Hamilton Bancorp, Inc.
Form 10-K/A
July 01, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

AMENDMENT NO. 1

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

For the fiscal year ended March 31, 2014

OR

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

For the transition period from __________ to __________

Commission File Number: 0-35693

HAMILTON BANCORP, INC.

(Exact name of registrant as specified in its charter)

MARYLAND **(State or other jurisdiction of** **incorporation or organization)**	**46-0543309** **(I.R.S. Employer** **Identification No.)**
501 Fairmount Avenue, Suite 200, Towson, Maryland **(Address of principal executive offices)**	**21286** **(Zip Code)**

(410) 823-4510

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	**Name of each exchange on which registered**
Common Stock, par value $0.01 per share	**Nasdaq Capital Market**

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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 x No ¨

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

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

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

The aggregate market value of the voting and non-voting common equity held by nonaffiliates as of September 30, 2013 was $53,025,920.

The number of shares outstanding of the registrant s common stock as of June 27, 2014 was 3,415,345.

DOCUMENTS INCORPORATED BY REFERENCE: None.

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EXPLANATORY NOTE

This Amendment No. 1 to the Form 10-K of Hamilton Bancorp, Inc. is being filed solely to correct the aggregate market value of the voting and non-voting common equity held by nonaffiliates as of September 30, 2013, as listed on the cover page, and to correct the name of Rowles & Company, LLP and the date of their opinion in Exhibit 23.0.

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This report contains certain forward-looking statements within the meaning of the federal securities laws. These statements are not historical facts; rather, they are statements based on Hamilton Bancorp, Inc. s current expectations regarding its business strategies, intended results and future performance. Forward-looking statements are preceded by terms such as expects, believes, anticipates, intends and similar expressions.

Management s ability to predict results or the effect of future plans or strategies is inherently uncertain. Factors which could affect actual results include changes in interest rates, national and regional economic conditions, legislative and regulatory changes, monetary and fiscal policies of the U.S. government, including policies of the U.S. Treasury and the Federal Reserve Board, the credit quality and composition of the loan and investment portfolios, valuation of assets acquired through foreclosure, deposit flows, competition, demand for loan products and for financial services in Hamilton Bancorp, Inc. s market area, changes in real estate market values in Hamilton Bancorp, Inc. s market area, changes in relevant accounting principles and guidelines and the inability of third party service providers to perform as required. For further discussion of factors that may affect the results, see Item 1A. Risk Factors in this Annual Report on Form 10-K (Annual Report). These factors should be considered in evaluating the forward-looking statements and undue reliance should not be placed on such statements. Except as required by law, we disclaim any intention or obligation to update or revise any forward-looking statements after the date of this Annual Report, whether as a result of new information, future events or otherwise.

In this Annual Report , the terms we, our, and us refer to Hamilton Bancorp, Inc. and Hamilton Bank, unless the context indicates another meaning. In addition, we sometimes refer to Hamilton Bancorp, Inc. as Hamilton Bancorp, and to Hamilton Bank as the Bank.

PART I

Item 1. BUSINESS

General

Hamilton Bancorp, Inc. is a Maryland chartered corporation established in June 2012 to become the holding company for Hamilton Bank in connection with the Bank s mutual-to-stock conversion. On October 11, 2012 the mutual-to-stock conversion was completed and the Bank became the wholly owned subsidiary of the Company. On that date the Company sold and issued 3,703,000 shares of its common stock at a price of $10.00 per share and received net offering proceeds of approximately $35.6 million. Hamilton Bancorp s principal business activity is the ownership of the Bank s capital stock and the management of the offering proceeds it retained in connection with the Bank s conversion. Hamilton Bancorp does not own or lease any property but instead uses the premises, equipment and other property of the Bank with the payment of appropriate rental fees, as required by applicable law and regulations, under the terms of an expense allocation agreement. In the future, Hamilton Bancorp may acquire or organize other operating subsidiaries; however, there are no current plans, arrangements, agreements or understandings, written or oral, to do so.

Hamilton Bank is a federally chartered savings bank that has served the banking needs of its customers since 1915. Hamilton Bank is headquartered in Towson, which is located in Baltimore County, Maryland. The Bank conducts business primarily from its four full-service banking offices located in Baltimore City, Maryland and the Maryland counties of Baltimore and Anne Arundel. Our business consists primarily of taking deposits from the general public and investing those deposits, together with funds generated from operations, in one- to four-family residential mortgage loans (including owner-occupied and investor loans), commercial real estate loans, commercial business loans, home equity loans and lines of credit, construction loans and, to a limited extent, consumer loans (consisting

primarily of loans secured by deposits and automobile loans). At March 31, 2014, $72.1 million, or 49.8%, of our total loan portfolio was comprised of permanent residential mortgage loans.

We also invest in securities, which consist primarily of U.S. government agency and municipal bond obligations, mortgage-backed securities and collateralized mortgage obligations issued or guaranteed by U.S. government-sponsored enterprises, and to a much lesser extent, equity securities of government-sponsored enterprises.

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We offer a variety of deposit accounts, including certificate of deposit accounts, money market accounts, savings accounts, NOW accounts and individual retirement accounts. We historically have not used borrowings to fund our operations. We are dedicated to offering alternative banking delivery systems, including ATMs, online banking and remote deposit capture.

Available Information

The Bank s website address is www.hamilton-bank.com. Information on the Bank s website should not be considered a part of this Annual Report.

Market Area

We conduct our operations from our four full-service banking offices in Maryland. Our primary deposit market includes the areas surrounding our banking offices in Cockeysville, Pasadena, Towson, and the Hamilton area of Baltimore City. In August 2013, we closed our branch office in the Overlea area of Baltimore City due to its close proximity to one of our four remaining branch locations. Our primary lending market includes Baltimore City and the Maryland counties of Anne Arundel and Baltimore. However, we occasionally make loans secured by property located outside of our primary lending market, especially to borrowers with whom we have an existing relationship or who have a significant presence within our primary market. Our primary lending market contains a diverse cross section of employment sectors, with a mix of services, manufacturing, wholesale/retail trade, federal and local government, health care facilities and finance related employment. The city of Baltimore is now considered a major center for the financial services and health services industries.

In recent years Baltimore City and Baltimore County have experienced relatively slow growth, while Anne Arundel County has grown at a faster pace. The stronger population growth experienced in Anne Arundel County has been reflected in higher household income and lower unemployment. Median household income during 2012 for Baltimore City, Baltimore County and Anne Arundel County was approximately $39,000, $62,000 and $89,000, respectively, compared to $71,000 and $51,000 for Maryland and the United States, respectively. Baltimore City, Baltimore County and Anne Arundel County reported preliminary unemployment rates of 8.3%, 5.8% and 4.9%, respectively, for December 2013, compared to the statewide and national unemployment rates of 6.1% and 6.7%, respectively.

Competition

We face significant competition within our market both in making loans and attracting deposits. Our market area has a high concentration of financial institutions including large money center and regional banks, community banks and credit unions. Some of our competitors offer products and services that we currently do not offer, such as trust services and private banking. Our competition for loans and deposits comes principally from commercial banks, savings institutions, mortgage banking firms, consumer finance companies and credit unions. We face additional competition for deposits from short-term money market funds, brokerage firms, mutual funds and insurance companies. Our primary focus is to build and develop profitable customer relationships across all lines of business while maintaining our position as a community bank.

As of June 30, 2013 (the latest date for which information is available), our market share was 0.41% of total deposits in Baltimore City, making us the 12th largest out of 35 financial institutions in Baltimore City based upon deposit share as of that date. In addition, as of June 30, 2013, our deposit market share was 0.71% and 0.47% of total deposits in Baltimore County and Anne Arundel County, respectively, making us the 21st largest out of 41 financial institutions in Baltimore County and the 18th largest out of 30 financial institutions in Anne Arundel County. The market share data provided above does not reflect the closing of our branch office in the Overlea area of Baltimore

City in August 2013.

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Lending Activities

General. Historically, our principal lending activity was the origination, for retention in our portfolio, of mortgage loans collateralized by one- to four-family residential real estate located within our primary market area. However, in 2009 we changed our business strategy to become less reliant upon one- to four-family lending and to emphasize commercial business and commercial real estate lending. In connection with this strategy, we have hired three commercial real estate and commercial business loan officers with strong experience in these lending areas. In addition, several new back office commercial loan personnel have been hired in the past six months to assist with the record keeping, underwriting, and monitoring of our commercial loan portfolio. Previously the Bank utilized the services of third parties to conduct the underwriting analysis of such loans based on our underwriting policies. However, in the past year we have begun to transition the commercial loan underwriting analysis in-house. In the past we have purchased commercial business and commercial real estate loans and participated in commercial and commercial real estate loans originated by other institutions. We currently sell almost all of our one- to four-family mortgage loans with terms over 10 years into the secondary market. In addition to commercial business loans, commercial real estate loans and residential mortgage loans, we also make home equity loans and lines of credit, residential and commercial construction loans, and, to a much lesser extent, consumer loans. A portion of the loans that we make for one- to four-family properties are made to investors who reside in our community.

Loan Portfolio Composition. Set forth below is selected information concerning the composition of our loan portfolio in dollar amounts and in percentages as of the dates indicated. Amounts shown do not include loans held for sale equal to $-0-, $197,000, $-0-, $-0- and $331,000 at March 31, 2014, 2013, 2012, 2011 and 2010, respectively.

	At March 31,					
	2014		2013		2012	
	Amount	Percent	Amount	Percent	Amount	Percent
	(Dollars in thousands)					
Real estate loans:						
Residential mortgage loans:						
One- to four-family residential	$ 57,674	39.8%	$ 63,912	39.6%	$ 76,687	44.2%
One- to four-family investor	14,000	9.7	15,826	9.8	17,265	9.9
Construction	3,268	2.3	3,508	2.2	3,865	2.2
Commercial real estate	41,406	28.6	36,239	22.5	31,018	17.9
Total real estate loans	116,348	80.4	119,485	74.1	128,835	74.2
Commercial business loans	15,657	10.8	26,937	16.7	27,158	15.7
Consumer:						
Home equity loans and lines of credit	11,660	8.0	13,727	8.5	16,344	9.4
Other consumer	1,154	0.8	1,123	0.7	1,181	0.7
Total consumer loans	12,815	8.8	14,850	9.2	17,525	10.1
Total loans receivable	144,819	100.0%	161,272	100.0%	173,518	100.0%
Premium on purchased loans			15		38	
	(119)		(96)		(100)	

Net deferred loan origination fees and costs			
Allowance for loan losses	(1,786)	(2,071)	(3,552)
Total loans receivable, net	$ 142,914	$ 159,120	$ 169,904

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	At March 31,			
	2011		2010	
	Amount	Percent	Amount	Percent
	(Dollars in thousands)			
Real estate loans:				
Residential mortgage loans:				
One- to four-family residential	$ 92,144	51.5%	$ 117,607	65.0%
One- to four-family investor	19,568	10.9	19,949	11.0
Construction	6,514	3.6	2,837	1.6
Commercial real estate	21,034	11.7	11,421	6.3
Total real estate loans	139,260	77.7	151,814	83.9
Commercial business loans	19,425	10.8	8,574	4.7
Consumer:				
Home equity loans and lines of credit	19,224	10.8	19,224	10.7
Other consumer	1,310	0.7	1,353	0.7
Total consumer loans	20,534	11.5	20,577	11.4
Total loans receivable	179,219	100.0%	180,965	100.0%
Premium on purchased loans	61		84	
Net deferred loan origination fees and costs	(206)		(261)	
Allowance for loan losses	(1,183)		(567)	
Total loans receivable, net	$ 177,891		$ 180,221	

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Loan Portfolio Maturities and Yields. The following table summarizes the scheduled repayments of our loan portfolio at March 31, 2014. Demand loans, loans having no stated repayment schedule or maturity, and overdraft loans are reported as being due in one year or less.

	One- to Four-Family Residential Real Estate		One- to Four-Family Investor Real Estate		Construction Real Estate		Commercial Real Estate	
	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate
	(Dollars in thousands)							
Due During the Years Ending March 31,								
2015	$ 41	4.19%	$ 188	6.26%	$ 3,268	6.31%	$ 1,709	3.25%
2016	1,188	5.01	56	5.46			6,374	7.12
2017	1,032	5.51	7,266	7.02			4,840	5.58
2018 to 2019	3,061	4.77	1,072	6.38			12,901	5.23
2020 to 2024	10,745	4.11	4,824	6.36			15,097	5.11
2025 to 2029	4,525	4.54	140	5.00				
2030 and beyond	37,082	4.93	454	6.26			485	5.15
Total	$ 57,674	4.75%	$ 14,000	6.68%	$ 3,268	6.31%	$ 41,406	5.44%

	Commercial Business		Home Equity Loans and Lines of Credit		Other Consumer		Total	
	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate
	(Dollars in thousands)							
Due During the Years Ending March 31,								
2015	$ 9,215	4.67%	$ 28	5.37%	$ 65	2.60%	$ 14,514	4.88%
2016	429	5.13	434	5.17	5	6.50	8,486	6.61
2017	127	6.00	263	3.90			13,528	6.32
2018 to 2019	3,102	6.62	295	4.19	14	4.50	20,445	5.42
2020 to 2024	2,585	4.17	1,593	5.54			34,844	4.92
2025 to 2029			4,294	3.91			8,959	4.25
2030 and beyond	199	6.50	4,753	4.13	1,070	3.34	44,043	4.83
Total	$ 15,657	5.02%	$ 11,660	4.28%	$ 1,154	3.33%	$ 144,819	5.15%

Fixed and Adjustable-Rate Loan Schedule. The following table sets forth at March 31, 2014, the dollar amount of all fixed-rate and adjustable-rate loans due after March 31, 2015.

	Due after March 31, 2015		
	Fixed	**Adjustable**	**Total**
		(In thousands)	
Real estate loans:			
One- to four-family residential	$ 57,132	$ 501	$ 57,633
One- to four-family investor	13,733	79	13,812
Construction			
Commercial	39,697		39,697
Commercial business loans	5,571	871	6,442
Consumer loans:			
Home equity loans and lines of credit	6,154	5,478	11,632
Other consumer	1,089		1,089
Total loans	$ 123,376	$ 6,929	$ 130,305

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Residential Mortgage Loans. Hamilton Bank originates mortgage loans secured by owner occupied one- to four-family residential properties. To a lesser extent, we have also made loans to investors for the purchase of one- to four-family residential properties that are not owner-occupied. As of March 31, 2014, we had a total of $72.1 million of residential mortgage loans secured by one- to four-family properties, of which $58.1 million, or 80.6%, were secured by properties serving as the primary residence of the owner. The remaining $14.0 million, or 19.4%, of such loans were secured by non owner-occupied properties. Almost all of our residential mortgage loans are secured by properties in the Greater Baltimore area.

Historically, the terms of our one- to four-family mortgage loans retained in our portfolio ranged from 10 to 30 years. In order to lower our interest rate risk, beginning in 2009 we have sold to the secondary market almost all one- to four-family loans that we originate with terms exceeding 10 years. During fiscal 2014 and 2013, we sold $2.4 million and $3.6 million of one- to four-family mortgage loans that we originated, respectively. Our residential mortgage portfolio is almost entirely comprised of fixed-rate loans, with 99.2% of residential mortgage loans due after March 31, 2015 having fixed rates at March 31, 2014. During the year ended March 31, 2014, we originated no residential mortgage loans with adjustable-rates.

We generally do not make new one- to four-family mortgage loans on owner-occupied properties with loan-to-value ratios exceeding 95% at the time the loan is originated, and all loans with loan-to-value ratios in excess of 80% require private mortgage insurance. Loan to value ratios on refinances may not exceed 80%, and loan-to-value ratios for non-owner occupied properties may not exceed 65%. In addition, borrower debt may generally not exceed 36% of the borrower s monthly cash flow. With respect to borrower debt on loans secured by non-owner occupied properties, we look to the investor s aggregate debt and cash flows from all investment properties the investor operates. We require all properties securing residential mortgage loans to be appraised by a board-approved independent appraiser.

Loans secured by non-owner occupied properties typically have 7 year terms and amortize over a 30 year period. Because of the increased risk associated with non-owner occupied properties, interest rates on such loans are higher than for owner-occupied properties, and are currently at 8.0%. We have generally only originated loans secured by non-owner occupied properties to investors that reside in our market area.

In an effort to provide financing for first-time home buyers, we offer 30-year fixed-rate one- to four-family mortgage loans with loan-to-value ratios up to 95%, which cannot be readily sold to the secondary market and are held in portfolio. In fiscal 2014 and 2013, we did not originate any such loans which we did not sell.

We also make jumbo loans (loans above $417,000, the current maximum conforming loan amount as established by the Federal Housing Finance Agency) that we typically sell into the secondary market. Jumbo loans that we originate and sell, typically have 30 year terms and maximum loan-to-value ratios of 80%. At March 31, 2014, our largest outstanding jumbo residential mortgage loan was for $1.6 million and was performing in accordance with its original terms.

Beginning in 2009, applications for loans that we intend to sell are processed through Mortgage Department Services, LLC (MDS), a company in which we have a minority interest. Prior to delivering applications to MDS, we review each application to ensure that the loan meets MDS standards for sale to the secondary market. However, we have outsourced the loan processing and loan underwriting to MDS as a cost savings measure. See Loan Originations, Participations, Purchases and Sales. We receive an origination fee for each loan processed and sold to the secondary market through MDS. All such loans are sold with servicing released and without recourse to Hamilton Bank other than for breaches of customary representations and warranties to the buyers.

All residential mortgage loans that we originate include due-on-sale clauses, which give us the right to declare a loan immediately due and payable in the event that, among other things, the borrower sells or otherwise disposes of the real property subject to the mortgage and the loan is not repaid. All borrowers are required to obtain title insurance for the benefit of Hamilton Bank. We also require homeowner s insurance and fire and casualty insurance and, where circumstances warrant, flood insurance on properties securing real estate loans.

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Commercial Real Estate Loans. We originate commercial real estate loans in the Greater Baltimore area that are secured by properties used for business purposes such as small office buildings or retail facilities. We have increased our origination of commercial real estate loans over the last several years, and intend to continue to grow this portion of our loan portfolio in the future. At March 31, 2014, commercial real estate loans totaled $41.4 million, which amounted to 28.6% of total loans, compared to approximately $11.4 million, or 6.3% of total loans, at March 31, 2010.

Our commercial real estate loans are underwritten based on our loan underwriting polices. Our policies provide that such loans may be made in amounts of up to 80% of the appraised value of the property, provided that the property is more than 50% owner-occupied, or 75% of the appraised value of the property if it is not owner-occupied. Our commercial real estate loans have terms of up to 5 years and amortize for a period of up to 20 years. Interest rates may be fixed or adjustable. If adjustable, then they are generally based on the Prime rate of interest.

The regulatory loan-to-one borrower limit is 15% of a bank s unimpaired capital plus unimpaired surplus. As a result of the additional capital received in the stock offering, Hamilton Bank s loans-to-one borrower limit is approximately $6.9 million. We have adopted an internal limit of $4.8 million. We generally target commercial real estate loans with balances of $250,000 to $3.0 million. At March 31, 2014, our commercial real estate loans had an average balance of $920,000. At that same date, our largest commercial real estate relationship included several loans totaling $5.0 million. These loans were secured by several restaurants, and were performing in accordance with their original terms at March 31, 2014.

Commercial real estate lending involves additional risks compared to one- to four-family residential lending because payments on loans secured by commercial real estate properties are often dependent on the successful operation or management of the properties, and/or the collateral value of the commercial real estate securing the loan. Repayment of such loans may be subject, to a greater extent than residential loans, to adverse conditions in the real estate market or the economy. Also, commercial real estate loans typically involve large loan balances to single borrowers or groups of related borrowers. Commercial real estate loans generally have a higher rate of interest and shorter term than residential mortgage loans because of increased risks associated with commercial real estate lending. We seek to minimize these risks through our underwriting standards. Recently we have experienced a decrease in delinquencies and non-performing loans in our commercial real estate loan portfolio. See Risk Factors Our entry into commercial real estate and commercial business lending has resulted in higher losses on our loans.

Commercial Business Loans. We originate commercial business loans and lines of credit secured by non-real estate business assets. These loans are generally originated to small businesses in our primary market area. Our commercial business loans are generally used for working capital purposes or for acquiring equipment, inventory or furniture, and are primarily secured by business assets other than real estate, such as business equipment, inventory and accounts receivable. We have increased our origination of commercial business loans over the last few years, and intend to continue to grow this portfolio at a moderate pace. At March 31, 2014, commercial business loans and lines of credit outstanding totaled $15.7 million, which amounted to 10.8% of total loans, compared to approximately $8.6 million, or 4.7% of total loans, at March 31, 2010. At March 31, 2014, we also had $2.6 million of unfunded commitments on such loans.

Our commercial business loans have terms up to 5 years at both fixed and adjustable rates of interest, although, adjustable rates of interest are preferred and obtained when possible. Our commercial business loans are underwritten based on our commercial business loan underwriting policies. The lending officers prepare a report on each loan application and present it to the board of directors or the appropriate loan committee. Our lending policies require that commercial business loans secured by accounts receivable do not exceed 75% of the value of the outstanding receivables less than 90 days past due. Commercial business advances secured by inventory are not to exceed 40% of

the inventory book value and those secured by equipment are not to exceed 90% of the equipment s carrying cost. We typically avoid making commercial business loans to purchase highly specialized, custom made equipment which may be difficult to dispose of in the event of default. When making commercial business loans, we consider the financial statements, lending history and debt service capabilities of the borrower (generally requiring a minimum debt service coverage ratio of 1.25:1.00), the projected cash flows of the business, and the value of the collateral, if any. Almost all commercial business loans are guaranteed by the principals of the borrower.

Hamilton Bank is also qualified to make Small Business Administration (SBA) loans. The SBA program is an economic development program which finances the expansion of small businesses. Under the SBA program, we originate and fund loans under the SBA 7(a) Loan Program which qualify for guarantees up to 90% of principal and accrued interest. We also originate loans under the SBA s CDC/504 Loan Program in which we generally provide 50% of the financing, taking a first lien on the real property as collateral. We do not treat the SBA guarantee as a substitute for a borrower meeting our credit standards, and, except for minimum capital levels or maximum loan terms, the borrower must meet our other credit standards as applicable to loans outside the SBA process. During fiscal 2014, we originated $75,000 of loans under SBA programs, compared to $1.1 million and $4.3 million of such loans originated in fiscal 2013 and 2012, respectively

We focus on the origination of commercial business loans in amounts between $500,000 and $1.5 million. At March 31, 2014, our commercial business loans had an average balance of $326,000. At that same date, our largest commercial business loan was a $3.1 million term loan secured by the business assets of the company. This loan was performing in accordance with its original terms at March 31, 2014.

Commercial business loans generally have a greater credit risk than one- to four-family residential mortgage loans. Unlike residential mortgage loans, which generally are made on the basis of the borrower s ability to make repayment from his or her employment and other income, and which are secured by real property whose value tends to be more easily ascertainable, commercial business loans are of higher risk and typically are made on the basis of the borrower s ability to make repayment from the cash flow of the borrower s business. As a result, the availability of funds for the repayment of commercial business loans may be substantially dependent on the success of the business itself. Further, the collateral securing the loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business. We seek to minimize these risks through our underwriting standards. However, we have recently experienced increased delinquencies and non-performing loans in our commercial business loan portfolio. See Risk Factors Our entry into commercial real estate and commercial business lending has resulted in higher losses on our loans.

Home Equity Loans and Lines of Credit. In addition to traditional one- to four-family residential mortgage loans, we offer home equity loans and lines of credit that are secured by the borrower s primary or secondary residence. At March 31, 2014, we had $11.7 million, or 8.0% of our total loan portfolio, in home equity loans and lines of credit. At that date we also had $17.5 million of undisbursed funds related to home equity lines of credit.

Home equity loans and lines of credit are generally underwritten using the same criteria that we use to underwrite one- to four-family residential mortgage loans. Home equity loans and lines of credit may be underwritten with a loan-to-value ratio of up to 80% when combined with the principal balance of the existing first mortgage loan. Our home equity loans are primarily originated with fixed rates of interest with terms of up to 20 years. Our home equity lines of credit are originated with adjustable-rates based on the prime rate of interest minus an applicable margin and require interest paid monthly. Our adjustable-rate lines of credit have floors of 4% and ceilings of 18%. Home equity loans and lines of credit are available in amounts of between $10,000 and $250,000.

Home equity loans and lines of credit secured by second mortgages have greater risk than one- to four-family residential mortgage loans secured by first mortgages. We face the risk that the collateral will be insufficient to compensate us for loan losses and costs of foreclosure. When customers default on their loans, we attempt to foreclose on the property and resell the property as soon as possible to minimize foreclosure and carrying costs. However, the value of the collateral may not be sufficient to compensate us for the amount of the unpaid loan and we may be unsuccessful in recovering the remaining balance from those customers. Particularly with respect to our home equity loans and lines of credit, decreases in real estate values could adversely affect the value of property securing the loan.

Construction Loans. We originate construction loans for both commercial and residential real estate. Construction loans we originate generally provide for the payment of interest only during the construction phase. At the end of the construction phase, the loan converts to a permanent mortgage loan at the same rate of interest. Before making a commitment to fund a construction loan,

Hamilton Bank requires detailed cost estimates to complete the project and an appraisal of the property by an independent licensed appraiser. Hamilton Bank also reviews and inspects each property before disbursement of funds during the term of the construction loan. Loan proceeds are disbursed after inspection based on the percentage of completion method. Construction loans for one- to four-family residential real estate may be underwritten with a loan-to-value ratio of up to 80% or 95% with private mortgage insurance. Commercial construction loans generally may not exceed a loan-to-value ratio of 75%.

Construction lending generally involves a greater degree of risk than other one- to four-family mortgage lending. The repayment of the construction loan is, to a great degree, dependent upon the successful and timely completion of construction. Various potential factors including construction delays or the financial viability of the builder may further impair the borrower s ability to repay the loan.

At March 31, 2014, total construction loans represented $3.3 million, or 2.3%, of Hamilton Bank s total loans, of which $473,000 consisted of residential construction loans and the remainder was commercial construction. At March 31, 2014, the unadvanced portion of total construction loans totaled $1.0 million. At March 31, 2014, our largest construction loan had a contractual principal balance of $2.6 million and a recorded investment balance of $1.6 million. Although the borrower is current on payments, the Bank has placed the loan on nonaccrual and charged off $1.0 million due to lack of additional funding required and the inability to complete the project in a timely manner.

Other Consumer Loans. We make loans secured by deposit accounts up to 90% of the amount of the depositor s deposit account balance. On a more limited basis, we also originate automobile loans to our customers. Other consumer loans totaled $1.2 million, or 0.8% of our total loan portfolio, at March 31, 2014.

Loan Originations, Participations, Purchases and Sales. Most of our loan originations are generated by our loan personnel operating at our corporate headquarters and banking office locations. All loans we originate are underwritten pursuant to our policies and procedures. While we originate both fixed-rate and adjustable-rate loans, our ability to generate each type of loan depends upon relative borrower demand and the pricing levels as set in the local marketplace by competing banks, thrifts, credit unions, and mortgage banking companies. Our volume of real estate loan originations is influenced significantly by market interest rates, and, accordingly, the volume of our real estate loan originations can vary from period to period.

Consistent with our interest rate risk strategy, in the low interest rate environment that has existed in recent years, we have sold on a servicing-released basis almost all of the one- to four-family residential mortgage loans with maturities over 10 years that we have originated. All loan applications that we have the intention of selling are processed through MDS. We have outsourced the loan processing and loan underwriting for one- to four-family residential mortgage loans to MDS as a cost savings measure. We pay a flat fee to MDS for each loan settled and we receive a fee per loan in return for delivery of the loan to the secondary market. All loans sold through MDS are sold without recourse to Hamilton Bank other than for breaches of customary representations and warranties to the buyers.

From time to time, we have purchased loan participations in commercial loans in which we are not the lead lender that are secured by real estate or other assets within the state of Maryland, but not necessarily our primary lending area. With regard to all loan participations, we follow our customary loan underwriting and approval policies, and although we may be only approving and servicing a portion of the loan, we underwrite the loan request as if we had originated the loan to ensure cash flow and collateral are sufficient. At March 31, 2014, our loan participations totaled $19.1 million, or 13.1% of our total loan portfolio, the majority of which were in our primary market area. Of these $19.1 million in participations, $1.7 million were on nonaccrual at March 31, 2014, a decrease of $1.2 million from March 31, 2013. We do not expect to enter into additional loan participations in the near future. However, we do look at opportunities for participations on a case by case basis.

During fiscal 2010, in connection with the acquisition of our Pasadena, Maryland office from K Bank, we purchased approximately $25.6 million of K Bank s loans. As of March 31, 2014, the remaining balance of loans purchased from K Bank totaled $10.6 million, or 7.3% of total gross loans, including two loans equaling $1.4 million that are classified as Troubled Debt Restructures that are performing as agreed under the restructure

agreement. The remaining loans are performing as agreed under their current contract at March 31, 2014. At March 31, 2014, we had no purchased loans in portfolio other than those purchased from K Bank. We do not expect to acquire whole loans from other financial institutions in the near future, however, we do look at opportunities for such purchases on a case by case basis.

The following table shows our loan origination, repayment and sale activities for the fiscal years indicated.

	Year Ended March 31,	
	2014	**2013**
	(In thousands)	
Total loans at beginning of year	$ 161,272	$ 173,518
Loans originated:		
Real estate loans:		
Residential mortgage loans:		
One- to four-family residential	3,799	2,718
One- to four-family investor		
Construction	2,381	
Commercial real estate	10,091	8,247
Total real estate loans	16,271	10,965
Commercial business loans	990	6,639
Consumer:		
Home equity loans and lines of credit	1,765	2,116
Other consumer	54	4
Total consumer loans	1,819	2,120
Total loans originated	19,080	19,724
Deduct:		
Principal repayments	33,110	28,240
Transferred to foreclosed real estate	1,003	428
Unused lines of credit	1,420	3,302
Net loan activity	(16,453)	(12,246)
Total loans at end of year	$ 144,819	$ 161,272

Loan Approval Procedures and Authority. Our lending activities follow written, non-discriminatory underwriting standards and loan origination procedures developed by management and approved by our board of directors. The loan approval process is intended to assess the borrower s ability to repay the loan and the value of the collateral that will secure the loan. To assess the borrower s ability to repay, our policies provide for the review of the borrower s employment and credit history and information on the historical and projected income and expenses of the borrower. We will also evaluate a guarantor when a guarantee is provided as part of the loan. As a cost saving measure, we have outsourced most of the processing and underwriting of our one- to four-family residential loan applications to a third party. The third party provides Hamilton Bank with a report on each loan application, which our lending officers then

present for approval.

Hamilton Bank s policies and loan approval limits are established by our board of directors. Residential real estate loans and home equity loans and lines of credit of up to $2.0 million may be approved by the Management Loan Committee consisting of our President, our Executive Vice President, Chief Credit Risk Officer and our Senior Vice President of Compliance and Risk. All real estate loans and home equity loans and lines of credit above $2.0 million must be approved by the Director Loan Committee. All commercial business loans and commercial real estate loans require two levels of approval. The first level of approval is the Executive Vice President and Chief Lending Officer or other senior loan officer presenting the loan. The second level of approval required depends on the amount of the loan. Commercial loans up to $2.0 million may be approved by the Management Loan Committee as described earlier. Commercial loans above $2.0 million or any loan that would result in the total loan relationship exceeding $2.0 million must be approved by the Director Loan Committee.

Securities Activities

General. Our investment policy is developed by management and approved by the board of directors. The objectives of the policy are to: (i) ensure adequate liquidity for loan demand and deposit fluctuations, and to allow us to alter our liquidity position to meet both day-to-day and long-term changes in assets and liabilities; (ii) manage interest rate risk in accordance with our interest rate risk policy; (iii) provide collateral for pledging requirements; (iv) maximize return on our investments; and (v) maintain a balance of high quality diversified investments to minimize risk.

Our Investment Committee, consisting of our President and Chief Executive Officer, our Senior Vice President and Treasurer, and Controller, is responsible for implementing our investment policy, including approval of investment strategies and monitoring investment performance. The President and Treasurer are authorized to execute purchases or sales of securities. The board of directors regularly reviews our investment strategies and the market value of our investment portfolio.

We account for investment and mortgage-backed securities in accordance with Accounting Standards Codification Topic 320, Investments Debt and Equity Securities. Accounting Standards Codification 320 requires that investments be categorized as held-to maturity, trading, or available for sale. Our securities are generally categorized as available-for-sale based on our need to meet daily liquidity needs and to take advantage of profits that may occur from time to time. At March 31, 2014, all of our securities were classified as available for sale.

Federally chartered savings institutions have authority to invest in various types of assets, including government-sponsored enterprise obligations, securities of various federal agencies, residential mortgage-backed securities, certain certificates of deposit of insured financial institutions, overnight and short-term loans to other banks, corporate debt instruments, debt instruments of municipalities and Fannie Mae and Freddie Mac equity securities. At March 31, 2014, our investment portfolio consisted entirely of securities and mortgage-backed securities issued by U.S. Government agencies, municipalities or U.S. Government-sponsored enterprises, including stock in the Federal Home Loan Mortgage Corporation. The principal and interest on our mortgage-backed securities are guaranteed by the issuing entity.

At March 31, 2014, we owned $266,000 in Federal Home Loan Bank of Atlanta stock. As a member of Federal Home Loan Bank of Atlanta, we are required to purchase stock in the Federal Home Loan Bank of Atlanta. At March 31, 2014, we had no investments in a single company or entity (other than an agency of the U.S. Government, a municipality or a U.S. Government-sponsored enterprise) that had an aggregate book value in excess of 10% of our equity

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Amortized Cost and Estimated Fair Value of Securities. The following table sets forth certain information regarding the amortized cost and estimated fair values of our securities as of the dates indicated.

	At March 31,					
	2014		2013		2012	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)					
Mortgage-backed securities:						
Fannie Mae	$ 47,189	$ 46,356	$ 49,657	$ 49,845	$ 30,975	$ 31,134
Ginnie Mae	4,753	4,802	11,536	11,975	22,049	22,571
Freddie Mac	26,426	25,617	27,303	27,380	21,992	22,303
Total mortgage-backed securities	78,368	76,775	88,496	89,200	75,016	76,008
U.S. Government agencies	24,539	23,413	27,075	27,029	18,766	18,821
Municpal bonds	3,242	3,338				
Freddie Mac stock	7	27	7	5	7	2
Total	$ 106,156	$ 103,553	$ 115,578	$ 116,234	$ 93,789	$ 94,831

Portfolio Maturities and Yields. The composition and maturities of the debt investment securities portfolio at March 31, 2014 are summarized in the following table. Maturities are based on the final contractual payment dates, and do not reflect the impact of prepayments or early redemptions that may occur.

	At March 31, 2014										
	One Year or Less		More Than One Year Through Five Years		More Than Five Years Through Ten Years		More Than Ten Years		Total Securities		
	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Estimated Fair Value	Weighted Average Yield
	(Dollars in thousands)										
Mortgage-backed securities:											
Fannie Mae	$	%	$	%	$ 11,043	2.22%	$ 36,146	2.28%	$ 47,189	$ 46,356	2.27%
Ginnie Mae					19	6.50	4,734	2.69	4,753	4,802	2.71
Freddie Mac			16	6.02	2,573	1.90	23,837	2.24	26,426	25,617	2.21
Total mortgage-backed securities			16	6.02	13,635	2.17	64,717	2.30	78,368	76,775	2.27

Municipal bonds							3,242	4.28	3,242	3,338	4.28
U.S. government agencies	1,017	4.53	4,522	0.79	17,000	2.11	2,000	1.00	24,539	23,413	1.88
Total	$ 1,017	4.53%	$ 4,538	0.81%	$ 30,635	2.13%	$ 69,959	2.35%	$ 106,149	$ 103,526	2.25%

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Sources of Funds

General. Deposits, scheduled amortization and prepayments of loan principal, maturities and calls of securities and funds provided by operations are our primary sources of funds for use in lending, investing and for other general purposes. We historically have not used Federal Home Loan Bank advances to fund our operations, and we had no such advances as of March 31, 2014 or 2013.

Deposits. We offer deposit products having a range of interest rates and terms. We currently offer statement savings accounts, NOW accounts, noninterest-bearing demand accounts, money market accounts and certificates of deposit. We also offer the Certificate of Deposit Account Registry Service (CDARS) program to our customers. Our strategic plan includes a greater emphasis on developing commercial business activities, both deposit and lending customer relationships.

Deposit flows are significantly influenced by general and local economic conditions, changes in prevailing interest rates, internal pricing decisions and competition. Our deposits are primarily obtained from areas surrounding our branch offices. In order to attract and retain deposits we rely on paying competitive interest rates and providing quality service.

Based on experience, we believe that our deposits are relatively stable. However, the ability to attract and maintain deposits and the rates paid on these deposits, has been and will continue to be significantly affected by market conditions. At March 31, 2014, $170.1 million, or 71.2% of our total deposit accounts were certificates of deposit, of which $102.0 million had maturities of one year or less.

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The following tables set forth the distribution of our average deposit accounts, by account type, for the years indicated.

	For the Years Ended March 31,								
	2014			2013			2012		
	Average Balance	Percent	Weighted Average Rate	Average Balance	Percent	Weighted Average Rate	Average Balance	Percent	Weighted Average Rate
	(Dollars in thousands)								
Deposit type:									
Certificates of deposit	$ 179,191	72.3%	1.04%	$ 208,204	75.8%	1.30%	$ 229,460	79.8%	1.62%
Money market	28,761	11.6	0.12	27,694	10.1	0.24	25,434	8.9	0.47
Statement savings	15,394	6.2	0.05	15,210	5.5	0.14	15,572	5.4	0.21
Noninterest bearing demand	14,869	6.0	0.00	15,967	5.8	0.00	9,280	3.2	0.00
NOW accounts	9,558	3.9	0.05	7,684	2.8	0.05	7,617	2.7	0.08
Total deposits	$ 247,773	100.0%	0.77%	$ 274,759	100.0%	1.02%	$ 287,363	100.0%	1.35%

The following table sets forth certificates of deposit classified by interest rate as of the dates indicated.

	At March 31,		
	2014	2013	2012
	(In thousands)		
Interest Rate:			
Less than 2.00%	$ 148,282	$ 164,194	$ 177,657
2.00% to 2.99%	21,522	22,876	24,486
3.00% to 3.99%	270	4,487	4,747
4.00% to 4.99%	17	4,411	10,982
5.00% and above		50	1,518
Total	$ 170,091	$ 196,018	$ 219,390

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Maturities of Certificates of Deposit Accounts. The following table sets forth the amount and maturities of certificates of deposit accounts at the dates indicated.

	At March 31, 2014 Period to Maturity					
	Less Than or Equal to One Year	**More Than One to Two Years**	**More Than Two to Three Years**	**More Than Three Years**	**Total**	**Percent of Total**
			(Dollars in thousands)			
Interest Rate Range:						
Less than 2.00%	$ 94,558	$ 30,629	$ 8,015	$ 15,080	$ 148,282	87.2%
2.00% to 2.99%	7,156	6,665	7,701		21,522	12.6
3.00% to 3.99%	270				270	0.2
4.00% to 4.99%	17				17	0.0
5.00% to 5.99%						
Total	$ 102,001	$ 37,294	$ 15,716	$ 15,080	$ 170,091	100.0%

As of March 31, 2014, the aggregate amount of outstanding certificates of deposit at Hamilton Bank in amounts greater than or equal to $100,000 was approximately $68.4 million. The following table presents the maturity of these certificates of deposit at such date.

Period to Maturity	**At March 31, 2014 (In thousands)**
Three months or less	$ 7,180
Over three through six months	9,578
Over six months through one year	21,748
Over one year to three years	23,390
Over three years	6,460
Total	$ 68,356

Borrowed Funds. As a member of the Federal Home Loan Bank of Atlanta, Hamilton Bank is eligible to obtain advances upon the security of the Federal Home Loan Bank common stock owned and certain residential mortgage loans, provided certain standards related to credit-worthiness have been met. Federal Home Loan Bank advances are available pursuant to several credit programs, each of which has its own interest rate and range of maturities. At March 31, 2014, based on available collateral, we had the ability to borrow approximately $58.1 million from the Federal Home Loan Bank of Atlanta. However, we historically have not used Federal Home Loan Bank advances to fund our operations, and had no such advances as of March 31, 2014 or 2013.

Hamilton Bank may also borrow up to $5.0 million from a correspondent bank under a secured federal funds line of credit, and $1.0 million under an unsecured line of credit. We would be required to pledge investment securities to

draw upon the secured line of credit.

Employees

As of March 31, 2014, we had 58 full-time equivalent employees. Our employees are not represented by any collective bargaining group. Management believes that we have a good working relationship with our employees.

Subsidiary Activities

Hamilton Bancorp has one subsidiary, Hamilton Bank. Hamilton Bank has one wholly owned subsidiary, 3110 FC, LLC, a Maryland limited liability company that was formed to hold other real estate owned acquired through foreclosure or deed-in-lieu of foreclosure.

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REGULATION AND SUPERVISION

General

Hamilton Bank is examined and supervised by the Office of the Comptroller of the Currency (OCC) and is subject to examination by the Federal Deposit Insurance Corporation (FDIC). This regulation and supervision establishes a comprehensive framework of activities in which an institution may engage and is intended primarily for the protection of the Federal Deposit Insurance Corporation s deposit insurance fund and depositors. Under this system of federal regulation, financial institutions are periodically examined to ensure that they satisfy applicable standards with respect to their capital adequacy, assets, management, earnings, liquidity and sensitivity to market interest rates. Hamilton Bank also is a member of and owns stock in the Federal Home Loan Bank of Atlanta, which is one of the twelve regional banks in the Federal Home Loan Bank System. Hamilton Bank is also regulated to a lesser extent by the Board of Governors of the Federal Reserve System (the Federal Reserve Board) governing reserves to be maintained against deposits and other matters. The Office of the Comptroller of the Currency examines Hamilton Bank and prepares reports for the consideration of its board of directors on any operating deficiencies. Hamilton Bank s relationship with its depositors and borrowers is also regulated to a great extent by federal law and, to a much lesser extent, state law, especially in matters concerning the ownership of deposit accounts and the form and content of Hamilton Bank s mortgage documents.

As a savings and loan holding company, Hamilton Bancorp, Inc. is required to comply with the rules and regulations of the Federal Reserve Board and to file certain reports with and is subject to examination by the Federal Reserve Board. Hamilton Bancorp is also subject to the rules and regulations of the Securities and Exchange Commission under the federal securities laws.

Any change in these laws or regulations, whether by the FDIC, the OCC, the Federal Reserve Board or Congress, could have a material adverse impact on Hamilton Bancorp and Hamilton Bank and their operations.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act) made extensive changes in the regulation of federal savings banks such as Hamilton Bank. Under the Dodd-Frank Act, the Office of Thrift Supervision was eliminated and responsibility for the supervision and regulation of federal savings banks was transferred to the OCC, which is also primarily responsible for the regulation and supervision of national banks. Responsibility for the regulation and supervision of savings and loan holding companies, such as Hamilton Bancorp was transferred to the Federal Reserve Board, which also supervises bank holding companies. Additionally, a new Consumer Financial Protection Bureau was established as an independent bureau of the Federal Reserve Board. The Consumer Financial Protection Bureau has assumed responsibility for the implementation of the federal financial consumer protection and fair lending laws and regulations, a function previously assigned to prudential regulators, and has authority to impose new requirements. However, institutions of less than $10 billion in assets, such as Hamilton Bank, continue to be examined for compliance with consumer protection and fair lending laws and regulations by, and are subject to the primary enforcement authority of, their primary regulator rather than the Consumer Financial Protection Bureau. The Dodd-Frank Act also, among other things, changed the base for FDIC insurance assessments, provided for originators of certain securitized loans to retain a percentage of the risk for transferred credits, directed the Federal Reserve Board to regulate pricing of certain debit card interchange fees and contained a number of reforms related to mortgage originations.

Set forth below is a brief description of certain regulatory requirements that are applicable to Hamilton Bancorp and Hamilton Bank. The description below is limited to certain material aspects of the statutes and regulations addressed, and is not intended to be a complete description of such statutes and regulations and their effects on Hamilton Bancorp and Hamilton Bank.

Federal Banking Regulation

Business Activities. A federal savings bank derives its lending and investment powers from the Home Owners Loan Act, as amended, and the regulations of the OCC. Under these laws and regulations, Hamilton Bank may invest in mortgage loans secured by residential and nonresidential real estate, commercial business loans and consumer loans, certain types of debt securities and certain other assets, subject to applicable limits. Hamilton Bank also may invest, subject to specified limits, in subsidiaries that may engage in activities not otherwise permissible for Hamilton Bank, including real estate investment and securities and insurance brokerage. The Dodd-Frank Act authorized the payment of interest on commercial checking accounts, effective July 21, 2011.

Capital Requirements. OCC regulations require federal savings banks to meet three minimum capital standards: a 1.5% tangible capital ratio, a 4% leverage ratio (3% for savings banks receiving the highest rating on the CAMELS rating system) and an 8% risk-based capital ratio.

The risk-based capital standard for federal savings banks requires the maintenance of Tier 1 (core) and total capital (which is defined as core capital and supplementary capital) to risk-weighted assets of at least 4% and 8%, respectively. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight factor of 0% to 200%, based on the risks believed inherent in the type of asset. Core capital is defined as common stockholders equity (including retained earnings), certain noncumulative perpetual preferred stock and related surplus and minority interests in equity accounts of consolidated subsidiaries, less intangibles other than certain mortgage servicing rights and credit card relationships. The components of supplementary capital currently include cumulative preferred stock, long-term perpetual preferred stock, mandatory convertible securities, subordinated debt and intermediate preferred stock, the allowance for loan and lease losses limited to a maximum of 1.25% of risk-weighted assets and up to 45% of net unrealized gains on available-for-sale equity securities with readily determinable fair values. Overall, the amount of supplementary capital included as part of total capital cannot exceed 100% of core capital. Additionally, a savings bank that retains credit risk in connection with an asset sale may be required to maintain additional regulatory capital because of the recourse back to the savings bank. In assessing an institution s capital adequacy, the Office of the Comptroller of the Currency takes into consideration not only these numeric factors but also qualitative factors as well, and has the authority to establish higher capital requirements for individual associations where necessary.

In July 2013, the Office of the Comptroller of the Currency and the other federal bank regulatory agencies issued a final rule that will revise their leverage and risk-based capital requirements and the method for calculating risk-weighted assets to make them consistent with agreements that were reached by the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. Among other things, the rule establishes a new common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets), increases the minimum Tier 1 capital to risk-based assets requirement (from 4% to 6% of risk-weighted assets) and assigns a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property. The final rule also requires unrealized gains and losses on certain available-for-sale securities holdings to be included for purposes of calculating regulatory capital requirements unless a one-time opt-in or opt-out is exercised. The rule limits a banking organization s capital distributions and certain discretionary bonus payments to executive officers if the banking organization does not hold a capital conservation buffer consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements. The final rule also implements the Dodd-Frank Act s directive to apply to savings and loan holding companies consolidated capital requirements that are not less stringent than those applicable to their subsidiary institutions. The final rule is effective January 1, 2015. The capital conservation buffer will be phased in from January 1, 2016 to January 1, 2019, when the full capital conservation buffer will be effective.

At March 31, 2014, Hamilton Bank s capital exceeded all applicable regulatory requirements and considered well capitalized.

Loans to One Borrower. Generally, a federal savings bank may not make a loan or extend credit to a single or related group of borrowers in excess of 15% of unimpaired capital and surplus. An additional amount may be loaned, equal to 10% of unimpaired capital and surplus, if the loan is secured by readily marketable collateral, which generally does not include real estate. As of March 31, 2014, Hamilton Bank was in compliance with the loans-to-one-borrower limitations.

Qualified Thrift Lender Test. As a federal savings bank, Hamilton Bank must satisfy the qualified thrift lender, or QTL, test. Under the QTL test, Hamilton Bank must maintain at least 65% of its portfolio assets in qualified thrift investments in at least nine months of the most recent 12 months. Portfolio assets generally means total assets of a savings institution, less the sum of specified liquid assets up to 20% of total assets, goodwill and other intangible assets, and the value of property used in the conduct of the savings institution s business. A savings bank that fails the qualified thrift lender test must operate under specified restrictions. The Dodd-Frank Act made noncompliance with the QTL Test potentially subject to agency enforcement action for a violation of law. At March 31, 2014, Hamilton Bank held 79.6% of its portfolio assets in qualified thrift investments, and satisfied the QTL Test.

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Capital Distributions. OCC or Federal Reserve Board regulations govern capital distributions by a federal savings bank, which include cash dividends, stock repurchases and other transactions charged to the capital account. A savings bank must file an application for approval of a capital distribution if:

- the total capital distributions for the applicable calendar year exceed the sum of the savings bank s net income for that year to date plus the savings bank s retained net income for the preceding two years;
- the savings bank would not be at least adequately capitalized (as defined in the prompt corrective action regulations discussed below) following the distribution;
- the distribution would violate any applicable statute, regulation, agreement or OCC imposed condition; or
- the savings bank is not eligible for expedited treatment of its filings.

Even if an application is not otherwise required, every savings bank that is a subsidiary of a holding company, such as Hamilton Bank, must still file a notice with the Federal Reserve Board at least 30 days before the board of directors declares a dividend or approves a capital distribution.

The Federal Reserve Board, upon consultation with OCC, may disapprove a notice or application if:

- the savings bank would be undercapitalized following the distribution;
- the proposed capital distribution raises safety and soundness concerns; or
- the capital distribution would violate a prohibition contained in any statute, regulation, agreement with a federal banking regulatory agency or condition, imposed in connection with an application or notice.

In addition, the Federal Deposit Insurance Act provides that an insured depository institution may not make any capital distribution if, after making such distribution, the institution would fail to satisfy any applicable regulatory capital requirement.

Liquidity. A federal savings bank is required to maintain a sufficient amount of liquid assets to ensure its safe and sound operation.

Community Reinvestment Act and Fair Lending Laws. All savings banks have a responsibility under the Community Reinvestment Act and related regulations of the OCC to help meet the credit needs of their communities, including low- and moderate-income neighborhoods. In connection with its examination of a federal savings bank, the OCC is required to assess the association s record of compliance with the Community Reinvestment Act. In addition, the Equal Credit Opportunity Act and the Fair Housing Act prohibit lenders from discriminating in their lending practices on the basis of characteristics specified in those statutes. An association s failure to comply with the provisions of the Community Reinvestment Act could, at a minimum, result in denial of certain corporate applications such as branches

or mergers, or in restrictions on its activities. The failure to comply with the Equal Credit Opportunity Act and the Fair Housing Act could result in enforcement actions by the OCC, as well as other federal regulatory agencies and the Department of Justice. Hamilton Bank received a satisfactory Community Reinvestment Act rating in its most recent federal examination.

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Transactions with Related Parties. A federal savings bank s authority to engage in transactions with its affiliates is limited by federal regulations and by Sections 23A and 23B of the Federal Reserve Act and its implementing Regulation W. An affiliate is a company that controls, is controlled by, or is under common control with an insured depository institution such as Hamilton Bank. Hamilton Bancorp is an affiliate of Hamilton Bank. In general, loan transactions between an insured depository institution and its affiliate are subject to certain quantitative and collateral requirements. In this regard, transactions between an insured depository institution and its affiliate are limited to 10% of the institution s unimpaired capital and unimpaired surplus for transactions with any one affiliate and 20% of unimpaired capital and unimpaired surplus for transactions in the aggregate with all affiliates. Collateral in specified amounts ranging from 100% to 130% of the amount of the transaction (depending on the type of collateral) must usually be provided by affiliates in order to receive loans from the insured depository institution. In addition, federal regulations prohibit a savings bank from lending to any of its affiliates that are engaged in activities that are not permissible for bank holding companies and from purchasing the securities of any affiliate, other than a subsidiary. Finally, transactions with affiliates must be consistent with safe and sound banking practices, not involve low-quality assets and be on terms that are as favorable to the institution as comparable transactions with non-affiliates. The OCC requires savings banks to maintain detailed records of all transactions with affiliates.

Hamilton Bank s authority to extend credit to its directors, executive officers and 10% stockholders, as well as to entities controlled by such persons, is currently governed by the requirements of Sections 22(g) and 22(h) of the Federal Reserve Act and Regulation O of the Federal Reserve Board. Among other things, these provisions require that extensions of credit to insiders (i) be made on terms that are substantially the same as, and follow credit underwriting procedures that are not less stringent than, those prevailing for comparable transactions with unaffiliated persons and that do not involve more than the normal risk of repayment or present other unfavorable features (subject to an exception for bank-wide lending programs available to all employees), and (ii) not exceed certain limitations on the amount of credit extended to such persons, individually and in the aggregate, which limits are based, in part, on the amount of Hamilton Bank s capital. In addition, extensions of credit in excess of certain limits must be approved by Hamilton Bank s board of directors. Extensions of credit to executive officers are subject to additional restrictions, including limits on various types of loans.

Enforcement. The OCC has primary enforcement responsibility over federal savings institutions and has the authority to bring enforcement action against all institution-affiliated parties, including stockholders, and attorneys, appraisers and accountants who knowingly or recklessly participate in wrongful action likely to have an adverse effect on an insured institution. Formal enforcement action by the OCC may range from the issuance of a capital directive or cease and desist order, to removal of officers and/or directors of the institution and the appointment of a receiver or conservator. Civil penalties cover a wide range of violations and actions, and range up to $25,000 per day, unless a finding of reckless disregard is made, in which case penalties may be as high as $1 million per day. The FDIC also has the authority to terminate deposit insurance or to recommend to the OCC that enforcement action be taken with respect to a particular savings institution. If action is not taken by the OCC, the FDIC has authority to take action under specified circumstances.

Standards for Safety and Soundness. Federal law requires each federal banking agency to prescribe certain standards for all insured depository institutions. These standards relate to, among other things, internal controls, information systems and audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, compensation, and other operational and managerial standards as the agency deems appropriate. The federal banking agencies adopted Interagency Guidelines Prescribing Standards for Safety and Soundness to implement the safety and soundness standards required under federal law. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. The guidelines address internal controls and information systems, internal audit systems, credit underwriting, loan documentation, interest rate risk exposure, asset growth, compensation, fees and benefits. If the

appropriate federal banking agency determines that an institution fails to meet any standard prescribed by the guidelines, the agency may require the institution to submit to the agency an acceptable plan to achieve compliance with the standard. If an institution fails to meet these standards, the appropriate federal banking agency may require the institution to submit a compliance plan.

Prompt Corrective Action Regulations. Under the prompt corrective action regulations, the OCC is required and authorized to take supervisory actions against undercapitalized savings banks. For this purpose, a savings bank is placed in one of the following five categories based on the savings bank s capital:

well-capitalized at least 5% leverage capital, 6% Tier 1 risk-based capital and 10% total risk-based capital;

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adequately capitalized at least 4% leverage capital (3% for savings banks with a composite examination rating of 1), 4% Tier 1 risk-based capital and 8% total risk-based capital;

undercapitalized less than 4% leverage capital (less than 3% for savings banks with a composite examination rating of 1), 4% Tier 1 risk-based capital or 8% total risk-based capital;

significantly undercapitalized less than 6% total risk-based capital, 3% Tier 1 risk-based capital or 3% leverage capital; or

critically undercapitalized less than 2% tangible capital.

Generally, the OCC is required to appoint a receiver or conservator for a savings bank that is critically undercapitalized within specific time frames. The regulations also provide that a capital restoration plan must be filed with the OCC within 45 days of the date a savings bank receives notice that it is undercapitalized, significantly undercapitalized or critically undercapitalized. Any holding company for the savings bank required to submit a capital restoration plan must guarantee the lesser of: an amount equal to 5% of a savings bank s assets at the time it was notified or deemed to be undercapitalized by the OCC, or the amount necessary to restore the savings bank to adequately capitalized status. This guarantee remains in place until the OCC notifies the savings bank that it has maintained adequately capitalized status for each of four consecutive calendar quarters, and the OCC has the authority to require payment and collect payment under the guarantee. Failure by a holding company to provide the required guarantee will result in certain operating restrictions on the savings bank, such as restrictions on the ability to declare and pay dividends, pay executive compensation and management fees, and increase assets or expand operations. The OCC may also take any one of a number of discretionary supervisory actions against undercapitalized savings banks, including the issuance of a capital directive and the replacement of senior executive officers and directors. At March 31, 2014, Hamilton Bank met the criteria for being considered well-capitalized.

In connection with the final capital rule described earlier, the federal banking agencies have adopted revisions, effective January 1, 2015, to the prompt corrective action framework. Under the revised prompt corrective action requirements, insured depository institutions would be required to meet the following in order to qualify as well capitalized: (1) a common equity Tier 1 risk-based capital ratio of 6.5%; (2) a Tier 1 risk-based capital ratio of 8% (increased from 6%); (3) a total risk-based capital ratio of 10% (unchanged from current rules) and (4) a Tier 1 leverage ratio of 5% (unchanged from the current rules).

Insurance of Deposit Accounts. Hamilton Bank s deposits are insured up to applicable limits by the Deposit Insurance Fund of the FDIC. The Dodd-Frank Act permanently increased the deposit insurance limit to $250,000 per account owner.

Under the FDIC s risk-based assessment system, insured institutions are assigned a risk category based on supervisory evaluations, regulatory capital levels and certain other factors. An institution s assessment rate depends upon the category to which it is assigned, and certain adjustments specified by FDIC regulations. Institutions deemed less risky pay lower assessments. The FDIC may adjust the scale uniformly, except that no adjustment can deviate more than two basis points from the base scale without notice and comment. No institution may pay a dividend if in default of the federal deposit insurance assessment.

The Dodd-Frank Act required the FDIC to revise its procedures to base its assessments upon each insured institution s total assets less tangible equity instead of deposits. The FDIC finalized a rule, effective April 1, 2011, that set the

assessment range at 2.5 to 45 basis points of total assets less tangible equity.

In addition to the assessment for deposit insurance, institutions are required to make payments on bonds issued in the late 1980s by the Financing Corporation to recapitalize a predecessor deposit insurance fund. That payment is established quarterly and during the quarter ended March 31, 2014 equaled .62 basis points of total assets less tangible capital.

The Dodd-Frank Act increased the minimum target Deposit Insurance Fund ratio from 1.15% of estimated insured deposits to 1.35% of estimated insured deposits. The FDIC must seek to achieve the 1.35% ratio by September 30, 2020. Insured institutions with assets of $10 billion or more are supposed to fund the increase. The Dodd-Frank Act eliminated the 1.5% maximum fund ratio, instead leaving it to the discretion of the FDIC and the FDIC has recently exercised that discretion by establishing a long range fund ratio of 2%.

The FDIC has authority to increase insurance assessments. A significant increase in insurance premiums would likely have an adverse effect on the operating expenses and results of operations of Hamilton Bank. We cannot predict what insurance assessment rates will be in the future.

Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or regulatory condition imposed in writing. We do not know of any practice, condition or violation that might lead to termination of deposit insurance.

Prohibitions Against Tying Arrangements. Federal savings banks are prohibited, subject to some exceptions, from extending credit to or offering any other service, or fixing or varying the consideration for such extension of credit or service, on the condition that the customer obtain some additional service from the institution or its affiliates or not obtain services of a competitor of the institution.

Federal Home Loan Bank System. Hamilton Bank is a member of the Federal Home Loan Bank System, which consists of 12 regional Federal Home Loan Banks. The Federal Home Loan Bank System provides a central credit facility primarily for member institutions as well as other entities involved in home mortgage lending. As a member of the Federal Home Loan Bank of Atlanta, Hamilton Bank is required to acquire and hold shares of capital stock in the Federal Home Loan Bank. As of March 31, 2014, Hamilton Bank was in compliance with this requirement.

Federal Reserve System

Federal Reserve Board regulations require savings banks to maintain noninterest-earning reserves against their transaction accounts, such as negotiable order of withdrawal and regular checking accounts. At March 31, 2014, Hamilton Bank was in compliance with these reserve requirements.

Other Regulations

Interest and other charges collected or contracted for by Hamilton Bank are subject to state usury laws and federal laws concerning interest rates. Hamilton Bank s operations are also subject to federal laws applicable to credit transactions, such as the:

Truth-In-Lending Act, governing disclosures of credit terms to consumer borrowers;

Real Estate Settlement Procedures Act, requiring that borrowers for mortgage loans for one- to four-family residential real estate receive various disclosures, including good faith estimates of settlement costs, lender servicing and escrow account practices, and prohibiting certain practices that increase the cost of settlement services;

Home Mortgage Disclosure Act, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;

Equal Credit Opportunity Act, prohibiting discrimination on the basis of race, creed or other prohibited factors in extending credit;

Fair Credit Reporting Act, governing the use and provision of information to credit reporting agencies;

- fair lending laws;
- Unfair or Deceptive Acts or Practices laws and regulations;
- Fair Debt Collection Act, governing the manner in which consumer debts may be collected by collection agencies;
- Truth in Savings Act; and
- Rules and regulations of the various federal agencies charged with the responsibility of implementing such federal laws.

The operations of Hamilton Bank also are subject to the:

- Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;
- Electronic Funds Transfer Act and Regulation E promulgated thereunder, which govern automatic deposits to and withdrawals from deposit accounts and customers rights and liabilities arising from the use of automated teller machines and other electronic banking services;
- Check Clearing for the 21st Century Act (also known as Check 21), which gives substitute checks, such as digital check images and copies made from that image, the same legal standing as the original paper check;
- The USA PATRIOT Act, which requires savings banks to, among other things, establish broadened anti-money laundering compliance programs, and due diligence policies and controls to ensure the detection and reporting of money laundering. Such required compliance programs are intended to supplement existing compliance requirements that also apply to financial institutions under the Bank Secrecy Act and the Office of Foreign Assets Control regulations; and
- The Gramm-Leach-Bliley Act, which places limitations on the sharing of consumer financial information by financial institutions with unaffiliated third parties. Specifically, the Gramm-Leach-Bliley Act requires all financial institutions offering financial products or services to retail customers to provide such customers with the financial institution s privacy policy and provide such customers the opportunity to opt out of the sharing of certain personal financial information with unaffiliated third parties.

Holding Company Regulation

Hamilton Bancorp is a unitary savings and loan holding company, subject to regulation and supervision by the Federal Reserve Board. The Federal Reserve Board has enforcement authority over Hamilton Bancorp and its non-savings

institution subsidiaries. Among other things, this authority permits the Federal Reserve Board to restrict or prohibit activities that are determined to be a risk to Hamilton Bank.

Activities. The activities of a savings and loan holding company, such as Hamilton Bancorp, are limited to those activities permissible for financial holding companies or for multiple savings and loan holding companies. A financial holding company may engage in activities that are financial in nature, including underwriting equity securities and insurance, incidental to financial activities or complementary to a financial activity. The Dodd-Frank Act added that any savings and loan holding company that engages in activities permissible for a financial holding company must meet the qualitative requirements for a bank holding company to be a financial holding company and conduct the activities in accordance with the requirements that would apply to a financial holding company s conduct of the activity. A multiple savings and loan holding company is generally limited to activities permissible for bank holding companies under Section 4(c)(8) of the Bank Holding Company Act, subject to the prior approval of the Federal Reserve Board, and certain additional activities authorized by Federal Reserve Board regulations.

Federal law prohibits a savings and loan holding company, directly or indirectly, or through one or more subsidiaries, from acquiring more than 5% of the voting shares of another savings institution or savings and loan holding company, without prior written approval of the Federal Reserve Board. It also generally prohibits the acquisition or retention of more than 5% of the voting shares of a company engaged in activities that are not closely related to banking or financial in nature or acquiring or retaining control of an institution that is not federally insured. In evaluating applications by holding companies to acquire savings institutions, the Federal Reserve Board must consider factors such as the financial and managerial resources and future prospects of the savings institution involved, the effect of the acquisition on the risk to the insurance fund, the convenience and needs of the community and competitive effects.

Capital Requirements. Savings and loan holding companies are not currently subject to specific regulatory capital requirements. The Dodd-Frank Act, however, required the Federal Reserve Board to promulgate consolidated capital requirements for depository institution holding companies that are no less stringent, both quantitatively and in terms of components of capital, than those applicable to institutions themselves. Instruments such as cumulative preferred stock and trust preferred securities will no longer be includable as Tier 1 capital, as is currently the case with bank holding companies, subject to certain grandfathering. The previously discussed final rule regarding regulatory capital requirements implements the Dodd-Frank Act as to savings and loan holding companies. Consolidated regulatory capital requirements identical to those applicable to the subsidiary depository institutions will apply to savings and loan holding companies as of January 1, 2015. As is the case with institutions themselves, the capital conservation buffer will be phased in between 2016 and 2019.

Source of Strength. The Dodd-Frank Act also extends the source of strength doctrine to savings and loan holding companies. The Federal Reserve Board has issued regulations requiring that all bank and savings and loan holding companies serve as a source of strength to their subsidiary depository institutions by providing capital, liquidity and other support in times of financial stress.

Capital Distributions and Stock Repurchases. The Federal Reserve Board has issued a policy statement regarding capital distributions by bank holding companies that it has made applicable to savings and loan holding companies as well. In general, the policy provides that dividends should be paid only out of current earnings and only if the prospective rate of earnings retention by the holding company appears consistent with the organization s capital needs, asset quality and overall financial condition. Regulatory guidance provides for prior regulatory consultation with respect to capital distributions in certain circumstances such as where the company s net income for the past four quarters, net of dividends previously paid over that period, is insufficient to fully fund the dividend or the company s overall rate of earnings retention is inconsistent with the company s capital needs and overall financial condition. The ability of a holding company to pay dividends may be restricted if a subsidiary depository institution becomes undercapitalized. The policy statement also provides for regulatory review prior to a holding company redeeming or repurchasing regulatory capital instruments when the holding company is experiencing financial weaknesses or redeeming or repurchasing common stock or perpetual preferred stock that would result in a net reduction in the amount of such equity instruments outstanding as of the end of a quarter compared with the beginning of the quarter in which the redemption or repurchase occurred. These regulatory policies could affect the ability of Hamilton Bancorp to pay dividends or otherwise engage in capital distributions.

Change in Control Regulations

Under the Change in Bank Control Act, no person may acquire control of a savings and loan holding company such as the Company unless the Federal Reserve Board has been given 60 days prior written notice and has not issued a notice disapproving the proposed acquisition, taking into consideration certain factors, including the financial and managerial resources of the acquirer and the competitive effects of the acquisition. Control, as defined under federal law, means ownership, control of or holding irrevocable proxies representing more than 25% of any class of voting stock, control

in any manner of the election of a majority of the company s directors, or a determination by the regulator that the acquirer has the power to direct, or directly or indirectly to exercise a controlling influence over, the management or policies of the institution. Acquisition of more than 10% of any class of a savings and loan holding company s voting stock constitutes a rebuttable presumption of control under the regulations under certain circumstances including where, as is the case with Hamilton Bancorp Inc., the issuer has registered securities under Section 12 of the Securities Exchange Act of 1934.

Federal Securities Laws

Hamilton Bancorp common stock is registered with the Securities and Exchange Commission. Hamilton Bancorp is subject to the information, proxy solicitation, insider trading restrictions and other requirements under the Securities Exchange Act of 1934.

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 addresses, among other issues, corporate governance, auditing and accounting, executive compensation, and enhanced and timely disclosure of corporate information. Our Chief Executive Officer and Chief Financial Officer are required to certify, among other things, that our quarterly and annual reports do not contain any untrue statement of a material fact.

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ITEM 1A. RISK FACTORS

Our recent emphasis on commercial real estate and commercial business loans has increased our credit risk.

We have significantly increased our origination of commercial real estate and commercial business loans during the last five years, and we intend to continue to grow our portfolios of such loans in the near term, subject to market conditions. At March 31, 2014, commercial real estate loans totaled $41.4 million, or 28.6% of total loans, compared to $6.9 million, or 4.4% of total loans, at March 31, 2009. At March 31, 2014, commercial business loans and lines of credit outstanding totaled $15.7 million, or 10.8% of total loans, compared to $1.3 million, or 0.8% of total loans, at March 31, 2009.

Commercial real estate and commercial business loans generally have more risk than the one- to four-family residential real estate loans that we originate. Because the repayment of commercial real estate and commercial business loans depends on the successful management and operation of the borrower s properties or businesses, repayment of such loans can be affected by adverse conditions in the local real estate market or economy. Commercial real estate and commercial business loans may also involve relatively large loan balances to individual borrowers or groups of related borrowers. In addition, a downturn in the real estate market or the local economy could adversely affect the value of properties securing the loan or the revenues from the borrower s business, thereby increasing the risk of nonperforming loans. See Our entry into commercial real estate and commercial business lending has resulted in higher losses on our loans, below.

Our entry into commercial real estate and commercial business lending has resulted in higher losses on our loans.

Beginning in 2009, we changed our business strategy to become less reliant upon one- to four-family lending and emphasize commercial business and commercial real estate lending. To support this strategy, we have hired additional commercial real estate and commercial loan officers with commercial lending experience, as well as additional back office monitoring and loan administration personnel. We are now performing the underwriting analysis of such loans in-house versus contracting with an outside third party in past years. We have also purchased whole commercial business and commercial real estate loans from other institutions and participated in commercial business and commercial real estate loans originated by other institutions in the past. We do not expect to purchase or participate in such loans in the near future, however, we do look at opportunities on a case by case basis.

Beginning in fiscal 2012, the level of our delinquent and non-performing commercial and commercial real estate loans began to increase, particularly in our portfolio of loan participations and purchased loans. During fiscal 2012, nonperforming loans increased $5.8 million, or 354%, to $7.4 million at March 31, 2012. During fiscal 2013, we had net charge-offs of $3.2 million, including $2.9 million of commercial business and commercial real estate loans (including commercial construction loans), and $5.1 million of nonperforming loans, including $1.3 million and $2.4 million of nonperforming commercial business loans and commercial real estate loans, respectively. During fiscal 2014, we had net charge-offs of $2.2 million, including $2.0 million of commercial business and commercial real estate loans, and at March 31, 2014 we had $5.0 million of nonperforming loans, including $2.5 million and $1.9 million of nonperforming commercial business loans and commercial real estate loans, respectively. Included in the $5.0 million of non-performing loans was $801,000 that were 90 days past their maturity date, but accruing and paying as agreed.

Given our recent emphasis on commercial business and commercial real estate lending, and that our portfolio of commercial business loans and commercial real estate loans is not seasoned, we have a limited loss history with which to measure the level of risk in our commercial real estate and commercial business loan portfolios. In addition, with our in-house underwriting function for commercial business and commercial real estate loans being relatively new, we

have a limited history on which to assess the effectiveness of our commercial business and commercial real estate loan underwriting processes and personnel. Delinquencies and loan losses related to our commercial real estate loans and commercial business loans could increase more than we have provided for in our allowance for loan losses as we continue to emphasize this type of lending activity.

If our allowance for loan losses is not sufficient to cover actual loan losses, our earnings could decrease.

We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan losses, we review our loans and our loss and delinquency experience, and we evaluate economic conditions. If our assumptions are incorrect, our allowance for loan losses may not be sufficient to cover probable incurred losses in our loan portfolio, resulting in additions to our allowance for loan losses. Additions to the allowance for loan losses are established through the provision for losses on loans which is charged against income.

The unseasoned nature of much of our commercial real estate loans and commercial business loans increases the risk that our allowance may be insufficient to absorb losses without significant additional provisions. See Our recent emphasis on commercial real estate and commercial business loans has increased our credit risk, and Our entry into commercial real estate and commercial business lending has resulted in higher losses on our loans, above. At March 31, 2014, our allowance for loan losses was $1.8 million, or 35.4% of non-performing loans.

Material additions to our allowance could materially decrease our net income. In addition, bank regulators periodically review our allowance for loan losses and may require us to increase our provision for loan losses or recognize further loan charge-offs. Any increase in our allowance for loan losses or loan charge-offs as required by these regulatory authorities might have a material adverse effect on our financial condition and results of operations.

Historically low interest rates may adversely affect our net interest income and profitability.

During the past five years it has been the policy of the Board of Governors of the Federal Reserve System (the Federal Reserve Board) to maintain interest rates at historically low levels through its targeted federal funds rate and the purchase of mortgage-backed securities. As a result, yields on securities we have purchased, and to a lesser extent, market rates on the loans we have originated, have been at levels lower than were available prior to 2008. Consequently, the average yield on our interest earning assets has decreased during the recent low interest rate environment. As a general matter, our interest-bearing liabilities reprice or mature more quickly than our interest-earning assets, which has resulted in increases in net interest income (the difference between interest income earned on assets and interest expense paid on liabilities) in the short term. However, our ability to lower our interest expense is limited at these interest rate levels, while the average yield on our interest-earning assets may continue to decrease.

The Federal Reserve Board has indicated its intention to maintain low interest rates until it believes appropriate progress has been made toward its objectives of maximum employment and price stability. Accordingly, our net interest income may be adversely affected and may even decrease, which may have an adverse effect on our profitability. For information with respect to changes in interest rates, see Changes in interest rates could adversely affect our results of operations and financial condition below.

Changes in interest rates could adversely affect our results of operations and financial condition.

Our profitability depends substantially on our net interest income, which is the difference between the interest income earned on our interest-earning assets and the interest expense paid on our interest-bearing liabilities. Increases in interest rates may decrease loan demand (which would also decrease our ability to generate noninterest income through the sale of loans into the secondary market and related fees for continuing to service those sold loans, particularly SBA loans sold) and make it more difficult for borrowers to repay adjustable-rate loans. In addition, as market interest rates rise, we will have competitive pressures to increase the rates we pay on deposits. Because interest

rates we pay on our deposits would be expected to increase more quickly than the increase in the yields we earn on our interest-earning assets, our net interest income would be adversely affected.

We also are subject to reinvestment risk associated with changes in interest rates. Changes in interest rates may affect the average life of loans and mortgage-related securities. Decreases in interest rates can result in increased prepayments of loans and mortgage-related securities, as borrowers refinance to reduce borrowing costs. Under these circumstances, we are subject to reinvestment risk to the extent that we are unable to reinvest the cash received from such prepayments at rates that are comparable to the interest rates on existing loans and securities.

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We could potentially recognize goodwill impairment charges.

As of March 31, 2014, we had $2.7 million of goodwill related to the acquisition of our Pasadena, Maryland branch office in 2009. Goodwill is not amortized but is tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. Impairment testing requires that the fair value of Hamilton Bank be compared to the carrying amount of the Bank s net assets, including goodwill. If the fair value of the Bank is less than book value, an expense may be required to write-down the related goodwill to the proper carrying value. We test for impairment of goodwill during February of each year. As a result of impairment testing performed during February 2014, no impairment charge was recorded. However, future declines in our banking franchise value could result in goodwill impairment expense that is material to our earnings.

Strong competition within our market areas may limit our growth and profitability.

Competition in the banking and financial services industry within our market area is intense. In our market area we compete with commercial banks, savings institutions, mortgage brokerage firms, credit unions, finance companies, mutual funds, insurance companies, and brokerage and investment banking firms operating locally and elsewhere. Many of these competitors have substantially greater resources and lending limits than we have and offer certain services that we do not or cannot provide. Our profitability depends upon our continued ability to successfully compete in our market area. The greater resources and broader range of deposit and loan products offered by our competition may limit our ability to increase our interest-earning assets and profitability. We expect competition to remain intense in the future as a result of legislative, regulatory and technological changes and the continuing trend of consolidation in the financial services industry. Technological advances, for example, have lowered barriers to entry, allowed banks to expand their geographic reach by providing services over the Internet and made it possible for non-depository institutions to offer products and services that traditionally have been provided by banks. Competition for deposits and the origination of loans could limit our ability to successfully implement our business plan, and could adversely affect our results of operations in the future.

A worsening of economic conditions could result in increases in our level of non-performing loans and/or reduce demand for our products and services, which could have an adverse effect on our results of operations.

Our markets have been adversely impacted by the severe national economic recession of 2008 and 2009. Recovery by many businesses has been impaired by lower consumer spending. If the Federal Reserve Board increases the federal funds rate or more rapidly curtails its bond purchasing program, higher interest rates would likely result, which may reduce our loan originations, and housing markets and U.S. economic activity would be negatively affected.

Unlike larger financial institutions that are more geographically diversified, our profitability depends on the general economic conditions in the Baltimore, Maryland metropolitan area. Local economic conditions have a significant impact on our commercial real estate and construction and consumer loans, the ability of the borrowers to repay these loans and the value of the collateral securing these loans. Almost all of our loans are to borrowers located in the greater Baltimore, Maryland metropolitan area or secured by collateral located in the greater Baltimore, Maryland metropolitan area.

A further deterioration in economic conditions or a prolonged delay in economic recovery in the market areas we serve, in particular the greater Baltimore, Maryland metropolitan area, could result in the following consequences, any of which could have a material adverse effect on our business, financial condition, liquidity and results of operations:

demand for our products and services may decline;

loan delinquencies, problem assets and foreclosures may increase;

- collateral for loans, especially real estate, may decline further in value, in turn reducing customers borrowing power, reducing the value of assets and collateral associated with existing loans;

- the net worth and liquidity of loan guarantors may decline, impairing their ability to honor commitments to us; and

- the amount of our low-cost or non-interest-bearing deposits may decrease.

Moreover, a significant decline in general economic conditions could further impact these local economic conditions and could further negatively affect the financial results of our banking operations.

We operate in a highly regulated environment and we may be adversely affected by changes in laws and regulations.

We are subject to extensive regulation, supervision and examination by the Federal Reserve Board and the Office of the Comptroller of the Currency, our primary federal regulators, and the Federal Deposit Insurance Corporation, as insurer of our deposits. Such regulation and supervision governs the activities in which an institution and its holding company may engage, and are intended primarily for the protection of the insurance fund and the depositors and borrowers of Hamilton Bank rather than for holders of our common stock. Regulatory authorities have extensive discretion in their supervisory and enforcement activities, including the imposition of restrictions on our operations, the classification of our assets and determination of the level of our allowance for loan losses. Any change in such regulation and oversight, whether in the form of regulatory policy, regulations, legislation or supervisory action, may have a material impact on our operations.

Income from secondary mortgage market operations is volatile, and we may incur losses or charges with respect to our secondary mortgage market operations which would negatively affect our earnings.

We generally sell in the secondary market all residential mortgage loans that we originate with terms over 10 years on a servicing released basis, earning noninterest income in the form of gains on sale. When interest rates rise, the demand for mortgage loans tends to fall and may reduce the number of loans available for sale. In addition to interest rate levels, weak or deteriorating economic conditions also tend to reduce loan demand. Although we sell loans in the secondary market without recourse, we are required to give customary representations and warranties to the buyers. If we breach those representations and warranties, the buyers can require us to repurchase the loans and we may incur a loss on the repurchase. Since 2009, we have outsourced the loan processing and underwriting functions with respect to loans that we intend to sell in the secondary market to a third-party company. While we review each application to ensure compliance with secondary market standards, there may be some additional risk in outsourcing these functions to a third party rather than utilizing our own employees. If our relationship with this third-party loan processor/underwriter were to terminate, we would incur additional costs to undertake such functions using our own employees. In addition, if our current third-party arrangement were to be terminated, we may not be able to process and underwrite the same volume of loans for the secondary market using our own employees, which could result in reduced income.

Legislative and regulatory initiatives may affect our business activities and increase operating costs.

The potential exists for additional federal or state laws and regulations regarding lending, funding practices, capital, and liquidity standards. Bank regulatory agencies are expected to be more active in responding to concerns and trends identified in examinations, including the expected issuance of many formal enforcement orders. In addition, new laws,

regulations, and other regulatory changes may also increase our compliance costs and affect our business and operations. Moreover, the Federal Deposit Insurance Corporation (FDIC) sets the cost of our FDIC insurance premiums, which can affect our profitability.

The Dodd-Frank Act made extensive changes in the regulation of insured depository institutions. The Dodd-Frank Act, among other things, directs changes in the way that institutions are assessed for deposit insurance, mandates the imposition of consolidated capital requirements on savings and loan holding companies, requires

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originators of certain securitized loans to retain a percentage of the risk for the transferred loans, stipulates regulatory rate-setting for certain debit card interchange fees, repeals restrictions on the payment of interest on commercial demand deposits and contains a number of reforms related to mortgage originations. The impact of many of the provisions of the Dodd-Frank Act cannot yet be fully assessed. However, there is a significant possibility that the Dodd-Frank Act will, at a minimum, result in increased regulatory burden, compliance costs and interest expense.

New laws, regulations, and other regulatory changes, along with negative developments in the financial industry and the domestic and international credit markets, may significantly affect the markets in which we do business, the markets for and value of our loans and investments, and our ongoing operations, costs and profitability. For more information, see Regulation and Supervision in Item 1 of this Annual Report.

Risks associated with system failures, interruptions, or breaches of security could negatively affect our earnings.

Information technology systems are critical to our business. We use various technology systems to manage our customer relationships, general ledger, securities, deposits, and loans. We have established policies and procedures to prevent or limit the impact of system failures, interruptions, and security breaches, but such events may still occur and may not be adequately addressed if they do occur. In addition any compromise of our systems could deter customers from using our products and services. Although we rely on security systems to provide security and authentication necessary to effect the secure transmission of data, these precautions may not protect our systems from compromises or breaches of security.

In addition, we outsource a majority of our data processing to certain third-party providers. If these third-party providers encounter difficulties, or if we have difficulty communicating with them, our ability to adequately process and account for transactions could be affected, and our business operations could be adversely affected. Threats to information security also exist in the processing of customer information through various other vendors and their personnel.

The occurrence of any system failures, interruption, or breach of security could damage our reputation and result in a loss of customers and business, subject us to additional regulatory scrutiny or expose us to litigation and possible financial liability. Any of these events could have a material adverse effect on our financial condition and results of operations.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

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ITEM 2. PROPERTIES

We conduct our business through our main banking office located in Baltimore City, Maryland, four other full-service branch offices located in Baltimore City and the Maryland counties of Baltimore and Anne Arundel, and our executive and administratinve office located in Towson, Maryland, which also serves as a limited service banking office. In August 2013, we closed our branch office in the Overlea area of Baltimore due to its close proximity to one of our four remaining branch locations. The aggregate net book value of our premises was $1.6 million at March 31, 2014. Our facilities are adequate and suitable for our operations as conducted by us. The following table sets forth certain information with respect to our offices at March 31, 2014, including lease expiration dates for leased properties.

Location	Leased or Owned	Year Opened/ Acquired	Lease Expiration Date
Main Office:			
5600 Harford Road Baltimore, Maryland 21214	Owned	1937	
Branches:			
19 W. Pennsylvania Ave. Towson, Maryland 21204	Owned	1975	
9 Cranbrook Road Cockeysville, Maryland 21030	Leased	2000	May 1, 2015
8108 Jumpers Hole Road Pasadena, Maryland 21122	Owned	2009	
Executive and Administrative Office (1):			
501 Fairmount Ave. Suite 200 Towson, Maryland 21286	Leased	2011	November 29, 2016

(1) Our executive and administrative office is a limited service banking office.

ITEM 3. LEGAL PROCEEDINGS

Periodically, there have been various claims and lawsuits against us, such as claims to enforce liens, condemnation proceedings on properties in which we hold security interests, claims involving the making and servicing of real property loans and other issues incident to our business. We are not a party to any pending legal proceedings that we believe would have a material adverse effect on our financial condition, results of operations or cash flows.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market and Dividend Information.

The Company s common stock is listed on the Nasdaq Capital Market (NASDAQ) under the trading symbol HBK. The Company completed its initial public offering on October 10, 2012, and its stock commenced trading on the same day.

The following table sets forth the high and low sales prices of the Company s common stock as reported by NASDAQ for the periods indicated. The Company has not paid any dividends to its stockholders to date. See Dividends below.

	Price Range Per Share	
Fiscal 2014:	**High**	**Low**
Fourth Quarter	$ 14.40	$ 13.29
Third Quarter	15.10	13.55
Second Quarter	15.45	13.30
First Quarter	14.22	12.55

	Price Range Per Share	
Fiscal 2013:	**High**	**Low**
Fourth Quarter	$ 14.33	$ 11.26
Third Quarter (from October 10, 2012)	12.05	11.20

Holders.

As of June 27, 2014, there were approximately 158 holders of record of the Company s common stock.

Dividends.

The Company has not paid any dividends to its stockholders to date. The payment of dividends in the future will depend upon a number of factors, including capital requirements, the Company s financial condition and results of operations, tax considerations, statutory and regulatory limitations and general economic conditions. In addition, the Company s ability to pay dividends is dependent on dividends received from Hamilton Bank. For more information regarding restrictions on the payment of cash dividends by the Company and by Hamilton Bank, see Business Regulation and Supervision Holding Company Regulation Capital Distributions and Stock Repurchases , Business Regulation and Supervision Federal Savings Institution Regulation Capital Distributions and Note 12 to the Consolidated Financial Statements included in this Annual Report. No assurances can be given that any dividends will be paid or that, if paid, will not be reduced or eliminated in the future.

Securities Authorized for Issuance under Equity Compensation Plans.

None.

Recent Sales of Unregistered Securities; Use of Proceeds from Registered Securities.

None.

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Purchases of Equity Securities by the Issuer and Affiliated Purchasers.

There were no shares repurchased by the Company in the fourth quarter of fiscal 2014. On May 28, 2014, the Company announced the adoption of a stock repurchase program under which the Company could repurchase up to 179,755 shares of its common stock, or approximately 5% of the shares then outstanding. The program provides for repurchases through open market or private transactions, through block trades, and pursuant to any trading plan adopted in accordance with Rule 10b5-1 of the Securities and Exchange Commission

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ITEM 6. SELECTED FINANCIAL DATA

The following tables set forth selected historical financial and other data of Hamilton Bancorp, Inc. for the periods and at the dates indicated. The following is only a summary and you should read it in conjunction with the consolidated financial statements of Hamilton Bancorp, Inc. and notes beginning on page F-1 of this Annual Report. The information at March 31, 2014 and 2013 and for the years then ended is derived in part from the audited consolidated financial statements that appear in this Annual Report. The information at March 31, 2012, 2011 and 2010 and for the years then ended is derived in part from audited financial statements that do not appear in this Annual Report.

	At March 31, (In thousands)				
	2014	**2013**	**2012**	**2011**	**2010**
Selected Financial Condition Data:					
Total assets	$ 302,769	$ 331,962	$ 318,468	$ 335,443	$ 320,539
Cash and cash equivalents	33,073	33,969	35,250	39,473	47,205
Investment securities	26,778	27,034	18,823	37,668	58,717
Mortgage-backed securities	76,776	89,200	76,008	63,483	18,410
Loans, net (1)	142,914	159,317	169,904	177,891	180,551
Federal Home Loan Bank of Atlanta stock at cost	266	401	502	504	455
Bank-owned life insurance	12,002	11,623	8,307	7,997	6,801
Deposits	238,820	260,117	281,015	298,613	284,683
Total equity	61,770	67,436	35,065	34,091	33,247

(1) Includes loans held for sale of $-0-, $197,000, $-0-, $-0- and $331,000 at March 31, 2014, 2013, 2012, 2011 and 2010, respectively.

	For the Years Ended March 31, (In thousands, except per share data)				
	2014	**2013**	**2012**	**2011**	**2010**
Selected Operating Data:					
Interest revenue	$ 10,236	$ 10,885	$ 12,463	$ 12,762	$ 11,227
Interest expense	1,916	2,802	3,863	5,288	5,787
Net interest income	8,320	8,083	8,600	7,474	5,440
Provision for loan losses	1,874	1,730	2,718	616	53
Net interest income after provision for loan losses	6,446	6,353	5,882	6,858	5,387
Noninterest revenue	973	941	947	994	945
Noninterest expense	9,606	7,773	6,815	6,228	5,015
Income (loss) before income taxes (benefit)	(2,187)	(479)	14	1,624	1,317
Income taxes (benefit)	(992)	(307)	(117)	511	289
Net income (loss)	$ (1,195)	$ (172)	$ 131	$ 1,113	$ 1,028

Basic earnings per common share	$ (0.35)	$ (0.05)	N/A	N/A	N/A
Diluted earnings per common share	$ (0.35)	$ (0.05)	N/A	N/A	N/A

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	At or For the Years Ended March 31,				
	2014	2013	2012	2011	2010
Selected Financial Ratios and Other Data:					
Performance Ratios:					
Return on average assets (ratio of net income to average total assets)	(0.38)%	(0.05)%	0.04%	0.34%	0.40%
Return on average equity (ratio of net income to average equity)	(1.84)%	(0.33)%	0.36%	3.22%	3.11%
Interest rate spread (1)	2.68%	2.44%	2.62%	2.20%	1.92%
Net interest margin (2)	2.85%	2.62%	2.77%	2.37%	2.19%
Efficiency ratio expressed as a percentage (3)	103.37%	86.14%	71.38%	73.54%	78.54%
Noninterest expense to average total assets	3.05%	2.37%	2.09%	1.88%	1.94%
Noninterest revenue to average assets	0.31%	0.29%	0.29%	0.30%	0.37%
Average interest-earning assets to average interest-bearing liabilities	125.30%	119.36%	111.65%	109.79%	111.77%
Average equity to average total assets	20.58%	15.72%	11.04%	10.44%	12.80%
Asset Quality Ratios:					
Non-performing assets to total assets	1.88%	1.77%	2.55%	0.48%	0.04%
Non-performing loans to total loans	3.48%	3.18%	4.25%	0.91%	0.06%
Allowance for loan losses to non-performing loans	35.44%	40.36%	48.20%	72.84%	488.79%
Allowance for loan losses to gross loans	1.23%	1.28%	2.05%	0.66%	0.31%
Net charge-offs to average loans	1.41%	1.96%	0.20%	0.00%	0.00%
Capital Ratios:					
Total capital (to risk-weighted assets) (4)	28.38%	26.70%	20.66%	17.72%	20.03%
Tier 1 capital (to risk-weighted assets) (4)	27.28%	25.52%	19.40%	17.07%	19.66%
Tier 1 capital (to total adjusted assets) (4)	15.10%	14.13%	9.91%	9.41%	9.60%
Equity to total assets	20.40%	20.31%	11.01%	10.16%	10.37%
Tangible equity to tangible assets	19.65%	19.62%	10.18%	9.35%	9.51%
Number of:					
Full service offices	4	5	5	5	5
Full time equivalent employees	58	56	51	47	47

(1) The interest rate spread represents the difference between the weighted-average yield on interest-earning assets and the weighted-average cost of interest-bearing liabilities for the period.

(2) The net interest margin represents net interest income as a percent of average interest-earning assets for the period.

(3) The efficiency ratio represents noninterest expense divided by the sum of net interest income and noninterest income.

(4) Capital ratios are for Bank only.

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

This discussion and analysis reflects our consolidated financial statements and other relevant statistical data, and is intended to enhance your understanding of our financial condition and results of operations. The information in this section has been derived from the audited consolidated financial statements, which appear beginning on page F-1 of this Annual Report. You should read the information in this section in conjunction with the business and financial information regarding Hamilton Bancorp, Inc. provided in this Annual Report.

Overview

Total assests have decreased from $335.4 million at March 31, 2011, to $302.8 million at March 31, 2014. Assets have decreased in two of the last three years as a conscious effort has been made to reduce the Bank s dependency on higher costing certificates of deposits and focus on growing lower costing core deposits, specifically commercial checking and money market accounts. Total deposits have decreased from $298.6 million at March 31, 2011 to $238.8 million at March 31, 2014, a decrease of $59.8 million or 20.0% over those three years. Assets increased during fiscal year 2013 as a result of the mutual to stock conversion that was completed on October 10, 2012 in which 3,703,000 shares of common stock were sold. Net proceeds from the offering were approximately $35.6 million.

As a result of the 2007 to 2009 financial recession and slow economic growth henceforth, the Bank has not needed to grow deposits to fund loan demand and has decreased the size of the Bank through deposit runoff, particulary higher costing certificates of deposit as previously mentioned. The result of this strategy has been an increase in the net interest margin from 2.37% for the year ended March 31, 2011 to 2.85% for the year ended March 31, 2014 as management has been able to reduce our cost of funds over this period in a declining interest rate environment faster than the decline in the yield on interest earning assets.

Hamilton Bank historically had very few non-performing loans. Beginning in fiscal year 2012 we experienced an increase in delinquencies and non-performing commercial business and commercial real estate loans, particularly in our loan participations and purchased loans. During fiscal 2012, non-performing loans increased $5.8 million, or 354%, from $1.6 million at March 31, 2011 to $7.4 million at March 31, 2012. Over the past two fiscal years the Bank has diligently been working through this increase in non-performing loans. During fiscal 2013, we had net charge-offs of $3.2 million, including $2.9 million of commercial business and commercial real estate loans (including commercial construction loans) and reduced non-performing loans to $5.1 million at March 31, 2013. We continued to work through our non-performing loans in fiscal year 2014 by charging-off $2.1 million in commercial business and commercial real estate loans and reducing our non-performing loans slightly to $5.0 million, including $4.2 million loans that were on non-accrual. Over this two year period, the Bank has been able to reduce non-performing assets as a percentage of total assets from 2.55% at March 31, 2012 to 1.88% at March 31, 2014 and non-performing loans as a percentage of total loans from 4.25% at March 31, 2012 to 3.48% at March 31, 2014. At March 31, 2014, commercial business loans and commercial real estate loans accounted for $2.5 million and $1.9 million of the $5.0 million in non-performing loans, respectively. Of the $4.4 million of non-performing commercial business and commercial real estate loans at March 31, 2014, $3.6 million were on non-accrual.

In connection with our recent emphasis on commercial business and commercial real estate lending, as well as the history of increases in such loans that are delinquent or non-performing, we have increased our lending staff and back office personnel to enhance our delinquent loan monitoring system to ensure that management and the board of directors receive more up-to-date information on delinquent loans. We also established a formal loan delinquency committee in fiscal year 2013 to address delinquent and non-performing loans. However, we can make no assurances that delinquencies or loan losses related to our commercial real estate loans and commercial business loans will be reduced or will not increase as we continue to emphasize this type of lending activity. See Risk Factors Our recent

emphasis on commercial real estate loans and commercial business loans has increased our credit risk and Our entry into commercial real estate and commercial business lending has resulted in higher losses on our loans.

At March 31, 2014, our investment portfolio consisted entirely of bonds and mortgage-backed securities issued by U.S. Government agencies, municipalties or U.S. Government-sponsored enterprises, including stock in the Federal Home Loan Mortgage Corporation. The principal and interest on our mortgage-backed securities are guaranteed by the issuing entity.

Income. Our primary source of pre-tax income is net interest income. Net interest income is the difference between interest revenue, which is the income that we earn on our loans and investments, and interest expense, which is the interest that we pay on deposits and borrowings. Other significant sources of pre-tax income are customer service fees (mostly from service charges on deposit accounts), loan servicing fees, gain on sale of residential one- to four-family morgtgages in the secondary market, and income from bank-owned life insurance.

Allowance for Loan Losses. The allowance for loan losses is a valuation allowance for probable losses inherent in the loan portfolio. Management evaluates the need to establish allowances against losses on loans on a quarterly basis. When additional allowances are necessary, a provision for loan losses is charged to earnings.

Expenses. The non-interest expenses the Company incurs in operating its business consists of salaries and employee benefits, occupancy and equipment, professional services, data processing and other expenses.

Salaries and employee benefits consist primarily of salaries and wages paid to the Bank s employees, stock-based compensation, payroll taxes, expenses for health insurance, retirement plans, and other employee benefits.

Occupancy and equipment expenses, which are the fixed and variable costs of buildings and equipment, consist primarily of depreciation charges, furniture and equipment expenses, maintenance, real estate taxes and costs of utilities. Depreciation of premises and equipment is computed using the straight-line method based on the useful lives of the related assets, which range from three to forty years. Leasehold improvements are amortized over the shorter of the useful life of the asset or the expected term of the lease. The expected term includes lease option periods to the extent that the exercise of such options is reasonably assured.

Professional services include the fees that we pay to our outside accountants, attorneys and other consultants.

Data processing expenses are the fees paid to third parties for processing customer information, deposits and loans.

Other expenses include expenses for marketing, office supplies, postage, telephone, insurance, charitable contributions, FDIC deposit insurance and OCC assessments and other miscellaneous operating expenses.

Critical Accounting Policies

The discussion and analysis of the financial condition and results of operations are based on our consolidated financial statements, which are prepared in conformity with generally accepted accounting principles used in the United States of America. The preparation of these consolidated financial statements requires management to make estimates and assumptions affecting the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities, and the reported amounts of income and expenses. We consider the accounting policies discussed below to be critical accounting policies. The estimates and assumptions that we use are based on historical experience and various other factors and are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions, resulting in a change that could have a material impact on the carrying value of our assets and liabilities and our results of operations.

On April 5, 2012, the Jumpstart Our Business Startups Act of 2012 (the JOBS Act) was signed into law. The JOBS Act contains provisions that, among other things, reduce certain reporting requirements for qualifying public companies. As an emerging growth company we may delay adoption of new or revised accounting pronouncements applicable to public companies until such pronouncements are made applicable to private companies. We have chosen to take advantage of the benefits of this extended transition period. Accordingly, our consolidated financial statements may not be comparable to companies that comply with such new or revised accounting standards.

The following represent our critical accounting policies:

Allowance for Loan Losses. The allowance for loan losses is the estimated amount considered necessary to cover inherent, but unconfirmed, credit losses in the loan portfolio at the balance sheet date. The allowance is established through the provision for losses on loans which is charged against income. In determining the allowance for loan losses, management makes significant estimates and has identified this policy as one of our most critical accounting policies.

Management performs a quarterly evaluation of the allowance for loan losses. Consideration is given to a variety of factors in establishing this estimate including, but not limited to, current economic conditions, delinquency statistics, geographic and industry concentrations, the adequacy of the underlying collateral, the financial strength of the borrower, results of internal loan reviews and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant change.

The analysis has two components, specific and general allocations. Specific percentage allocations can be made for unconfirmed losses related to loans that are determined to be impaired. Impairment is measured by determining the present value of expected future cash flows or, for collateral-dependent loans, the fair value of the collateral adjusted for market conditions and selling expenses. If the fair value of the loan is less than the loan s carrying value, a charge is recorded for the difference. The general allocation is determined by segregating the remaining loans by type of loan, risk weighting (if applicable) and payment history. We also analyze historical loss experience, delinquency trends, general economic conditions and geographic and industry concentrations. This analysis establishes factors that are applied to the loan groups to determine the amount of the general reserve. Actual loan losses may be significantly more than the allowances we have established which could result in a material negative effect on our financial results.

Securities Valuation and Impairment. We classify our investments in debt and equity securities as either held to maturity or available for sale. Securities classified as held to maturity are recorded at cost or amortized cost. Available-for-sale securities are carried at fair value. We obtain our fair values from a third party service. This service s fair value calculations are based on quoted market prices when such prices are available. If quoted market prices are not available, estimates of fair value are computed using a variety of techniques, including extrapolation from the quoted prices of similar instruments or recent trades for thinly traded securities, fundamental analysis, or through obtaining purchase quotes. Due to the subjective nature of the valuation process, it is possible that the actual fair values of these investments could differ from the estimated amounts, thereby affecting our financial position, results of operations and cash flows.

If the estimated value of investments is less than the cost or amortized cost, we evaluate whether an event or change in circumstances has occurred that may have a significant adverse effect on the fair value of the investment. If such an event or change has occurred and we determine that the impairment is other-than-temporary, we record the impairment of the investment in the period in which the event or change occurred. We also consider how long a security has been in a loss position in determining if it is other than temporarily impaired. Management also assesses the nature of the unrealized losses taking into consideration factors such as changes in risk-free interest rates, general credit spread widening, market supply and demand, creditworthiness of the issuer, and quality of the underlying collateral. At March 31, 2014, all of our securities were either issued by U.S. government agencies, U.S. government-sponsored enterprises, or municipalities and the principal and interest on 96.8% of our securities were guaranteed by the issuing entity.

Goodwill Impairment. Goodwill represents the excess purchase price paid for our Pasadena branch over the fair value of the net assets acquired. Goodwill is not amortized but is tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. The Company is considered the Reporting Unit

for purposes of impairment testing. Impairment testing requires that the fair value of the Company be compared to the carrying amount of the Company s net assets, including goodwill. If the fair value

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of the Company exceeds the book value, no write-down of recorded goodwill is required. If the fair value of the Company is less than book value, an expense may be required to write-down the related goodwill to the proper carrying value. We test for impairment of goodwill during February of each year. We estimate the fair value of the Company utilizing four valuation methods including the Comparable Transactions Approach, the Control Premium Approach, the Public Market Peers Approach, and the Discounted Cash Flow Approach.

Based on our impairment testing during February 2014, there was no evidence of impairment of the Company s goodwill or intangible assets.

Income Taxes. We account for income taxes under the asset/liability method. We recognize deferred tax assets for the future consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, as well as operating loss and tax credit carry-forwards. We measure deferred tax assets and liabilities using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. We recognize the effect on deferred tax assets and liabilities of a change in tax rates in income in the period indicated by the enactment date. We establish a valuation allowance for deferred tax assets when, in the judgment of management, it is more likely than not that such deferred tax assets will not become realizable. The judgment about the level of future taxable income is dependent to a great extent on matters that may, at least in part, be beyond our control. It is at least reasonably possible that management s judgment about the need for a valuation allowance for deferred tax assets could change in the near term.

Comparison of Financial Condition at March 31, 2014 and March 31, 2013

Assets. Total assets decreased $29.2 million, or 8.8%, to $302.8 million at March 31, 2014 from $332.0 million at March 31, 2013. The decrease in assets is primarily attributable to a $16.4 million decrease in net loans and a $12.7 million decrease in investment securities during the fiscal year ended March 31, 2014.

Loans. Net loans receivable, including loans held for sale, decreased by $16.4 million, or 10.3%, to $142.9 million at March 31, 2014 from $159.3 million at March 31, 2013. The decrease in loans receivable during this period was primarily due to a decrease of $7.6 million, or 9.5%, in total one- to four-family mortgage loans, a decrease of $2.1 million, or 15.1%, in home equity loans and lines of credit, and a decrease of $11.3 million, or 41.9%, in commercial business loans, partially offset by a $5.2 million, or 14.3%, increase in commercial real estate loans. The decrease in one- to four-family mortgage loans was primarily due to principal paydowns, prepayments, pay offs and the sale of newly originated residential mortgage loans in the secondary market. The decrease in commercial business loans was primarily due to charge-offs and the pay-off of several larger commercial loan borrowers who opted to refiance with other financial institutions. The increase in commercial real esate loans reflected our continued emphasis on originating these types of loans.

Securities. Investment securities decreased $12.7 million, or 10.9%, to $103.6 million at March 31, 2014, from $116.2 million at March 31, 2013. The decrease in securities during fiscal 2014 was primarily due to a $3.3 million decrease in the fair value of the investment portfolio due to rising interest rates over the past year, as well as the need to fund a $21.3 million decrease in deposits as part of our business strategy to allow higher costing certificates of deposit to run off at maturity, and gradually replace them with lower-cost core deposits. The decrease in investments was partially offset by the proceeds received from the $16.4 million decrease in net loans receivable from March 31, 2013 to March 31, 2014.

Cash and Cash Equivalents. During the year ended March 31, 2014, cash and cash equivalents decreased by $895,000, or 2.6%, to $33.1 million.

Bank-Owned Life Insurance. We invest in bank-owned life insurance to provide us with a funding source for our benefit plan obligations. Bank-owned life insurance also generally provides us noninterest income that is tax-exempt. Federal regulations generally limit our investment in bank-owned life insurance to 25% of our Tier 1 capital plus our allowance for loan losses. At March 31, 2014, our investment in bank-owned life insurance was $12.0 million, an increase of $379,000 from $11.6 million at March 31, 2013. The increase is primarily attributable to the increase in the cash surrender value of the insurance policies.

Deposits. Total deposits decreased $21.3 million, or 8.2%, to $238.8 million at March 31, 2014 from $260.1 million at March 31, 2013. The decrease is attributable to our on-going efforts to reduce our reliance on certificates of deposit as a funding source. We continued to allow higher costing certificates of deposit to runoff at maturity during fiscal 2014 and 2013, as we focused on increasing the level of core deposits. During fiscal 2014, certificates of deposit decreased $25.9 million, or 13.2%, to $170.1 million, while noninterest bearing checking increased $3.8 million, or 32.7%, to $15.3 million. Statement savings, NOW and money market accounts all increased slightly from fiscal 2013. Statement savings accounts increased $469,000, or 3.0%, to $16.0 million, NOW accounts increased $208,000, or 2.3%, to $9.1 million and money market accounts increased $182,000, or 0.6%, to $28.4 million.

Borrowings. We had no borrowings outstanding at March 31, 2014 or 2013. At March 31, 2014, we had the ability to borrow approximately $58.1 million from the Federal Home Loan Bank of Atlanta, subject to our pledging sufficient assets. At that date we also had the ability to borrow $5.0 million under a secured Line of Credit, along with a $1.0 million unsecured Line of Credit with a correspondent financial institution.

Equity. Total equity decreased $5.7 million, or 8.4%, to $61.8 million at March 31, 2014 from $67.4 million at March 31, 2013. The decrease was primarily attributable to a 5.0% stock buyback program completed in November 2013 for $2.8 million. In addition, there was a $2.0 million decrease in accumulated other comprehensive income and a $1.2 million net loss for the fiscal year ended March 31, 2014. The decrease in accumulated other comprehensive income was due to the negative impact of rising interest rates over the past year on the market value of the investment portfolio.

Comparison of Results of Operations for the Years Ended March 31, 2014 and March 31, 2013

General. Net loss increased $1.0 million to a net loss of $1.2 million for the year ended March 31, 2014 compared to a net loss of $172,000 for the year ended March 31, 2013. The primary reason for the decrease was a $1.8 million increase in noninterest expenses, including increases in salaries and benefits, legal services, other professional services and costs associated with foreclosed real estate along with an increase of $144,000 in the provision for loan losses. The increase in noninterest expenses was partially offset by a $237,000 increase in net interest income and a $685,000 increase in the income tax benefit.

Net Interest Income. Net interest income increased by $237,000, or 2.9%, to $8.3 million for the year ended March 31, 2014 from $8.1 million for the year ended March 31, 2013. The increase resulted from a decrease of $886,000 in interest expense, partially offset by a decrease of $649,000 in interest and dividend income. These decreases were driven by both declining market interest rates and average balances during the year ended March 31, 2014. The average cost of our interest-bearing liabilities declined 26 basis points to 0.82% while the the average yield on our interest-earning assets remained relatively flat at 3.51%. In addition, the average balance on our interest-bearing liabilities decreased $25.9 million, or 10.0%, compared to a decrease of $17.1 million, or 5.5%, in our average interest-earning assets. Overall, our net interest-earning assets increased $8.8 million during fiscal 2014. As a result, our net interest margin and interest rate spread increased 23 and 24 basis points to 2.85% and 2.68% for the year ended March 31, 2014 from 2.62% and 2.44%, respectively, for the year ended March 31, 2013.

Interest and Dividend Revenue. Interest and dividend revenue decreased $649,000 to $10.2 million for the year ended March 31, 2014 from $10.9 million for the year ended March 31, 2013. The decrease resulted primarily from a $930,000 decrease in interest revenue on loans, partially offset by a $329,000 increase in interest on securities.

Interest revenue on loans decreased $930,000, or 10.3%, to $8.1 million for the year ended March 31, 2014 from $9.0 million for the year ended March 31, 2013. This decrease primarily resulted from a 22 basis point decrease in the average yield on loans to 5.28% for the year ended March 31, 2014 from 5.50% for the year ended March 31, 2013,

reflecting decreases in market interest rates. The decrease was also due in part to a decrease in the average balance of loans of $10.9 million, or 6.7%, to $153.0 million for the year ended March 31, 2014 from $163.9 million for the year ended March 31, 2013.

Interest and dividend revenue on total securities increased $329,000 to $2.1 million for the year ended March 31, 2014 from $1.8 million for the year ended March 31, 2013. The increase resulted from a $162,000 increase in interest revenue on mortgage-backed securities and a $167,000 increase in interest revenue on other investment securities. The increase in interest revenue from mortgage-backed securities was due to a $6.6 million increase in the average balance of mortgage-backed securities in conjunction with a 5 basis point increase in the average yield from 1.80% to 1.85%. The increase in interest revenue on other investment securities was primarily due to an $8.7 million increase in the average balance of other investment securities while the average yield remained flat at 1.91% compared to fiscal year 2013. The slight increase in the overall average yield reflects the steady nature of interest rates on securities experienced during fiscal year 2014.

Interest Expense. Interest expense, consisting entirely of the cost of interest-bearing deposits, decreased $886,000, or 31.6%, to $1.9 million for the year ended March 31, 2014 from $2.8 million for the year ended March 31, 2013. The decrease in the cost of interest-bearing deposits was due to a decrease of 26 basis points in the average rate paid on interest-bearing deposits to 0.82% for the year ended March 31, 2014 from 1.08% for the year ended March 31, 2013. We experienced decreases in the cost of all categories of interest-bearing deposits, except NOW accounts which remained flat at 0.05%, for the year ended March 31, 2014. The most significant decrease in the average rate paid on interest-bearing deposits was in certificate of deposit, reflecting lower market interest rates. The decrease in interest expense was also due to a $25.9 million, or 10.0%, decrease in the average balance of interest-bearing deposits to $232.9 million for the year ended March 31, 2014 from $258.8 million for the year ended March 31, 2013. The decline in the average balance of interest-bearing deposits was primarily due to our strategy to allow higher costing certificates of deposit to runoff, and gradually replace them with lower-cost core deposits. The average balance of certificates of deposit decreased $29.0 million for the year ended March 31, 2014 compared to the year ended March 31, 2013, while the average balances of money market and NOW accounts accounts increased $1.1 million, or 3.9%, and $1.9 million, or 24.4%, respectively. The average balance of noninterest bearing demand accounts decreased $1.1 million, or 6.9%, to $14.9 million for the year ended March 31, 2014. The higher average balance for noninterest bearing demand deposits during fiscal 2013 is primarily attributable to the excess proceeds received leading up to the completion of the stock offering in October 2012.

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Average Balances and Yields. The following table presents information regarding average balances of assets and liabilities, the total dollar amounts of interest income and dividends from average interest-earning assets, the total dollar amounts of interest expense on average interest-bearing liabilities, and the resulting annualized average yields and costs. The yields and costs for the periods indicated are derived by dividing income or expense by the average balances of assets or liabilities, respectively, for the periods presented. For purposes of this table, average balances have been calculated using daily average balances, nonaccrual loans are included in average balances only, and loan fees are included in interest income on loans.

	Years Ended March 31,					
	2014			2013		
	Average Balance	Interest and Dividends	Yield/ Cost	Average Balance	Interest and Dividends	Yield/ Cost
	(Dollars in thousands)					
Interest-earning assets:						
Loans (1)	$ 153,019	$ 8,080	5.28%	$ 163,930	$ 9,010	5.50%
Investment securities (2)	26,399	505	1.91	17,666	336	1.91
Mortgage-backed securities	87,110	1,614	1.85	80,481	1,451	1.80
Cash and cash equivalents	25,294	37	0.15	46,825	88	0.19
Total interest-earning assets	291,822	10,236	3.51	308,902	10,885	3.52
Noninterest-earning assets	22,966			19,689		
Total assets	$ 314,788			$ 328,591		
Interest-bearing liabilities:						
Certificates of deposit	$ 179,191	1,868	1.04%	$ 208,204	2,710	1.30%
Money market	28,761	35	0.12	27,694	67	0.24
Statement savings	15,394	8	0.05	15,210	21 0.6	0.7 2.0.7
Total	$ 1.0	$ 0.7	$ 8.5	$ 0.7		

Restructuring charges are summarized in the table below by statement of earnings line item (millions of dollars):

	Three Months Ended January 31,		Six Months Ended January 31,	
	2016	2015	2016	2015
Cost of sales	$0.9	$0.7	$4.1	$0.7
Operating expenses	0.1	—	4.4	—
Total	$1.0	$0.7	$8.5	$0.7

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Overview

The Company is a worldwide manufacturer of filtration systems and replacement parts. The Company’s core strengths are leading filtration technologies, strong Customer relationships, and its global presence. Products are manufactured at 42 plants around the world and through three joint ventures.

The Company has two reporting segments: Engine Products and Industrial Products. Products in the Engine Products segment consist of air filtration systems, exhaust and emissions systems, liquid filtration systems, including hydraulics, fuel, and lube systems, replacement filters, and filter monitoring products. The Engine Products segment sells to original equipment manufacturers (OEMs) in the construction, mining, agriculture, aerospace, defense, and truck markets, and to independent distributors, OEM dealer networks, private label accounts, and large equipment fleets. Products in the Industrial Products segment include dust, fume, and mist collectors, compressed air purification systems, air filtration systems for gas turbines, polytetrafluoroethylene (PTFE) membrane-based products, and specialized air and gas filtration systems for applications including computer hard disk drives and semi-conductor manufacturing. The Industrial Products segment sells to various industrial dealers, distributors, OEMs of gas-fired turbines, and OEMs and end-users requiring clean filtration solutions and replacement filters.

The following discussion of the Company’s results of operations and financial condition should be read in conjunction with the Condensed Consolidated Financial Statements and Notes thereto and other financial information included elsewhere in this report.

Results of Operations

Three months ended January 31, 2016 compared to three months ended January 31, 2015

Operating results for the three months ended January 31, 2016 and 2015, are as follows (millions of dollars):

	Three Months Ended January 31,					
	2016			2015		
Net sales	$517.2			$588.5		
Cost of sales	346.4	67.0	%	385.4	65.5	%
Gross profit	170.8	33.0	%	203.1	34.5	%
Operating income	53.7	10.4	%	65.8	11.2	%
Earnings before income taxes	49.4	9.6	%	65.4	11.1	%
Income taxes	11.4	2.2	%	17.4	3.0	%
Net earnings	$38.0	7.3	%	$48.0	8.2	%

For the three months ended January 31, 2016, net sales declined 12.1 percent to $517.2 million compared to the same period in the prior fiscal year. Net sales in the Engine Products and Industrial Products segments declined $36.2 million and $35.1 million, respectively. On a constant currency basis, net sales for the quarter ended January 31, 2016, declined 7.6 percent compared to the three months ended January 31, 2015. The Company's Gas Turbine Systems Products, which experienced a 40.8 percent decline compared to the three months ended January 31, 2015, was the largest contributor to the net sales decline compared to prior year.

The impact of foreign currency translation during the second quarter of Fiscal 2016 decreased net sales by $26.3 million, or 4.5 percent, from the prior year. The impact of foreign currency translation decreased net earnings by $4.9 million, or 10.2 percent for the three months ended January 31, 2016.

Cost of sales for the three months ended January 31, 2016, were $346.4 million compared to $385.4 million for the three months ended January 31, 2015, a decrease of $39.0 million or 10.1 percent. The increase in cost of sales as a percentage of net sales resulted from under absorption of fixed manufacturing costs from a decline in sales volume combined with the impact of foreign translation. The Company was able to offset some of this unfavorable impact through lower raw material costs and Continuous Improvement initiatives across the company. Purchased raw materials generally represent approximately 60 to 65 percent of the Company’s cost of sales. Of that amount, steel, including fabricated parts, represents approximately 20 percent. Filter media represents approximately 15 to 20 percent and the remainder is primarily made up of petroleum-based products, electrical and mechanical components, and other miscellaneous raw materials. The cost the Company paid for steel during the three months ended January 31, 2016, varied by grade, but in aggregate decreased compared to the prior year quarter in the U.S. The Company’s

cost of filter media varies by type and decreased slightly in cost compared to the prior year quarter. The cost of petroleum-based products showed a decrease compared to the prior year quarter. The Company enters into selective supply arrangements with certain of its suppliers that allow the Company to reduce volatility in its costs. The Company does strive to

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recover or offset all material cost increases through selective price increases to its Customers and the Company’s Continuous Improvement cost reduction initiatives, which include material substitution, process improvement, and product redesigns.

Operating expenses were $117.1 million for the quarter ended January 31, 2016, compared to $137.3 million in the prior year period. As a percent of net sales, operating expenses for the current year quarter were 22.6 percent compared to 23.3 percent during the prior year quarter. The decrease in operating expenses as a percentage of sales was primarily due to lower variable compensation costs, the benefit of restructuring actions and other expense controls. In addition, the prior year period included a pension settlement charge of $3.9 million. Partially offsetting these favorable items was an increase in ERP related expenses, which reflected go-live efforts in multiple regions of the world.

Interest expense increased from $3.7 million during the quarter ended January 31, 2015, to $5.5 million during the current year quarter. The increase in interest expense results from higher levels of long-term debt partially offset by lower short-term borrowings. The Company issued $150.0 million of long-term debt in April 2015.

Other income, net was $1.2 million for the three months ended January 31, 2016, compared to $3.3 million in the same period of the prior year. The decrease between the current year quarter compared to the prior year quarter was primarily due to a $1.8 million unfavorable impact of foreign exchange losses.

The effective tax rate for the three months ended January 31, 2016, was 23.0 percent as compared to 26.7 percent during the same period in the prior fiscal year. The decrease in the effective tax rate for the three months ended January 31, 2016, was primarily due to a reduction in the Company's base tax rate, which was driven by a favorable shift in mix of earnings between tax jurisdictions, the retroactive aspects of the Protecting Americans From Tax Hikes Act of 2015, a non- recurring tax benefit associated with foreign dividend distributions and an increase in the ratio of total discrete item benefits to pre-tax book income versus the prior year.

Six months ended January 31, 2016 compared to six months ended January 31, 2015

Operating results for the six months ended January 31, 2016 and 2015 are as follows (millions of dollars):

	Six Months Ended January 31,					
	2016			2015		
Net sales	$1,055.2			$1,185.0		
Cost of sales	706.3	66.9	%	772.8	65.2	%
Gross profit	348.9	33.1	%	412.2	34.8	%
Operating income	109.2	10.3	%	142.8	12.1	%
Earnings before income taxes	102.8	9.7	%	142.7	12.0	%
Income taxes	26.3	2.5	%	38.8	3.3	%
Net earnings	$76.5	7.2	%	$103.9	8.8	%

Net sales for the six months ended January 31, 2016 were $1,055.2 million or a decrease of 11.0 percent compared to the six months ended January 31, 2015. Current year net sales in the Engine Products and Industrial Products segments decreased $80.3 million and $49.5 million, respectively, when compared to the same period in the prior fiscal year. On a constant currency basis, net sales for the six months ended January 31, 2016 declined 5.6 percent from net sales for the six months ended January 31, 2015.

For the six months ended January 31, 2016, cost of sales decreased $66.5 million, or 8.6 percent, to $706.3 million compared to the same period of the prior fiscal year. Approximately $4.1 million of costs associated with the Company's restructuring actions are included in cost of sales for the six months ended January 31, 2016. The increase in cost of sales as a percentage of net sales resulted from unabsorption of fixed manufacturing costs from a decline in sales volume combined with the impact of foreign translation. The Company was able to offset some of this unfavorable impact through lower raw material costs and Continuous Improvement initiatives across the company.

Operating expenses were $239.7 million for the six months ended January 31, 2016 as compared to $269.4 million in the prior year period, a decrease of $29.7 million or 11.0 percent. As a percent of sales, operating expenses for the current fiscal year period were 22.7 percent which is unchanged from the same period in the prior fiscal years. The decrease in operating expense dollars was the result of the benefits of the restructuring actions and disciplined management of discretionary expenses partially offset by higher warranty costs. Approximately $4.4 million of costs

associated with restructuring actions and $3.1 million associated with the GTS investigation are included in operating expenses for the six months ended January 31, 2016.

Interest expense for the six months ended January 31, 2016 was $10.5 million compared to $7.2 million for the six months ended January 31, 2015. The increase in interest expense primarily results from $150.0 million of long-term debt issued in April 2015 that was outstanding during the Fiscal 2016 period.
Other income, net was $4.1 million for the six months ended January 31, 2016 compared to $7.1 million during the six months ended January 31, 2015. The decrease primarily results from a net loss of $1.2 million incurred by the Company's share of the AFSI joint venture during the six months ended January 31, 2016 compared to income of $1.4 million during the same period of the prior year.
The effective tax rate for the six months ended January 31, 2016 was 25.6 percent compared to 27.2 percent for the prior fiscal year period. The decrease in the Company's effective tax rate for the six months ended January 31, 2016, was primarily due to a favorable shift in the mix of earnings between tax jurisdictions and an increase in the ratio of total discrete item benefits to pre-tax book income versus the prior year.
Restructuring
2016 Actions
In the first quarter of Fiscal 2016, the Company took actions to further align its operating and manufacturing cost structure with current and projected Customer and end-market demand. These actions consisted of one-time termination benefits from restructuring the salaried and production workforce in all geographic regions and in both reportable segments. Total charges related to this action were expected to be $7.2 million. These actions have been completed and resulted in a total pre-tax charge of $6.2 million with $5.8 million recorded during the first quarter of Fiscal 2016 and $0.4 million recorded during the second quarter of Fiscal 2016. The Engine Products segment incurred $0.4 million of restructuring charges during the three months ended January 31, 2016. For the six months ended January 31, 2016, restructuring charges of $3.8 million and $2.4 million were incurred in the Engine Products and Industrial Products segments, respectively. As the charges were incurred and paid in the same period there was no liability balance as of either October 31, 2015 or January 31, 2016.
2015 Actions
In the second quarter of Fiscal 2015, the Company took actions to align its operating and manufacturing cost structure with current and projected Customer and end-market demand. These actions consisted of one-time termination benefits, project management fees, warehousing costs, moving expenses, and supplies and equipment related to the closing of the Company's Grinnell, Iowa facility. Total charges related to this action were expected to be $5.8 million. This action was completed in the second quarter of Fiscal 2016. Total charges related to this action since the second quarter of Fiscal 2015 were $5.8 million and have been recorded in the Engine Products segment.
Restructuring charges are summarized in the table below (millions of dollars):

	Three Months Ended January 31,		Six Months Ended January 31,	
	2016	2015	2016	2015
2016 Actions	$0.4	$—	$6.2	$—
2015 Actions	0.6	0.7	2.3	0.7
Total	$1.0	$0.7	$8.5	$0.7

Restructuring charges are summarized in the table below by statement of earnings line item (millions of dollars):

	Three Months Ended January 31,		Six Months Ended January 31,	
	2016	2015	2016	2015
Cost of sales	$0.9	$0.7	$4.1	$0.7
Operating expenses	0.1	—	4.4	—
Total	$1.0	$0.7	$8.5	$0.7

Total savings from the 2016 actions were initially estimated to result in $25 million of annual pre-tax savings. The Company continues to believe that an estimated $25 million in annual pre-tax savings is reasonable. The savings are a result of reduction in workforce and therefore, the savings are expected to commence immediately and will allow the Company to invest in other strategic initiatives.

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Operations by Segment

Following is financial information for the Company's Engine and Industrial Products segments. Corporate and Unallocated includes corporate expenses determined to be non-allocable to the segments and interest income and expense. Segment detail is summarized as follows (millions of dollars):

Following are net sales by product within the Engine and Industrial Products segments (millions of dollars):

	Three Months Ended January 31,		Six Months Ended January 31,	
	2016	2015	2016	2015
Net Sales:				
Total Engine Products segment	$320.9	$357.1	$667.5	$747.8
Total Industrial Products segment	196.3	231.4	387.7	437.2
Total Company	$517.2	$588.5	$1,055.2	$1,185.0
Earnings Before Income Taxes:				
Engine Product segment	$27.4	$41.5	$63.4	$94.6
Industrial Product segment	27.7	35.1	51.7	62.7
Corporate and Unallocated	(5.7)	(11.2)	(12.3)	(14.6)
Total Company	$49.4	$65.4	$102.8	$142.7

Engine Products Segment Following are net sales by product within the Engine Products segment (millions of dollars):

	Three Months Ended January 31,		Six Months Ended January 31,	
	2016	2015	2016	2015
Net Sales Engine Products segment:				
Off-Road Products	$52.6	$63.8	$107.4	$137.3
On-Road Products	32.5	31.6	68.3	68.4
Aftermarket Products*	213.7	235.6	445.9	492.1
Aerospace and Defense Products	22.1	26.1	45.9	50.0
Net Sales Engine Products segment	$320.9	$357.1	$667.5	$747.8

* Includes replacement part sales to the Company's OEM Engine Products Customers.

For the second quarter of Fiscal 2016, worldwide Engine Products sales were $320.9 million, a decrease of 10.1 percent from $357.1 million in the second quarter of the prior year. This decrease was driven by a 9.3 percent decrease in Aftermarket Products, due to weakness in the agricultural equipment, mining, and oil and gas markets, along with a 17.4 percent decrease in Off-Road Products, due to continued weakness in the global agriculture, Asia Pacific construction, and global mining markets. On-Road Products increased during the second quarter of Fiscal 2016 by 2.4 percent when compared to the second quarter of the prior year. Engine Products Sales in the Americas, Europe, and Asia decreased by 11.0 percent, 6.8 percent, and 9.3 percent, respectively, compared to the same period in the prior year. The impact of foreign currency translation during the second quarter of Fiscal 2016 decreased sales by $15.7 million or 4.4 percent. Year-to-date worldwide Engine Products sales were $667.5 million, a decrease of 10.7 percent from $747.8 million in the prior year period. This decrease was driven by a 9.4 percent decrease in Aftermarket Products, a 21.7 percent decrease in Off-Road Products, and an 8.1 percent decrease in Aerospace and Defense Products. Engine Products sales in the Americas, Europe, and Asia decreased by 10.6 percent, 10.9 percent, and 9.3 percent, respectively, compared to the same period in the prior year. The impact of foreign currency translation on the year-to-date results for the first six months of Fiscal 2016 decreased sales by $38.8 million or 5.2 percent.

Worldwide sales of Off-Road Products in the current quarter were $52.6 million, a decrease of 17.4 percent from $63.8 million in the second quarter of the prior year. Year-to-date worldwide sales of Off-Road Products totaled $107.4 million, a decrease of 21.7 percent from $137.3 million in the prior year. For the three and six months ended January 31, 2016, the sales decreases were driven by a continued weakness in the global agricultural equipment and Asia Pacific construction equipment markets, with decreased build rates in all regions, continued by softness in the

global mining equipment markets, and the negative impacts of foreign currency translation. In local currency sales decreased $8.2 million, or 12.9 percent for the three months ended January 31, 2016 and year-to-date sales decreased $23.2 million, or 16.9 percent.

Worldwide sales of On-Road Products in the current quarter were $32.5 million, an increase of 2.4 percent from $31.6 million in the second quarter of the prior year. Year-to-date worldwide sales of On-Road Products were $68.3 million, a 0.1 percent decrease from $68.4 million in the prior year. In local currency, sales increased $1.9 million, or 5.9 percent for the three months ended January 31, 2016 and increased $2.8 million, or 4.0 percent for the six months ended January 31, 2016.

Worldwide sales of Aftermarket Products in the current quarter were $213.7 million, a decrease of 9.3 percent from $235.6 million in the second quarter of the prior year. Year-to-date worldwide sales of Aftermarket Products were $445.9 million, a 9.4 percent decrease from $492.1 million in the prior year. For the three and six months ended January 31, 2016, sales decreased mainly due to weakness in the global agricultural equipment, mining, oil and gas markets. In local currency, sales decreased $10.8 million or 4.6 percent for the three months ended January 31, 2016 and year-to-date sales decreased $18.9 million, or 3.8 percent. PowerCore proprietary replacement filter sales increased $0.5 million in the three months ended January 31, 2016, which was an increase of 2.3 percent, from the prior year same period. Year to date PowerCore replacement filter sales increased $2.2 million, or a 4.0 percent increase from prior year period.

Worldwide sales of Aerospace and Defense Products were $22.1 million, a decrease of 15.3 percent from $26.1 million in the second quarter of the prior year. Year-to-date sales of Aerospace and Defense Products were $45.9 million, an 8.1 percent decrease from $50.0 million in the prior year. For the three and six months ended January 31, 2016, the sales decreases were primarily due to the prior year periods benefiting from a large order of replacement parts. In local currency, sales decreased $3.3 million, or 12.4 percent three months ended January 31, 2016 and year-to-date sales decreased $2.3 million, or 4.5 percent.

For the three months ended January 31, 2016, earnings before income taxes as a percentage of Engine Product segment sales were 8.5 percent, a decrease from 11.6 percent in the prior year period. Year-to-date earnings before income taxes as a percentage of Engine Products segment sales were 9.5 percent, a decrease from 12.7 percent in the prior year. The percentage earnings decrease for the three and six months ended January 31, 2016, were driven by lower cost absorption due to a decrease in production volumes and the impact of foreign currency translation. The current year earnings before income taxes includes restructuring charges of $6.1 million.

Industrial Products Segment Following are net sales by product within the Industrial Products segment (millions of dollars):

	Three Months Ended January 31,		Six Months Ended January 31,	
	2016	2015	2016	2015
Net Sales Industrial Products segment:				
Industrial Filtration Solutions	$120.4	$130.2	$246.9	$260.7
Gas Turbine Systems	32.8	55.4	57.0	86.5
Special Application Products	43.1	45.8	83.8	90.0
Net Sales Industrial Products segment	$196.3	$231.4	$387.7	$437.2

For the second quarter, worldwide sales in the Industrial Products segment were $196.3 million, a decrease of 15.1 percent from 231.4 million in the second quarter of the prior year. The decrease was driven by a 40.8 percent decrease in Gas Turbine Systems, in addition to decreases in Industrial Filtration Solutions and Special Applications Products of 7.5 percent and 5.7 percent, respectively. The impact of foreign currency translation during the second quarter of Fiscal 2016 decreased Industrial Products sales by $10.5 million, or 4.5 percent. In local currency, worldwide sales decreased $24.5 million, or a decrease of 10.6 percent for the three months ended January 31, 2016. Year-to-date sales were $387.7 million, an 11.3 percent decrease from $437.2 million in the prior year. This decrease was driven by decreases of 34.1 percent in Gas Turbine Systems, 5.3 percent in Industrial Filtration Solutions, and 6.8 percent in Special Applications Products. The impact of foreign currency translation during the six months ended January 31, 2016, decreased Industrial Products sales by $24.9 million, or 5.7 percent. In local currency, reported sales decreased $24.6 million, or 5.6 percent for the six months ended January 31, 2016.

Worldwide sales of Industrial Filtration Solutions in the current quarter were $120.4 million, a decrease of 7.5 percent from $130.2 million in the prior year quarter. Sales decreased in Europe, Asia, and the Americas by 12.8 percent, 8.7

percent, and 1.2 percent, respectively. Year-to-date worldwide sales of Industrial Filtration Solutions were $246.9 million, a decrease of 5.3 percent from $260.7 million in the prior year. Sales decreased 11.9 percent in Europe and 4.3 percent in Asia, partially offset by a 1.2 percent increase in America, from the prior year period. For the three and six months ended January 31, 2016, the decrease was due to foreign currency translation. In local currency, sales increased $2.3 million when compared to prior year due to increased equipment sales in all regions during the first quarter of Fiscal 2016.

Worldwide sales of the Company’s Gas Turbine Systems in the second quarter were $32.8 million, a decrease of 40.8 percent compared to sales of $55.4 million in the prior year quarter. In local currency, sales decreased $21.8 million in the three months ended January 31, 2016. Year-to-date global sales of the Company's Gas Turbine Systems were $57.0 million, a decrease of 34.1

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percent compared to sales of $86.5 million in the prior year. Gas Turbine Systems sales are typically large systems and, as a result, the Company's shipments and revenues fluctuate from period to period.
Worldwide sales of Special Application Products were $43.1 million in the current quarter, a decrease of 5.7 percent compared to sales of $45.8 million in the prior year quarter. Year-to-date worldwide sales of Special Application Products were $83.8 million, a 6.8 percent decrease from $90.0 million in the prior year. For the three and six months ended January 31, 2016, sales increased $0.2 million for the three months ended January 31, 2016, and sales were flat for the six months ended January 31, 2016 in local currency.
For the three months ended January 31, 2016, Industrial Products' earnings before income taxes as a percentage of sales were 14.1 percent, a decrease from 15.2 percent in the prior year period. Year-to-date earnings before income taxes as a percentage of Industrial Products segments sales were 13.3 percent, a decrease from 14.3 percent percent in the prior year. The current year earnings before income taxes includes restructuring charges of $2.4 million. The decrease in profits is primarily due to the decline in sales partially offset by lower operating expenses.
Liquidity and Capital Resources
During the six months ended January 31, 2016, $109.3 million of cash was generated from operating activities, compared to $85.4 million in the same period in the prior fiscal year. The increase in cash generated from operating activities of $23.9 million was primarily attributable to changes in operating assets and liabilities, partially offset by lower net earnings. The changes in operating assets and liabilities reflect favorable changes in accounts receivable and inventory of $24.0 million and $19.4 million, respectively for the six months ended January 31, 2016, compared to the same period of Fiscal 2015.
The accounts receivable balance as of January 31, 2016 was $402.7 million, a decrease of $57.3 million from $460.0 million as of July 31, 2015. The decrease is a result of higher revenues in the fourth quarter of fiscal 2015. Days sales outstanding was 69 days as of January 31, 2016, compared to 64 days as of July 31, 2015. The increase in days sales outstanding reflects delayed payments and longer payment terms associated with some large Gas Turbine Systems projects during Fiscal 2016. The Company’s days sales outstanding is also impacted by the mix of foreign sales particularly in countries where extended payment terms are required. Days sales outstanding is calculated using the count back method which calculates the number of days of most recent revenue that is reflected in the net accounts receivable balance.
The inventory balance as of January 31, 2016 was $274.8 million, an increase of $9.8 million from $265.0 million as of July 31, 2015. The increase is due to higher inventory levels in the Gas Turbine Systems business to support upcoming projects. Inventory turns were 3.9 times per year as of January 31, 2016, compared to 4.3 times per year as of July 31, 2015. Inventory turns are calculated by taking the inventoriable portion of cost of goods sold for the trailing twelve month period divided by the average gross inventory value over the prior thirteen month period.
In the first six months of Fiscal 2016, operating cash flows, cash on hand, and credit lines were used to repurchase 2.1 million shares of treasury stock for $68.0 million, make $42.8 million in capital investments, pay $45.2 million in dividends, and acquire Engineered Products Company (EPC). For additional information regarding share repurchases, see Part II, Item 2, “Unregistered Sales of Equity Securities and Use of Proceeds.”
At the end of the second quarter, the Company held $222.1 million in cash and cash equivalents, up from $189.9 million at July 31, 2015. Short-term investments were $9.8 million compared to $27.5 million at July 31, 2015. Short-term investments may change from quarter to quarter based on maturity dates of existing investments and the Company’s outlook of cash needs, and available access to liquidity. The amount of unused lines of credit as of January 31, 2016, was approximately $403.1 million. Long-term debt of $389.0 million at January 31, 2016, a slight decrease from $389.2 million at July 31, 2015. Long-term debt represented 35.5 percent of total long-term capital, defined as long-term debt plus total shareholders’ equity, compared to 33.3 percent at July 31, 2015.
The majority of the Company’s cash and cash equivalents and short-term investments are held by its foreign subsidiaries, as over half of the Company’s earnings occur outside the U.S. Most of these funds are considered permanently reinvested outside the U.S., and will only be repatriated when it is tax effective to do so, as the cash generated from U.S. operations and the Company’s access to liquidity is anticipated to be sufficient for the U.S. operations' cash needs. On September 24, 2015, the Company repatriated $20.3 million, or €18.0 million, of cash held by its foreign subsidiaries in the form of a cash dividend. Additionally, on September 30, 2015, the Company

repatriated $5.2 million of cash held by its foreign subsidiaries in the form of a cash dividend. These dividends represented a portion of the total planned dividends for Fiscal 2016. The Company anticipates the net tax impact of the Fiscal 2016 dividends to be tax neutral.

In October of Fiscal 2015, the Company completed a foreign legal entity restructuring. The restructuring resulted in the ability to repatriate additional prior year earnings at no additional tax cost and still follow the Company's policy of only repatriating cash when it is tax effective to do so. As a result, the Company changed its assertion regarding certain foreign earnings that were previously considered permanently reinvested and repatriated approximately $45 million of those earnings in addition to the

approximately $80 million repatriation of current year earnings not previously considered indefinitely reinvested. The level of repatriation in Fiscal 2015 is viewed as nonrecurring in nature due to a change in the mix of foreign earnings and taxes as a result of this restructuring.

The Company's general funding policy for its pension plans is to make at least the minimum contributions as required by applicable regulations. The Company may elect to make additional contributions up to the maximum tax-deductible contribution. For the six months ended January 31, 2016, the Company made contributions of $1.7 million to its non-U.S. pension plans and $0.6 million to its U.S. pension plans. The minimum funding requirement for the Company's U.S. plans for Fiscal 2016 is $10.8 million. Per the Pension Protection Act of 2006, this obligation can be met with existing credit balances that resulted from payments above the minimum obligation in prior years. The Company plans to utilize existing credit balances to meet the minimum obligation for Fiscal 2016. The Company currently estimates that it will contribute an additional $2.2 million to its non-U.S. pension plans during the remainder of Fiscal 2016.

The following table summarizes the Company's contractual obligations as of January 31, 2016 (millions of dollars):

		Payments Due by Period			
Contractual Obligations	Total	Less than 1 year	1 - 3 years	3 - 5 years	More than 5 years
Long-term debt obligations	$388.7	$—	$100.0	$13.7	$275.0
Capital lease obligations	0.9	0.8	0.1	—	—
Interest on long-term debt obligations	114.1	14.9	23.0	18.7	57.5
Operating lease obligations	28.6	11.1	14.1	3.2	0.2
Purchase obligations (1)	133.9	125.0	8.2	0.5	0.2
Pension and deferred compensation (2)	122.9	18.6	15.2	14.7	74.4
Total (3)	$789.1	$170.4	$160.6	$50.8	$407.3

(1) Purchase obligations consist primarily of inventory, tooling, contract employment services, and capital expenditures. The Company's purchase orders for inventory are based on expected Customer demand and quantities and dollar volumes are subject to change.

(2) Pension and deferred compensation consists of long-term pension liabilities and salary and bonus deferrals elected by certain executives under the Company's Deferred Compensation Plan. Deferred compensation balances earn interest based on a treasury bond rate as defined by the plan (10-year treasury bond STRIP rate plus two percent for deferrals prior to January 1, 2011, and 10-year treasury bond rates for deferrals after December 31, 2010) and approved by the Human Resources Committee of the Board of Directors, and are payable at the election of the participants.

(3) In addition to the above contractual obligations, the Company may be obligated for additional cash outflows of $21.6 million of potential tax obligations, including accrued interest and penalties. The payment and timing of any such payments is affected by the ultimate resolution of the tax years that are under audit or remain subject to examination by the relevant taxing authorities. Therefore, quantification of an estimated range and timing of future payments cannot be made at this time.

On January 31, 2016, the Company had a contingent liability for standby letters of credit totaling $7.8 million that have been issued and are outstanding. The letters of credit guarantee payment to third parties in the event the Company is in breach of insurance contract terms as detailed in each letter of credit. As of January 31, 2016, there were no amounts drawn upon these letters of credit.

On October 28, 2014, the Company entered into a First Amendment (Amendment) to its five-year, multi-currency revolving credit facility with a group of banks under which the Company may borrow up to $250.0 million. The Amendment increased the borrowing availability up to $400.0 million. The credit facility provides that loans may be made under a selection of currencies and rate formulas including Base Rate Loans or LIBOR Rate Loans. The interest rate on each advance is based on certain market interest rates and leverage ratios. Facility fees and other fees on the

entire loan commitment are payable over the duration of this facility. As of January 31, 2016, there was $245.0 million borrowed under this facility. The multi-currency revolving facility contains debt covenants specifically related to maintaining a certain interest coverage ratio, and a certain leverage ratio, as well as other covenants that, under certain circumstances, can restrict the Company’s ability to incur additional indebtedness, make investments and other restricted payments, create liens, and sell assets. As of January 31, 2016, the Company was in compliance with all such covenants.

On April 16, 2015, the Company entered into a First Supplement to Note Purchase Agreement (First Supplement), dated April 16, 2015, with a group of institutional investors, which supplements a Note Purchase Agreement, dated March 27, 2014. Pursuant to the First Supplement, the Company issued $25.0 million of senior unsecured notes due April 16, 2025, and $125.0 million senior unsecured notes due June 17, 2030. The debt was issued at face value and bears interest payable semi-annually at an annual rate of interest of 2.93 percent. The proceeds from the notes were primarily used to refinance existing debt, and were also used for general corporate purposes. The notes contain debt covenants specifically related to maintaining a certain leverage ratio as well as other covenants that, under certain circumstances, can restrict the Company’s ability to incur additional indebtedness,

make investments and other restricted payments, create liens, and sell assets. As of January 31, 2016, the Company was in compliance with all such covenants.
The Company has two uncommitted credit facilities in the U.S., which provide unsecured borrowings for general corporate purposes. At January 31, 2016 and 2015, there was $48.6 million and $43.8 million available for use, respectively, under these two facilities. There was $16.4 million outstanding at January 31, 2016, and $21.1 million outstanding at January 31, 2015, under these facilities. The weighted average interest rate on the short-term borrowings outstanding at January 31, 2016, was 1.19 percent.
During the quarter, credit in the global credit markets was accessible and market interest rates remained low. The Company believes that its current financial resources, together with cash generated by operations, are sufficient to continue financing its operations for the next twelve months. There can be no assurance, however, that the cost or availability of future borrowings will not be impacted by future capital market disruptions.
The Company does not have any off-balance sheet arrangements, with the exception of the guarantee of 50 percent of certain debt of its joint venture, AFSI, as further discussed in Note I of the Company’s Notes to Condensed Consolidated Financial Statements.
For new accounting standards not yet adopted refer to Note A Summary of Significant Accounting Policies.
Critical Accounting Policies
Other than noted in the following paragraph there have been no other material changes to the Company’s critical accounting policies as disclosed in the Company’s Annual Report on Form 10-K for the year ended July 31, 2015.
Goodwill and other intangible assets Goodwill is assessed for impairment annually, or more frequently if events or changes in circumstances indicate that the asset may be impaired. The Company performed an impairment assessment during the third quarter of Fiscal 2015. The results of this assessment showed that the estimated fair values of the reporting units to which goodwill is assigned continued to exceed the corresponding carrying values of the respective reporting units resulting in no goodwill impairment.
During the second quarter of Fiscal 2016, the Company revised its forecast associated with its Gas Turbine Systems reporting unit. While the previous forecast for this reporting unit called for a year-over-year decline in sales, the Company continued to face deferrals and softening demand for large-turbine projects. Given the challenges facing this business, the Company revisited its strategic focus. The Company's priorities for the Gas Turbine Systems business will shift slightly. The Company will continue to focus on innovative products while growing the aftermarket business. The strategic shift is the Company will be more selective in taking on large-turbine projects. This strategic shift resulted in the revised forecast associated with its Gas Turbine Systems reporting unit.
As a result of the strategic shift and revised forecast actions taken in the second quarter of Fiscal 2016, the Company concluded that an interim goodwill triggering event had occurred for the Gas Turbine Systems reporting unit. Goodwill associated with the Gas Turbine Systems reporting unit is $60.2 million as of January 31, 2016 and is included in the Industrial Products segment. The Company completed its goodwill impairment assessment using a discounted cash flow model based on management's judgments and assumptions to determine the estimated fair value of the reporting unit. Based on the results of this assessment the Company concluded the estimated fair value of the Gas Turbine Systems reporting unit exceeded the respective carrying amount of the reporting unit by approximately 13.6 percent. Therefore, the second step of the impairment test was not necessary for this reporting unit.
In determining the estimated fair value of the reporting unit, the Company used the income approach, a valuation technique using an estimate of future cash flows from the reporting unit's financial forecast. A terminal growth rate of 3.0 percent and a discount rate of 12.0 percent were used reflecting the relative risk of achieving cash flows as well as any other specific risks or factors related to the Gas Turbine Systems reporting unit. The Company believes the assumptions used in its discounted cash flow analysis are appropriate and result in reasonable estimate of the reporting unit's fair value. The Company performed a sensitivity analysis to determine how the assumptions made impact the results of the impairment test. Holding all other assumptions constant, an unfavorable change in projected cash flows of 25.0 percent or more would potentially result in an indication of impairment. Additionally, a decrease in the residual growth rate of 4.5 percentage points or more or an increase in the discount rate of 1.2 percentage points or more would potentially result in an indication of impairment. While the current projections support no impairment of this reporting unit as of January 31, 2016, given that our second quarter 2016 results fell below expectations and the

sensitivities to the assumptions used in the calculations of the estimated cash flows, it is possible that an impairment could be incurred in the future. The Company will continue to monitor results and expected cash flows in the future to assess whether goodwill impairment in our Gas Turbine Systems reporting unit may be necessary.

Outlook

Donaldson expects Fiscal 2016 adjusted EPS to be between $1.51 and $1.61, compared with prior adjusted EPS guidance of $1.49 to $1.69. Fiscal 2016 GAAP EPS is expected to be approximately 6 cents lower than adjusted EPS, reflecting the full-year impact from restructuring charges and investigation related costs.

Donaldson's full year 2016 guidance reflects:

Sales between $2.20 billion and $2.25 billion, or 5 percent to 7 percent below last year, compared with prior guidance for sales to be approximately 3 percent to 7 percent below last year.

Excluding the negative impact from currency translation of $90 million to $100 million, sales in local currencies are expected to decline between 1 percent and 3 percent. The midpoint of this range is consistent with that of the prior guidance range.

Adjusted operating margin in a range between 13.0 percent and 13.6 percent. The midpoint of this range is consistent with that of the prior guidance range.

An effective income tax rate between 25.5 percent and 27.5 percent, compared with prior guidance of 26.0 percent to 28.0 percent.

Repurchasing up to 2 percent of outstanding shares.

SAFE HARBOR STATEMENT UNDER THE SECURITIES REFORM ACT OF 1995
The Company, through its management, may make forward-looking statements reflecting the Company's current views with respect to future events and financial performance. These forward-looking statements, which may be included in reports filed under the Securities Exchange Act of 1934, as amended (the Exchange Act), in press releases and in other documents and materials as well as in written or oral statements made by or on behalf of the Company, are subject to certain risks and uncertainties, including those discussed in Item 1A of the Company's Annual Report on Form 10-K for the year ended July 31, 2015, which could cause actual results to differ materially from historical results or those anticipated. The words or phrases "will likely result," "are expected to," "will continue," "estimate," "project," "believe," "exp "anticipate," "forecast" and similar expressions are intended to identify forward-looking statements within the meaning of Section 21e of the Exchange Act and Section 27A of the Securities Act of 1933, as amended, as enacted by the Private Securities Litigation Reform Act of 1995 (PSLRA). In particular, the Company desires to take advantage of the protections of the PSLRA in connection with the forward-looking statements made in this Quarterly Report on Form 10-Q, including those contained in the "Outlook" section of Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations." All statements other than statements of historical fact are forward-looking statements. These statements do not guarantee future performance.
Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date such statements are made. In addition, the Company wishes to advise readers that the factors listed in Item 1A of the Company's Annual Report on Form 10-K for the year ended July 31, 2015, as well as other factors, could affect the Company's performance and could cause the Company's actual results for future periods to differ materially from any opinions or statements expressed. These factors include, but are not limited to, world economic factors and the ongoing economic uncertainty, currency fluctuations, commodity prices, political factors, the Company's international operations, highly competitive markets, governmental laws and regulations, including the impact of the various economic stimulus and financial reform measures, potential global events resulting in market instability including financial bailout and defaults of sovereign nations, military and terrorist activities, including political conditions where we do business, health outbreaks, natural disasters, and other factors included in Item 1A of the Company's Annual Report on Form 10-K for the year ended July 31, 2015. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes in the reported market risk of the Company since July 31, 2015. See further discussion of these market risks in the Company's Annual Report on Form 10-K for the year ended July 31, 2015.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of January 31, 2016 (the Evaluation Date), the Company carried out an evaluation, under the supervision and with the participation of management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act). Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that, as of the Evaluation Date, the Company's disclosure controls and procedures were not effective to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is (i) recorded, processed, summarized, and reported within the time periods specified in applicable rules and forms, and (ii) accumulated and communicated to the Company's management, including the Chief Executive Officer and the Chief Financial Officer, to allow timely decisions regarding required disclosure. This conclusion was reached as a result of a material weakness in the Company's internal control over financial reporting described below.
A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis.
As previously disclosed in the Company's 2015 Annual Report on Form 10-K, the Company did not maintain effective controls over recognition of revenue in its European Gas Turbine Products business. Specifically,

transactions were not recorded in the proper period because the design of the controls did not contemplate effective review of delivery terms associated with Gas Turbine Products business projects revenue and the fulfillment of certain contractual terms by the Company was not sufficiently verified by reference to independent third party documentation.

The financial statement errors that arose because of the identified material weakness resulted in the revision of previously reported interim financial statements for the quarters ended January 31, 2015 and April 30, 2015. Management concluded that the material weakness described above continued to exist as of January 31, 2016, and could result in a material misstatement to the annual or interim financial statements that would not be prevented or detected on a timely basis.

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Notwithstanding the material weakness described above, our management, including our Chief Executive Officer and Chief Financial Officer, has concluded that the Company's consolidated financial statements included in this Form 10-Q present fairly, in all material respects, our financial position, results of operations and cash flows for the periods presented in conformity with accounting principles generally accepted in the United States.

Changes in Internal Control over Financial Reporting

Other than the changes noted in the Remediation Plan section below related to the control over the European Gas Turbine Products, there have been no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) that occurred during the current quarter, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

The Company is in the process of a multi-year implementation of a global enterprise resource planning system (Global ERP Project). In the second quarter of Fiscal 2014, the Company began deploying the system in certain operations, primarily in the Americas. In November 2014, the Company completed deploying the system in the Americas with the exception of Brazil, which goes live at a later date. In March 2015, the Company began deploying the system in Europe. The Company expects this system will continue to be deployed further in Europe and Asia throughout Fiscal 2016. In response to business integration activities related to the new system, the Company is aligning and streamlining the design and operation of the financial reporting controls environment to be responsive to the changing operating environment.

Remediation Plan

Management has executed its remediation plan to address the material weakness identified above. Specifically, management implemented changes, including enhancement of existing controls, to ensure European Gas Turbine Systems revenue is recognized in the appropriate period, and took multiple disciplinary actions, including termination of certain employees. In addition, a training program was implemented to provide clarity on the Company's policies and procedures for proper revenue recognition. Improvements implemented during the quarters ended October 31, 2015 and January 31, 2016, to the control activities associated with the European Gas Turbine Systems business projects revenue included:

- Thorough review and approval by management of all delivery terms on gas turbine projects.
- Expanded use of third party documentation for support of the decision as to when recognition of revenue is appropriate.
- The utilization of standard forms for determining and documenting the revenue recognition decision.

We are committed to maintaining a strong internal control environment and believe that these actions will be effective in remediating the material weakness described above. While we believe that enhancing existing controls remediates the identified material weakness, the material weakness in internal control will not be considered fully addressed until the new procedures have been in place for a sufficient period of time and tested to allow management to conclude that the controls are effective.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company records provisions with respect to identified claims or lawsuits when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Claims and lawsuits are reviewed quarterly and provisions are taken or adjusted to reflect the status of a particular matter. The Company believes the recorded estimated liability in its consolidated financial statements is adequate in light of the probable and estimable outcomes. Any recorded liabilities were not material to the Company's financial position, results of operations or liquidity, and the Company does not believe that any of the currently identified claims or litigation will materially affect its financial position, results of operations, or liquidity.

Item 1A. Risk Factors

There are inherent risks and uncertainties associated with the Company's global operations that involve the manufacturing and sale of products for highly demanding Customer applications throughout the world. These risks and uncertainties could adversely affect the Company's operating performances or financial condition. The "Risk Factors" section in the Company's Annual Report on Form 10-K for the year ended July 31, 2015, includes a discussion of these risks and uncertainties.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Repurchases of Equity Securities The following table sets forth information in connection with purchases made by, or on behalf of, the Company or any affiliated purchaser of the Company, of shares of the Company's common stock during the three months ended January 31, 2016:

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
November 1 - November 30, 2015	7,733	$30.91	—	10,974,199
December 1 - December 31, 2015	17,325	30.20	—	10,974,199
January 1 - January 31, 2016	3,087	28.43	—	10,974,199
Total	28,145	$30.20	—	10,974,199

(1) On May 29, 2015, the Company announced that the Board of Directors authorized the repurchase of up to 14.0 million shares of common stock. This repurchase authorization, which is effective until terminated by the Board of Directors, replaced the existing authority for repurchase of 15.0 million shares of common stock that was authorized on September 27, 2013. There were no repurchases of common stock made outside of the Company's current repurchase authorization during the three months ended January 31, 2016. However, the "Total Number of Shares Purchased" column of the table above includes 28,145 previously owned shares tendered by option holders in payment of the exercise price of options during the quarter. While not considered repurchases of shares, the Company does at times withhold shares that would otherwise be issued under equity-based awards to cover the withholding of taxes due as a result of exercising stock options or payment of equity-based awards.

Item 6. Exhibits

*3-A – Restated Certificate of Incorporation of Registrant as currently in effect (Filed as Exhibit 3-A to Form 10-Q Report for the Second Quarter ended January 31, 2012)

*3-B – Certificate of Designation, Preferences and Rights of Series A Junior Participating Preferred Stock of Registrant, dated as of March 3, 2006 (Filed as Exhibit 3-B to 2011 Form 10-K Report)

*3-C – Amended and Restated Bylaws of Registrant (as of January 30, 2009) (Filed as Exhibit 3-C to Form 10-Q Report for the Second Quarter ended January 31, 2009)

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*4-A – Preferred Stock Amended and Restated Rights Agreement between Registrant and Wells Fargo Bank, N.A., as Rights Agent, dated as of January 27, 2006 (Filed as Exhibit 4-A to 2011 Form 10-K Report)

31-A – Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31-B – Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32 – Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101 – The following information from the Donaldson Company, Inc. Quarterly Report on Form 10-Q for the fiscal quarter ended January 31, 2016, as filed with the Securities and Exchange Commission, formatted in Extensible Business Reporting Language (XBRL): (i) the Condensed Consolidated Statements of Earnings, (ii) the Condensed Consolidated Balance Sheets, (iii) the Condensed Consolidated Statements of Comprehensive Income, (iv) The Condensed Consolidated Statements of Cash Flows and (v) the Notes to Condensed Consolidated Financial Statements.

* Exhibit has previously been filed with the Securities and Exchange Commission and is incorporated herein by reference as an exhibit.

** Pursuant to the provisions of Regulation S-K Item 601(b)(4)(iii)(A) copies of instruments defining the rights of holders of certain long-term debts of the Company and its subsidiaries are not filed and in lieu thereof the Company agrees to furnish a copy thereof to the Securities and Exchange Commission upon request.

*** Denotes compensatory plan or management contract.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

DONALDSON COMPANY, INC.
(Registrant)

Date: March 10, 2016

By: /s/ Tod E. Carpenter
Tod E. Carpenter
President and
Chief Executive Officer
(duly authorized officer)

Date: March 10, 2016

By: /s/ Scott J. Robinson
Scott J. Robinson
Vice President,
Chief Financial Officer
(principal financial officer)

Date: March 10, 2016

By: /s/ Melissa A. Osland
Melissa A. Osland
Corporate Controller
(principal accounting officer)

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