,970	$1,150	$1,729	$2,879	$83	$4,586	$6
Commercial and industrial	617	575	5	580	575	278	1
Residential real estate	3,498	—	3,280	3,280	—	2,800	86
Home equity lines of credit	347	—	347	347	—	327	12
Consumer	182	—	182	182	—	127	15
Total	$9,614	$1,725	$5,543	$7,268	$658	$8,118	$120

At March 31, 2014, Peoples' impaired loans shown in the table above included loans that were classified as troubled debt restructurings ("TDRs").

In assessing whether or not a borrower is experiencing financial difficulties, Peoples considers information currently available regarding the financial condition of the borrower. This information includes, but is not limited to, whether (i) the debtor is currently in payment default on any of its debt; (ii) a payment default is probable in the foreseeable future without the modification; (iii) the debtor has declared or is in the process of declaring bankruptcy and (iv) the debtor's projected cash flow is insufficient to satisfy contractual payments due under the original terms of the loan without a modification.

Peoples considers all aspects of the modification to loan terms to determine whether or not a concession has been granted to the borrower. Key factors considered by Peoples include the debtor's ability to access funds at a market rate for debt with similar risk characteristics, the significance of the modification relative to the unpaid principal balance or collateral value of the debt, and the significance of a delay in the timing of payments relative to the original contractual terms of the loan. The most common concessions granted by Peoples generally include one or more modifications to the terms of the debt, such as (i) a reduction in the interest rate for the remaining life of the debt, (ii) an extension of the maturity date at an interest rate lower than the current market rate for new debt with similar risk, (iii) a temporary period of interest-only payments, and (iv) a reduction in the contractual payment amount for either a short period or the remaining term of the loan.

The following table summarizes the loans that were modified as a TDR during the three months ended March 31, 2014 and 2013.

		Three Months Ended		
		Recorded Investment (1)		
	Number of Contracts	Pre-Modification	Post-Modification	At March 31, 2014
Commercial real estate, other	1	$511	$ 511	$503
Residential real estate	8	$496	$ 497	$496
Home equity lines of credit	2	$47	$ 47	$47
Consumer	5	$64	$ 64	$64

		Three Months Ended		
		Recorded Investment (1)		
	Number of Contracts	Pre-Modification	Post-Modification	At March 31, 2013
Residential real estate	6	$180	$ 180	$180
Home equity lines of credit	1	$25	$ 25	$25
Consumer	10	$69	$ 69	$69

(1) The amounts shown are inclusive of all partial paydowns and charge-offs. Loans modified in a TDR that were fully paid down, charged-off or foreclosed upon by period end are not reported.

The following table presents those loans for the three months ended March 31, 2014 that were modified as a TDR during the last twelve months that subsequently defaulted (i.e., 90 days or more past due following a modification). There were no such loans during the three months ended March 31, 2013.

March 31, 2014

	Number of Contracts	Recorded Investment (1)	Impact on the Allowance for Loan Losses
Residential real estate	2	$91	$—
Total	2	$91	$—

(1) The amounts shown are inclusive of all partial paydowns and charge-offs. Loans modified in a TDR that were fully paid down, charged-off or foreclosed upon by period end are not reported.

Peoples had no additional commitments to lend additional funds to the related debtors whose terms have been modified in a TDR.

Allowance for Loan Losses

Changes in the allowance for loan losses in the periods ended March 31, were as follows:

(Dollars in thousands)	Commercial Real Estate	Commercial and Industrial	Residential Real Estate	Home Equity Lines of Credit	Consumer	Deposit Account Overdrafts	Total
Balance, January 1, 2014	$13,215	$2,174	$881	$343	$316	$136	$17,065
Charge-offs	—	(49)	(137)	(20)	(302)	(110)	(618)
Recoveries	112	5	38	6	184	70	415
Net recoveries (charge-offs)	112	(44)	(99)	(14)	(118)	(40)	(203)
Provision for loan losses	—	—	—	—	—	8	8
Balance, March 31, 2014	$13,327	$2,130	$782	$329	$198	$104	$16,870
Period-end amount allocated to:							
Loans individually evaluated for impairment	$111	$526	$—	$—	$—	$—	$637
Loans collectively evaluated for impairment	13,216	1,604	782	329	198	104	16,233
Ending balance	$13,327	$2,130	$782	$329	$198	$104	$16,870
Balance, January 1, 2013	$14,215	$1,733	$801	$479	$438	$145	$17,811
Charge-offs	(566)	—	(134)	(2)	(159)	(130)	(991)
Recoveries	1,374	17	116	8	104	65	1,684
Net recoveries (charge-offs)	808	17	(18)	6	(55)	(65)	693
Recovery of loan losses	(1,050)	—	—	—	—	(15)	(1,065)
Balance, March 31, 2013	$13,973	$1,750	$783	$485	$383	$65	$17,439
Period-end amount allocated to:							
Loans individually evaluated for impairment	$1,226	$315	$77	$—	$—	$—	$1,618
Loans collectively evaluated for impairment	12,747	1,435	706	485	383	65	15,821
Ending balance	$13,973	$1,750	$783	$485	$383	$65	$17,439

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Note 5. Stockholders' Equity

The following table details the progression in shares of Peoples' common and treasury stock during the three months ended March 31, 2014:

	Common Stock	Treasury Stock
Shares at December 31, 2013	11,206,576	600,794
Changes related to stock-based compensation awards:		
Release of restricted shares	48,621	11,189
Changes related to deferred compensation plan:		
Purchase of treasury stock		894
Reissuance of treasury stock		(7,910)
Shares issued under dividend reinvestment plan	5,035	
Reissuance of treasury stock under Board of Directors' compensation plan	—	(2,304)
Shares at March 31, 2014	11,260,232	602,663

Under its Amended Articles of Incorporation, Peoples is authorized to issue up to 50,000 preferred shares, in one or more series, having such voting powers, designations, preferences, rights, qualifications, limitations and restrictions as determined by the Board of Directors. At March 31, 2014, Peoples had no preferred shares issued or outstanding.

Accumulated Other Comprehensive (Loss) Income

The following table details the change in the components of Peoples' accumulated other comprehensive (loss) income for the three months ended March 31, 2014:

(Dollars in thousands)	Unrealized (Loss) Gain on Securities	Unrecognized Net Pension and Postretirement Costs	Accumulated Other Comprehensive (Loss) Income
Balance, December 31, 2013	$ (9,761)	$ (3,483)	$ (13,244)
Reclassification adjustments to net income:			
Realized loss on sale of securities, net of tax	19	—	19
Realized loss due to settlement and curtailment, net of tax	—	316	316
Other comprehensive income (loss), net of reclassifications and tax	5,616	(663)	4,953
Balance, March 31, 2014	$ (4,126)	$ (3,830)	$ (7,956)

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Note 6. Employee Benefit Plans

Peoples sponsors a noncontributory defined benefit pension plan that covers substantially all employees hired before January 1, 2010. The plan provides retirement benefits based on an employee's years of service and compensation. For employees hired before January 1, 2003, the amount of postretirement benefit is based on the employee's average monthly compensation pay over the highest five consecutive years out of the employee's last ten years with Peoples while an eligible employee. For employees hired on or after January 1, 2003, the amount of postretirement benefit is based on 2% of the employee's annual compensation plus accrued interest. Effective January 1, 2010, the pension plan was closed to new entrants. Effective March 1, 2011, the accrual of pension plan benefits for all participants was frozen. Peoples recognized this freeze as a curtailment as of December 31, 2010 and March 1, 2011, under the terms of the pension plan. Peoples also provides post-retirement health and life insurance benefits to former employees and directors. Only those individuals who retired before January 27, 2012 were eligible for life insurance benefits. All retirees are eligible for health benefits; however, Peoples only pays 100% of the cost for those individuals who retired before January 1, 1993. For all others, the retiree is responsible for most, if not all, of the cost of health benefits. Peoples' policy is to fund the cost of the benefits as they arise.
The following tables detail the components of the net periodic cost for the plans:

	Pension Benefits Three Months Ended March 31,	
(Dollars in thousands)	2014	2013
Interest cost	$143	$133
Expected return on plan assets	(169)	(165)
Amortization of net loss	33	52
Settlement of benefit obligation	486	—
Net periodic cost	$493	$20

	Postretirement Benefits Three Months Ended March 31,	
(Dollars in thousands)	2014	2013
Interest cost	$1	$2
Amortization of net loss	(2)	—
Net periodic (benefit) cost	$(1)	$2

Under US GAAP, Peoples is required to recognize a settlement gain or loss when the aggregate amount of lump-sum distributions to participants equals or exceeds the sum of the service and interest cost components of the net periodic pension cost. The amount of settlement gain or loss recognized is the pro rata amount of the unrealized gain or loss existing immediately prior to the settlement. In general, both the projected benefit obligation and fair value of plan assets are required to be remeasured in order to determine the settlement gain or loss.
In the first quarter of 2014, the total lump-sum distributions made to participants caused the total settlements to exceed the recognition threshold for settlement gains or losses. As a result, Peoples remeasured its pension obligation and plan assets as of January 1, 2014 as part of the calculation of the settlement loss recognized.

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The following table summarizes the change in pension obligation and funded status as a result of this remeasurement and the aggregate settlements for the three months ended March 31, 2014:

(Dollars in thousands) Funded status:	As of December 31, 2013	March 31, 2014 Before Settlement	Impact of Settlements	After Settlements
Projected benefit obligation	$14,723	$15,856	$(1,196)	$14,660
Fair value of plan assets	11,287	11,369	(1,196)	10,173
Funded status	$(3,436)	$(4,487)	$—	$(4,487)
Gross unrealized loss	$5,436	$6,480	$(486)	$5,994
Assumptions:				
Discount rate	4.30%	3.90%		3.90%
Expected return on plan assets	7.50%	7.50%		7.50%

Note 7. Stock-Based Compensation

Under the Peoples Bancorp Inc. Second Amended and Restated 2006 Equity Plan (the "2006 Equity Plan"), Peoples may grant, among other awards, nonqualified stock options, incentive stock options, restricted stock awards, stock appreciation rights and unrestricted share awards to employees and non-employee directors. The total number of shares available under the 2006 Equity Plan is 1,081,260. The maximum number of shares that can be issued for incentive stock options is 800,000 shares. Prior to 2007, Peoples granted nonqualified and incentive stock options to employees and nonqualified stock options to non-employee directors under the 2006 Equity Plan and predecessor plans. Since February 2007, Peoples has granted a combination of restricted shares and stock appreciation rights ("SARs") to be settled in shares to employees and restricted shares to non-employee directors subject to the terms and conditions prescribed by the 2006 Equity Plan. In general, shares issued in connection with stock-based awards are issued from treasury shares to the extent available. If no treasury shares are available, shares are issued from authorized but unissued shares.

Stock Options

Under the provisions of the 2006 Equity Plan and predecessor stock option plans, the exercise price per share of any stock option granted may not be less than the grant date fair market value of the underlying shares. All stock options granted to both employees and non-employee directors expire ten years from the date of grant. The most recent stock option grants to employees and non-employee directors occurred in 2006. The stock options granted to employees vested three years after the grant date, while the stock options granted to non-employee directors vested six months after the grant date.

The following summarizes the changes to Peoples' stock options for the period ended March 31, 2014:

	Number of Shares Subject to Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life	Aggregate Intrinsic Value
Outstanding at January 1	57,094	$27.96		
Expired	7,728	28.52		
Outstanding at March 31	49,366	$27.87	1.4 years	$1,000
Exercisable at March 31	49,366	$27.87	1.4 years	$1,000

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The following table summarizes Peoples’ stock options outstanding at March 31, 2014:

Range of Exercise Prices			Options Outstanding & Exercisable Shares Subject to Options Outstanding & Exercisable	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price
$23.59	to	$25.94	2,792	0.4 years	$25.41
$26.01	to	$27.74	20,334	0.7 years	27.08
$28.25	to	$28.26	15,040	1.9 years	28.25
$28.57	to	$30.00	11,200	2.2 years	29.40
Total			49,366	1.4 years	$27.87

Stock Appreciation Rights

SARs granted to employees have an exercise price equal to the fair market value of Peoples’ shares on the date of grant and will be settled using shares of Peoples. Additionally, the SARs granted vested three years after the grant date and expire ten years from the date of grant. The most recent grant of SARs occurred in 2008. The following summarizes the changes to Peoples' SARs for the period ended March 31, 2014:

	Number of Shares Subject to SARs	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life	Aggregate Intrinsic Value
Outstanding at January 1	21,292	$25.96		
Forfeited	—	—		
Outstanding at March 31	21,292	$25.96	3.4 years	$13,000
Exercisable at March 31	21,292	$25.96	3.4 years	$13,000

The following table summarizes Peoples’ SARs outstanding at March 31, 2014:

Exercise Price	Number of Shares Subject to SARs Outstanding & Exercisable	Weighted-Average Remaining Contractual Life
$23.26	2,000	3.3 years
$23.77	10,582	3.9 years
$29.25	8,710	2.9 years
Total	21,292	3.4 years

Restricted Shares

Under the 2006 Equity Plan, Peoples may award restricted shares to officers, key employees and non-employee directors. In general, the restrictions on shares awarded to non-employee directors expire after six months, while the restrictions on shares awarded to employees expire after periods ranging from one to three years. In the first quarter of 2014, Peoples granted restricted shares subject to performance-based vesting to officers and key employees with restrictions that will lapse one to three years after the grant date provided that Peoples has net income greater than zero and maintains a well-capitalized status by regulatory standards.

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The following summarizes the changes to Peoples' restricted shares for the period ended March 31, 2014:

	Time-Based Vesting		Performance-Based Vesting	
	Number of Shares	Weighted-Average Grant Date Fair Value	Number of Shares	Weighted-Average Grant Date Fair Value
Outstanding at January 1	60,206	$17.18	85,254	$20.98
Awarded	2,000	22.79	83,514	21.68
Released	10,994	16.93	37,746	19.93
Forfeited	—	—	100	21.68
Outstanding at March 31	51,212	$17.46	130,922	$21.73

For the three months ended March 31, 2014, the total intrinsic value of restricted shares released was $1,064,000.

Stock-Based Compensation

Peoples recognized stock-based compensation expense, which is included as a component of Peoples' salaries and employee benefit costs, based on the estimated fair value of the awards on the grant date. The following summarizes the amount of stock-based compensation expense and related tax benefit recognized:

	Three Months Ended March 31,	
(Dollars in thousands)	2014	2013
Total stock-based compensation	$490	$297
Recognized tax benefit	(172)	(104)
Net expense recognized	$318	$193

Total unrecognized stock-based compensation expense related to unvested awards was $2.0 million at March 31, 2014, which will be recognized over a weighted-average period of 1.7 years.

Note 8. Earnings Per Share

The calculations of basic and diluted earnings per share were as follows:

	Three Months Ended March 31,	
(Dollars in thousands, except per share data)	2014	2013
Distributed earnings allocated to shareholders	$1,605	$1,275
Undistributed earnings allocated to shareholders	3,146	3,702
Net earnings allocated to shareholders	$4,751	$4,977
Weighted-average shares outstanding	10,636,089	10,556,261
Effect of potentially dilutive shares	104,795	15,122
Total weighted-average diluted shares outstanding	10,740,884	10,571,383
Earnings per share:		
Basic	$0.45	$0.47
Diluted	$0.44	$0.47
Anti-dilutive shares excluded from calculation:		
Stock options and SARs	73,422	116,566

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Note 9. Acquisitions

On January 21, 2014, Peoples entered into an Agreement and Plan of Merger (the "Midwest Agreement") with Midwest Bancshares, Inc. (“Midwest”). The Midwest Agreement calls for Midwest to merge into Peoples, and for Midwest's wholly-owned subsidiary, First National Bank of Wellston, which operates two full-service branches in Wellston and Jackson, Ohio, to merge into Peoples' wholly-owned subsidiary, Peoples Bank. This transaction is expected to close during the second quarter of 2014.
On April 4, 2014, Peoples entered into an Agreement and Plan of Merger (the "Ohio Heritage Agreement") with Ohio Heritage Bancorp, Inc. (“Ohio Heritage”). The Ohio Heritage Agreement calls for Ohio Heritage to merge into Peoples, and for Ohio Heritage's wholly-owned subsidiary, Ohio Heritage Bank, which operates six full-service branches in Coshocton, Newark, Heath, Mount Vernon and New Philadelphia, Ohio, to merge into Peoples' wholly-owned subsidiary, Peoples Bank. This transaction is expected to close during the third quarter of 2014.
On April 21, 2014, Peoples entered into an Agreement and Plan of Merger (the "North Akron Agreement") with North Akron Savings Bank (“North Akron”), which operates four full-service branches in Akron, Cuyahoga Falls, Munroe Falls and Norton, Ohio. The North Akron Agreement calls for North Akron to merge into Peoples’ wholly-owned subsidiary, Peoples Bank. This transaction is expected to close during the fourth quarter of 2014.

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

SELECTED FINANCIAL DATA

The following data should be read in conjunction with the Unaudited Consolidated Financial Statements and the Management's Discussion and Analysis that follows:

	At or For the Three Months Ended March 31,			
	2014		2013	
SIGNIFICANT RATIOS				
Return on average stockholders' equity	8.56	%	9.18	%
Return on average assets	0.95	%	1.06	%
Net interest margin	3.35	%	3.10	%
Efficiency ratio (a)	71.13	%	71.61	%
Pre-provision net revenue to average assets (b)	1.38	%	1.24	%
Average stockholders' equity to average assets	11.05	%	11.58	%
Average loans to average deposits	76.94	%	65.36	%
Dividend payout ratio	33.91	%	25.79	%
ASSET QUALITY RATIOS				
Nonperforming loans as a percent of total loans (c)(d)	0.73	%	1.32	%
Nonperforming assets as a percent of total assets (c)(d)	0.47	%	0.71	%
Nonperforming assets as a percent of total loans and other real estate owned (c)(d)	0.79	%	1.41	%
Allowance for loan losses as a percent of loans, net of deferred fees and costs (c)(d)	1.38	%	1.78	%
Allowance for loan losses to nonperforming loans (c)(d)	188.19	%	133.96	%
Provision for (recovery of) loan losses as a percent of average total loans	—	%	(0.44	)%
Net charge-offs (recoveries) as a percentage of average total loans (annualized)	0.07	%	(0.29	)%
CAPITAL RATIOS (d)				
Tier 1	12.56	%	14.69	%
Total (Tier 1 and Tier 2)	13.92	%	16.05	%
Tier 1 leverage	8.56	%	8.90	%
Tangible equity to tangible assets (e)	7.66	%	8.35	%
PER SHARE DATA				
Earnings per share – Basic	$0.45		$0.47	
Earnings per share – Diluted	0.44		0.47	
Cash dividends declared per share	0.15		0.12	
Book value per share (d)	21.63		21.39	
Tangible book value per share (d)(e)	$14.38		$14.77	
Weighted-average number of shares outstanding – Basic	10,636,089		10,556,261	
Weighted-average number of shares outstanding – Diluted	10,740,884		10,571,383	
Shares outstanding at end of period	10,657,569		10,568,147	

(a) Non-interest expense (less intangible asset amortization) as a percentage of fully tax-equivalent net interest income plus non-interest income (excluding gains or losses on investment securities and asset disposals and other transactions).

(b) These amounts represent non-GAAP financial measures since they exclude the provision for loan losses and all gains and losses included in earnings. Additional information regarding the calculation of these measures can be found later in this section under the caption "Pre-Provision Net Revenue".

(c) Nonperforming loans include loans 90 days past due and accruing, renegotiated loans and nonaccrual loans. Nonperforming assets include nonperforming loans and other real estate owned.

(d) Data presented as of the end of the period indicated.

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(e) These amounts represent non-GAAP financial measures since they exclude the balance sheet impact of intangible assets acquired through acquisitions on both total stockholders' equity and total assets. Additional information regarding the calculation of these measures can be found later in this discussion under the caption "Capital/Stockholders' Equity".

Forward-Looking Statements

Certain statements in this Form 10-Q, which are not historical fact, are forward-looking statements within the meaning of Section 27A of the Securities Act , Section 21E of the Exchange Act, and the Private Securities Litigation Reform Act of 1995. Words such as "anticipate", "estimates", "may", "feels", "expects", "believes", "plans", "will", "would", "should similar expressions are intended to identify these forward-looking statements but are not the exclusive means of identifying such statements. Forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially. Factors that might cause such a difference include, but are not limited to:

(1) the success, impact, and timing of the implementation of Peoples' business strategies, including the successful integration of the recently completed acquisitions and the expansion of consumer lending activity;
(2) Peoples' ability to complete and, if completed, successfully integrate future acquisitions, including the pending mergers of Midwest, Ohio Heritage and North Akron with and into Peoples;
(3) competitive pressures among financial institutions or from non-financial institutions may increase significantly, including product and pricing pressures and Peoples' ability to attract, develop and retain qualified professionals;
(4) changes in the interest rate environment due to economic conditions and/or the fiscal policies of the U.S. government and Federal Reserve Board, which may adversely impact interest margins and interest rate sensitivity;
(5) changes in prepayment speeds, loan originations and charge-offs, which may be less favorable than expected and adversely impact the amount of interest income generated;
(6) adverse changes in the economic conditions and/or activities, including impacts from the implementation of the Budget Control Act of 2011 and the American Taxpayer Relief Act of 2012, as well as continuing economic uncertainty in the U.S., the European Union, and other areas, which could decrease sales volumes and increase loan delinquencies and defaults;
(7) legislative or regulatory changes or actions, including in particular the Dodd-Frank Act and the regulations promulgated and to be promulgated thereunder by the OCC, the Federal Reserve Board and the CFPB, which may subject Peoples, its subsidiaries, or one or more acquired companies to a variety of new and more stringent legal and regulatory requirements which adversely affect their respective businesses;
(8) deterioration in the credit quality of Peoples' loan portfolio, which may adversely impact the provision for loan losses;
(9) changes in accounting standards, policies, estimates or procedures, which may adversely affect Peoples' reported financial condition or results of operations;
(10) adverse changes in the conditions and trends in the financial markets, including political developments, which may adversely affect the fair value of securities within Peoples' investment portfolio, the interest rate sensitivity of Peoples' consolidated balance sheet, and the income generated by Peoples' trust and investment activities;
(11) Peoples' ability to receive dividends from its subsidiaries;
(12) Peoples' ability to maintain required capital levels and adequate sources of funding and liquidity;
(13) the impact of larger or similar sized financial institutions encountering problems, which may adversely affect the banking industry and/or Peoples' business generation and retention, funding and liquidity;
(14) the costs and effects of regulatory and legal developments, including the outcome of potential regulatory or other governmental inquiries and legal proceedings and results of regulatory examinations;
(15) Peoples' ability to secure confidential information through the use of computer systems and telecommunications networks, including those of Peoples' third-party vendors and other service providers, may prove inadequate, which could adversely affect customer confidence in Peoples and/or result in Peoples incurring a financial loss;

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(16) the overall adequacy of Peoples' risk management program; and

(17) other risk factors relating to the banking industry or Peoples as detailed from time to time in Peoples' reports filed with the SEC, including those risk factors included in the disclosure under "ITEM 1A. RISK FACTORS" of Peoples' 2013 Form 10-K.

All forward-looking statements speak only as of the filing date of this Form 10-Q and are expressly qualified in their entirety by the cautionary statements. Although management believes the expectations in these forward-looking statements are based on reasonable assumptions within the bounds of management's knowledge of Peoples' business and operations, it is possible that actual results may differ materially from these projections. Additionally, Peoples undertakes no obligation to update these forward-looking statements to reflect events or circumstances after the filing date of this Form 10-Q or to reflect the occurrence of unanticipated events except as may be required by applicable legal requirements. Copies of documents filed with the SEC are available free of charge at the SEC's website at www.sec.gov and/or from Peoples Bancorp Inc.'s website – www.peoplesbancorp.com under the "Investor Relations" section.

This discussion and analysis should be read in conjunction with the audited Consolidated Financial Statements, and notes thereto, contained in Peoples' 2013 Form 10-K, as well as the Unaudited Consolidated Financial Statements, ratios, statistics and discussions contained elsewhere in this Form 10-Q.

Business Overview

The following discussion and analysis of Peoples' Unaudited Consolidated Financial Statements is presented to provide insight into management's assessment of the financial condition and results of operations.

Peoples offers diversified financial products and services through 49 financial service locations and 47 ATMs in northeastern, central and southeastern Ohio, west central West Virginia and northeastern Kentucky through its financial service units – Peoples Bank, National Association ("Peoples Bank") and Peoples Insurance Agency, LLC ("Peoples Insurance"), a subsidiary of Peoples Bank. Peoples Bank is a member of the Federal Reserve System and subject to regulation, supervision and examination by the Office of the Comptroller of the Currency.

Peoples' products and services include traditional banking products, such as deposit accounts, lending products and trust services. Peoples provides services through traditional offices, ATMs and telephone and internet-based banking. Peoples also offers a complete array of insurance products and makes available custom-tailored fiduciary and wealth management services. Brokerage services are offered by Peoples exclusively through an unaffiliated registered broker-dealer.

Critical Accounting Policies

The accounting and reporting policies of Peoples conform to US GAAP and to general practices within the financial services industry. The preparation of the financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could materially differ from those estimates. Management has identified the accounting policies that, due to the judgments, estimates and assumptions inherent in those policies, are critical to understanding Peoples' Unaudited Consolidated Financial Statements and Management's Discussion and Analysis at March 31, 2014, which were unchanged from the policies disclosed in Peoples' 2013 Form 10-K.

Summary of Recent Transactions and Events

The following is a summary of recent transactions and events that have impacted or are expected to impact Peoples' results of operations or financial condition:

On April 21, 2014, Peoples entered into an Agreement and Plan of Merger (the "North Akron Agreement") with North Akron, which operates four full-service branches in Akron, Cuyahoga Falls, Munroe Falls and Norton, Ohio. The North Akron Agreement calls for North Akron to merge into Peoples' wholly-owned subsidiary, Peoples Bank. Under the terms of the North Akron Agreement, shareholders of North Akron will receive $7,655 per share, or approximately $20.1 million total value, with 80% of the total consideration to be paid in Peoples' shares and the remaining 20% to be paid in cash. The exchange ratio for the stock component of the transaction will be determined based on the Peoples' average closing stock price during the 20 consecutive trading days immediately preceding the closing of the transaction. The North Akron transaction is expected to be completed during the fourth quarter of 2014 and add $0.06 to $0.08 to Peoples' annual earnings per share starting in 2015. One-time acquisition costs will more

than offset the incremental earnings in 2014.
On April 4, 2014, Peoples entered into an Agreement and Plan of Merger (the "Ohio Heritage Agreement") with Ohio Heritage. The Ohio Heritage Agreement calls for Ohio Heritage to merge into Peoples, and for Ohio Heritage's

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wholly-owned subsidiary, Ohio Heritage Bank, an Ohio-chartered savings bank, which operates six full-service branches in Coshocton, Newark, Heath, Mount Vernon and New Philadelphia, Ohio, to merge into Peoples' wholly-owned subsidiary, Peoples Bank. Under the terms of the Ohio Heritage Agreement, shareholders of Ohio Heritage will have the right to receive merger consideration equal to $110.00 per share, or approximately $37.6 million total value, of which $93.50 per share is to be paid in Peoples' stock and the remaining $16.50 is to be paid in cash. The exchange ratio for the Peoples shares component of the consideration will be determined based on Peoples' volume weighted-average closing share price during the 20 consecutive trading days immediately preceding the closing of the merger. The Ohio Heritage transaction is expected to be completed during the third quarter of 2014, pending adoption of the Ohio Heritage Agreement by the shareholders of Ohio Heritage, the satisfaction of various closing conditions, including the receipt of all necessary bank regulatory approvals, the accuracy of the representations and warranties of each party (subject to certain exceptions), the performance in all material respects by each party of its obligations under the Ohio Heritage Agreement, and other conditions customary for transactions of this type. The Ohio Heritage transaction is expected to add $0.10 to $0.12 to Peoples' annual earnings per share starting in 2015. One-time acquisition costs are expected to offset incremental earnings in 2014.

On January 21, 2014, Peoples entered into an Agreement and Plan of Merger (the "Midwest Agreement") with Midwest. The Midwest Agreement calls for Midwest to merge into Peoples, and for Midwest's wholly-owned subsidiary, First National Bank of Wellston, which operates two full-service branches in Wellston and Jackson, Ohio, to merge into Peoples' wholly-owned subsidiary, Peoples Bank. Under the terms of the Midwest Agreement, shareholders of Midwest will have the right to receive merger consideration equal to $65.50 per share, or $12.6 million total value, with between 50% and 75% of the total consideration to be paid in Peoples' shares and the remainder to be paid in cash, with the actual mix to be based on the elections of the shareholders of Midwest and subject to proration. The exchange ratio for the stock component of the transaction will be determined based on the Peoples' average closing stock price during the 20 consecutive trading days immediately preceding the closing of the transaction. The Midwest transaction is expected to be completed during the second quarter of 2014.

At the close of business on October 11, 2013, Peoples Bank completed the acquisition of Ohio Commerce Bank ("Ohio Commerce") and its single full-service office in Beachwood, Ohio. Under the terms of the agreement, Peoples Bank paid $13.75 in cash for each share of Ohio Commerce stock for a total cash consideration of $16.5 million. The acquisition added $96.6 million of loans and $110.9 million of deposits.

Peoples periodically has taken actions to reduce interest rate exposure within the investment portfolio and the entire balance sheet, which have included the sale of low yielding investment securities and repayment of high-cost borrowings. These actions included the sale of $68.8 million of investment securities, primarily low or volatile yielding residential mortgage-backed securities, during the first quarter of 2013. Some of the proceeds from these investment sales were reinvested in securities during the first quarter with the remaining reinvested early in the second quarter of 2013. During the first quarter of 2014, Peoples used the cash flow generated from the investment portfolio to fund loan growth.

Since the second quarter of 2011, Peoples has experienced generally improving trends in several asset quality metrics, after a three-year trend of higher credit losses and nonperforming assets than Peoples' long-term historical levels. Additionally, the amount of criticized loans has decreased due in part to Peoples upgrading the loan quality ratings of various commercial loans. These conditions have resulted in recoveries of or lower provisions for loan losses.

Peoples' net interest income and margin are impacted by changes in market interest rates based upon actions taken by the Federal Reserve Board either directly or through its Open Market Committee. These actions include changing its target Federal Funds Rate (the interest rate at which banks lend money to each other), Discount Rate (the interest rate charged to banks for money borrowed from the Federal Reserve Bank) and longer-term market interest rates (primarily U.S. Treasury securities). Longer-term market interest rates also are affected by the demand for U.S. Treasury securities. The resulting changes in the yield curve slope have a direct impact on reinvestment rates for Peoples' earning assets.

The Federal Reserve Board has maintained its target Federal Funds Rate at a historically low level of 0% to 0.25% since December 2008 and has maintained the Discount Rate at 0.75% since December 2010. The Federal Reserve Board has indicated the possibility these short-term rates could start to be raised as early as 2015.

From late 2008 until year-end 2012, the Federal Reserve Board took various actions to lower longer-term market interest rates as a means of stimulating the economy – a policy commonly referred to as "quantitative easing". These actions included the buying and selling of mortgage-backed and other debt securities through its open market

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operations. In December 2013, the Federal Reserve Board announced plans to taper its quantitative easing efforts. As a result, the slope of the U.S. Treasury yield curve has fluctuated significantly. Substantial flattening occurred in late 2008, in mid-2010 and early third quarter of 2011 through 2012, while moderate steepening occurred in the second half of 2009, late 2010 and mid-2013. The curve has remained relatively steep since mid-2013, primarily as a reaction to the Federal Reserve's announcement of a reduction in monthly asset purchases and generally improving economic conditions.

The impact of these transactions and events, where material, is discussed in the applicable sections of this Management's Discussion and Analysis.

EXECUTIVE SUMMARY

Net income for the quarter ended March 31, 2014 was $4.8 million, or $0.44 per diluted share, compared to $5.0 million and $0.47 per diluted share a year ago and $5.1 million or $0.47 per diluted share in the fourth quarter of 2013. The lower earnings in the first quarter of 2014 reflect Peoples recording a nominal provision for loan losses in the first quarter of 2014 while recording $1.1 million and $1.0 million of recoveries of loan losses a year ago and in the linked quarter, respectively.

Peoples' provision for loan losses for the three months ended March 31, 2014 was $8,000, compared to recoveries of loan losses of $1.1 million and $1.0 million during the three months ended March 31, 2013 and December 31, 2013, respectively. Asset quality metrics remained favorable during the first quarter of 2014. However, the recoveries experienced in the first quarter of 2014 were lower than the previous year, and resulted in a minimal net charge-off position.

Net interest income was $15.5 million in the first quarter of 2014, compared to $13.0 million for the first quarter of 2013, while net interest margin was 3.35% and 3.10%, respectively. The improvement over the prior year was driven by a 10% increase in earning assets due to higher loan balances, and normal accretion of $231,000 from the recent acquisition of Ohio Commerce. Compared to the linked quarter, net interest margin declined 8 basis points and was the result of recognition by Peoples of $427,000 of income in the fourth quarter of 2013 for prepayment fees and interest recovered on nonaccrual loans.

Non-interest income, which excludes gains and losses on investment securities, asset disposals and other transactions, for the first quarter of 2014 was up 10% from the linked quarter and 13% over the prior year. This increase was primarily from increased insurance income due to higher annual contingent performance-based commissions typically recognized in the first quarter. In addition, insurance business acquisitions completed during 2013 provided another $387,000 of income during the first quarter of 2014. Peoples also experienced 8% year-over-year growth in both investment and electronic banking income, while mortgage banking income declined significantly as secondary market loan origination volumes have declined in response to the higher long-term interest rates.

Total non-interest expense was $18.8 million for the quarter ended March 31, 2014, 2% higher than the linked quarter and 16% higher than the prior year. In the first quarter of 2014, Peoples recognized $486,000 of pension settlement charges, acquisition-related expenses for legal and professional services of $150,000, increased employee benefit costs and stock-based compensation expense totaling $1.2 million. In comparison, during the first quarter of 2013, acquisition-related expenses totaled $65,000 and Peoples did not incur any pension settlement charges. Compared to the linked quarter, salary and employee benefit costs increased 14% due largely to annual merit increases and a difference in the timing of certain benefit costs, such as pension and employee medical plan expenses.

At March 31, 2014, total assets were $2.08 billion, up $19.1 million from year-end 2013. The largest increase was due to higher loan balances, which grew $30.3 million from year-end 2013 primarily from organic loan growth within commercial and consumer lending. The allowance for loan losses was $16.9 million, or 1.38% of loans (net of deferred fees and costs), compared to $17.1 million and 1.43% of loans (net of deferred fees and costs) at December 31, 2013.

Total liabilities were $1.85 billion at March 31, 2014, up $10.1 million since year-end 2013. Retail deposit balances grew 4% since year-end, primarily due to seasonal increases in governmental deposits and a 2% increase in non-interest-bearing deposits. The growth in deposits allowed Peoples to reduce its total borrowed funds 20% from the year-end level.

At March 31, 2014, total stockholders' equity was $230.6 million, up $9.0 million since December 31, 2013. The primary driver was an increase in the fair value of the available-for-sale investment portfolio, coupled with earnings exceeding dividends declared for the quarter. Regulatory capital ratios remained significantly higher than "well capitalized" minimums. Peoples' Tier 1 Common Capital ratio remained stable at 12.56% at March 31, 2014, versus 12.42% at December 31, 2013, while the Total Risk-Based Capital ratio was 13.92% versus 13.78% at December 31, 2013. In addition, Peoples' tangible equity to tangible asset ratio was 7.66% and tangible book value per share was $14.38 at March 31, 2014, versus 7.26% and $13.57 at December 31, 2013, respectively.

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RESULTS OF OPERATIONS

Net Interest Income

Net interest income, the amount by which interest income exceeds interest expense, remains Peoples' largest source of revenue. The amount of net interest income earned by Peoples each quarter is affected by various factors, including changes in market interest rates due to the Federal Reserve Board's monetary policy, the level and degree of pricing competition for both loans and deposits in Peoples' markets, and the amount and composition of Peoples' earning assets and interest-bearing liabilities.

The following tables detail Peoples' average balance sheets for the periods presented:

	For the Three Months Ended								
	March 31, 2014			December 31, 2013			March 31, 2013		
(Dollars in thousands)	Average Balance	Income/ Expense	Yield/Cost	Average Balance	Income/ Expense	Yield/Cost	Average Balance	Income/ Expense	Yield/Cost
Short-term investments	$7,058	$20	1.15 %	$8,652	$30	1.38 %	$39,099	$18	0.20 %
Other long-term investments	2,254	3	0.54 %	2,948	2	0.27 %	—	—	— %
Investment Securities (1):									
Taxable	623,444	4,383	2.81 %	639,584	4,400	2.75 %	657,319	4,262	2.59 %
Nontaxable (2)	51,867	641	4.94 %	51,781	640	4.94 %	48,213	583	4.84 %
Total investment securities	675,311	5,024	2.98 %	691,365	5,040	2.92 %	705,532	4,845	2.75 %
Loans (3):									
Commercial real estate, construction	51,839	498	3.84 %	48,485	542	4.37 %	30,574	337	4.41 %
Commercial real estate, other	454,107	5,114	4.50 %	422,866	5,396	4.99 %	379,391	4,367	4.60 %
Commercial and industrial	236,741	2,570	4.34 %	213,953	2,431	4.45 %	179,435	1,793	4.00 %
Residential real estate	270,739	3,069	4.53 %	268,641	3,112	4.63 %	238,332	3,062	5.14 %
Home equity lines of credit	60,029	545	3.63 %	59,099	536	3.63 %	50,232	501	3.99 %
Consumer	141,209	1,614	4.73 %	134,241	1,602	4.83 %	107,092	1,435	5.58 %
Total loans	1,214,664	13,410	4.43 %	1,147,285	13,619	4.69 %	985,056	11,495	4.69 %
Less: Allowance for loan losses	(17,228)			(17,439)			(18,783)		
Net loans	1,197,436	13,410	4.49 %	1,129,846	13,619	4.75 %	966,273	11,495	4.81 %
Total earning assets	1,882,059	18,457	3.93 %	1,832,811	18,691	4.04 %	1,710,904	16,358	3.83 %
Intangible assets	77,448			77,025			69,988		
Other assets	91,095			102,016			133,827		
Total assets	$2,050,602			$2,011,852			$1,914,719		
Deposits:									
Savings accounts	$220,935	$30	0.06 %	$211,116	$29	0.05 %	$190,769	$25	0.05 %
Governmental deposit accounts	149,057	123	0.33 %	141,181	131	0.37 %	145,714	202	0.56 %
Interest-bearing demand accounts	137,026	28	0.08 %	128,877	26	0.08 %	126,763	25	0.08 %
Money market accounts	278,413	111	0.16 %	256,398	104	0.16 %	288,161	96	0.14 %
Brokered deposits	47,335	436	3.74 %	49,320	462	3.72 %	54,134	476	3.57 %
Retail certificates of deposit	360,457	840	0.95 %	360,733	890	0.98 %	381,650	1,115	1.18 %
Total interest-bearing deposits	1,193,223	1,568	0.53 %	1,147,625	1,642	0.57 %	1,187,191	1,939	0.66 %
Borrowed Funds:									
Short-term FHLB advances	63,733	16	0.10 %	75,538	31	0.16 %	2,000	1	0.20 %
Retail repurchase agreements	39,141	15	0.15 %	44,597	18	0.16 %	31,975	12	0.15 %

Total short-term borrowings	102,874	31	0.12	%	120,135	49	0.16	%	33,975	13	0.15	%
Long-term FHLB advances	62,380	521	3.39	%	63,382	539	3.37	%	64,538	541	3.40	%
Wholesale repurchase agreements	40,000	363	3.63	%	40,000	371	3.71	%	40,000	363	3.63	%
Other borrowings	19,137	188	3.93	%	20,331	205	3.95	%	23,883	235	3.94	%
Total long-term borrowings	121,517	1,072	3.55	%	123,713	1,115	3.58	%	128,421	1,139	3.57	%
Total borrowed funds	224,391	1,103	1.98	%	243,848	1,164	1.89	%	162,396	1,152	2.86	%
Total interest-bearing liabilities	1,417,614	2,671	0.76	%	1,391,473	2,806	0.80	%	1,349,587	3,091	0.93	%
Non-interest-bearing deposits	385,471				370,962				319,994			
Other liabilities	20,876				26,108				23,381			
Total liabilities	1,823,961				1,788,543				1,692,962			
Total stockholders' equity	226,641				223,309				221,757			
Total liabilities and stockholders' equity	$2,050,602				$2,011,852				$1,914,719			
Interest rate spread		$15,786	3.17	%		$15,885	3.24	%		$13,267	2.90	%
Net interest margin			3.35	%			3.43	%			3.10	%

(1) Average balances are based on carrying value.

(2) Interest income and yields are presented on a fully tax-equivalent basis using a 35% federal statutory tax rate.

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(3) Average balances include nonaccrual and impaired loans. Interest income includes interest earned on nonaccrual loans prior to the loans being placed on nonaccrual status. Loan fees included in interest income were immaterial for all periods presented.

(4) Loans held for sale are included in the average loan balance listed. Related interest income on loans originated for sale prior to the loan being sold is included in loan interest income.

Net interest margin, which is calculated by dividing fully tax-equivalent ("FTE") net interest income by average interest-earning assets, serves as an important measurement of the net revenue stream generated by the volume, mix and pricing of earning assets and interest-bearing liabilities. FTE net interest income is calculated by increasing interest income to convert tax-exempt income earned on obligations of states and political subdivisions to the pre-tax equivalent of taxable income using a 35% federal statutory tax rate. The following table details the calculation of FTE net interest income:

	Three Months Ended		
	March 31,	December 31,	March 31,
(Dollars in thousands)	2014	2013	2013
Net interest income, as reported	$15,480	$13,155	$12,975
Taxable equivalent adjustments	306	2,730	292
Fully tax-equivalent net interest income	$15,786	$15,885	$13,267

The following table provides an analysis of the changes in FTE net interest income:

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	Three Months Ended March 31, 2014 Compared to					
(Dollars in thousands)	December 31, 2013			March 31, 2013		
Increase (decrease) in:	Rate	Volume	Total [1]	Rate	Volume	Total [1]
INTEREST INCOME:						
Short-term investments	$(5)	$(5)	$(10)	$110	$(108)	$2
Other long-term investments	$4					