TIMBERLAND BANCORP INC
Form 10-Q
February 09, 2017
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended December 31, 2016
OR
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the Transition Period from $\qquad$ to $\qquad$ .

Commission file number 0-23333
TIMBERLAND BANCORP, INC.
(Exact name of registrant as specified in its charter)

Washington
(State or other jurisdiction of incorporation or organization) (IRS Employer Identification No.)

624 Simpson Avenue, Hoquiam, Washington 98550
(Address of principal executive offices) (Zip Code)
(360) 533-4747
(Registrant's telephone number, including area code)
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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer $\qquad$ Accelerated Filer X Non-accelerated filer $\qquad$ Smaller reporting company $\qquad$ Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes $\qquad$ No _X_

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.
CLASS SHARES OUTSTANDING AT FEBRUARY 9, 2017
Common
stock, $7,345,397$
$\$ .01$ par
value

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## PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (unaudited)
TIMBERLAND BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
December 31, 2016 and September 30, 2016
(Dollars in thousands, except per share amounts)

Assets
Cash and cash equivalents:
Cash and due from financial institutions $\quad \$ 16,598 \quad \$ 16,686$
Interest-bearing deposits in banks
Total cash and cash equivalents
December 31, September 30,
20162016
(Unaudited)

| Certificates of deposit ("CDs") held for investment (at cost, which approximates fair value) | 53,432 | 53,000 |
| :---: | :---: | :---: |
| Investment securities held to maturity, at amortized cost (estimated fair value $\$ 8,134$ and $\$ 8,395$ ) | 7,418 | 7,511 |
| Investment securities available for sale, at fair value | 1,288 | 1,342 |
| Federal Home Loan Bank of Des Moines ("FHLB") stock | 2,204 | 2,204 |
| Loans held for sale | 2,008 | 3,604 |
| Loans receivable, net of allowance for loan losses of \$9,843 and \$9,826 | 669,140 | 663,146 |
| Premises and equipment, net | 17,816 | 16,159 |
| Other real estate owned ("OREO") and other repossessed assets, net | 3,254 | 4,117 |
| Accrued interest receivable | 2,443 | 2,348 |
| Bank owned life insurance ("BOLI") | 18,858 | 18,721 |
| Goodwill | 5,650 | 5,650 |
| Mortgage servicing rights ("MSRs"), net | 1,706 | 1,573 |
| Other assets | 3,064 | 3,072 |
| Total assets | \$ 923,751 | \$ 891,388 |

Liabilities and shareholders' equity
Liabilities
Deposits:
Non-interest-bearing demand
Interest-bearing
Total deposits
\$ 176,382 \$ 172,283
613,593 589,251

FHLB borrowings
789,975 761,534

Other liabilities and accrued expenses
30,000 30,000
Total liabilities
4,142 3,020

* Derived from audited consolidated financial statements.

See notes to unaudited consolidated financial statements

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TIMBERLAND BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS (continued)
December 31, 2016 and September 30, 2016
(Dollars in thousands, except per share amounts)

|  | December 31, September 30,  <br> 2016 2016 <br> (Unaudited) $*$ |  |
| :---: | :---: | :---: |
| Shareholders' equity |  |  |
| Preferred stock, \$.01 par value; 1,000,000 shares authorized; none issued | \$ | \$ - |
| Common stock, \$. 01 par value; 50,000,000 shares authorized; |  |  |
| 6,956,568 shares issued and outstanding - December 31, 2016 6,943,868 shares issued and outstanding - September 30, 2016 | 10,188 | 9,961 |
| Unearned shares issued to Employee Stock Ownership Plan ("ESOP") | (595 ) | ) (661 |
| Retained earnings | 90,230 | 87,709 |
| Accumulated other comprehensive loss | (189 ) | ) (175 |
| Total shareholders' equity | 99,634 | 96,834 |
| Total liabilities and shareholders' equity | \$ 923,751 | \$ 891,388 |
| - Derived from audited consolidated financial statements. |  |  |

See notes to unaudited consolidated financial statements

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TIMBERLAND BANCORP, INC. AND SUBSIDIARYCONSOLIDATED STATEMENTS OF INCOME
For the three months ended December 31, 2016 and 2015
(Dollars in thousands, except per share amounts)(Unaudited)
Three Months
EndedDecember 31,20162015
Interest and dividend income
Loans receivable and loans held for sale ..... \$8,788 \$8,429
Investment securities ..... 70 ..... 69
Dividends from mutual funds and FHLB stock ..... 24 ..... 22
Interest-bearing deposits in banks and CDs ..... 281 ..... 171
Total interest and dividend income ..... 9,163 8,691
Interest expense
Deposits ..... 543 ..... 504
FHLB borrowings ..... 307 ..... 477
Total interest expense ..... 850 ..... 981
Net interest income ..... $8,313 \quad 7,710$
Provision for loan losses
Net interest income after provision for loan losses ..... $8,313 \quad 7,710$
Non-interest income
Service charges on deposits ..... 1,105 972
ATM and debit card interchange transaction fees ..... 800700
BOLI net earnings ..... 137136
Gain on sales of loans, net ..... 689394
Escrow fees ..... 7641
Servicing income on loans sold ..... 97
Other, net$312 \quad 210$
Total non-interest income, net ..... 3,216 2,518

See notes to unaudited consolidated financial statements

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| TIMBERLAND BANCORP, INC. AND SUBSIDIARY |  |  |
| :---: | :---: | :---: |
| CONSOLIDATED STATEMENTS OF INCOME (continued) |  |  |
| For the three months ended December 31, 2016 and 2015 (Dollars in thousands, except per share amounts) (Unaudited) |  |  |
|  | Three Months <br> Ended <br> December 31, |  |
| Non-interest expense |  |  |
| Salaries and employee benefits | \$3,680 | \$ 3,471 |
| Premises and equipment | 755 | 760 |
| Advertising | 162 | 205 |
| OREO and other repossessed assets, net | 30 | 244 |
| ATM and debit card interchange transaction fees | 311 | 322 |
| Postage and courier | 95 | 100 |
| State and local taxes | 155 | 132 |
| Professional fees | 201 | 130 |
| Federal Deposit Insurance Corporation ("FDIC") insurance | 113 | 107 |
| Loan administration and foreclosure | 94 | 29 |
| Data processing and telecommunications | 450 | 450 |
| Deposit operations | 309 | 172 |
| Other | 455 | 357 |
| Total non-interest expense | 6,810 | 6,479 |
| Income before federal income taxes | 4,719 | 3,749 |
| Provision for federal income taxes | 1,572 | 1,221 |
| Net income | \$3,147 | \$ 2,528 |
| Net income per common share |  |  |
| Basic | \$0.46 | \$ 0.37 |
| Diluted | \$0.43 | \$ 0.36 |
| Weighted average common shares outstanding |  |  |
| Basic | 6,862,7 | 449,869,726 |
| Diluted | 7,235,5 | 1退083,864 |
| Dividends paid per common share | \$0.09 | \$ 0.12 |

See notes to unaudited consolidated financial statements
TIMBERLAND BANCORP, INC. AND SUBSIDIARY CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the three months ended December 31, 2016 and 2015
(Dollars in thousands)
(Unaudited)


See notes to unaudited consolidated financial statements

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TIMBERLAND BANCORP, INC. AND SUBSIDIARY CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
For the three months ended December 31, 2016 and 2015
(Dollars in thousands, except per share amounts)
(Unaudited)

Balance, September 30, 2015
Net income
Other comprehensive loss
Exercise of stock options
Common stock dividends (\$0.12 per common share)
Earned ESOP shares, net of income taxes
Stock option compensation expense
Balance, December 31, 2015

Balance, September 30, 2016
Net income
Other comprehensive loss
Exercise of stock options
Common stock dividends (\$0.09 per common share)
Earned ESOP shares, net of income taxes
Stock option compensation expense
Balance, December 31, 2016

| Number of Shares | Amount | Unearned Shares |  | Accumulated Other |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Common | Common | Issued | Retained | Compre- |  |  |
| Stock | Stock |  | Earnings | hensive |  | Total |
|  |  | ESOP |  | Loss |  |  |
| 6,988,848 | \$ 10,293 | \$ (926 ) | \$80,133 | \$ (313 | ) | \$89,187 |
| - | - | - | 2,528 | - |  | 2,528 |
| - | - | - | - | (2 | ) | (2 |
| 5,300 | 42 | - | - | - |  | 42 |
| - | - | - | (838 | ) - |  | (838 |
|  | 26 | 67 | - | - |  | 93 |
| - | 41 | - | - | - |  | 41 |
| 6,994,148 | 10,402 | (859 ) | 81,823 | (315 | ) | 91,051 |

$\left.\begin{array}{lllllll}6,943,868 & 9,961 & (661 & ) 87,709 & (175 & ) & 96,834 \\ - & - & - & 3,147 & - & 3,147 \\ - & - & - & - & (14 & ) & (14\end{array}\right)$

See notes to unaudited consolidated financial statements

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## TIMBERLAND BANCORP, INC. AND SUBSIDIARY CONSOLIDATED STATEMENTS OF CASH FLOWS

For the three months ended December 31, 2016 and 2015
(In thousands)
(Unaudited)

|  | Three Months Ended December 31, 20162015 |
| :---: | :---: |
| Cash flows from operating activities |  |
| Net income | \$3,147 \$2,528 |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |
| Depreciation | $313 \quad 340$ |
| Earned ESOP shares | $66 \quad 67$ |
| Stock option compensation expense | $40 \quad 37$ |
| Stock option tax effect less excess tax benefit | $8 \quad 2$ |
| Loss (gain) on sales of OREO and other repossessed assets, net | $(3) 3$ |
| Provision for OREO losses | 9160 |
| Loss on sales/dispositions of premises and equipment, net | 3 |
| BOLI net earnings | (137 ) (136 ) |
| Gain on sales of loans, net | (689 ) (394 ) |
| Decrease in deferred loan origination fees | (45 ) (10 ) |
| Amortization of MSRs | 125154 |
| Loans originated for sale | $(21,914)(10,475)$ |
| Proceeds from sales of loans | 24,199 12,616 |
| Net change in accrued interest receivable and other assets, and other liabilities and accrued expenses | $760 \quad 750$ |
| Net cash provided by operating activities | 5,879 5,645 |
| Cash flows from investing activities |  |
| Net increase in CDs held for investment | (432 ) (2,254) |
| Proceeds from maturities and prepayments of investment securities held to maturity | 136124 |
| Proceeds from maturities and prepayments of investment securities available for sale | 1413 |
| Increase in loans receivable, net | $(5,994)(20,253)$ |
| Additions to premises and equipment | (1,970) (78 ) |
| Capitalized improvements to OREO | (142) |
| Proceeds from sales of OREO and other repossessed assets | 902166 |
| Net cash used in investing activities | $(7,344)(22,424)$ |

See notes to unaudited consolidated financial statements


Timberland Bancorp, Inc. and Subsidiary
Notes to Unaudited Consolidated Financial Statements

## (1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Presentation: The accompanying unaudited consolidated financial statements for Timberland Bancorp, Inc. ("Company") were prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and with instructions for Form 10-Q and, therefore, do not include all disclosures necessary for a complete presentation of consolidated financial condition, results of operations, and cash flows in conformity with GAAP. However, all adjustments which are, in the opinion of management, necessary for a fair presentation of the interim consolidated financial statements have been included. All such adjustments are of a normal recurring nature. The unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended September 30, 2016 ("2016 Form 10-K"). The unaudited consolidated results of operations for the three months ended December 31, 2016 are not necessarily indicative of the results that may be expected for the entire fiscal year ending September 30, 2017.
(b) Principles of Consolidation: The unaudited consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Timberland Bank ("Bank"), and the Bank's wholly-owned subsidiary, Timberland Service Corporation. All significant intercompany transactions and balances have been eliminated in consolidation.
(c) Operating Segment: The Company has one reportable operating segment which is defined as community banking in western Washington under the operating name, "Timberland Bank."
(d) The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.
(e) Certain prior period amounts have been reclassified to conform to the December 31, 2016 presentation with no change to net income or total shareholders' equity as previously reported.

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## (2) INVESTMENT SECURITIES

Held to maturity and available for sale investment securities have been classified according to management's intent and were as follows as of December 31, 2016 and September 30, 2016 (dollars in thousands):

|  | Gross | Gross | Estimated |
| :--- | :--- | :--- | :--- |
| Amortized | Unrealized | Unrealized | Fair |
| Cost | Uains | Losses | Value |

December 31, 2016
Held to maturity
Mortgage-backed securities ("MBS"):

| U.S. government agencies | $\$ 636$ | $\$ 15$ | $\$(1$ | $)$ |
| :--- | :--- | :--- | :--- | :--- |
| Private label residential | 775 | 709 | $(5)$ | 1,479 |
| U.S. Treasury and U.S government agency securities | 6,007 | 19 | $(21$ | $)$ |
| Total | $\$ 7,418$ | $\$ 743$ | $\$(27$ | $)$ |
| 88,134 |  |  |  |  |

Available for sale
MBS: U.S. government agencies \$ 323 \$ 22 \$ (1 ) \$ 344
Mutual funds
Total
1,000 - (56 ) 944
\$ 1,323 \$ 22 \$ (57 ) \$ 1,288
September 30, 2016
Held to maturity
MBS:

| U.S. government agencies | $\$ 670$ | $\$ 18$ | $\$(1)$ | $\$ 687$ |
| :--- | :--- | :--- | :--- | :--- |
| Private label residential | 835 | 762 | $(2$ | $)$ |
| 1,595 |  |  |  |  |
| U.S. Treasury and U.S. government agency securities | 6,006 | 107 | - | 6,113 |
| Total | $\$ 7,511$ | $\$ 887$ | $\$(3$ | $)$ |
| 88,395 |  |  |  |  |

Available for sale
MBS: U.S. government agencies $\quad \$ 336 \quad \$ 30 \quad \$-\quad \$ 366$
Mutual funds
Total
1,000 - (24 ) 976
\$ 1,336 \$ 30 \$ (24 ) \$ 1,342

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Held to maturity and available for sale investment securities with unrealized losses were as follows for December 31, 2016 (dollars in thousands):

|  | Less Than 12 Months Estimatedross |  |  |  | 12 Months or Longe Estimattedss |  |  |  | Total Estimatedross |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Fair <br> Value | Unreal |  |  | y Fair Unrealized |  |  | dQ | Fair | Unrealized |  |
|  |  | Losses |  |  | Valu | eLosses |  |  | Value | Losses |  |
| Held to maturity |  |  |  |  |  |  |  |  |  |  |  |
| MBS: |  |  |  |  |  |  |  |  |  |  |  |
| U.S. government agencies | \$50 | \$ - |  | 2 | \$91 | \$ (1 |  | 5 | \$141 | \$ (1 | ) |
| Private label residential | 13 | - |  | 1 |  | (5 |  | 11 | 116 | (5 | ) |
| U.S. Treasury and U.S. government agency securities | 2,971 | (21 | ) | 1 | - | - |  | - | 2,971 | (21 | ) |
| Total | \$3,034 | \$ (21 | ) | 4 | \$194 | \$ (6 | ) | 16 | \$3,228 | \$ (27 | ) |
| Available for sale |  |  |  |  |  |  |  |  |  |  |  |
| MBS: U.S. government agency | \$35 | \$ (1 | ) | 1 | \$- | \$ - |  | - | \$35 | \$ (1 | ) |
| Mutual funds | - | - |  | - |  | (56 | ) | 1 | 944 | (56 | ) |
| Total | \$35 | \$ (1 |  | 1 | \$944 | \$ (56 |  |  | \$979 | \$ (57 | ) |

Held to maturity and available for sale investment securities with unrealized losses were as follows for September 30, 2016 (dollars in thousands):

| Less Than 12 Months | 12 Months or Longer | Total |
| :--- | :--- | :--- |
| EstimAteoss | Estimatedss | Estimatedss |
| Fair Unrealized Quantity | Fair Unrealized Quantity | Fair Unrealized |
| ValuŁosses | ValueLosses | ValueLosses |

Held to maturity
MBS:

| U.S. government agenc |  | \$ | -1 | \$96 | \$ (1 | ) | 5 | \$105 | \$ |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Private label residential | 1 | - | 1 | 112 | (2 | ) | 10 |  | (2 |  |  |
| Total | \$ 10 | \$ | -2 | \$208 | \$ (3 | ) | 15 | \$218 | \$ |  | ) |
| Available for sale |  |  |  |  |  |  |  |  |  |  |  |
| Mutual funds | \$- | \$ |  | \$976 | \$ (24 | ) | 1 | \$976 |  | (24 |  |
| Total | \$- | \$ |  | \$976 | \$ (24 | ) | 1 | \$976 |  |  |  |

The Company has evaluated the investment securities in the above tables and has determined that the decline in their value is temporary. The unrealized losses are primarily due to changes in market interest rates and spreads in the market for mortgage-related products. The fair value of these securities is expected to recover as the securities approach their maturity dates and/or as the pricing spreads narrow on mortgage-related securities. The Company has the ability and the intent to hold the investments until the market value recovers. Furthermore, as of December 31, 2016, management does not have the intent to sell any of the securities classified as available for sale where the estimated fair value is below the recorded value and believes that it is more likely than not that the Company will not have to sell such securities before a recovery of cost or recorded value if previously written down.

In accordance with GAAP, the Company bifurcates OTTI into (1) amounts related to credit losses which are recognized through earnings and (2) amounts related to all other factors which are recognized as a component of other comprehensive income (loss). To determine the component of the gross OTTI related to credit losses, the Company compared the amortized cost basis of the

OTTI security to the present value of its revised expected cash flows, discounted using its pre-impairment yield. The revised expected cash flow estimates for individual securities are based primarily on an analysis of default rates, prepayment speeds and third-party analytic reports. Significant judgment by management is required in this analysis that includes, but is not limited to, assumptions regarding the collectability of principal and interest, net of related expenses, on the underlying loans.

The following table presents a summary of the significant inputs utilized to measure management's estimates of the credit loss component on OTTI securities as of December 31, 2016 and September 30, 2016:

| Range | Weighted |
| :--- | :--- |
| MinimuMaximum | Average |

December 31, 2016
Constant prepayment rate $6.00 \% \quad 15.00 \quad \% \quad 12.28$ \%
Collateral default rate $\quad \begin{array}{lllll}0.34 \% & 13.35 & \% & 5.66 & \%\end{array}$
Loss severity rate $\quad 5.00 \% \quad 81.00 \quad \% \quad 46.05 \%$

December 31, 2015
Constant prepayment rate $6.00 \% \quad 15.00 \quad \% \quad 9.63 \quad \%$
Collateral default rate $\quad 0.11 \% \quad 15.97 \quad \% \quad 5.33 \quad \%$
Loss severity rate $\quad 1.00 \% \quad 77.00 \quad \% \quad 40.54 \%$

For the
three
months
ended
December
31, 2016
and 2015 no
OTTI was
recognized.

The following table presents a roll forward of the credit loss component of held to maturity and available for sale debt securities that have been written down for OTTI with the credit loss component recognized in earnings for the three months ended December 31, 2016 and 2015 (dollars in thousands):
Three Months
Ended December
31,
$\left.\begin{array}{ll}2016 & 2015 \\ \$ 1,505 & \$ 1,576 \\ (13 \quad) & (28\end{array}\right)$
$\$ 1,492 \quad \$ 1,548$

Beginning balance of credit loss
2015

Subtractions:
Realized losses previously recorded as credit losses
Ending balance of credit loss \$1,492 \$1,548

During the three months ended December 31, 2016, the Company recorded a $\$ 13,000$ net realized loss (as a result of the securities being deemed worthless) on 11 held to maturity residential MBS, of which the entire amount had been recognized previously as a credit loss. During the three months ended December 31, 2015, the Company recorded a $\$ 28,000$ net realized loss (as a result of the securities being deemed worthless) on 14 held to maturity residential MBS, of which the entire amount had been recognized previously as a credit loss.

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The recorded amount of residential MBS, treasury and agency securities pledged as collateral for public fund deposits, federal treasury tax and loan deposits, FHLB collateral and other non-profit organization deposits totaled $\$ 6.98$ million and $\$ 7.04$ million at December 31, 2016 and September 30, 2016, respectively.

The contractual maturities of debt securities at December 31, 2016 were as follows (dollars in thousands). Expected maturities may differ from scheduled maturities due to the prepayment of principal or call provisions.

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|  | Held to Maturity |  |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :---: | :---: | | Available for |
| :--- |
| Sale |

## (3) GOODWILL

Goodwill is initially recorded when the purchase price paid for an acquisition exceeds the estimated fair value of the net identified tangible and intangible assets acquired. Goodwill is presumed to have an indefinite useful life and is analyzed annually for impairment. The Company performs an annual review during the third quarter of each fiscal year, or more frequently if indicators of potential impairment exist, to determine if the recorded goodwill is impaired.

The goodwill impairment test involves a two-step process. Step one estimates the fair value of the reporting unit. If the estimated fair value of the Company's sole reporting unit, the Bank, under step one exceeds the recorded value of the reporting unit, goodwill is not considered impaired and no further analysis is necessary. If the estimated fair value of the Company's sole reporting unit is less than the recorded value, then a step two test, which calculates the fair value of assets and liabilities to calculate an implied value of goodwill, is performed.

The Company performed its fiscal year 2016 goodwill impairment test during the quarter ended June 30, 2016 with the assistance of an independent third-party firm specializing in goodwill impairment valuations for financial institutions. The third-party analysis was conducted as of May 31, 2016 and the step one test concluded that the reporting unit's fair value was greater than its recorded value and, therefore, the recorded value of goodwill as of May 31, 2016 was not impaired. Accordingly, step two of the analysis was not necessary.

Step one of the goodwill impairment test estimates the fair value of the reporting unit utilizing a discounted cash flow income approach analysis, a public company market approach analysis, a merger and acquisition market approach analysis and a trading price market approach analysis in order to derive an enterprise value for the Company.

The discounted cash flow income approach analysis uses a reporting unit's projection of estimated operating results and cash flows and discounts them using a rate that reflects current market conditions. The projection uses management's estimates of economic and market conditions over the projected period including growth rates in loans and deposits, estimates of future expected changes in net interest margins and cash expenditures. Key assumptions used by the Company in its discounted cash flow model (income approach) included an annual loan growth rate that ranged from $3.00 \%$ to $3.90 \%$, an annual deposit growth rate that ranged from $2.50 \%$ to $3.50 \%$ and a return on assets that ranged from $0.90 \%$ to $1.10 \%$. In addition to the above projections of estimated operating results, key assumptions used to determine the fair value estimate under this approach were the discount rate of $10.6 \%$ and the residual capitalization rate of $7.6 \%$. The discount rate used was the cost of equity capital. The cost of equity capital was based on the capital asset pricing model ("CAPM"), modified to account for a small stock premium. The small stock premium represents the additional return required by investors for small stocks based on the Duffs and Phelps 2016 Valuation Handbook. Beyond the approximate five-year forecast period, residual free cash flows were estimated to increase at a constant rate into perpetuity. These cash flows were converted to a residual value using an appropriate residual capitalization rate. The residual capitalization rate was equal to the discount rate minus the expected long-term growth rate of cash flows. Based on historical results, the economic climate, the outlook for the industry
and management's expectations, a long-term growth rate of $3.0 \%$ was estimated.
The public company market approach analysis estimates the fair value by applying cash flow multiples to the reporting unit's operating performance. The multiples are derived from comparable publicly traded companies with operating and investment characteristics similar to those of the Company. Key assumptions used by the Company included the selection of comparable public companies and performance ratios. In applying the public company analysis, the Company selected nine publicly traded institutions based on similar lines of business, markets, growth prospects, risks and firm size. The performance ratios included price to earnings (last twelve months), price to earnings (current year to date), price to book value, price to tangible book value and price to deposits.

The merger and acquisition market approach analysis estimates the fair value by using merger and acquisition transactions involving companies that are similar in nature to the Company. Key assumptions used by the Company included the selection of comparable merger and acquisition transactions and the valuation ratios to be used. The analysis used banks located in Washington or Oregon that were acquired after January 1, 2013. The valuation ratios from these transactions for price to earnings and price to tangible book value were then used to derive an estimated fair value of the Company.

The trading price market approach analysis used the closing market price at May 31, 2016 of the Company's common stock, traded on the NASDAQ Global Market, to determine the market value of total equity capital.

A key assumption used by the Company in the public company market approach analysis and the trading price market approach analysis was the application of a control premium. The Company's common stock is thinly traded, and therefore management believes the trading price reflects a discount for illiquidity. In addition, the trading price of the Company's common stock reflects a minority interest value. To determine the fair market value of a majority interest in the Company's stock, premiums were calculated and applied to the indicated values. Therefore, a control premium was applied to the results of the discounted cash flow income approach analysis, the public company market approach analysis and the trading price market approach analysis because the initial value conclusion was based on minority interest transactions. Merger and acquisition studies were analyzed to conclude that the difference between the acquisition price and a company's stock price prior to acquisition indicates, in part, the price effect of a controlling interest. Based on the evaluation of mergers and acquisition studies, a control premium of $25 \%$ was used.

A significant amount of judgment is involved in determining if an indicator of goodwill impairment has occurred. Such indicators may include, among others: a significant decline in the expected future cash flows; a sustained, significant decline in the Company's stock price and market capitalization; a significant adverse change in legal factors or in the business climate; adverse assessment or action by a regulator; and unanticipated competition. Key assumptions used in the annual goodwill impairment test are highly judgmental and include: selection of comparable companies, amount of control premium, projected cash flows and discount rate applied to projected cash flows. Any change in these indicators or key assumptions could have a significant negative impact on the Company's financial condition, impact the goodwill impairment analysis or cause the Company to perform a goodwill impairment analysis more frequently than once per year.

As of December 31, 2016, management believed that there had been no events or changes in the circumstances since May 31, 2016 that would indicate a potential impairment of goodwill. No assurances can be given, however, that the Company will not record an impairment loss on goodwill in the future.

## (4) LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

Loans receivable by portfolio segment consisted of the following at December 31, 2016 and September 30, 2016 (dollars in thousands):

|  | $\begin{aligned} & \text { December 31, } \\ & 2016 \end{aligned}$ |  | $\begin{aligned} & \text { September 30, } \\ & 2016 \end{aligned}$ |  |
| :---: | :---: | :---: | :---: | :---: |
|  | Amount | Percent | Amount | Percent |
| Mortgage loans: |  |  |  |  |
| One- to four-family | \$ 119,485 | 16.2 \% | \$118,560 | 16.4 \% |
| Multi-family | 52,062 | 7.1 | 62,303 | 8.6 |
| Commercial | 323,496 | 44.0 | 312,525 | 43.2 |
| Construction - custom and owner/builder | 96,292 | 13.1 | 93,049 | 12.9 |
| Construction - speculative one- to four-family | 6,133 | 0.8 | 8,106 | 1.1 |
| Construction - commercial | 8,627 | 1.2 | 9,365 | 1.3 |
| Construction - multi-family | 22,092 | 3.0 | 12,590 | 1.7 |
| Land | 22,359 | 3.0 | 21,627 | 3.0 |
| Total mortgage loans | 650,546 | 88.4 | 638,125 | 88.2 |
| Consumer loans: |  |  |  |  |
| Home equity and second mortgage | 37,602 | 5.1 | 39,727 | 5.5 |
| Other | 4,523 | 0.7 | 4,139 | 0.5 |
| Total consumer loans | 42,125 | 5.8 | 43,866 | 6.0 |
| Commercial business loans | 42,657 | 5.8 | 41,837 | 5.8 |
| Total loans receivable | 735,328 | 100.0\% | 723,828 | 100.0\% |
| Less: |  |  |  |  |
| Undisbursed portion of construction loans in process | 54,161 |  | 48,627 |  |
| Deferred loan origination fees | 2,184 |  | 2,229 |  |
| Allowance for loan losses | 9,843 |  | 9,826 |  |
|  | 66,188 |  | 60,682 |  |
| Loans receivable, net | \$669,140 |  | \$663,146 |  |

Allowance for Loan Losses
The following tables set forth information for the three months ended December 31, 2016 and 2015 regarding activity in the allowance for loan losses by portfolio segment (dollars in thousands):

Three Months Ended December 31, 2016
Provision
$\begin{aligned} & \text { for } \\ & \text { Beginning } \\ & \text { Allowance } \\ & \text { of) Loan } \\ & \text { Losses }\end{aligned}$
Loffs $\begin{aligned} & \text { Charge- }\end{aligned}$ Recoveries $\begin{aligned} & \text { Ending } \\ & \text { Allowance }\end{aligned}$
Mortgage loans:

| One- to four-family | $\$ 1,239$ | $\$(83$ | $)$ | $\$-$ | $\$$ | 21 | $\$ 1,177$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Multi-family | 473 | $(73$ | $)$ | - | - | 400 |  |
| Commercial | 4,384 | 144 |  | $(5$ | $)$ | - | 4,523 |
| Construction - custom and owner/builder | 619 | 17 |  | - | - | 636 |  |
| Construction - speculative one- to four-family 130 | $(30$ | $)$ | - | - | 100 |  |  |
| Construction - commercial | 268 | 14 | - | - | 282 |  |  |
| Construction - multi-family | 316 | 69 | - | - | 385 |  |  |
| Land | 820 | 13 | $(2$ | $)$ | 5 | 836 |  |
| Consumer loans: |  |  |  |  |  |  |  |
| Home equity and second mortgage | 939 | $(80$ | $)$ | - | - | 859 |  |
| Other | 156 | 2 | $(3$ | $)$ | 1 | 156 |  |
| Commercial business loans | 482 | 7 | - | - | 489 |  |  |
| Total | $\$ 9,826 \$-$ | $\$(10)$ | $\$$ | 27 | $\$ 9,843$ |  |  |

Three Months Ended December 31, 2015
Provision
$\begin{aligned} & \text { for } \\ & \text { Beginnink } \\ & \text { Allowancecapture } \\ & \text { of) Loan } \\ & \text { Losses }\end{aligned}$ $\begin{aligned} & \text { Charge- } \\ & \text { offs }\end{aligned}$ Recoveries $\begin{aligned} & \text { Ending } \\ & \text { Allowance }\end{aligned}$

| Mortgage loans: |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| One- to four-family | \$ 1,480 | \$ (37 | ) | \$ (26 | ) | 3 | \$ 1,420 |
| Multi-family | 392 | (19 | ) | - |  |  | 373 |
| Commercial | 4,065 | (140 | ) | (27 | ) |  | 3,898 |
| Construction - custom and owner/builder | 451 | 104 |  | - |  |  | 555 |
| Construction - speculative one- to four-family | 123 | (1) | ) | - |  |  | 122 |
| Construction - commercial | 426 | 60 |  | - |  |  | 486 |
| Construction - multi-family | 283 | 22 |  | - |  |  | 336 |
| Land | 1,021 | (96 | ) | (8 | ) |  | 923 |
| Consumer loans: |  |  |  |  |  |  |  |
| Home equity and second mortgage | 1,073 | 42 |  | (13 | ) |  | 1,102 |
| Other | 187 | (24 | ) | (3 | ) |  | 161 |
| Commercial business loans | 423 | 89 |  | - |  |  | 513 |
| Total | \$9,924 | \$ - |  | \$ (77 | ) | 42 | \$ 9,889 |

The following tables present information on the loans evaluated individually and collectively for impairment in the allowance for loan losses by portfolio segment at December 31, 2016 and September 30, 2016 (dollars in thousands):

|  | Allowance for Loan <br> Losses <br> Individuralllbetively <br> Evaluatedluated <br> for for <br> Total <br> Impaidimpatirment |  |  | Recorded Investment in Loans |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  |  | IndividuaUlyllectively <br> EvaluatedEvaluated for for Impairmehnpairment |  | Total |
| December 31, 2016 |  |  |  |  |  |  |
| Mortgage loans: |  |  |  |  |  |  |
| One- to four-family | \$68 | \$ 1,109 | \$1,177 | \$2,190 | \$ 117,295 | \$ 119,485 |
| Multi-family | - | 400 | 400 | - | 52,062 | 52,062 |
| Commercial | 406 | 4,117 | 4,523 | 10,615 | 312,881 | 323,496 |
| Construction - custom and owner/builder | - | 636 | 636 | 367 | 53,181 | 53,548 |
| Construction - speculative one- to four-family |  | 100 | 100 | - | 3,118 | 3,118 |
| Construction - commercial | - | 282 | 282 | - | 6,860 | 6,860 |
| Construction - multi-family | - | 385 | 385 | - | 15,457 | 15,457 |
| Land | 52 | 784 | 836 | 1,448 | 20,911 | 22,359 |
| Consumer loans: |  |  |  |  |  |  |
| Home equity and second mortgage | 217 | 642 | 859 | 981 | 36,621 | 37,602 |
| Other | 13 | 143 | 156 | 29 | 4,494 | 4,523 |
| Commercial business loans | - | 489 | 489 | - | 42,657 | 42,657 |
| Total | \$756 | \$ 9,087 | \$9,843 | \$15,630 | \$ 665,537 | \$681,167 |

September 30, 2016
Mortgage loans:

| One- to four-family | $\$ 70$ | $\$ 1,169$ | $\$ 1,239$ | $\$ 2,264$ | $\$ 116,296$ | $\$ 118,560$ |
| :--- | :---: | :--- | :--- | :--- | :--- | :--- |
| Multi-family | - | 473 | 473 | - | 62,303 | 62,303 |
| Commercial | 413 | 3,971 | 4,384 | 11,309 | 301,216 | 312,525 |
| Construction - custom and owner/builder | - | 619 | 619 | 367 | 51,662 | 52,029 |
| Construction - speculative one- to four-family- | 130 | 130 | - | 4,074 | 4,074 |  |
| Construction - commercial | - | 268 | 268 | - | 6,841 | 6,841 |
| Construction - multi-family | - | 316 | 316 | - | 11,539 | 11,539 |
| Land | 53 | 767 | 820 | 1,268 | 20,359 | 21,627 |
| Consumer loans: |  |  |  |  |  |  |
| Home equity and second mortgage | 227 | 712 | 939 | 999 | 38,728 | 39,727 |
| Other | 13 | 143 | 156 | 30 | 4,109 | 4,139 |
| Commercial business loans | - | 482 | 482 | - | 41,837 | 41,837 |
| Total | $\$ 776$ | $\$ 9,050$ | $\$ 9,826$ | $\$ 16,237$ | $\$ 658,964$ | $\$ 675,201$ |

The following tables present an analysis of loans by aging category and portfolio segment at December 31, 2016 and September 30, 2016 (dollars in thousands):

| 30-59 | 60-89 |  | Past Due |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Days | Days | Non- | 90 Days | Total | Current | Total |
| Past | Past | $\begin{aligned} & \text { Act } \\ & \text { (1) } \end{aligned}$ | or More | $\begin{aligned} & \text { Past } \\ & \text { Due } \end{aligned}$ | Current | Loans |
| Due | Due |  | Accruing |  |  |  |

December 31, 2016
Mortgage loans:

| One- to four-family | $\$ 394$ | $\$-$ | $\$ 846$ | $\$-$ |  | $\$ 1,240$ | $\$ 118,245$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| $\$ 119,485$ |  |  |  |  |  |  |  |
| Multi-family | - | - | - | - |  | 5 | 52,062 |
| 52,062 |  |  |  |  |  |  |  |
| Commercial | 299 | 111 | - | - |  | 410 | 323,086 |
| 323,496 |  |  |  |  |  |  |  |
| Construction - custom and owner/builder | 213 | - | 367 | - |  | 580 | 52,968 |
| Construction - speculative one- to four- family | - | - | - | - |  | 53,548 |  |
| Construction - commercial | - | - | - | - |  | 3,118 | 3,118 |
| Construction - multi-family | - | - | - | - |  | 6,860 | 6,860 |
| Land | 232 | - | 735 | - |  | 15,457 | 15,457 |
| Consumer loans: |  |  |  |  |  | 21,392 | 22,359 |
| Home equity and second mortgage | 206 | 41 | 387 | 135 | 769 | 36,833 | 37,602 |
| Other | 31 | - | 29 | - | 60 | 4,463 | 4,523 |
| Commercial business loans | 34 | - | - | - | 34 | 42,623 | 42,657 |
| Total | $\$ 1,409$ | $\$ 152$ | $\$ 2,364$ | $\$ 135$ | $\$ 4,060$ | $\$ 677,107$ | $\$ 681,167$ |

September 30, 2016

| Mortgage loans: |  |  |  |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| One- to four-family | $\$-$ | $\$ 207$ | $\$ 914$ | $\$-$ |  | $\$ 1,121$ | $\$ 117,439$ |$\$ 118,560$

(1) Includes non-accrual loans past due 90 days or more and other loans classified as non-accrual.

Credit Quality Indicators
The Company uses credit risk grades which reflect the Company's assessment of a loan's risk or loss potential. The Company categorizes loans into risk grade categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors such as the estimated fair value of the collateral. The Company uses the following definitions for credit risk ratings as part of the on-going monitoring of the credit quality
of its loan portfolio:
Pass: Pass loans are defined as those loans that meet acceptable quality underwriting standards.
Watch: Watch loans are defined as those loans that still exhibit acceptable quality, but have some concerns that justify greater attention. If these concerns are not corrected, a potential for further adverse categorization exists. These concerns could relate to a specific condition peculiar to the borrower, its industry segment or the general economic environment.

Special Mention: Special mention loans are defined as those loans deemed by management to have some potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in the deterioration of the payment prospects of the loan.

Substandard: Substandard loans are defined as those loans that are inadequately protected by the current net worth and paying capacity of the obligor, or of the collateral pledged. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the repayment of the debt. If the weakness or weaknesses are not corrected, there is the distinct possibility that some loss will be sustained.

Loss: Loans in this classification are considered uncollectible and of such little value that continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this loan even though partial recovery may be realized in the future. At December 31, 2016 and September 30, 2016, there were no loans classified as loss.

The following tables present an analysis of loans by credit quality indicator and portfolio segment at December 31, 2016 and September 30, 2016 (dollars in thousands):

## Loan Grades

| December 31, 2016 | Pass | Watch | Special <br> Mention | Substandard Total |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Mortgage loans: |  |  |  |  |  |
| One- to four-family | $\$ 116,242$ | $\$ 357$ | $\$ 657$ | $\$ 2,229$ | $\$ 119,485$ |
| Multi-family | 50,275 | - | 1,787 | - | 52,062 |
| Commercial | 304,358 | 8,363 | 10,775 | - | 323,496 |
| Construction - custom and owner/builder | 53,181 | - | - | 367 | 53,548 |
| Construction - speculative one- to four-family3,118 | - | - | - | 3,118 |  |
| Construction - commercial | 6,860 | - | - | - | 6,860 |
| Construction - multi-family | 15,457 | - | - | - | 15,457 |
| Land | 18,581 | 1,036 | 1,843 | 899 | 22,359 |
| Consumer loans: |  |  |  |  |  |
| Home equity and second mortgage | 36,024 | 588 | 136 | 854 | 37,602 |
| Other | 4,463 | - | - | 60 | 4,523 |
| Commercial business loans | 42,620 | 37 | - | - | 42,657 |
| Total | $\$ 651,179$ | $\$ 10,381$ | $\$ 15,198$ | $\$ 4,409$ | $\$ 681,167$ |

September 30, 2016
Mortgage loans:
One- to four-family $\quad \$ 115,131 \$ 364 \quad \$ 661 \quad \$ 2,404 \quad \$ 118,560$
$\begin{array}{lllllll}\text { Multi-family } & 60,504 & - & 1,799 & - & 62,303\end{array}$
$\begin{array}{llllll}\text { Commercial } & 292,756 & 8,411 & 10,746 & 612 & 312,525\end{array}$
$\begin{array}{llllll}\text { Construction - custom and owner/builder } & 51,432 & 229 & - & 368 & 52,029\end{array}$
Construction - speculative one- to four-family 4,074 - $\quad$ - 4,074
Construction - commercial 6,841 - $\quad$ - $\quad$ - 6,841
Construction - multi-family 11,539 - $\quad$ - $\quad$ 11,539
$\begin{array}{llllll}\text { Land } & 18,010 & 1,043 & 1,859 & 715 & 21,627\end{array}$
Consumer loans:
Home equity and second mortgage
$\begin{array}{llll}38,261 & 590 & - & 876\end{array}$
Other
Commercial business loans
4,078 - $\quad$ - 61 4,139

Total
$41,797 \quad 40 \quad-\quad-\quad 41,837$
\$644,423 \$ 10,677 \$ 15,065 \$ 5,036 \$675,201

## Impaired Loans

In accordance with GAAP, a loan is considered impaired when it is probable that a creditor will be unable to collect all amounts (principal and interest) when due according to the contractual terms of the loan agreement. Smaller balance homogeneous loans, such as residential mortgage loans and consumer loans, may be collectively evaluated for impairment. When a loan has been identified as being impaired, the amount of the impairment is measured by using discounted cash flows, except when, as an alternative, the current estimated fair value of the collateral, reduced by estimated costs to sell (if applicable), or observable market price is used. The valuation of real estate collateral is subjective in nature and may be adjusted in future periods because of changes in economic conditions. Management considers third-party appraisals, as well as independent fair market value assessments from realtors or persons involved in selling real estate, in determining the estimated fair value of particular properties. In addition, as certain of these third-party appraisals and independent fair market value assessments are only updated periodically, changes in the values of specific properties may have occurred subsequent to the most recent appraisals. Accordingly, the amounts of any such potential changes and any related adjustments are generally recorded at the time such information is received. When the measurement of the impaired loan is less than the recorded investment in the loan (including accrued interest and net deferred loan origination fees or costs), impairment is recognized by creating or adjusting an allocation of the allowance for loan losses and uncollected accrued interest is reversed against interest income. If ultimate collection of principal is in doubt, all cash receipts on impaired loans are applied to reduce the principal balance.

The categories of non-accrual loans and impaired loans overlap, although they are not identical.
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The following table is a summary of information related to impaired loans by portfolio segment as of December 31, 2016 and for the three months then ended (dollars in thousands):

|  | Unpaid | Related | Year to |  | YTD Cash <br> Basis |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  | Principal |  |  |  |  |
|  | Balance |  | Date | YTD |  |
| Recorded Investment | (Loan |  | ("YTD") | Interest | Interest |
|  | Balance | Allowance | Average | Income | Income |
|  | Plus |  | Recorded | Recognized | Recognized |
|  | Charge |  | Investment | (1) | (1) |
|  | Off) |  | (1) |  |  |

With no related allowance recorded:
Mortgage loans:

| One- to four-family | \$ 893 | \$ 1,040 | \$ | \$ 904 | \$ 12 |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Commercial | 6,892 | 7,953 | - | 7,229 | 113 | 87 |
| Construction - custom and owner/ builder | 367 | 367 | - | 367 | 7 | 7 |
| Land | 879 | 1,284 | - | 786 | 4 | 3 |
| Consumer loans: |  |  |  |  |  |  |
| Home equity and second mortgage | 387 | 578 | - | 395 | - | - |
| Subtotal | 9,418 | 11,222 | - | 9,681 | 136 | 108 |

With an allowance recorded:
Mortgage loans:

| One- to four-family | 1,297 | 1,297 | 68 | 1,324 | 27 | 20 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Commercial | 3,723 | 3,723 | 406 | 3,733 | 65 | 54 |
| Land | 569 | 569 | 52 | 572 | 9 | 8 |
| Consumer loans: |  |  |  |  |  |  |
| Home equity and second mortgage | 594 | 594 | 217 | 596 | 10 | 9 |
| Other | 29 | 29 | 13 | 30 | - | - |
| Subtotal | 6,212 | 6,212 | 756 | 6,255 | 111 | 91 |

Total:
Mortgage loans:

| One- to four-family | 2,190 | 2,337 | 68 | 2,228 | 39 | 31 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Commercial | 10,615 | 11,676 | 406 | 10,962 | 178 | 141 |
| Construction - custom and owner/ builder | 367 | 367 | - | 367 | 7 | 7 |
| Land | 1,448 | 1,853 | 52 | 1,358 | 13 | 11 |
| Consumer loans: |  |  |  |  |  |  |
| Home equity and second mortgage | 981 | 1,172 | 217 | 991 | 10 | 9 |
| Other | 29 | 29 | 13 | 30 | - | - |
| Total | \$ 15,630 | \$ 17,434 | \$ 756 | \$ 15,936 | \$ 247 | \$ 199 |

(1)For the three months ended December 31, 2016.

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The following table is a summary of information related to impaired loans by portfolio segment as of and for the year ended September 30, 2016 (dollars in thousands):


With no related allowance recorded:
Mortgage loans:

| One- to four-family | \$ 914 | \$ 1,060 | \$ | \$ 1,349 |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Multi-family | - | - | - | 152 | - | - |
| Commercial | 7,566 | 8,685 | - | 7,784 | 421 | 330 |
| Construction - custom and owner/b | r367 | 367 | - | 73 | - | - |
| Land | 693 | 1,101 | - | 839 | 16 | 12 |
| Consumer loans: |  |  |  |  |  |  |
| Home equity and second mortgage | 402 | 593 | - | 264 | - | - |
| Commercial business loans | - | - | - | 15 | - | - |
| Subtotal | 9,942 | 11,806 | - | 10,476 | 475 | 380 |

With an allowance recorded:
Mortgage loans:

| One- to four-family | 1,350 | 1,350 | 70 | 1,921 | 118 | 89 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Multi-family | - | - | - | 655 | - | - |
| Commercial <br> Land <br> Consumer loans: | 3,743 | 3,743 | 413 | 4,181 | 275 | 215 |
| Home equity and second mortgage <br> Other | 597 | 597 | 227 | 709 | 44 | 40 |
| Subtotal <br> Total: | 30 | 30 | 13 | 33 | 2 | 2 |
| Mortgage loans: <br> One- to four-family | 6,295 | 6,295 | 776 | 8,103 | 478 | 378 |
| Multi-family <br> Commercial <br> Construction - custom and owner/builder367 | 1,268 | 1,676 | 53 | 1,443 | 55 | 42 |
| Land <br> Consumer loans: | 2,264 | 2,410 | 70 | 3,270 | 156 | 127 |
| Home equity and second mortgage <br> Other <br> Commercial business loans <br> Total | 999 | 1,190 | 227 | 973 | 44 | 40 |

(1) For the year ended September 30, 2016.

A troubled debt restructured loan ("TDR") is a loan for which the Company, for reasons related to a borrower's financial difficulties, grants a significant concession to the borrower that the Company would not otherwise

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consider. Examples of such concessions include but are not limited to: a reduction in the stated interest rate; an extension of the maturity at an interest rate below current market rates; a reduction in the face amount of the debt; a reduction in the accrued interest; or re-amortizations, extensions, deferrals and renewals. TDR loans are considered impaired and are individually evaluated for impairment. TDR loans are classified as either accrual or non-accrual. TDR loans are classified as non-performing loans unless they have been performing in accordance with their modified terms for a period of at least six months. The Company had $\$ 7.98$ million and $\$ 8.16$ million in TDR loans included in impaired loans at December 31, 2016 and September 30, 2016, respectively, and had no commitments at these dates to lend additional funds on these loans. The allowance for loan losses allocated to TDR loans at December 31, 2016 and September 30, 2016 was $\$ 462,000$ and $\$ 465,000$, respectively. There were no TDR loans which incurred a payment default within 12 months of the restructure date during the three months ended December 31, 2016.

The following tables set forth information with respect to the Company's TDR loans by interest accrual status as of December 31, 2016 and September 30, 2016 (dollars in thousands):

|  | December 31, 2016 |  |  |
| :---: | :---: | :---: | :---: |
|  | Accruin | Non- <br> Accrual | Total |
| Mortgage loans: |  |  |  |
| One- to four-family | \$ 1,344 | \$ - | \$1,344 |
| Commercial | 5,232 | - | 5,232 |
| Land | 713 | 252 | 965 |
| Consumer loans: |  |  |  |
| Total | 290 | 152 | 442 |
|  | \$7,579 | \$ 404 | \$7,983 |
|  | September 30, 2016 |  |  |
|  | Accruin | Non- <br> Accrual | Total |
| Mortgage loans: |  |  |  |
| One- to four-family | \$ 1,350 | \$ 126 | \$1,476 |
| Commercial | 5,268 | - | 5,268 |
| Land | 720 | 253 | 973 |
| Consumer loans: |  |  |  |
| Home equity and second mortgage | 291 | 152 | 443 |
| Total | \$7,629 | \$ 531 | \$8,160 |

The were no new TDR loans during the three months ended December 31, 2016 or the year ended September 30, 2016.

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## (5) NET INCOME PER COMMON SHARE

Basic net income per common share is computed by dividing net income to common shareholders by the weighted average number of common shares outstanding during the period, without considering any dilutive items. Diluted net income per common share is computed by dividing net income to common shareholders by the weighted average number of common shares and common stock equivalents for items that are dilutive, net of shares assumed to be repurchased using the treasury stock method at the average share price for the Company's common stock during the period. Common stock equivalents arise from the assumed conversion of outstanding stock options and the outstanding warrant to purchase common stock. Shares owned by the Bank's ESOP that have not been allocated are not considered to be outstanding for the purpose of computing basic and diluted net income per common share. At December 31, 2016 and 2015, there were 84,964 and 118,097 shares, respectively, that had not been allocated under the Bank's ESOP.

Information regarding the calculation of basic and diluted net income per common share for the three months ended December 31, 2016 and 2015 is as follows (dollars in thousands, except per share amounts):

Three Months
Ended
December 31,
20162015
Basic net income per common share computation
Numerator - net income
\$3,147 \$ 2,528
Denominator - weighted average common shares outstanding
6,862,749,869,726
Basic net income per common share
\$0.46 \$ 0.37
Diluted net income per common share computation
Numerator - net income
\$3,147 \$ 2,528
Denominator - weighted average common shares outstanding
6,862,749,869,726
Effect of dilutive stock options (1)
Effect of dilutive stock warrant (2)
139,49352,985
Weighted average common shares outstanding - assuming dilution $7,235,51$, 083,864
Diluted net income per common share
\$0.43 \$ 0.36
(1) For the three months ended December 31, 2016 all outstanding options were included in the computation of diluted net income per share. For the three months ended December 31, 2015, average options to purchase 154,000 of common stock were outstanding but not included in the computation of diluted net income per common share because their effect would have been anti-dilutive.
(2) Represents a warrant to purchase 370,899 shares of the Company's common stock at an exercise price of $\$ 6.73$ per share (subject to anti-dilution adjustments) at any time through December 23, 2018 (the "Warrant"). The Warrant was granted on December 23, 2008 to the U.S. Treasury Department ("Treasury") as part of the Company's participation in the Treasury's Troubled Asset Relief Program ("TARP"). On June 12, 2013, the Treasury sold the Warrant to private investors. On January 31, 2017, the Warrant was exercised and 370,899 shares of the Company's common stock were issued in exchange for $\$ 2.50$ million.

## (6) ACCUMULATED OTHER COMPREHENSIVE LOSS

The changes in accumulated other comprehensive loss ("AOCI") by component during the three months ended December 31, 2016 and 2015 are as follows (dollars in thousands):

Three Months Ended
December 31, 2016
Changes
in fair
value OTTI on
of held to
availabmeaturity Total
for securities
(1)
sale (1)
securities
(1)

Balance of AOCI at the beginning of period \$4 \$(179 ) \$(175)
Net change, net of income taxes
(27 ) 13 (14 )
Balance of AOCI at the end of period
\$(23) \$ (166 ) \$(189)
Three Months Ended
December 31, 2015
Changes
in
fair
value OTTI on
of held to of maturity
available securities
for
(1)
sale
securities
(1)

Balance of AOCI at the beginning of period \$3 \$ (316 ) \$(313)
Net change, net of income taxes
(12) 10 (2 )

Balance of AOCI at the end of period
\$(9) \$ (306 ) \$(315)
(1) All amounts are net of income taxes.

## (7) STOCK COMPENSATION PLANS

Under the Company's 2003 Stock Option Plan, the Company was able to grant options for up to 300,000 shares of common stock to employees, officers, directors and directors emeriti. Under the Company's 2014 Equity Incentive Plan, the Company is able to grant options and awards of restricted stock (with or without performance measures) for up to 352,366 shares of common stock to employees, officers, directors and directors emeriti. Shares issued may be purchased in the open market or may be issued from authorized and unissued shares. The exercise price of each option equals the fair market value of the Company's common stock on the date of grant. Generally, options and restricted stock vest in $20 \%$ annual installments on each of the five anniversaries from the date of the grant, and options generally have a maximum contractual term of ten years. At December 31, 2016, there were 171,116 shares of common stock available which may be awarded as options or restricted stock pursuant to future grant under the 2014

Equity Incentive Plan. At December 31, 2016, there were no options available for future grant under the 2003 Stock Option Plan.

At both December 31, 2016 and 2015, there were no unvested restricted stock grant shares. There were no restricted stock grants awarded during the three months ended December 31, 2016 and 2015.

Stock option activity for the three months ended December 31, 2016 and 2015 is summarized as follows:

|  | Three Months Ended December 31, 2016 |  | Three Months Ended December 31, 2015 |  |
| :---: | :---: | :---: | :---: | :---: |
|  | Number of Shares | Weighted <br> Average <br> Exercise <br> Price | Number of Shares | Weighted <br> Average <br> Exercise <br> Price |
| Options outstanding, beginning of period | 373,130 | \$ 9.82 | 341,300 | \$ 8.73 |
| Exercised | (12,700 | 6.31 | (5,300 | 7.88 |
| Forfeited | - | - | (400 | 5.86 |
| Options outstanding, end of period | 360,430 | \$ 9.94 | 335,600 | \$ 8.74 |

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The aggregate intrinsic value of options exercised during the three months ended December 31, 2016 and 2015 was $\$ 157,000$ and $\$ 20,000$, respectively.

At December 31, 2016, there were 221,950 unvested options with an aggregate grant date fair value of $\$ 438,000$, all of which the Company assumes will vest. The aggregate intrinsic value of unvested options at December 31, 2016 was $\$ 2.07$ million. There were 28,500 options with an aggregate grant date fair value of $\$ 67,000$ that vested during the three months ended December 31, 2016.

At December 31, 2015, there were 233,800 unvested options with an aggregate grant date fair value of $\$ 506,000$. There were 28,500 options with an aggregate grant date fair value of $\$ 67,000$ that vested during the three months ended December 31, 2015.

Additional information regarding options outstanding at December 31, 2016 is as follows:


The aggregate intrinsic value of options outstanding at December 31, 2016 and 2015 was $\$ 3.86$ million and $\$ 1.06$ million, respectively.

Compensation expense during the three months ended December 31, 2016 and 2015 for all stock-based plans was as follows (dollars in thousands):

|  | Three |
| :--- | :--- |
|  | Months |
|  | Ended |
|  | December |
|  | 31, |
|  | 2016 |
|  | 2015 |
| Stock options | $\$ 85 \quad \$ 41$ |
| Less: related tax benefit recognized | $(45)(4)$ |
| Total | $\$ 40 \quad \$ 37$ |

As of December 31, 2016, unrecognized compensation cost related to non-vested stock options was $\$ 384,000$, which is expected to be recognized over a weighted average life of 2.03 years.

## (8) FAIR VALUE MEASUREMENTS

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GAAP defines fair value and establishes a framework for measuring fair value. Fair value is the price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date. The three levels for categorizing assets and liabilities under GAAP's fair value measurement requirements are as follows:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2: Significant observable inputs other than quoted prices included within Level 1, such as quoted prices for similar (as opposed to identical) assets or liabilities in active markets, quoted prices for identical or similar assets or

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liabilities in markets that are not active, and inputs other than quoted prices that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a company's own assumptions about the assumptions market participants would use in pricing an asset or liability based on the best information available in the circumstances.

The Company's assets measured at fair value on a recurring basis consist of investment securities available for sale. The estimated fair value of MBS are based upon market prices of similar securities or observable inputs (Level 2). The estimated fair value of mutual funds are based upon quoted market prices (Level 1).

The Company had no liabilities measured at fair value on a recurring basis at December 31, 2016 and September 30, 2016. The Company's assets measured at estimated fair value on a recurring basis at December 31, 2016 and September 30, 2016 are as follows (dollars in thousands):

December 31, 2016
Estimated Fair
Value
Level Level Level

| 1 | 2 | 3 |
| :--- | :--- | :--- | :--- |

Available for sale investment securities
MBS: U.S. government agencies $\quad \$-\quad \$ 344 \$ \$ 344$
Mutual funds
944 - - 944
Total $\quad \$ 944$ \$344 \$ \$1,288
September 30, 2016

## Estimated Fair

Value
$\begin{array}{llll}\text { Level Level Level } & \\ 1 & 2 & \text { Total }\end{array}$
Available for sale investment securities
MBS: U.S. government agencies $\quad \$-\quad \$ 366 \$ \$ 366$
Mutual funds 976 - $\quad 976$
Total $\$ 976$ \$366 \$ \$1,342
There were no transfers among Level 1, Level 2 and Level 3 during the three months ended December 31, 2016 and the year ended September 30, 2016.

The Company may be required, from time to time, to measure certain assets and liabilities at fair value on a non-recurring basis in accordance with GAAP. These include assets that are measured at the lower of cost or market value that were recognized at fair value below cost at the end of the period.

The Company uses the following methods and significant assumptions to estimate fair value on a non-recurring basis:
Impaired Loans: The estimated fair value of impaired loans is calculated using the collateral value method or on a discounted cash flow basis. The specific reserve for collateral dependent impaired loans is based on the estimated fair value of the collateral less estimated costs to sell, if applicable. In some cases, adjustments are made to the appraised values due to various factors including age of the appraisal, age of comparables included in the appraisal and known changes in the market and in the collateral. Such adjustments may be significant and typically result in a Level 3 classification of the inputs for determining fair value. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

Investment Securities Held to Maturity: The estimated fair value of investment securities held to maturity is based upon the assumptions market participants would use in pricing the investment security. Such assumptions include quoted market prices (Level 1), market prices of similar securities or observable inputs (Level 2) and unobservable

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inputs such as dealer quotes, discounted cash flows or similar techniques (Level 3).
OREO and Other Repossessed Assets, net: OREO and other repossessed assets are recorded at estimated fair value less estimated costs to sell. Estimated fair value is generally determined by management based on a number of factors, including third-party appraisals of estimated fair value in an orderly sale. Estimated costs to sell are based on standard market factors. The valuation of OREO and other repossessed assets is subject to significant external and internal judgment (Level 3).

The following table summarizes the balances of assets measured at estimated fair value on a non-recurring basis at December 31, 2016 (dollars in thousands):

Estimated Fair<br>Value<br>Lekevel Level<br>123

Impaired loans:
Mortgage loans:
One- to four-family $\$$ -
Commercial - 3,317
Land - 517
Consumer loans:
Home equity and second mortgage _- 377
Other - 16
Total impaired loans - 5,456
Investment securities - held to maturity:
MBS - private label residential -7 -
OREO and other repossessed assets - 3,254
Total
\$ \$ $7 \quad \$ 8,710$

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis as of December 31, 2016 (dollars in thousands):

|  | Estimated Valuation <br> Fair Value Technique(s) | Unobservable Input(s) | Range |
| :--- | :--- | :--- | :--- |
| Impaired loans | $\$ 5,456$ | Market <br> approach | Appraised value less selling costs | NA

The following table summarizes the balances of assets measured at estimated fair value on a non-recurring basis at September 30, 2016 (dollars in thousands):

> Estimated Fair
> Value
> Lekevel Level
> $12 \quad 3$

Impaired loans:
Mortgage loans:
One- to four-family $\quad \$ \mathbf{-}$ - $\$ 1,280$
Commercial - 3,330
Land - 522
Consumer loans:
Home equity and second mortgage - 370
Other - 17
Total impaired loans - $\quad$-5,519
Investment securities - held to maturity:
MBS - private label residential -20 -
OREO and other repossessed assets - 4,117
Total
\$ $\$ 20$ \$9,636

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis as of September 30, 2016 (dollars in thousands):

|  | Estimat <br> Fair Val | Valuation <br> Technique(s) | Unobservable Input(s) | Range |
| :---: | :---: | :---: | :---: | :---: |
| Impaired loans | \$ 5,519 | Market approach | Appraised value less selling costs | NA |
| OREO and other repossessed assets | \$ 4,117 | Market approach | Lower of appraised value or listing price less selling costs | NA |

GAAP requires disclosure of estimated fair values for financial instruments. Such estimates are subjective in nature, and significant judgment is required regarding the risk characteristics of various financial instruments at a discrete point in time. Therefore, such estimates could vary significantly if assumptions regarding uncertain factors were to change. In addition, as the Company normally intends to hold the majority of its financial instruments until maturity, it does not expect to realize many of the estimated amounts disclosed. The disclosures also do not include estimated fair value amounts for certain items which are not defined as financial instruments but which may have significant value. The Company does not believe that it would be practicable to estimate a representational fair value for these types of items as of December 31, 2016 and September 30, 2016. Because GAAP excludes certain items from fair value disclosure requirements, any aggregation of the fair value amounts presented would not represent the underlying value of the Company.

The following methods and assumptions were used by the Company in estimating fair value of its other financial instruments:

Cash and Cash Equivalents: The estimated fair value of financial instruments that are short-term or re-price frequently and that have little or no risk are considered to have an estimated fair value equal to the recorded value.

CDs Held for Investment: The estimated fair value of financial instruments that are short-term or re-price frequently and that have little or no risk are considered to have an estimated fair value equal to the recorded value.

Investment Securities: See descriptions above.
FHLB Stock: No ready market exists for this stock, and it has no quoted market value. However, redemption of this stock has historically been at par value. Accordingly, par value is deemed to be a reasonable estimate of fair value.

Loans Receivable, Net: The fair value of non-impaired loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers for the same remaining maturities. Prepayments are based on the historical experience of the Bank. Fair values for impaired loans are estimated using the methods described above.

Loans Held for Sale: The estimated fair value is based on quoted market prices (for one-to four-family loans) and the guaranteed value of U.S. Small Business Administration ("SBA") loans (made to small businesses under the SBA's 7(a) loan programs). Quoted market prices are obtained from the Federal Home Loan Mortgage Corporation ("Freddie Mac").

Accrued Interest: The recorded amount of accrued interest approximates the estimated fair value.
Deposits: The estimated fair value of deposits with no stated maturity date is deemed to be the amount payable on demand. The estimated fair value of fixed maturity certificates of deposit is computed by discounting future cash flows using the rates currently offered by the Bank for deposits of similar remaining maturities.

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FHLB Borrowings: The estimated fair value of FHLB borrowings is computed by discounting the future cash flows of the borrowings at a rate which approximates the current offering rate of the borrowings with a comparable remaining life.

Off-Balance-Sheet Instruments: Since the majority of the Company's off-balance-sheet instruments consist of variable-rate commitments, the Company has determined that they do not have a distinguishable estimated fair value.

The recorded amounts and estimated fair values of financial instruments were as follows as of December 31, 2016 and September 30, 2016 (dollars in thousands):

|  | Decemb |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  | Fair Value Measurements Using: <br> Estimated |  |  |  |  |
|  | Recorded <br> Amount | Fair <br> Value | Level 1 | Level | Level 3 |
| Financial assets |  |  |  |  |  |
| Cash and cash equivalents | \$135,470 | \$135,470 | \$135,470 | \$ | \$ |
| CDs held for investment | 53,432 | 53,432 | 53,432 | - | - |
| Investment securities | 8,706 | 9,422 | 3,929 | 5,493 | - |
| FHLB stock | 2,204 | 2,204 | 2,204 | - | - |
| Loans receivable, net | 669,140 | 669,287 | - | - | 669,287 |
| Loans held for sale | 2,008 | 2,054 | 2,054 | - | - |
| Accrued interest receivable | 2,443 | 2,443 | 2,443 | - | - |
| Financial liabilities |  |  |  |  |  |
| Deposits: |  |  |  |  |  |
| Non-interest-bearing demand | 176,382 | 176,382 | 176,382 | - | - |
| Interest-bearing | 613,593 | 613,841 | 467,477 | - | 146,364 |
| Total deposits | 789,975 | 790,223 | 643,859 | - | 146,364 |
| FHLB borrowings | 30,000 | 30,336 | - | 30,336 | - |
| Accrued interest payable | 263 | 263 | 263 | - | - |
|  | September 30, 2016 |  |  |  |  |
|  | Fair Value Measurements Using Estimated |  |  |  |  |
|  | Recorded <br> Amount | Fair <br> Value | Level 1 | Level | Level 3 |
| Financial assets |  |  |  |  |  |
| Cash and cash equivalents | \$ 108,941 | \$108,941 | \$108,941 | \$ | \$ |
| CDs held for investment | 53,000 | 53,000 | 53,000 | - | - |
| Investment securities | 8,853 | 9,737 | 4,029 | 5,708 | - |
| FHLB stock | 2,204 | 2,204 | 2,204 | - | - |
| Loans receivable, net | 663,146 | 671,017 | - | - | 671,017 |
| Loans held for sale | 3,604 | 3,714 | 3,714 | - | - |
| Accrued interest receivable | 2,348 | 2,348 | 2,348 | - | - |
| Financial liabilities |  |  |  |  |  |
| Deposits: |  |  |  |  |  |
| Non-interest-bearing demand | 172,283 | 172,283 | 172,283 | - | - |
| Interest-bearing | 589,251 | 589,762 | 441,277 | - | 148,485 |
| Total deposits | 761,534 | 762,045 | 613,560 | - | 148,485 |
| FHLB borrowings | 30,000 | 30,684 | - | 30,684 | 4 - |
| Accrued interest payable | 247 | 247 | 247 | - | - |

The Company assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the estimated fair value of the Company's financial instruments will change when interest rate levels change, and that change may either be favorable or unfavorable to the Company. Management attempts to match maturities of assets and liabilities to the extent believed necessary to appropriately manage interest rate risk. However, borrowers with fixed interest rate obligations are less likely to prepay in a rising interest rate
environment and more likely to prepay in a falling

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interest rate environment. Conversely, depositors who are receiving fixed interest rates are more likely to withdraw funds before maturity in a rising interest rate environment and less likely to do so in a falling interest rate environment. Management monitors interest rates and maturities of assets and liabilities, and attempts to manage interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate the Company's overall interest rate risk.

## (9) RECENT ACCOUNTING PRONOUNCEMENTS

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (Topic 606). The core principle of this ASU is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In general, the new guidance requires companies to use more judgment and make more estimates than under current guidance, including identifying performance obligations in the contract and estimating the amount of variable consideration to include in the transaction price related to each separate performance obligation. This ASU is effective for annual periods beginning after December 15, 2017, including interim periods within that reporting period. The adoption of ASU No. 2014-09 is not expected to have a material impact on the Company's consolidated financial statements.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The main provisions of this ASU address the valuation and impairment of certain equity investments along with simplified disclosures about the fair value of financial instruments. The amendments in this ASU are effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. The adoption of ASU No. 2016-01 is not expected to have a material impact on the Company's consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). This ASU is intended to increase transparency and comparability among organizations by requiring the recognition of lease assets and lease liabilities on the balance sheet and disclosure of key information about leasing arrangements. The principal change required by this ASU relates to lessee accounting, and is that for operating leases, a lessee is required to (1) recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position, (2) recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis, and (3) classify all cash payments within operating activities in the statement of cash flows. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term. This ASU also changes disclosure requirements related to leasing activities and requires certain qualitative disclosures along with specific quantitative disclosures. The amendments in this ASU are effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2018. Early application of the amendments in this ASU is permitted. The Company is currently evaluating the impact that the adoption of ASU No. 2016-02 will have on the Company's future consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, Improvements to Employee Share-Based Payment Accounting. This ASU includes provisions intended to simplify various aspects related to how share-based payments are accounted for and presented in the financial statements. This ASU is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2016. The Company is currently evaluating the impact that the adoption of ASU No. 2016-09 will have on the Company's future consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses. This ASU replaces the existing incurred losses methodology for estimating allowances with a current expected credit losses methodology
with respect to most financial assets measured at amortized cost and certain other instruments, including trade and other receivables, loans, held to maturity investment securities and off-balance sheet commitments. In addition, this ASU requires credit losses relating to available for sale debt securities to be recorded through an allowance for credit losses rather than a reduction of the carrying amount. ASU No. 2016-13 also changes the accounting for purchased credit-impaired debt securities and loans. The standard retains many of the current disclosure requirements in current GAAP and expands certain disclosure requirements. This ASU is effective for fiscal years beginning after December 15,2019 , including interim periods within those fiscal years. The Company is currently evaluating the impact that the adoption of ASU 2016-13 will have on the Company's future consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-04, Intangibles - Goodwill and Other: Simplifying the Test for Goodwill Impairment. This ASU simplifies the subsequent measurement of goodwill and eliminates Step 2 from the goodwill impairment
test. In computing the implied fair value of goodwill under Step 2, an entity had to perform procedures to determine the fair value at the impairment testing date of its assets and liabilities (including unrecognized assets and liabilities) following the procedure that would be required in determining the fair value of assets acquired and liabilities assumed in a business combination. Under ASU No. 2017-04, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. Additionally, an entity should consider income tax effects from any tax deductible goodwill on the carrying amount of the reporting unit when measuring the goodwill impairment loss, if applicable. ASU No. 2017-04 will be effective for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early application of this ASU is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The adoption of ASU No. 2017-04 is not expected to have a material impact on the Company's future consolidated financial statements.

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

As used in this Form 10-Q, the terms "we," "our" and "Company" refer to Timberland Bancorp, Inc. and its consolidated subsidiaries, unless the context indicates otherwise. When we refer to "Bank" in this Form 10-Q, we are referring to Timberland Bank, a wholly-owned subsidiary of Timberland Bancorp, Inc. and the Bank's wholly-owned subsidiary, Timberland Service Corporation.

The following analysis discusses the material changes in the consolidated financial condition and results of operations of the Company at and for the three months ended December 31, 2016. This analysis as well as other sections of this report contains certain "forward-looking statements."

Certain matters discussed in this Quarterly Report on Form 10-Q may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our financial condition, results of operations, plans, objectives, future performance or business. Forward-looking statements are not statements of historical fact, are based on certain assumptions and often include the words "believes," "expects," "anticipates," "estimates," "forecasts," "intends," "plans," "targets," "potentially," "probably," "projects," "outlook" or similar or future or conditional verbs such as "may," "will," "should," "would" and "could." Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, assumptions and statements about future economic performance. These forward-looking statements are subject to known and unknown risks, uncertainties and other factors that could cause actual results to differ materially from the results anticipated or implied by our forward-looking statements, including, but not limited to: the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets which may lead to increased losses and non-performing loans in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses, and require us to materially increase our loan loss reserves; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes, land and other properties and fluctuations in real estate values in our market areas; secondary market conditions for loans and our ability to sell loans in the secondary market; results of examinations of us by the Board of Governors of the Federal Reserve System ("Federal Reserve") and of our bank subsidiary by the FDIC, the Washington State Department of Financial Institutions, Division of Banks or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, institute a formal or informal enforcement action against us or our bank subsidiary
which could require us to increase our allowance for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits or impose additional requirements or restrictions on us, any of which could adversely affect our liquidity and earnings; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules including as a result of Basel III; the impact of the Dodd Frank Wall Street Reform and Consumer Protection Act and implementing regulations; our ability to attract and retain deposits; increases in premiums for deposit insurance; our ability to control operating costs and expenses; the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risks associated with the loans on our consolidated balance sheet; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our work force and potential associated charges; the failure or security breach of computer systems on which we depend; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our business

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strategies; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we may acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; our ability to manage loan delinquency rates; increased competitive pressures among financial services companies; changes in consumer spending, borrowing and savings habits; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; our ability to pay dividends on our common stock; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the FASB, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; the economic impact of war or any terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations; pricing, products and services; and other risks described elsewhere in this Form 10-Q and in the Company's other reports filed with or furnished to the Securities and Exchange Commission, including our 2016 Form 10-K.

Any of the forward-looking statements that we make in this Form 10-Q and in the other public statements we make are based upon management's beliefs and assumptions at the time they are made. We do not undertake and specifically disclaim any obligation to publicly update or revise any forward-looking statements included in this report to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements or to update the reasons why actual results could differ from those contained in such statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, the forward-looking statements discussed in this document might not occur and we caution readers not to place undue reliance on any forward-looking statements. These risks could cause our actual results for fiscal 2017 and beyond to differ materially from those expressed in any forward-looking statements by, or on behalf of us, and could negatively affect the Company's consolidated financial condition and results of operations as well as its stock price performance.

## Overview

Timberland Bancorp, Inc., a Washington corporation, is the holding company for Timberland Bank. The Bank opened for business in 1915 and serves consumers and businesses across Grays Harbor, Thurston, Pierce, King, Kitsap and Lewis counties, Washington with a full range of lending and deposit services through its 22 branches (including its main office in Hoquiam). At December 31, 2016, the Company had total assets of $\$ 923.75$ million and total shareholders' equity of $\$ 99.63$ million. The Company's business activities generally are limited to passive investment activities and oversight of its investment in the Bank. Accordingly, the information set forth in this report relates primarily to the Bank's operations.

The profitability of the Company's operations depends primarily on its net interest income after provision for loan losses. Net interest income is the difference between interest income, which is the income that the Company earns on interest-earning assets, which are primarily loans and investments, and interest expense, the amount the Company pays on its interest-bearing liabilities, which are primarily deposits and borrowings. Net interest income is affected by changes in the volume and mix of interest-earning assets, interest earned on those assets, the volume and mix of interest-bearing liabilities and interest paid on those interest-bearing liabilities. Management strives to match the re-pricing characteristics of the interest-earning assets and interest-bearing liabilities to protect net interest income from changes in market interest rates and changes in the shape of the yield curve.

The provision for loan losses is dependent on changes in the loan portfolio and management's assessment of the collectability of the loan portfolio as well as prevailing economic and market conditions. The allowance for loan losses reflects the amount that the Company believes is adequate to cover probable credit losses inherent in its loan portfolio.

Net income is also affected by non-interest income and non-interest expenses. For the three month period ended December 31, 2016, non-interest income consisted primarily of service charges on deposit accounts, gain on sales of loans, ATM and debit card interchange transaction fees, an increase in the cash surrender value of BOLI, servicing income on loans sold and other operating income. Non-interest income is reduced by net OTTI losses on investment securities, if any. Non-interest expenses consisted primarily of salaries and employee benefits, premises and equipment, advertising, ATM and debit card interchange transaction fees, OREO and other repossessed asset expenses, postage and courier expenses, state and local taxes, professional fees, FDIC insurance premiums, loan administration and foreclosure expenses, deposit operation expenses and data processing and telecommunication expenses. Non-interest income and non-interest expenses are affected by the growth of the Company's operations and growth in the number of loan and deposit accounts.

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Results of operations may be affected significantly by general and local economic and competitive conditions, changes in market interest rates, governmental policies and actions of regulatory authorities.

The Bank is a community-oriented bank which has traditionally offered a variety of savings products to its retail customers while concentrating its lending activities on real estate mortgage loans. Lending activities have been focused primarily on the origination of loans secured by real estate, including residential construction loans, one- to four-family residential loans, multi-family loans and commercial real estate loans. The Bank originates adjustable-rate residential mortgage loans that do not qualify for sale in the secondary market. The Bank also originates commercial business loans and other consumer loans.

## Critical Accounting Policies and Estimates

The Company has identified several accounting policies that as a result of judgments, estimates and assumptions inherent in those policies, are critical to an understanding of the Company's Consolidated Financial Statements. Critical accounting policies and estimates are discussed in the Company's 2016 Form 10-K under Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operation - Critical Accounting Policies and Estimates." That discussion highlights estimates the Company makes that involve uncertainty or potential for substantial change. There have been no material changes in the Company's critical accounting policies and estimates as previously disclosed in the Company's 2016 Form 10-K.

Comparison of Financial Condition at December 31, 2016 and September 30, 2016
The Company's total assets increased by $\$ 32.36$ million, or $3.6 \%$, to $\$ 923.75$ million at December 31, 2016 from $\$ 891.39$ million at September 30, 2016. The increase in total assets was primarily due to an increase in total cash and cash equivalents and net loans receivable. The increase in total assets was funded primarily by an increase in total deposits.

Net loans receivable increased by $\$ 5.99$ million, or $0.9 \%$, to $\$ 669.14$ million at December 31, 2016 from $\$ 663.15$ million at September 30, 2016. The increase was primarily due to increases in commercial real estate loans, multi-family construction loans and custom and owner/builder construction loans. These increases to net loans receivable were partially offset by a decrease in multi-family loans.

Total deposits increased by $\$ 28.44$ million, or $3.7 \%$, to $\$ 789.98$ million at December 31, 2016 from $\$ 761.53$ million at September 30, 2016. The increase was primarily a result of increases in money market, savings, N.O.W. checking and non-interest-bearing demand account balances, which were partially offset by a decrease in certificates of deposit account balances.

Shareholders' equity increased by $\$ 2.80$ million, or $2.9 \%$, to $\$ 99.63$ million at December 31, 2016 from $\$ 96.83$ million at September 30, 2016. The increase in shareholders' equity was primarily due to net income for the three months ended December 31, 2016, which was partially offset by the payment of dividends to common shareholders.

A more detailed explanation of the changes in significant balance sheet categories follows:
Cash and Cash Equivalents and CDs Held for Investment: Cash and cash equivalents and CDs held for investment increased by $\$ 26.96$ million, or $16.6 \%$, to $\$ 188.90$ million at December 31, 2016 from $\$ 161.94$ million at September 30, 2016. The increase was primarily due to a $\$ 26.53$ million, or $24.4 \%$, increase in cash and cash equivalents.

Investment Securities: Investment securities decreased by $\$ 147,000$, or $1.7 \%$, to $\$ 8.71$ million at December 31, 2016 from $\$ 8.85$ million at September 30, 2016, primarily due to scheduled amortization and prepayments. For additional information on investment securities, see Note 2 of the Notes to Unaudited Consolidated Financial Statements contained in "Item 1, Financial Statements."

FHLB Stock: FHLB stock was unchanged at $\$ 2.20$ million at both December 31, 2016 and September 30, 2016.

Loans: Net loans receivable increased by $\$ 5.99$ million, or $0.9 \%$, to $\$ 669.14$ million at December 31, 2016 from $\$ 663.15$ million at September 30, 2016. The increase in the portfolio was primarily a result of a $\$ 10.97$ increase in commercial real estate loans, a $\$ 9.50$ million increase in multi-family construction loans, a $\$ 3.24$ million increase in one- to four-family custom and owner/builder construction loans, a $\$ 925,000$ increase in one- to four family mortgage loans, and an $\$ 820,000$ increase in commercial business loans. These increases in net loans receivable were partially offset by a $\$ 10.24$ million decrease in multi-family loans, a $\$ 5.53$ million increase in the amount of undisbursed construction loans in process, a $\$ 1.97$ million decrease in speculative one- to four-family construction loans, and a $\$ 1.74$ million decrease in consumer loans.

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Loan originations increased by $\$ 36.39$ million, or $67.7 \%$, to $\$ 90.15$ million for the three months ended December 31, 2016 from $\$ 53.76$ million for the three months ended December 31, 2015, primarily due to increased market demand. The Company continued to sell longer-term fixed rate one- to four-family mortgage loans for asset liability management purposes and to generate non-interest income. The Company also (on a much smaller volume) sells the guaranteed portion of U.S. Small Business Administration ("SBA") loans. Sales of fixed rate one- to four-family mortgage loans and SBA loans increased by $\$ 11.58$ million, or $91.8 \%$, to $\$ 24.20$ million for the three months ended December 31, 2016 compared to $\$ 12.62$ million for the three months ended December 31, 2015 as more one- to four-family construction loans were completed, converted to permanent financing and then were sold in the secondary market.

For additional information, see Note 4 of the Notes to Unaudited Consolidated Financial Statements contained in "Item 1, Financial Statements."

Premises and Equipment: Premises and equipment increased by $\$ 1.66$ million, or $10.3 \%$, to $\$ 17.82$ million at December 31, 2016 from $\$ 16.16$ million at September 30, 2016. The increase was primarily a result of the Bank purchasing the building that it had been leasing for its Gig Harbor branch office for $\$ 1.84$ million in December 2016.

OREO (Other Real Estate Owned): OREO and other repossessed assets decreased by $\$ 863,000$, or $21.0 \%$, to $\$ 3.25$ million at December 31, 2016 from $\$ 4.12$ million at September 30, 2016. The decrease was primarily due to the disposition of four OREO properties. At December 31, 2016, total OREO and other repossessed assets consisted of 19 individual properties and one other repossessed asset. The properties consisted of 13 land parcels totaling $\$ 2.10$ million, three commercial real estate properties totaling $\$ 636,000$, three single-family homes totaling $\$ 456,000$ and one mobile home with a book value of $\$ 67,000$.

Goodwill: The recorded amount of goodwill of $\$ 5.65$ million at December 31, 2016 was unchanged from September 30, 2016.

Deposits: Deposits increased by $\$ 28.44$ million, or $3.7 \%$, to $\$ 789.98$ million at December 31, 2016 from $\$ 761.53$ million at September 30, 2016. The increase was primarily a result of a $\$ 14.95$ million increase in money market accounts, a $\$ 7.65$ million increase in savings accounts, a $\$ 4.10$ million increase in non-interest-bearing demand accounts and a $\$ 3.60$ million increase in negotiable order of withdrawal ("N.O.W.") checking account balances. These increases were partially offset by a $\$ 1.86$ million decrease in certificates of deposit accounts.

Deposits consisted of the following at December 31, 2016 and September 30, 2016 (dollars in thousands):

| December 31, <br> 2016 |  | September 30, |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
| 2016 |  |  |  |  |  |

FHLB Borrowings: The Company has short- and long-term borrowing lines with the FHLB with total credit available on the lines equal to $35 \%$ of the Bank's total assets, limited by available collateral. Borrowings are considered
short-term when the original maturity is less than one year. At December 31, 2016, FHLB borrowings consisted of two $\$ 15.00$ million long-term borrowings with scheduled maturities of August 1, 2017, and September 1, 2017, which bear interest at rates of $4.27 \%$ and $3.69 \%$, respectively. Their maturities are expected to significantly reduce the Company's interest expense. FHLB borrowings remained unchanged at $\$ 30.00$ million at both December 31, 2016 and September 30, 2016.

Shareholders' Equity: Total shareholders' equity increased by $\$ 2.80$ million, or $2.9 \%$, to $\$ 99.63$ million at December 31, 2016 from $\$ 96.83$ million at September 30, 2016. The increase was primarily due to net income of $\$ 3.15$ million for the three months ended December 31, 2016, which was partially offset by the payment of $\$ 626,000$ in dividends on the Company's common stock. The Company did not repurchase any shares of its common stock during the three months ended December 31,

2016, and at December 31, 2016, had 221,893 shares authorized to be repurchased under the Company's existing stock repurchase plan. For additional information, see Item 2 of Part II of this Form 10-Q.

Asset Quality: The non-performing assets to total assets ratio improved to $0.70 \%$ at December 31, 2016 from $0.88 \%$ at September 30, 2016 as total non-performing assets decreased by $\$ 1.43$ million, or $18.1 \%$, to $\$ 6.43$ million at December 31, 2016 from $\$ 7.86$ million at September 30, 2016. The decrease was primarily due to a $\$ 863,000$ decrease in OREO and other repossessed assets and a $\$ 509,000$ decrease in non-accrual loans.

Troubled debt restructured loans on accrual status (which are not included in the non-performing asset totals) decreased by $\$ 50,000$, or $0.7 \%$, to $\$ 7.58$ million at December 31, 2016 from $\$ 7.63$ million at September 30, 2016.

The following table sets forth information with respect to the Company's non-performing assets at December 31, 2016 and September 30, 2016 (dollars in thousands):

(1) As of December 31, 2016 and September 30, 2016, the balance of non-accrual one- to-four family properties includes $\$ 213,000$ and $\$ 138,000$, respectively, in the process of foreclosure.
(2) As of December 31, 2016 and September 30, 2016, the balance of OREO includes $\$ 456,000$ and $\$ 1.07$ million, respectively, of foreclosed residential real estate property recorded as a result of obtaining physical possession of the property.
(3) Does not include troubled debt restructured loans on accrual status.
(4) Does not include troubled debt restructured loans totaling $\$ 404,000$ and $\$ 531,000$ reported as non-accrual loans at December 31, 2016 and September 30, 2016, respectively.
(5) Does not include loans held for sale and loan balances are before the allowance for loan losses.

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Comparison of Operating Results for the Three Months Ended December 31, 2016 and 2015
Net income increased by $\$ 619,000$, or $24.5 \%$, to $\$ 3.15$ million for the quarter ended December 31, 2016 from $\$ 2.53$ million for the quarter ended December 31, 2015. Net income per diluted common share increased $\$ 0.07$, or $19.4 \%$, to $\$ 0.43$ for the quarter ended December 31, 2016 from $\$ 0.36$ for the quarter ended December 31, 2015.

The increase in net income for the three months ended December 31, 2016 was primarily due to increases in net interest income and non-interest income, which was partially offset by an increase in non-interest expense. A more detailed explanation of the income statement categories is presented below.

Net Interest Income: Net interest income increased by $\$ 603,000$, or $7.8 \%$, to $\$ 8.31$ million for the quarter ended December 31, 2016 from $\$ 7.71$ million for the quarter ended December 31, 2015. The net interest margin decreased to $3.91 \%$ for the quarter ended December 31, 2016 from $4.00 \%$ for the quarter ended December 31, 2015, primarily due to a decrease in the amount of non-accrual interest collected. The collection of non-accrual interest increased the net interest margin by approximately one basis point for the quarter ended December 31, 2016 and by approximately 25 basis points for the quarter ended December 31, 2015.

Total interest and dividend income increased by $\$ 472,000$, or $5.4 \%$, to $\$ 9.16$ million for the quarter ended December 31, 2016 from $\$ 8.69$ million for the quarter ended December 31, 2015, primarily due to a $\$ 78.59$ million increase in the average balance of total interest-bearing assets to $\$ 849.73$ million from $\$ 771.14$ million. The average yield on interest-bearing assets decreased to $4.31 \%$ for the quarter ended December 31, 2016 from $4.51 \%$ for the quarter ended December 31, 2015, primarily due to a decrease in the amount of non-accrual interest collected. During the quarter ended December 31, 2016, a total of $\$ 21,000$ in non-accrual interest was collected compared to $\$ 475,000$ for the quarter ended December 31, 2015. Total interest expense decreased by $\$ 131,000$, or $13.4 \%$, to $\$ 850,000$ for the quarter ended December 31, 2016 from $\$ 981,000$ for the quarter ended December 31, 2015. The decrease in interest expense was primarily due to a $\$ 170,000$ decrease in interest expense on FHLB borrowings, as the Company prepaid a $\$ 15.00$ million FHLB borrowing on September 30, 2016 which had an interest rate of $4.34 \%$, reducing interest expense by approximately $\$ 54,000$ per month during the quarter. The average balance of interest-bearing liabilities increased by $\$ 34.58$ million to $\$ 627.79$ million for the quarter ended December 31, 2016 from $\$ 593.21$ million for the quarter ended December 31, 2015. The average rate paid on interest-bearing liabilities decreased 12 basis points to $0.54 \%$ for the quarter ended December 31, 2016 from $0.66 \%$ for the quarter ended December 31, 2015, primarily due to the decrease in FHLB borrowing expense.

Average Balances, Interest and Average Yields/Cost
The following tables set forth, for the periods indicated, information regarding average balances of assets and liabilities as well as the total dollar amounts of interest income from average interest-bearing assets and interest expense on average interest-bearing liabilities and average yields and costs. Such yields and costs for the periods indicated are derived by dividing income or expense by the average daily balance of assets or liabilities, respectively, for the periods presented. (Dollars in thousands)

|  | Three Months Ended December 31, |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Average Balance | Interest <br> and <br> Dividends | Yield/ Cost |  | Average Balance | Interest <br> and <br> Dividends | Yield Cost |  |
| Interest-earning assets: |  |  |  |  |  |  |  |  |
| Loans receivable (1)(2) | \$684,911 | \$ 8,788 | 5.13 | \% | \$625,558 | \$ 8,429 | 5.16 | \% |
| Investment securities (2) | 7,822 | 70 | 3.58 |  | 8,288 | 69 | 3.34 |  |
| Dividends from mutual funds and FHLB stock | 3,167 | 24 | 3.01 |  | 3,667 | 22 | 2.40 |  |
| Interest-bearing deposits | 153,831 | 281 | 0.72 |  | 133,643 | 171 | 0.51 |  |
| Total interest-earning assets | 849,731 | 9,163 | 4.31 |  | 771,156 | 8,691 | 4.51 |  |
| Non-interest-earning assets | 57,105 |  |  |  | 58,204 |  |  |  |
| Total assets | \$906,836 |  |  |  | \$829,360 |  |  |  |
| Interest-bearing liabilities: |  |  |  |  |  |  |  |  |
| Savings accounts | \$ 127,656 | 18 | 0.06 |  | \$ 110,356 | 15 | 0.05 |  |
| Money market accounts | 120,311 | 97 | 0.32 |  | 104,377 | 80 | 0.30 |  |
| N.O.W. checking accounts | 202,385 | 118 | 0.23 |  | 179,611 | 113 | 0.25 |  |
| Certificates of deposit | 147,433 | 310 | 0.83 |  | 153,866 | 296 | 0.76 |  |
| Long-term borrowings (3) | 30,000 | 307 | 4.07 |  | 45,000 | 477 | 4.21 |  |
| Total interest-bearing liabilities | 627,785 | 850 | 0.54 |  | 593,210 | 981 | 0.66 |  |
| Non-interest-bearing deposits | 176,768 |  |  |  | 142,518 |  |  |  |
| Other liabilities | 4,495 |  |  |  | 3,788 |  |  |  |
| Total liabilities | 809,048 |  |  |  | 739,516 |  |  |  |
| Shareholders' equity | 97,788 |  |  |  | 89,844 |  |  |  |
| Total liabilities and shareholders' equity | \$906,836 |  |  |  | \$829,360 |  |  |  |
| Net interest income |  | \$ 8,313 |  |  |  | \$ 7,710 |  |  |
| Interest rate spread |  |  | 3.77 | \% |  |  | 3.85 | \% |
| Net interest margin (4) |  |  | 3.91 | \% |  |  | 4.00 | \% |
| Ratio of average interest-earning assets to average interest-bearing liabilities |  |  | 135.35 |  |  |  | 130.00 |  |

[^0]Rate Volume Analysis
The following table sets forth the effects of changing rates and volumes on the net interest income of the Company. Information is provided with respect to the (i) effects on interest income attributable to changes in volume (changes in volume multiplied by prior rate), (ii) effects on interest income attributable to changes in rate (changes in rate multiplied by prior volume), and (iii) the net change (sum of the prior columns). Changes in rate/volume have been allocated to rate and volume variances based on the absolute values of each (in thousands):

Three months ended
December 31, 2016
compared to three
months
ended December 31, 2015
increase (decrease) due
to

Rate Volume | Net |
| :--- |
| Change |

Interest-earning assets:

| Loans receivable and loans held for sale | $\$(416)$ | $\$ 775$ | $\$ 359$ |
| :--- | :--- | :--- | :--- |
| Investment securities | 5 | $(4$ | $)$ |
| Dividends from mutual funds and FHLB stock | 5 | $(3$ | $)$ |
| Interest-bearing deposits | 81 | 29 | 110 |
| Total net increase (decrease) in income on interest-earning assets | $(325$ | $)$ | 797 |
| Tot | 472 |  |  |

Interest-bearing liabilities:

| Savings accounts | 1 | 2 | 3 |
| :--- | :--- | :--- | :--- |
| Money market accounts | 4 | 12 | 16 |
| N.O.W. checking accounts | $(9$ | $)$ | 14 |
| Certificates of deposit accounts | 26 | $(11$ | 5 |
| $\quad$ Long term FHLB borrowings | $(13$ | $)(157$ | $(15)$ |
| Total net increase (decrease) in expense on interest-bearing liabilities | 9 | $(140$ | $)$ |
|  |  | $(131)$ |  |
| Net increase (decrease) in net interest income | $\$(334) \$ 937$ | $\$ 603$ |  |

Provision for Loan Losses: There was no provision for loan losses for the quarters ended December 31, 2016 and 2015, as improved credit quality measures have been sufficient to cover any additional reserves needed for growth and changes in the mix of the loan portfolio. There was a net recovery of $\$ 17,000$ for the quarter ended December 31, 2016, compared to a net charge-off of $\$ 35,000$ for the quarter ended December 31, 2015. Non-accrual loans decreased by $17.8 \%$ to $\$ 2.36$ million at December 31, 2016, from $\$ 2.87$ million at September 30, 2016 and decreased by $51.1 \%$ from $\$ 4.83$ million at December 31, 2015. Total delinquent loans (past due 30 days or more) and non-accrual loans increased by $17.0 \%$ to $\$ 4.06$ million at December 31, 2016, from $\$ 3.47$ million at September 30, 2016 and decreased by $25.9 \%$ from $\$ 5.48$ million one year ago.

The Company has established a comprehensive methodology for determining the allowance for loan losses. On a quarterly basis the Company performs an analysis that considers pertinent factors underlying the quality of the loan portfolio. The factors include changes in the amount and composition of the loan portfolio, historical loss experience for various loan segments, changes in economic conditions, delinquency rates, a detailed analysis of impaired loans, and other factors to determine an appropriate level of allowance for loan losses. Based on its comprehensive analysis, management believes the allowance for loan losses of $\$ 9.84$ million at December 31, 2016 ( $1.45 \%$ of loans receivable and $393.8 \%$ of non-performing loans) was adequate to provide for probable losses inherent in the loan portfolio based on an evaluation of known and inherent risks in the loan portfolio at that date. Impaired loans are subjected to an
impairment analysis to determine an appropriate reserve amount to be allocated to each loan. The aggregate principal impairment reserve amount determined at December 31, 2016 was $\$ 756,000$ compared to $\$ 776,00$ at September 30, 2016 and $\$ 833,000$ at December 31, 2015. The allowance for loan losses was $\$ 9.83$ million ( $1.46 \%$ of loans receivable and $326.7 \%$ of non-performing loans) at September 30, 2016 and $\$ 9.89$ million ( $1.56 \%$ of loans receivable and $193.3 \%$ of non-performing loans) at December 31, 2015.

While management believes the estimates and assumptions used in its determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will not be proved incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be
required will not adversely impact the Company's consolidated financial condition and results of operations. In addition, the determination of the amount of the Company's allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the establishment of additional reserves based upon their analysis of information available to them at the time of their examination. Any material increase in the allowance for loan losses would adversely affect the Company's consolidated financial condition and results of operations. For additional information, see Note 4 of the Notes to Unaudited Consolidated Financial Statements contained in "Item 1, Financial Statements."

Non-interest Income: Total non-interest income increased by $\$ 698,000$, or $27.7 \%$, to $\$ 3.22$ million for the quarter ended December 31, 2016 from $\$ 2.52$ million for the quarter ended December 31, 2015. The increase in non-interest income was primarily due to a $\$ 295,000$ increase in gain on sales of loans, a $\$ 133,000$ increase in service charges on deposits, a $\$ 100,000$ increase in ATM and debit card interchange transaction fees and smaller increases several other categories. The increase in gain on sales of loans was primarily due to an increase in the dollar volume of fixed-rate one- to four-family loans sold during the current quarter. The increase in service charges on deposits was primarily due to an increase in the amount of service charges collected on checking accounts owned by business associated with the marijuana (or Initiative-502) industry in Washington State. It is permissible in Washington State to handle accounts associated with this industry in compliance with federal regulatory guidelines. The increase in ATM and debit card interchange transaction fees was primarily due to an increase in debit card transactions.

Non-interest Expense: Total non-interest expense increased by $\$ 331,000$, or $5.1 \%$, to $\$ 6.81$ million for the quarter ended December 31, 2016 from $\$ 6.48$ million for the quarter ended December 31, 2015. The increased expense was primarily due to a $\$ 209,000$ increase in salaries and employee benefits expense, a $\$ 137,000$ increase in deposit operations expense and smaller increases in several other categories. These increases were partially offset by a $\$ 214,000$ decrease in OREO and other repossessed assets expense and smaller decreases in several other categories. The increase in salary and employee benefits expense was primarily due to annual salary adjustments and the hiring of additional lending personnel. The increase in deposit operations expense was primarily due to an increase in the level of checking account acquisition promotional costs and check fraud expenses. The decrease in OREO and other repossessed assets expense was primarily due to a decrease in the level of market value write-downs on OREO properties.

The efficiency ratio for the current quarter improved to $59.07 \%$ from $63.35 \%$ for the comparable quarter one year ago as the increases in net interest income and non-interest income outpaced the increase in non-interest expense.

Provision for Federal Income Taxes: The provision for federal income taxes increased by $\$ 351,000$, or $28.7 \%$, to $\$ 1.57$ million for the quarter ended December 31, 2016 from $\$ 1.22$ million for the quarter ended December 31, 2015, primarily as a result of increased income before federal income taxes. The Company's effective tax rate was $33.31 \%$ for the quarter ended December 31, 2016 and $32.57 \%$ for the quarter ended December 31, 2015.

## Liquidity

The Company's primary sources of funds are customer deposits, proceeds from principal and interest payments on loans, the sale of loans, maturing investment securities, maturing CDs held for investment, FHLB borrowings and other borrowings. While maturities and the scheduled amortization of loans are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition.

Liquidity management is both a short and long-term responsibility of the Bank's management. The Bank adjusts its investments in liquid assets based upon management's assessment of (i) expected loan demand, (ii) projected loan sales, (iii) expected deposit flows, and (iv) yields available on interest-bearing deposits. Excess liquidity is invested generally in interest-bearing overnight deposits and other short-term investments.

The Bank generally maintains sufficient cash and short-term investments to meet short-term liquidity needs. At December 31, 2016, the Bank's regulatory liquidity ratio (net cash, and short-term and marketable assets, as a percentage of net deposits and short-term liabilities) was $22.89 \%$.

The Company's total cash and cash equivalents and CDs held for investment increased by $\$ 26.96$ million, or $16.6 \%$, to $\$ 188.90$ million at December 31, 2016 from $\$ 161.94$ million at September 30, 2016. If the Bank requires funds that exceed its ability to generate them internally, it has additional borrowing capacity with the FHLB, the Federal Reserve Bank of San Francisco ("FRB") and Pacific Coast Bankers' Bank ("PCBB"). At December 31, 2016, the Bank maintained an uncommitted credit facility with the FHLB that provided for immediately available advances up to an aggregate amount equal to $35 \%$ of total assets, limited by available collateral. The Bank also has a Letter of Credit ("LOC") of up to $\$ 22.0$ million with the FHLB for the purpose of collateralizing Washington State public deposits. Any amount pledged for public deposit under the LOC reduces

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the Bank's available borrowing amount under the FHLB advance agreement. At December 31, 2016, the Bank had $\$ 30.00$ million in FHLB advances outstanding and $\$ 22.00$ million pledged under the LOC, which left $\$ 243.07$ million available for additional borrowings. The Bank maintains a short-term borrowing line with the FRB with available total credit based on eligible collateral. At December 31, 2016, the Bank had $\$ 59.93$ million available for borrowings with the FRB and there was no outstanding balance on this borrowing line. The Bank also maintains a $\$ 10.00$ million overnight borrowing line with PCBB. At December 31, 2016, the Bank did not have an outstanding balance on this borrowing line.

The Bank's primary investing activity is the origination of one- to four-family mortgage loans, commercial mortgage loans, construction loans, consumer loans, and commercial business loans. At December 31, 2016, the Bank had loan commitments totaling $\$ 76.18$ million and undisbursed construction loans in process totaling $\$ 54.16$ million. The Bank anticipates that it will have sufficient funds available to meet current loan commitments. CDs that are scheduled to mature in less than one year from December 31, 2016 totaled $\$ 82.78$ million. Historically, the Bank has been able to retain a significant amount of its non-brokered CDs as they mature. At December 31, 2016, the Bank had $\$ 3.21$ million in brokered CDs.

## Capital Resources

The Bank, as a state-chartered, federally insured savings bank, is subject to the capital requirements established by the FDIC. Under the FDIC's capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weighting and other factors.

Based on its capital levels at December 31, 2016, the Bank exceeded all regulatory capital requirements as of that date. Consistent with the Bank's goals to operate a sound and profitable organization, it is the Bank's policy to maintain a "well-capitalized" status under the regulatory capital categories of the FDIC. Based on capital levels at December 31, 2016, the Bank was considered to be "well-capitalized" under applicable regulatory requirements. Management monitors the capital levels to provide for current and future business opportunities and to maintain the Bank's "well-capitalized" status.

The following table compares the Bank's actual capital amounts at December 31, 2016 to its minimum regulatory capital requirements at that date (dollars in thousands):

| Actual |  | To Be "Well |
| :---: | :---: | :---: |
|  | Regulatory | Capitalized" |
|  | Minimum To | Under Prompt |
|  | Be "Adequately | Corrective |
|  | Capitalized" | Action |
|  |  | Provisions |
| Amount Ratio | Amount Ratio | Amount Ratio |

Leverage Capital Ratio:
Tier 1 capital
\$93,037 10.32\% \$36,066 4.00\% \$45,082 5.00 \%
Risk-based Capital Ratios:

| Common equity tier 1 capital | 93,037 | 14.72 | 28,448 | 4.50 | 41,091 | 6.50 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Tier 1 capital | 93,037 | 14.72 | 37,930 | 6.00 | 50,574 | 8.00 |

$\begin{array}{lllllll}\text { Total capital } & 100,965 & 15.97 & 50,574 & 8.00 & 63,217 & 10.00\end{array}$
In addition to the minimum common equity Tier 1 ("CET1"), Tier 1 and total capital ratios, the Bank now has to maintain a capital conservation buffer consisting of additional CET1 capital above the required minimum levels in order to avoid limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses based on percentages of retained income that could be utilized for such actions. The new capital conservation buffer requirement began to be phased in beginning in January 2016 at $0.625 \%$ of risk-weighted assets and increases each year until fully implemented to an amount equal to $2.5 \%$ of risk weighted assets in January 2019.

Timberland Bancorp, Inc. is a bank holding company registered with the Federal Reserve. Bank holding companies are subject to capital adequacy requirements of the Federal Reserve under the Bank Holding Company Act of 1956, as amended, and the regulations of the Federal Reserve. For a bank holding company with less than $\$ 1.0$ billion in assets, the capital guidelines
apply on a bank only basis and the Federal Reserve expects the holding company's subsidiary bank to be well capitalized under the prompt corrective action regulations. If Timberland Bancorp, Inc. were subject to regulatory guidelines for bank holding companies with $\$ 1.0$ billion or more in assets, at December 31, 2016, Timberland Bancorp, Inc. would have exceeded all regulatory requirements.

The following table presents the regulatory capital ratios for Timberland Bancorp, Inc. as of December 31, 2016 (dollars in thousands):

Actual<br>Amount Ratio

Leverage Capital Ratio:
Tier 1 capital
\$95,692 10.60\%
Risk-based Capital Ratios:
Common equity tier 1 capital $95,69215.13$
Tier 1 capital 95,692 15.13
Total capital 103,623 16.39
Key Financial Ratios and Data
(Dollars in thousands, except per share data)
Three Months
Ended
December 31,
20162015

## PERFORMANCE RATIOS:

Return on average assets $1.39 \% 1.22 \%$
Return on average equity $\quad 12.87 \% 11.26 \%$
Net interest margin $\quad 3.91 \% 4.00 \%$
Efficiency ratio $\quad 59.07 \%$ 63.35\%
Item 3. Quantitative and Qualitative Disclosures About Market Risk
There were no material changes in information concerning market risk from the information provided in the Company's Form 10-K for the fiscal year ended September 30, 2016.

Item 4. Controls and Procedures
Evaluation of Disclosure Controls and Procedures: An evaluation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the "Exchange Act")) was carried out under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer and several other members of the Company's senior management as of the end of the period covered by this
(a) report. The Company's Chief Executive Officer and Chief Financial Officer concluded that as of December 31, 2016 the Company's disclosure controls and procedures were effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is (i) accumulated and communicated to the Company's management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner to allow timely decisions regarding required disclosure, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.
(b)Changes in Internal Controls: There have been no changes in our internal control over financial reporting (as defined in 13a-15(f) of the Exchange Act) that occurred during the quarter ended December 31, 2016, that have

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materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. The Company continued, however, to implement suggestions from its internal auditor and independent auditors to strengthen existing controls. The Company does not expect that its disclosure controls and procedures and internal
control over financial reporting will prevent all errors and fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns in controls or procedures can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any control procedure is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; as over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

## PART II. OTHER INFORMATION

Item 1. Legal Proceedings
Neither the Company nor the Bank is a party to any material legal proceedings at this time. From time to time, the Bank is involved in various claims and legal actions arising in the ordinary course of business.

Item 1A. Risk Factors
There have been no material changes in the Risk Factors previously disclosed in Item 1A of the Company's 2016 Form 10-K.

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

(a) Not applicable
(b) Not applicable
(c) Stock Repurchases

There were no shares repurchased by the Company during the quarter ended December 31, 2016. On July 28, 2015 the Company announced a plan to repurchase 352,681 shares of the Company's common stock. As of December 31, 2016, a total of 130,788 shares had been repurchased at an average price of $\$ 11.69$ per share and there were 221,893 shares still authorized to be repurchased under the plan. All shares were repurchased through open market broker transactions and no shares were directly repurchased from directors or officers of the Company.

## Item 3. Defaults Upon Senior Securities

Not applicable.
Item 4. Mine Safety Disclosures
Not applicable.
Item 5. Other Information
None to be reported.

## Item 6. Exhibits

(a) Exhibits
3.1 Articles of Incorporation of the Registrant (1)
3.3 Amended and Restated Bylaws of the Registrant (2)
4.1 Warrant to purchase shares of Company's common stock dated December 23, 2008 (3)

Letter Agreement (including Securities Purchase Agreement Standard Terms attached as Exhibit A) dated December 23, 2008 between the Company and the United States Department of the Treasury (3)
10.1 Employee Severance Compensation Plan, as revised (4)
10.2 Employee Stock Ownership Plan (4)
10.31999 Stock Option Plan (5)
10.4 Management Recognition and Development Plan (5)
10.5 2003 Stock Option Plan (6)
10.6 Form of Incentive Stock Option Agreement (7)
10.7 Form of Non-qualified Stock Option Agreement (7)
10.8 Form of Management Recognition and Development Award Agreement (7)
10.9 Employment Agreement with Michael R. Sand (8)
10.10Employment Agreement with Dean J. Brydon (8)
10.11 Timberland Bancorp, Inc. 2014 Equity Incentive Plan (9)
31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes OxleyAct
31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes Oxley Act Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes Oxley Act
The following materials from Timberland Bancorp Inc's Quarterly Report 10-Q for the quarter ended December 31, 2016, formatted on Extensible Business Reporting Language (XBRL) (a) Consolidated Balance Sheets; (b)
101 Consolidated Statements of Income; (c) Consolidated Statements of Comprehensive Income; (d) Consolidated Statements of Shareholders' Equity; (e) Consolidated Statements of Cash Flows; and (f) Notes to Unaudited Consolidated Financial Statements
(1) Incorporated by reference to the Registrant's Registration Statement on Form S-1 (333-35817).
(2) Incorporated by reference to the Registrant's Current Report on Form 8-K filed on April 29, 2010.
(3)Incorporated by reference to the Registrant's Current Report on Form 8-K filed on December 23, 2008.
(4)Incorporated by reference to the Registrant's Current Report on Form 8-K dated April 16, 2007.
(5)Incorporated by reference to the Registrant's 1999 Annual Meeting Proxy Statement dated December 15, 1998.
(6) Incorporated by reference to the Registrant's 2004 Annual Meeting Proxy Statement dated December 24, 2003. (7) Incorporated by reference to the Exhibit 99.2 included in the Registrant's Registration Statement on Form S-8 ${ }^{(7)}$ (333-1161163).
(8) Incorporated by reference to the Registrant's Current Report on Form 8-K filed on March 29, 2013.
(9) Attached as Appendix A to the Registrant's Annual Meeting Proxy Statement filed on December 19, 2014.

## 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.

Timberland Bancorp, Inc.

Date: February 9, 2017 By: /s/ Michael R. Sand
Michael R. Sand
Chief Executive Officer
(Principal Executive Officer)

Date: February 9, 2017 By: /s/ Dean J. Brydon
Dean J. Brydon
Chief Financial Officer
(Principal Financial Officer)
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## EXHIBIT INDEX

Exhibit
No.
Description of Exhibit
31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act

32 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act
The following materials from Timberland Bancorp Inc.'s Quarterly Report on Form 10-Q for the quarter ended December 31, 2016, formatted on Extensible Business Reporting Language (XBRL) (a) Consolidated Balance
101 Sheets; (b) Consolidated Statements of Income; (c) Consolidated Statements of Comprehensive Income; (d) Consolidated Statements of Shareholders' Equity; (e) Consolidated Statements of Cash Flows; and (f) Notes to Unaudited Consolidated Financial Statements


[^0]:    1) Does not include interest on loans on non-accrual status. Includes loans held for sale. Amortized net deferred loan
    ${ }^{1)}$ fees, late fees, extension fees and prepayment penalties are included with interest and dividends.
    (2) Average balances include loans and investment securities on non-accrual status.
    (3) Includes FHLB borrowings with original maturities of one year or greater.
    (4) Net interest income divided by total average interest-earning assets, annualized.
