



A QUEST FOR THE EXTRAORDINARY



2014 ANNUAL REPORT



A woman with dark hair, wearing a light blue short-sleeved shirt and white pants, stands with her back to the camera in a field of tall, golden-brown grass. She is holding a light-colored hat. In the background, there is a valley with a town and rolling hills under a dramatic, orange-hued sunset sky. The sun is low on the horizon, creating a strong glow and long shadows.

A QUEST FOR THE EXTRAORDINARY

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2014 ANNUAL REPORT

## CONTENTS

- 2 President's Letter to Shareholders
- 4 A Banking Culture for the Extraordinary Client
  - 6 The Vision Becomes Reality
    - 8 Success Stories
    - 12 Directors and Officers
  - 17 Independent Auditor's Report
  - 18 Consolidated Balance Sheets
  - 19 Consolidated Statements of Income
- 20 Consolidated Statements of Comprehensive Income
- 20 Consolidated Statements of Stockholders' Equity
  - 21 Consolidated Statements of Cash Flows
- 22 Notes to Consolidated Financial Statements
- 54 Management's Report on the Financial Statements and the Internal Control Over Financial Reporting
- 55 Management's Assessment of Compliance with Laws and Regulations
  - 56 Locations

# TO OUR SHAREHOLDERS

Last year I opened my letter to you stating that “2013 was the most successful year in the bank’s nearly 15-year history.” It is my pleasure to report that our results in 2014 have eclipsed even last year’s historic performance.

We are blessed to be located in two of the best financial markets in the United States. The Triangle and Charlotte regions are where banks and busi-

nesses want to be located. Both are consistently ranked among the top ten markets in just about every category.

We are also blessed to have attracted a talented and accomplished staff of business development and service professionals. Management has added new Private Bankers to call on owners of companies, corporate executives and individuals who desire a higher

level of professional and personal attention. We have also added Commercial Client Development Officers in both markets.

To support our continued growth, a new Private Banking office was opened in Cary and we completed our relocation into a beautiful, high-visibility office in Charlotte that dramatically improves client access.

Our management team and Board of Directors decided that the time had come to improve liquidity for our very patient shareholders. We began that process by obtaining shareholder approval to combine our two classes of common stock. The Board also approved a 125-for-1 stock split. We hired Raymond James to sponsor Paragon’s DTC eligibility, which allows our stock to be traded electronically. Paragon Commercial Corporation common stock is now quoted on the OTC Markets under the ticker symbol “PBNC.”

Management’s major focus has been to increase our franchise value in the marketplace. That includes loan and deposit growth, loan and deposit mix, credit quality and efficiency.

To that end, we continue to emphasize core deposit generation to fund growth while allowing non-core deposits, including brokered and Internet deposits, to roll off as they mature. This is important for two reasons: it adds to our franchise value as clients come from both the loan and the deposit side of the balance sheet; and it reduces our cost of funds. This results in a higher net interest margin, which along with growth is the primary driver of our income.



**SOME OF OUR FINANCIAL HIGHLIGHTS INCLUDE:**

■ **Earnings** – We improved net after-tax income to \$8.0 million, a 62% increase over 2013. Our consolidated return on assets was .72 versus a budget of .68.

■ **Loan and Deposit Growth** – We increased our loan portfolio by 13%. This is outstanding given the fact that our credit department eliminated \$50 million in loans which were out of market (primarily Richmond loans made when we had a Virginia presence) and riskier real estate loans and non-performers. In addition, Raleigh and Charlotte had \$97 million in unanticipated payoffs during the year.

The bank also generated an impressive 25% increase in local deposits in 2014.

■ **Credit Quality** – Our non-performing assets as a percentage of total assets decreased from 1.95% to 1.31%. In addition, our non-performing loans decreased to 1.05% of total loans, which was well below that of our peers.

■ **Loan Mix** – The investment community likes to see a healthy mix of loans

in a bank’s portfolio. This also adds to a bank’s franchise value. To that end, we increased our percentage of loans to the commercial and industrial market from 23% to 28% at year’s end. This is a result of management’s emphasis and additional loan officers focusing on C&I clients. We also increased our private banking loans (primarily equity lines and home mortgages) from 20% to 23% of our portfolio. At the same time, we reduced our exposure in commercial real estate loans. The result is an improved loan mix in our portfolio.

■ **Deposit Mix** – Franchise value also comes from a proper mix of deposits. Management has made tremendous strides in reducing our level of brokered and Internet deposits, replacing them with checking and money market accounts for local clients. Our local deposits as a percentage of total deposits increased from 67% in December 2013 to 73% in December 2014.

■ **Efficiency** – Franchise value also comes from efficiencies gained, which translates into net income. Our model of business and private banking with three strategically located offices and \$1.2 billion in assets contributes to an

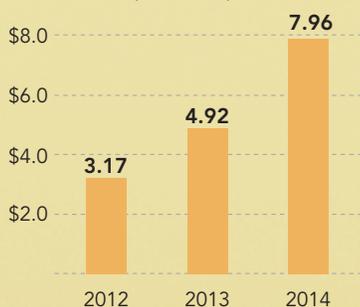
efficiency ratio markedly better than our peers. “Overhead-to-assets ratio” and “efficiency ratio” are two primary metrics we use to compare our performance to other banks and to our goals. We consistently lead North Carolina with our overhead ratio and are in the top quartile in efficiency ratio. If we are successful in continuing to increase our earnings while controlling our overhead, we believe both ratios will continue to improve.

Our 15th anniversary has been marked by historic achievements, controlled growth, and continued optimism. What began as a dream in 1999 has become reality at Paragon Bank. We have identified the mission and we have dedicated ourselves to the unending quest for the Extraordinary Client Experience.

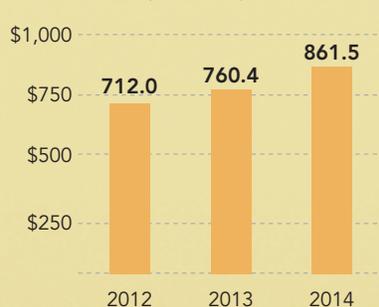


**Robert C. Hatley**  
President and Chief Executive Officer

**CONSOLIDATED NET INCOME**  
(In millions)



**LOANS**  
(In millions)



**DEPOSITS**  
(In millions)



A person in a dark jacket stands on a rocky mountain peak, looking out over a vast valley. The sky is filled with dramatic, colorful clouds in shades of pink, orange, and purple, suggesting a sunset or sunrise. The valley below is a patchwork of green fields and small settlements, with rolling hills in the distance.

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A HARMONIOUS  
BANKING ENVIRONMENT  
BUILT AROUND THE NEEDS  
OF EACH CLIENT.  
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## A BANKING CULTURE FOR THE EXTRAORDINARY CLIENT

To the outside world, it's just another bank. To Paragon clients, it's another universe. This is where expectations rise and are actually met, a bank where everyone really is there to serve. It is an extraordinary banking culture created for the extraordinary client.

Paragon is the exception to a cookie-cutter banking world—a harmonious banking environment built around the unique needs of each client. It is a sustainable culture of service excellence that permeates every aspect of the business.

### **PREPARED. PRESENT. PROACTIVE.**

These watchwords form the bank's holistic approach to client service and involve every employee. From large business relationships to individual private banking relationships, every client is served by an elite team of banking professionals that is fully prepared, always accessible and proactively involved in ongoing goals-based, client-inspired plans of action.

Simply put, each client that walks through the doors enters a world created just for them—a world where every option inside and outside the

bank's capabilities is considered. It is a dynamic, ever-changing world supported by Paragon's Extraordinary Client Experience initiative to ensure consistent delivery of the Paragon promise at every level of operation.

This culture of the Extraordinary Client Experience defines the Paragon brand, setting it apart from other banks and empowering it to attract a growing list of elite clientele. A tangible difference in the way the client is served has given rise to a banking philosophy that is gaining acceptance throughout the marketplace. Loyalty to the Paragon brand is building. The bank's future has never looked brighter.

So it is appropriate then to look back to a moment in time at the founding of Paragon Bank. It was fifteen years ago this year that CEO Bob Hatley and others sat at his kitchen table with loose leaf notebook and pen and imagined a new kind of bank—one that would refuse to be everything to everyone—but would instead focus on a heightened level of service that would position it to attract an elite level of clientele. That was the vision. This is the bank.

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EACH CLIENT THAT  
WALKS THROUGH THE DOORS  
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JUST FOR THEM.

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## THE VISION BECOMES REALITY

Through its first 15 years Paragon Bank has remained true to its founding vision. A new branding campaign was unveiled in 2014 to underscore the bank's strategic foundation—the Extraordinary Client Experience. Paragon's unwavering commitment to that vision has elevated its status in the marketplace and positively impacted the bottom line for both the bank and its shareholders. The year-end results confirm it.

The numbers were trending upward in just about every area of the bank in 2014. Net income was up dramatically,

62 percent over the previous year. Annual loan growth was up. About the only thing that was down was nonperforming loans, another plus in the bank's overall performance. CEO Bob Hatley called it "our best year in just about every measure since our founding. We achieved record net income, significant growth and continued strong credit quality—all in the same year."

Paragon shareholders saw fully diluted earnings per share increase to \$1.79 from \$1.11 the previous year. Paragon Commercial Corporation, the bank's

parent company, authorized a 125-for-1 stock split on June 8, 2014. The move is significant for current and future shareholders in that it increases the liquidity of Paragon shares, bringing the stock price to a more attractive level for investors. And shareholders will soon have the ability to conduct future trades electronically.

The bank also saw a continued focus on growth in 2014. The move to a more visible Charlotte office location was completed in February 2014. The new location increases the bank's Charlotte



footprint from 7,000 square feet to over 16,000 square feet, giving team members more room to serve clients in a highly visible, easily accessible location.

Paragon unveiled its third North Carolina location in October 2014 with the opening of a new Cary office. The 2,700 square foot space will serve the bank's growing private banking and commercial business in the vibrant Cary market.

A new 11,500 square-foot operations center opened in Raleigh in July 2014. The move places vital operations staff in a highly secure, offsite location.

The most important area of growth in 2014 was in the bank's client list. And to support that growth, Paragon added 32 experienced banking professionals in the form of sales, administrative and support staff. These new hires join a growing team of dedicated individuals whose mission is to continue the unending quest to create extraordinary client experiences.

The quest continues.



*Success Stories*

# ZEPSA INDUSTRIES: A FAMILY FIRM FOR THE AGES

Zepsa Industries is a 21st century business with the soul of an old-world master. What their craftsmen can do with a piece of wood would make even Michelangelo a tinge envious. The company is a rare jewel in this faster-is-good-cheaper-is-better world. Zepsa Industries designs, engineers, manufactures and installs the finest handcrafted architectural woodwork, yacht interiors and monumental stairs to be found anywhere in the world.

If you want to work with Zepsa Industries, know this: It will not be cheap; it will not be fast; but it will be magnificent. That is why the most demanding professionals in America—the top architects, interior designers, general contractors and mega yacht builders—like doing business with founder Ed Zepsa, sons Brian and Peter, wife Maripat and their 100 craftsmen. So do his clients, many of which are counted amongst America's most recognized names.

The Zepsa family treats every project as if it were their final masterpiece. The most mundane details are attended to like a mother tending to her only child. The same attention and devotion is shared by each of their employees.

Everything about Zepsa Industries is personal and intimate. You see it in their commitment to each other and to every project. The company expects the same from their banker. Until seven years ago, Ed Zepsa worked with his



small hometown community bank. He describes it as a scene out of Mayberry. "I can't say anything negative about them," he recalled. "We had a great 20-year relationship, but we outgrew them."

Ed asked his CPA for help in finding a new bank. He introduced him to several mid-sized banks. "We believed we would never find the same personal attention," he said, "or the same kind of grounded, reasonable people at a

larger bank. We heard the big banks talk about relationships, but Paragon actually delivered. Paragon is always there for me," he said, "they seem to understand what this is all about, what we're all about."

Ed Zepa's belief in the importance of the relationship has led Zepa Industries to the top of its field and, ultimately, to a bank that shares his vision.

*Master craftsman, Ed Zepa, with sons (left to right) Brian and Peter.*





### *Success Stories*

## MIKE RUSSO: THE MAN BEHIND THE CURTAIN

In Mike Russo's world you actually can judge a book by its cover, and it is not what's on the inside that counts. This isn't some strange opposite universe where up is down and right is left. This is SPS Corporation, one of the largest glass and glazing specialty contractors in the country. Founded in 1982, SPS is all about outside appearances. They have built some of the most beautiful architectural curtainwall and metal panel projects that you may ever see.

The SPS success story began in Fort Wayne, Indiana in 1982. The strong

Triangle construction market brought them cross-country to Apex, North Carolina where they eventually set up their national headquarters in 2004.

By 2005 they decided that the time had come to move their banking business. "It was an interesting process that led us to select Paragon Bank as our partner," Mike recalled. "We were with a bank that was similar to Paragon. By that I mean a bank with a more personal approach and structure. I'm not saying that big banks are a bad thing, but I think it is important that you team

with a bank that is a reflection of your company's structure and work culture."

After several meetings with Paragon's President and CEO, Robert Hatley, the partners felt they had found the right fit. "We began to see," Mike explained, "that Paragon's individual approach to the client set them apart from other banks. We like the fact that we have clear contacts and relationships with the people that support us at Paragon, and as business issues come up, we are always taken care of quickly and professionally. I have worked with other



*Mike Russo (left) and business partner Chris Craney, creators of architectural curtainwalls.*

banks where that hasn't been the case. Sometimes in bigger banks the process of accomplishing tasks can be cumbersome and ultimately cost a company time and money."

Time and money are something that Russo and business partner Chris Craney cannot afford to waste. They have built their business into a national powerhouse by delivering on their promises and by partnering with the best suppliers and subcontractors in the industry. "From a business perspective," he said, "we thoroughly

enjoy the relationship that has been established between us. I like the fact that there is a level of trust, that we know Paragon will do the right things to help and support us as a bank and business partner." After a short pause, he added, "When you look inside Paragon and peel away the layers, everything is about the relationship. It was the right choice for us."

In Mike Russo's world nothing is more important than outside appearances, that is, until it comes time to choose a bank.



# BOARD OF DIRECTORS



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Barringer Sasser, LLP



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Owner  
Brewer Properties



**J. Scott Edwards**  
Retired



**Roy L. Harmon, Jr.**  
Chairman and CEO  
Bank of Tennessee



**Robert C. Hatley**  
President and CEO  
Paragon Bank



**K. Wesley M. Jones**  
Managing Partner  
Five Oaks Capital Partners



**Howard Jung** (Chairman)  
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Ace Hardware Stores, Inc.



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CEO  
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**F. Alton Russell**  
Chairman and Counsel  
The Title Company of  
North Carolina



**R. Frank Gray** (Bank Counsel)  
Partner  
Jordan Price Wall Gray  
Jones & Carlton, PLLC

## SENIOR LEADERSHIP



### EXECUTIVE OFFICERS

*Left to right:*

**Robert C. Hatley**  
President and  
Chief Executive Officer

**Steven E. Crouse**  
Executive Vice President  
Chief Financial Officer

**Matthew C. Davis**  
Executive Vice President  
Chief Operating Officer



### SENIOR MANAGEMENT

*Left to right:*

**James M. Fielding**  
Senior Vice President  
Chief Credit Officer

**Rebecca A. McClain**  
Senior Vice President  
Director of Operations

**Brian K. Reid**  
Triangle Market President

**Carol A. Isaac**  
Senior Vice President  
Human Resource Manager

**Phillip R. Journey**  
Charlotte Market President

**Scott V. Williams**  
Senior Vice President  
Director of Marketing

## TRIANGLE CLIENT DEVELOPMENT OFFICERS



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Senior Vice President



**Martin W. Borden**  
Senior Vice President



**JoAnn D. Harper**  
Vice President



**Patsy D. Johnson**  
Senior Vice President  
Cary City Executive



**Preston N. Mahan**  
Vice President



**Sally A. Neuman**  
Senior Vice President



**Pat Barry O'Quinn**  
Senior Vice President



**Bryan C. Pennington**  
Senior Vice President

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**D. Keith Brokke**  
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**Jonathan H. Taylor**  
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**R. Connie Thames**  
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Vice President

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**Bobby R. Lewis**  
Principal  
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**John D. McKinney**  
VP of Sales & Marketing  
Alfred Williams & Company

**Virginia G. Parker**  
Senior Vice President for  
Resource Development and  
Strategic Partnerships  
United Way of the Greater Triangle

**James R. Vann**  
Attorney  
Vann Attorneys

**Tommy H. West**  
Chairman  
West Brothers Transportation  
Services

**Erica R. Winter**  
Executive Director and  
Vice President  
American Heart Association

## CHARLOTTE CLIENT DEVELOPMENT OFFICERS



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Senior Vice President



**C. Ryan Borst**  
Senior Vice President



**Stephanie L. Bryant**  
Senior Vice President



**Lisa M. Gallimore**  
Vice President



**M. Salley Griffith**  
Vice President



**Al S. Grygiel**  
Senior Vice President



**Jessica L. Kerr**  
Vice President



**Warren D. Miller**  
Senior Vice President



**Melanie C. Robinson**  
Senior Vice President



**D. Gray Steelman**  
Senior Vice President

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**W. Charles Campbell**  
Partner  
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**George H. Edmiston, Jr.**  
President  
Carolinas Investment Consulting

**D. Hunter Edwards, Jr.**  
President and CEO  
Mechanical Systems & Services

**D. Stan Howey**  
President  
The Howey Co., Inc.

**Wesley M. Jones**  
Managing Partner  
Five Oaks Capital Partners

**Phillip R. Journey**  
Charlotte Market President

**C. Wesley Walls**  
Senior Vice President  
of Development  
Pavilion Development Company

**Peirce C. Ward**  
Investment Advisor  
New England Financial

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# INDEPENDENT AUDITOR'S REPORT



To the Board of Directors of  
Paragon Commercial Corporation:

## REPORT ON THE FINANCIAL STATEMENTS

We have audited the accompanying consolidated financial statements of Paragon Commercial Corporation and subsidiaries, which comprise the consolidated balance sheet as of December 31, 2014, and the related consolidated statement of income, comprehensive income, stockholder's equity and cash flows for the year then ended, and the related notes to the consolidated financial statements.

## MANAGEMENT'S RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

## AUDITOR'S RESPONSIBILITY

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting

policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

## OPINION

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Paragon Commercial Corporation and subsidiaries as of December 31, 2014, and the results of their operations and their cash flows for the year then ended, in accordance with accounting principles generally accepted in the United States of America.

## AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING

We also have examined in accordance with attestation standards established by the American Institute of Certified Public Accountants, Paragon Commercial Corporation's internal control over financial reporting as of December 31, 2014, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 2013 and our report dated March 25, 2015 expressed an unmodified opinion.

## OTHER MATTERS

The consolidated financial statements of the Company as of and for the year ended December 31, 2013 were audited by other auditors whose report, dated March 19, 2014, expressed an unmodified opinion on those statements.

A handwritten signature in cursive script that reads 'Elliott Davis Decosimo, PLLC'.

Raleigh, North Carolina  
March 25, 2015

# CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

At December 31:

	2014	2013
<b>ASSETS</b>		
Cash and due from banks:		
Interest-earning	\$ 19,400	\$ 25,238
Noninterest-earning	16,995	19,899
Investment securities – available-for-sale, at fair value	183,675	147,196
Federal Home Loan Bank stock, at cost	7,006	6,323
Loans – net of unearned income and deferred fees	868,405	767,392
Allowance for loan losses	(6,869)	(6,939)
Net Loans	861,536	760,453
Accrued interest receivable	3,636	3,130
Bank premises and equipment, net	17,071	15,268
Bank owned life insurance	27,421	26,622
Other real estate owned	14,991	18,174
Deferred tax assets	4,925	8,477
Other assets	8,599	4,991
Total Assets	\$ 1,165,255	\$ 1,035,771
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Deposits:		
Noninterest-bearing demand	\$ 118,895	\$ 83,897
Interest-bearing checking and money market	375,833	277,205
Time deposits	388,912	409,050
Total Deposits	883,640	770,152
Repurchase agreements and federal funds purchased	27,482	28,012
Federal Home Loan Bank advances	135,000	115,000
Other borrowings	7,256	9,616
Subordinated debentures	18,558	30,338
Accrued interest payable	405	624
Other liabilities	5,252	4,426
Total Liabilities	1,077,593	958,168
Commitments and contingencies (Notes H and N)		
Stockholders' Equity:		
Common stock, \$0.008 par value; 20,000,000 shares authorized; 4,530,000 issued and outstanding as of December 31, 2014	36	–
Common stock-Class A, \$1 par value; 10,000,000 shares authorized; 34,608 issued and outstanding as of December 31, 2013	–	34
Common stock-Class B, \$1 par value; 10,000,000 shares authorized; 884 issued and outstanding as of December 31, 2013	–	1
Additional paid-in-capital	52,358	51,963
Accumulated other comprehensive income (loss)	1,142	(562)
Retained earnings	34,126	26,167
Total Stockholders' Equity	87,662	77,603
Total Liabilities and Stockholders' Equity	\$ 1,165,255	\$ 1,035,771

The accompanying notes are an integral part of these consolidated financial statements.

# CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except share data)

Years Ended December 31:	2014	2013
<b>INTEREST INCOME</b>		
Loans and fees on loans	\$ 37,999	\$ 36,811
Investment securities and FHLB stock	4,698	3,735
Federal funds and other	86	55
Total Interest Income	42,783	40,601
<b>INTEREST EXPENSE</b>		
Interest-bearing checking and money market	2,144	1,479
Time deposits	5,371	6,931
Borrowings and repurchase agreements	1,163	2,108
Total Interest Expense	8,678	10,518
Net Interest Income	34,105	30,083
<b>PROVISION FOR LOAN LOSSES</b>		
Net Interest Income after Provision for Loan Losses	33,567	29,927
<b>NON-INTEREST INCOME</b>		
Service charges and fees	207	245
Net gain on sale of securities	87	88
Impairment on securities	–	(39)
Mortgage origination fees and gains on sale of loans	112	171
Net loss on sale or impairment of foreclosed assets	(903)	(3,824)
Increase in cash surrender value of bank owned life insurance	799	847
Other fees and income	402	437
Total Non-Interest Income	704	(2,075)
<b>NON-INTEREST EXPENSE</b>		
Salaries and employee benefits	11,826	9,531
Problem loan and foreclosure related expenses	496	1,446
FDIC and other supervisory assessments	932	1,637
Occupancy	999	1,550
Data processing	1,229	1,097
Professional fees	1,119	944
Other	5,308	3,969
Total Non-Interest Expense	21,909	20,174
Income before Income Taxes	12,362	7,678
<b>INCOME TAX EXPENSE</b>		
Net Income	\$ 7,959	\$ 4,924
<b>NET INCOME PER COMMON SHARE</b>		
Basic	\$ 1.79	\$ 1.11
Diluted	\$ 1.77	\$ 1.11

The accompanying notes are an integral part of these consolidated financial statements.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

Years Ended December 31:	2014	2013
Net income	\$ 7,959	\$ 4,924
Other comprehensive income (loss) items:		
Securities available for sale:		
Unrealized gains (losses)	5,965	(7,921)
Reclassification of gains recognized in net income	(87)	(49)
Other comprehensive income (loss)	5,878	(7,970)
Deferred tax (benefit) expense	2,288	(3,150)
Other comprehensive income (loss), net of tax	3,590	(4,820)
Cash flow hedges:		
Unrealized gains (losses)	(3,099)	2,285
Other comprehensive income (loss)	(3,099)	2,285
Deferred tax (benefit) expense	(1,213)	902
Other comprehensive income (loss), net of tax	(1,886)	1,383
Total other comprehensive income (loss), net of tax	1,704	(3,437)
Comprehensive income	\$ 9,663	\$ 1,487

The accompanying notes are an integral part of these consolidated financial statements.

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(In thousands, except share data)	Common Stock						Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total Stockholders' Equity
	Class A		Class B		Common Stock					
	Shares	Amount	Shares	Amount	Shares	Amount				
<b>Balance at December 31, 2012</b>	34,464	\$ 34	884	\$ 1	-	-	\$ 51,832	\$ 2,875	\$ 21,243	\$ 75,985
Net income	-	-	-	-	-	-	-	-	4,924	4,924
Unrealized loss on securities, net of tax expense of \$3,150	-	-	-	-	-	-	-	(4,820)	-	(4,820)
Unrealized gain on cash flow hedges, net of tax expense of \$902	-	-	-	-	-	-	-	1,383	-	1,383
Stock based compensation	-	-	-	-	-	-	20	-	-	20
Exercise of stock options	144	-	-	-	-	-	111	-	-	111
<b>Balance at December 31, 2013</b>	34,608	\$ 34	884	\$ 1	-	-	\$ 51,963	\$ (562)	\$ 26,167	\$ 77,603
Net income	-	-	-	-	-	-	-	-	7,959	7,959
Unrealized gain on securities, net of tax expense of \$2,288	-	-	-	-	-	-	-	3,590	-	3,590
Unrealized loss on cash flow hedges, net of tax benefit of \$1,213	-	-	-	-	-	-	-	(1,886)	-	(1,886)
Stock options and restricted stock awards:										
Compensation expense recognized	-	-	-	-	-	-	23	-	-	23
Exercise of stock options	-	-	-	-	6,000	-	59	-	-	59
Issuance of restricted stock awards	550	1	-	-	18,750	-	313	-	-	314
Reclassification of shares 125 for 1 stock split	(35,158)	(35)	(884)	(1)	36,042	36	-	-	-	-
	-	-	-	-	4,469,208	-	-	-	-	-
<b>Balance at December 31, 2014</b>	-	\$ -	-	\$ -	4,530,000	\$ 36	\$ 52,358	\$ 1,142	\$ 34,126	\$ 87,662

The accompanying notes are an integral part of these consolidated financial statements.

# CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

Years Ended December 31:	2014	2013
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 7,959	\$ 4,924
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,087	831
Provision for loan losses	538	156
Net loss on sale or impairment of foreclosed assets	903	3,824
Increase in cash surrender value of life insurance	(799)	(847)
Accretion of premiums/discounts on securities, net	(833)	(964)
Net gain on sale of securities	(87)	(88)
Net loss on disposition of premises and equipment	–	11
Impairment on securities	–	39
Deferred tax expense	2,477	2,118
Stock based compensation	336	20
Changes in assets and liabilities:		
Accrued interest receivable and other assets	(7,212)	(931)
Accrued interest payable and other liabilities	608	307
Net cash provided by operating activities	4,977	9,400
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Net (increase) decrease in Federal Home Loan Bank stock	(683)	73
Purchase of securities available for sale	(75,536)	(47,083)
Proceeds from maturities and paydowns of securities available for sale	17,389	23,962
Proceeds from sales of securities available for sale	28,466	18,284
Net increase in loans	(102,725)	(59,243)
Proceeds from sale of foreclosed real estate	3,383	7,536
Additions to bank premises and equipment	(2,890)	(2,331)
Other investing activities, net	–	(126)
Net cash used in investing activities	(132,596)	(58,928)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in demand and money market deposit accounts	133,626	94,387
Net decrease in time deposits	(20,138)	(24,536)
Net increase (decrease) in repurchase agreements	(530)	1,709
Net increase in FHLB and other borrowings	17,640	4,616
Net decrease in subordinated debentures	(11,780)	–
Exercise of stock options	59	111
Net cash provided by financing activities	118,877	76,287
Net change in cash and cash equivalents	(8,742)	26,759
Cash and cash equivalents at beginning of year	45,137	18,378
Cash and cash equivalents at end of year	\$ 36,395	\$ 45,137

The accompanying notes are an integral part of these consolidated financial statements.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE A – ORGANIZATION AND OPERATIONS

On June 30, 2001, Paragon Commercial Corporation (the “Company”) was formed as a holding company for Paragon Commercial Bank (the “Bank”). The Company currently has no operations and conducts no business on its own other than owning the Bank and two Trusts, Paragon Commercial Capital Trust I and II.

The Bank was incorporated on May 4, 1999 and began banking operations on May 10, 1999. The Bank is engaged in general commercial banking in Wake and Mecklenberg Counties, NC, operating under the banking laws of North Carolina and the rules and regulations of the Federal Deposit Insurance Corporation and the North Carolina Commissioner of Banks. The Bank undergoes periodic examinations by those regulatory authorities.

The Company formed Paragon Commercial Capital Trust I (“Trust I”) during 2004 in order to facilitate the issuance of trust preferred securities. The Trust is a statutory business trust formed under the laws of the state of Delaware, of which all common securities are owned by the Company. The Company formed Paragon Commercial Capital Trust II (“Trust II”) during 2006 to serve the same purpose. The junior subordinated debentures issued by the Company to the trusts are classified as debt and the Company’s equity interest in the trusts are included in other assets.

The trust preferred securities presently qualify as Tier 1 regulatory capital and are reported in Federal Reserve regulatory reports as minority interests in unconsolidated subsidiaries. The junior subordinated debentures do not qualify as Tier 1 regulatory capital.

In addition to its headquarters in Raleigh, NC, the Bank has locations in Charlotte and Cary, NC.

## NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Basis of Presentation

The accompanying consolidated financial statements include the accounts and transactions of Paragon Commercial Corporation and Paragon Commercial Bank. All significant intercompany transactions and balances are eliminated in consolidation. Paragon Commercial Capital Trusts I and II are not consolidated subsidiaries of the Company.

### Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, other than temporary impairment on investment securities, fair value of other real estate owned, realization of deferred tax assets and the fair value of financial instruments.

### Cash and Cash Equivalents

Cash and cash equivalents include demand and time deposits (with original maturities of 90 days or less) at other institutions, federal funds sold and other short-term investments. Generally, federal funds are purchased and sold for one-day periods. At times, the Company places deposits with high credit quality financial institutions in amounts, which may be in excess of federally insured limits. Depository institutions are required to maintain reserve and clearing balances with the Federal Reserve Bank (“FRB”). Accordingly, the Company has amounts restricted for this purpose of \$14.1 million and \$8.9 million included in cash and due from banks on the consolidated balance sheets as of December 31, 2014 and 2013, respectively.

### Investment Securities

Debt securities that the Bank has the positive intent and ability to hold to maturity are classified as “held-to-maturity” securities and reported at amortized cost. Debt and equity securities that are bought and held principally for the purpose of selling in the near term are classified as “trading” securities and reported at fair value with unrealized gains and losses included in earnings. Available-for-sale securities are reported at fair value and consist of debt or equity securities not classified as trading securities nor as held-to-maturity securities. Unrealized holding gains and losses on available-for-sale securities are reported as a net amount in other comprehensive income net of income taxes. Gains and losses on the sale of available-for-sale securities are determined using the specific-identification method. Premiums and discounts are recognized in interest income using the effective interest method over the period to maturity.

At each reporting date, the Company evaluates each investment security in a loss position for other-than-temporary impairment. The review includes an analysis of the facts and circumstances of each individual investment such as (1) the length of time and the extent to which the fair value has been below cost, (2) changes in the earnings performance, credit rating, asset quality, or business prospects of the issuer, (3) the ability of the issuer to make principal and interest payments, (4) changes in the regulatory, economic, or technological environment of the issuer, and (5) changes in the general market condition of either the geographic area or industry in which the issuer operates.

Regardless of these factors, if the Company has developed a plan to sell the security or it is likely that the Company will be forced to sell the security in the near future, then the impairment is considered other-than-temporary and the carrying value of the security is permanently written down to the current fair value with the difference between the new carrying value and the amortized cost charged to earnings. If the Company does not intend to sell the security and it is not more-likely-than-not that the Company will be required to sell the security before recovery of its amortized cost basis less any current period credit loss, the other-than-temporary impairment is separated into the following: (1) the amount representing the credit loss and (2) the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings, and the amount of the total other-than-temporary impairment related to other factors is recognized in other comprehensive income, net of applicable taxes.

### **Loans**

Loans that management has the intent and ability to hold for the foreseeable future or until maturity are reported at their outstanding principal adjusted for any charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans. Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield of the related loan. The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed and any subsequent payments received are applied only to the outstanding principal balance.

### **Allowance for Loan and Lease Losses**

The allowance for loan and lease losses ("ALLL") is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. The provision for loan losses is based upon management's best estimate of the amount needed to provide for losses that are inherent in the portfolio. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the ALLL.

The Company conducts an analysis of the loan portfolio on a regular basis. This analysis is used in assessing the sufficiency of the allowance for loan losses and in the determination of the necessary provision for loan losses. The review process generally begins with the identification of problem loans to be reviewed on an individual basis for impairment. When a loan has been identified as impaired, a specific reserve may be established based on the Company's calculation of the loss embedded in the individual loan. In addition to specific reserves on impaired loans, the Company has a nine point grading system for each non-homogeneous loan in the portfolio to reflect the risk characteristic of the loan. The loans identified and measured for impairment are segregated from risk-rated loans within the portfolio. Loans are then grouped by loan type and by risk rating. Each loan type is assigned an allowance factor based on historical loss experience, economic conditions and overall portfolio quality including delinquency rates and concentrations. The ALLL is an accounting estimate and as such there is uncertainty associated with the estimate due to the level of subjectivity and judgment inherent in performing the calculation. Management's evaluation of the ALLL also includes considerations of existing general economic and business conditions affecting the key lending areas of the Company, credit quality trends, collateral values, loan volumes and concentrations, seasoning of the loan portfolio, specific industry conditions within portfolio segments, recent loss experience in particular segments of the portfolio, duration of the current business cycle, bank regulatory examination results and findings of the Company's outsourced loan review consultants. The total of specific reserves required for impaired classified loans and the calculated reserves comprise the allowance for loan losses.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining whether a loan is impaired include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Additionally, management's policy is generally to evaluate only those loans greater than \$500 thousand for impairment. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Company's control, including the performance of the Company's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

## **Other Real Estate Owned**

Other real estate owned acquired through, or in lieu of, loan foreclosure are initially recorded at fair value less selling costs, establishing a new cost basis. After foreclosure, valuations are periodically performed by management and the real estate is carried at the lower of cost or net realizable value. Net realizable value is equivalent to fair market value less costs to sell the assets. Revenue and expenses from holding the properties and adjustments to the cost basis are included in earnings.

## **Bank Premises and Equipment**

Bank premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is calculated on the straight-line method over the estimated useful lives of the assets which are 3-10 years for furniture

and equipment and 40 years for buildings. Leasehold improvements are amortized over the terms of the respective leases or the estimated useful lives of the improvements, whichever is shorter. Repairs and maintenance costs are charged to operations as incurred, and additions and improvements to premises and equipment are capitalized. Upon sale or retirement, the cost and related accumulated depreciation are removed from the accounts and any gains or losses are reflected in current operations.

## **Federal Home Loan Bank Stock**

As a requirement for membership, the Bank invests in stock of the Federal Home Loan Bank of Atlanta ("FHLB"). This investment is carried at cost. Due to the redemption provisions of the FHLB, the Bank estimated that fair value approximates cost.

## **Bank Owned Life Insurance**

The Company has purchased life insurance policies on certain key employees. These policies are recorded at their cash surrender value, or the amount that can be realized. Income from these policies and changes in the net cash surrender value are recorded in noninterest income.

## **Derivative Instruments and Hedging Activities**

The Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative and the resulting designation. Derivatives used to hedge the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives used to hedge the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges.

For derivatives designated as cash flow hedges, the effective portion of changes in the fair value of the derivative is initially reported in other comprehensive income (outside of earnings) and subsequently reclassified to earnings when the hedged transaction affects earnings, and the ineffective portion of the change in the fair value of the derivative is recognized directly in earnings. The Company assesses the effectiveness of each hedging relationship by comparing the changes in cash flows of the derivative hedging instrument with the changes in cash flows of the designated hedged transactions.

The Company's objective in using derivatives is to add stability to interest income and to manage its exposure to adverse changes in interest rates. To accomplish this objective, the Company uses interest rate caps and swaps as part of its cash flow hedging strategy.

To mitigate exposure to variability in expected future cash flows resulting from changes in interest rates, in May 2013 the Company entered into two Forward Swap arrangements whereby the Company would pay fixed rates on two short term borrowings at some point in the future for a determined period of time. For both agreements, the Company would renew advances with the FHLB for 3 month terms as a primary funding source and pay the prevailing 3 month rate. The first swap, a "2-5 Swap", was a \$20 million agreement whereby 2 years from the May 2013 execution date, the Company would begin to swap out the 3 month FHLB advance pricing at that date for a fixed rate of 1.964% for a period of 5 years. The second swap, a "3-5 Swap", was similar in terms except that it was a \$30 million agreement whereby 3 years from the May 2013 execution date, the Company would begin to swap out the 3 month FHLB advance pricing at that date for a fixed rate of 2.464% for a period of 5 years.

The Company designated the forward-starting interest rate swaps (the hedging instruments) as cash flow hedges of the risk of changes attributable to the benchmark 3-Month LIBOR interest rate risk for the forecasted issuances of FHLB advances arising from a rollover strategy. The company intended to sequentially issue a series of 3-month fixed rate debt as part of a planned roll-over of short term debt for the next seven to eight years.

In September 2014, as a result of continued increasing fixed rate exposure, the Company determined that an additional strategy was needed and, as a result, exited from the Swaps for a deferred gain of \$372,000. In their place, the Company purchased \$100 million in interest rate caps with a strike price of 3 month Libor at 50bps and a five year term. The instruments to be hedged were Federal Home Loan Bank borrowings maturing quarterly on the same reset dates. The Company executed three separate agreements between \$30 million and \$35 million maturing between August 2019 and October 2019. The following table reflects the cash flow hedges include in the Consolidated Balance Sheets as of December 31, 2014 and 2013:

	2014		2013	
	Notational Amount	Fair Value	Notational Amount	Fair Value
<i>(In thousands)</i>				
Included in other assets:				
Cap 1 - maturing August 2019	\$ 35,000	\$ 2,064	\$ -	\$ -
Cap 2 - maturing September 2019	35,000	2,108	-	-
Cap 3 - maturing October 2019	30,000	1,857	-	-
Interest rate swap 1 - maturing May 2020	-	-	20,000	809
Interest rate swap 2 - maturing May 2021	-	-	30,000	1,476
	\$ 100,000	\$ 6,029	\$ 50,000	\$ 2,285

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Amortization of the premium on the interest rate caps is as follows:

<i>(In thousands)</i>	
2015	\$ 154
2016	913
2017	1,779
2018	2,247
2019	1,750
	<u>\$ 6,843</u>

In 2014, the bank recorded \$255 in amortization associated with the interest rate caps that is reflected in the consolidated financial statements as a component of Federal Home Loan Bank advances interest expense. There was no such expense in 2013.

Amortization of the gain associated with the exit of the swaps is as follows:

<i>(In thousands)</i>	
2015	\$ 19
2016	57
2017	74
2018	75
Thereafter	147
	<u>\$ 372</u>

There were no gains realized on the swap recorded in 2014 as a reduction of Federal Home Loan Bank interest expense.

The company anticipates little to no ineffectiveness in this hedging relationship as long as the terms are matched at each forecasted debt issuance. The company notes that the actual interest cost incurred at each rollover will be a function of market rates at that time. However the company is only hedging the benchmark interest rate risk in that rollover.

The Company does not use derivatives for trading or speculative purposes.

## Income Taxes

Deferred tax assets and liabilities are recognized for the estimated future tax benefits or consequences attributable to differences between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes. Deferred tax assets are also recognized for operating loss carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in

which the temporary differences are expected to be recovered or settled. Deferred tax assets are reduced by a valuation allowance if it is more likely than not that the tax benefits will not be realized.

At December 31, 2014, the Company had \$4.9 million in net deferred tax assets. A valuation allowance is provided when it is more-likely-than-not that some portion of the deferred tax asset will not be realized. All available evidence, both positive and negative, was considered to determine whether, based on the weight of that evidence, impairment should be recognized. Our forecast process includes judgmental and quantitative elements that may be subject to significant change. If our forecast of taxable income within the carryforward periods available under applicable law and prudent tax planning strategies are not sufficient to cover the amount of net deferred tax assets, such assets may be impaired. Based on our analysis of both positive and negative evidence we concluded there were no valuation allowances with respect to the deferred tax assets at December 31, 2014 and 2013.

## Stock Compensation Plans

The Company has two stock-based compensation plans covering certain officers and directors. The Company stock option plan grants stock options under the plan for a fixed number of shares with an exercise price equal to the fair value of the shares on the date of grant. The restricted stock plan grants a fixed number of shares with a grant price equal to the fair value of the shares on the date of grant. See Note J.

## Earnings Per Common Share

Basic and diluted net income per common share have been computed by dividing net income for each period by the weighted average number of shares of common stock outstanding during each period. Diluted net income per common share reflects the potential dilution that could occur if outstanding stock options were exercised.

In 2014, the Company did a 125 for 1 stock split to reduce the per share market price to a price more in line with other bank stocks. As a part of the conversion, the Company merged both A and B class shares into one class before executing the split. As a result, all 2013 per share disclosures have been adjusted to reflect the split.

Basic and diluted net income per common share have been computed based upon net income as presented in the accompanying Consolidated Statements of Income

divided by the weighted average number of common shares outstanding or assumed to be outstanding as summarized below:

	2014	2013
Shares used in the computation of earnings per share:		
Weighted average number of shares outstanding – basic	4,456,002	4,433,875
Dilutive effect of restricted shares	39,011	–
Weighted average number of shares outstanding – diluted	4,495,013	4,433,875

In 2014 and 2013, because the exercise price was in excess of the average current trading price, none of the Company's outstanding stock options were used in the calculation of diluted EPS. The dilutive effect of stock options and unvested restricted shares are the only common stock equivalents for purposes of calculating diluted earnings per common share.

Weighted average anti-dilutive stock options and unvested restricted shares excluded from the computation of diluted earnings per share are as follows:

	2014	2013
Anti-dilutive stock options	101,000	111,000
Anti-dilutive restricted shares	48,958	–

### Comprehensive Income

The Company reports as comprehensive income all changes in stockholders' equity during the year from sources other than stockholders. Other comprehensive income refers to all components (revenues, expenses, gains, and losses) of comprehensive income that are excluded from net income.

The Company's only two components of other comprehensive income are unrealized gains and losses on investment securities available-for-sale, net of income taxes and unrealized gains and losses on cash flow hedges, net of income taxes. Information concerning the Company's accumulated other comprehensive income for the years ended December 31, 2014 and 2013 is as follows:

<i>(In thousands)</i>	2014	2013
Unrealized gains (losses) on securities available-for-sale	\$ 2,663	\$ (3,215)
Deferred tax benefit (expense)	(1,018)	1,270
Other comprehensive income (loss), net of tax	1,645	(1,945)
Unrealized gains on cash flow hedges	(814)	2,285
Deferred tax expense (benefit)	311	(902)
Other comprehensive income (loss), net of tax	(503)	1,383
Total other comprehensive income (loss)	\$ 1,142	\$ (562)

### Recent Accounting Pronouncements

In January 2014, the Financial Accounting Standards Board ("FASB") amended Receivables topic of the Accounting Standards Codification ("ASC"). The amendments are intended to resolve diversity in practice with respect to when a creditor should reclassify a collateralized consumer mortgage loan to other real estate owned (OREO). In addition, the amendments require a creditor reclassify a collateralized consumer mortgage loan to OREO upon obtaining legal title to the real estate collateral, or the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement. The amendments will be effective for the Company for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015, with early implementation of the guidance permitted. In implementing this guidance, assets that are reclassified from real estate to loans are measured at the carrying value of the real estate at the date of adoption. Assets reclassified from loans to real estate are measured at the lower of the net amount of the loan receivable or the fair value of the real estate less costs to sell at the date of adoption. The Company will apply the amendments prospectively. The Company does not expect these amendments to have a material effect on its financial statements.

In May 2014, the FASB issued guidance to change the recognition of revenue from contracts with customers. The core principle of the new guidance is that an entity should recognize revenue to reflect the transfer of goods

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

and services to customers in an amount equal to the consideration the entity receives or expects to receive. The guidance will be effective for the Company for annual periods beginning after December 15, 2017, and interim periods within annual reporting periods beginning after December 15, 2018. The Company will apply the guidance using a full retrospective approach. The Company does not expect these amendments to have a material effect on its financial statements.

In June 2014, the FASB issued guidance which makes limited amendments to the guidance on accounting for certain repurchase agreements. The new guidance (1) requires entities to account for repurchase-to-maturity transactions as secured borrowings (rather than as sales with forward repurchase agreements), (2) eliminates accounting guidance on linked repurchase financing transactions, and (3) expands disclosure requirements related to certain transfers of financial assets that are accounted for as sales and certain transfers (specifically, repos, securities lending transactions, and repurchase-to-maturity transactions) accounted for as secured borrowings. The amendments will be effective for the Company for annual periods beginning after December 15, 2014, and interim periods beginning after December 15, 2015. The Company will apply the guidance by making a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. The Company does not expect these amendments to have a material effect on its financial statements.

In June 2014, the FASB issued guidance which clarifies that performance targets associated with stock compensation should be treated as a performance condition and should not be reflected in the grant date fair value of the stock award. The amendments will be effective for the Company for fiscal years that begin after December 15, 2015. The Company will apply the guidance to stock awards with performance targets that are outstanding at the start of the first fiscal year in the financial statements and to all stock awards that are granted or modified after the effective date. The Company does not expect these amendments to have a material effect on its financial statements.

In August 2014, the FASB issued guidance that is intended to define management's responsibility to evaluate whether there is substantial doubt about an organization's ability to continue as a going concern and to provide related footnote disclosures. In connection with preparing financial statements, management will need to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the organization's ability to continue as a going concern within one year after the date that the financial statements are issued. The amendments will be effective for the Company for annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. The Company does not expect these amendments to have a material effect on its financial statements.

In January 2015, the FASB issued guidance that eliminated the concept of extraordinary items from U.S. GAAP. Existing U.S. GAAP required that an entity separately classify, present, and disclose extraordinary events and transactions. The amendments will eliminate the requirements for reporting entities to consider whether an underlying event or transaction is extraordinary, however, the presentation and disclosure guidance for items that are unusual in nature or occur infrequently will be retained and will be expanded to include items that are both unusual in nature and infrequently occurring. The amendments are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. The amendments may be applied either prospectively or retrospectively to all prior periods presented in the financial statements. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. The Company does not expect these amendments to have a material effect on its financial statements.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

## **Reclassifications**

Certain amounts in the 2013 financial statements have been reclassified to conform to the 2014 presentation. The reclassifications had no effect on total assets, net income or stockholders' equity as previously reported.

## NOTE C – INVESTMENT SECURITIES

The following is a summary of the securities portfolio by major classification at December 31, 2014 and 2013.

<i>(In thousands)</i>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Tax Equivalent Yield
<b>December 31, 2014</b>					
Available-for-sale:					
U.S. agency obligations	\$ 31,710	\$ 256	\$ 124	\$ 31,842	2.63%
Collateralized mortgage obligations	69,519	672	135	70,056	2.71%
Mortgage-backed securities	33,921	627	–	34,548	2.74%
Municipal bonds	44,511	991	322	45,180	3.94%
Other	1,351	698	–	2,049	0.00%
	\$ 181,012	\$ 3,244	\$ 581	\$ 183,675	2.98%
<b>December 31, 2013</b>					
Available-for-sale:					
U.S. agency obligations	\$ 30,291	\$ 39	\$ 1,187	\$ 29,143	2.59%
Collateralized mortgage obligations	52,627	354	371	52,610	2.62%
Mortgage-backed securities	39,820	403	630	39,593	2.76%
Municipal bonds	25,302	–	2,331	22,971	3.85%
Other	2,371	908	400	2,879	1.60%
	\$ 150,411	\$ 1,704	\$ 4,919	\$ 147,196	2.84%

The amortized cost and fair values of securities available-for-sale at December 31, 2014 by contractual maturity are shown below. Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

<i>(In thousands)</i>	Within One Year	After One Within Five Years	After Five Within Ten Years	After Ten Years	No Stated Maturity Date	Total
U.S. agency obligations	\$ –	\$ –	\$ 2,950	\$ 28,892	\$ –	\$ 31,842
Collateralized mortgage obligations	–	–	–	70,056	–	70,056
Mortgage-backed securities	–	–	11,672	22,876	–	34,548
Municipal bonds	–	740	2,258	42,182	–	45,180
Other	–	–	–	–	2,049	2,049
	\$ –	\$ 740	\$ 16,880	\$ 164,006	\$ 2,049	\$ 183,675

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following tables show gross unrealized losses and fair values of investment securities, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position at December 31, 2014 and 2013. At December 31, 2014, the unrealized losses related to four US Agency obligations, five collateralized mortgage obligations, and twenty-two municipal bonds of which one collateralized mortgage obligation and all of the municipal bonds and US Agency obligations in a loss position had continuous unrealized losses for more than 12 months. At December 31, 2013, the unrealized losses related to nine US Agency obligations, eleven collateralized mortgage obligations, eleven mortgage-backed securities, thirty-five municipal bonds and one other security of which one municipal and one other security had continuous unrealized losses for more than 12 months. The unrealized losses primarily relate to debt securities that have incurred fair value reductions

due to higher market interest rates since the securities were purchased. The unrealized losses are not likely to reverse unless and until market interest rates decline to the levels that existed when the securities were purchased. Since none of the unrealized losses on the debt securities in 2013 or 2014 relate to the marketability of the securities or the issuer's ability to honor redemption obligations and since management has the intent to hold these securities until maturity and believes it is more likely than not that the Company will not have to sell any such securities before a recovery of cost given the current liquidity position, none of those debt securities are deemed to be other than temporarily impaired. During 2013, the Company charged additional impairment of \$39,000 on shares of common stock against earnings and wrote those securities down to their current market value as of January 2013.

	Less than 12 months		12 months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<i>(In thousands)</i>						
<b>December 31, 2014</b>						
Securities available-for-sale:						
U.S. agency obligations	\$ -	\$ -	\$ 10,337	\$ 124	\$ 10,337	\$ 124
Collateralized mortgage obligations	19,051	90	3,630	45	22,681	135
Municipal bonds	-	-	12,524	322	12,524	332
Total temporarily impaired securities	\$ 19,051	\$ 90	\$ 26,491	\$ 491	\$ 45,542	\$ 581
<b>December 31, 2013</b>						
Securities available-for-sale:						
U.S. agency obligations	\$ 25,796	\$ 1,186	\$ -	\$ -	\$ 25,796	\$ 1,186
Collateralized mortgage obligations	26,335	371	-	-	26,335	371
Mortgage-backed securities	26,067	630	-	-	26,067	630
Municipal bonds	22,267	2,242	703	90	22,970	2,332
Other	-	-	600	400	600	400
Total temporarily impaired securities	\$ 100,465	\$ 4,429	\$ 1,303	\$ 490	\$ 101,768	\$ 4,919

During the years ended December 31, 2014 and 2013, the Company recognized gross gains and (losses) on sales of available-for-sale investment securities of \$208,000 and (\$121,000), respectively, for 2014 and \$106,000 and (\$18,000), respectively, for 2013. Proceeds received from these sales totaled \$28.5 million and \$18.3 million in 2014 and 2013, respectively.

Securities with a fair value of \$84.1 million and \$77.2 million were pledged as of December 31, 2014 and 2013, respectively, to secure repurchase agreements, lines of credit and other borrowings.

## NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES

Following is a summary of loans at December 31, 2014 and 2013:

<i>(In thousands)</i>	<b>2014</b>	<b>2013</b>
Construction and land development	\$ 62,817	\$ 81,316
Commercial real estate:		
Commercial real estate	408,129	373,379
Farmland	1,078	1,123
Multifamily, nonresidential and junior liens	78,024	63,965
Total commercial real estate	487,231	438,467
Consumer real estate:		
Home equity lines	46,782	21,117
Secured by 1-4 family residential, secured by first deeds of trust	143,793	118,686
Secured by 1-4 family residential, secured by second deeds of trust	4,940	5,774
Total consumer real estate	195,515	145,577
Commercial and industrial loans (except those secured by real estate)	117,126	93,841
Consumer and other	5,722	8,505
Total loans	868,411	767,706
Deferred loan costs	(6)	(314)
Allowance for loan losses	(6,869)	(6,939)
Net loans	\$ 861,536	\$ 760,453

Loans are primarily made in the Research Triangle and Charlotte areas of North Carolina. Real estate loans can be affected by the condition of the local real estate market. Commercial and installment loans can be affected by the local economic conditions.

Changes in the allowance for loan losses for the years ended December 31, 2014 and 2013 were as follows:

<i>(In thousands)</i>	Construction and Land Development	Commercial Real Estate	Consumer Real Estate	Commercial and Industrial Loans Not Secured By Real Estate	Consumer and Other	Total Loans
<b>December 31, 2014</b>						
Balance at beginning of the year	\$ 2,021	\$ 1,184	\$ 1,540	\$ 2,150	\$ 44	\$ 6,939
Provision for loan losses	(317)	1,287	104	(635)	99	538
Loans charged off	(898)	(1)	(64)	(99)	–	(1,062)
Recoveries	154	40	14	246	–	454
Net recoveries (chargeoffs)	(744)	39	(50)	147	–	(608)
Balance at end of the year	\$ 960	\$ 2,510	\$ 1,594	\$ 1,662	\$ 143	\$ 6,869
<b>December 31, 2013</b>						
Balance at beginning of the year	\$ 3,746	\$ 2,463	\$ 1,466	\$ 2,573	\$ 100	\$ 10,348
Provision for loan losses	400	(910)	778	(56)	(56)	156
Loans charged off	(2,676)	(761)	(738)	(494)	–	(4,669)
Recoveries	551	392	34	127	–	1,104
Net chargeoffs	(2,125)	(369)	(704)	(367)	–	(3,565)
Balance at end of the year	\$ 2,021	\$ 1,184	\$ 1,540	\$ 2,150	\$ 44	\$ 6,939

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on the impairment method for the years ended December 31, 2014 and 2013 were as follows:

<i>(In thousands)</i>	Construction and Land Development	Commercial Real Estate	Consumer Real Estate	Commercial and Industrial Loans Not Secured By Real Estate	Consumer and Other	Total Loans
<b>December 31, 2014</b>						
Allowance for Loan Losses:						
Individually evaluated for impairment	\$ 5	\$ 189	\$ 282	\$ 178	\$ 26	\$ 680
Collectively evaluated for impairment	955	2,321	1,312	1,484	117	6,189
Total ending allowance	\$ 960	\$ 2,510	\$ 1,594	\$ 1,662	\$ 143	\$ 6,869
Loans:						
Individually evaluated for impairment	\$ 345	\$ 4,538	\$ 646	\$ 720	\$ 26	\$ 6,275
Collectively evaluated for impairment	62,472	482,693	194,869	116,406	5,696	862,136
Total ending loans	\$ 62,817	\$ 487,231	\$ 195,515	\$ 117,126	\$ 5,722	\$ 868,411
<b>December 31, 2013</b>						
Allowance for Loan Losses:						
Individually evaluated for impairment	\$ 300	\$ –	\$ –	\$ 491	\$ –	\$ 791
Collectively evaluated for impairment	1,721	1,184	1,540	1,659	44	6,148
Total ending allowance	\$ 2,021	\$ 1,184	\$ 1,540	\$ 2,150	\$ 44	\$ 6,939
Loans:						
Individually evaluated for impairment	\$ 5,938	\$ 3,313	\$ 1,755	\$ 1,402	\$ 214	\$ 12,622
Collectively evaluated for impairment	75,378	435,154	143,822	92,439	8,291	755,084
Total ending loans	\$ 81,316	\$ 438,467	\$ 145,577	\$ 93,841	\$ 8,505	\$ 767,706

Loans are charged down or off as soon as the Bank determines that the full principal balance due under any loan becomes uncollectible. The amount of the charge is determined as follows:

- If unsecured, the loan must be charged off in full.
- If secured, the outstanding principal balance of the loan should be charged down to the net realizable value of the collateral.

Loans are considered uncollectible when:

- No regularly scheduled payment has been made within four months unless fully secured and in the process of collection, or
- The collateral value is insufficient to cover the outstanding indebtedness and it is unlikely the borrower will have the ability to pay the debt in a timely manner.

- The loan is unsecured, the borrower files for bankruptcy protection and there is no other (guarantor, etc.) support from an entity outside of the bankruptcy proceedings.

Impaired loans totaled \$6.3 million and \$12.6 million at December 31, 2014 and 2013, respectively. Included in the \$6.3 million at December 31, 2014 is \$2.9 million of loans classified as troubled debt restructurings (“TDRs”). Included in the \$12.6 million at December 31, 2013 is \$3.4 million of loans classified as troubled debt restructurings (“TDRs”). A modification of a loan’s terms constitutes a TDR if the creditor grants a concession to the borrower for economic or legal reasons related to the borrower’s financial difficulties that it would not otherwise consider. All TDRs are considered impaired.

The following table provides information on performing and nonperforming restructures for the years ended December 31, 2014 and 2013:

<i>(In thousands)</i>	<b>2014</b>	<b>2013</b>
Performing restructurings:		
Construction and land development	\$ –	\$ 1,173
Commercial real estate	2,337	1,457
Consumer real estate	355	365
Total performing restructurings	2,692	2,995
Nonperforming restructurings:		
Construction and land development	131	155
Consumer real estate	70	72
Consumer and other	–	214
Total nonperforming restructurings	201	441
Total restructurings	\$ 2,893	\$ 3,436

During 2014, there were no new loans identified as TDRs. In addition, there were no loans considered as TDRs in 2013 that subsequently defaulted in 2014.

Interest is not typically accrued on loans where an impairment exists. For loans classified as TDRs, the Company further evaluates the loans as performing or non-performing. If, at the time of restructure, it is determined that no impairment exists, the loan will be classified as performing. At December 31, 2014 and

2013, \$2.7 million and \$3.0 million of TDRs were accruing interest as they were classified as performing. Interest income recognized on performing TDRs was \$151,000 and \$115,000 for the years ended December 31, 2014 and 2013, respectively.

In order to quantify the value of impairment, the Company evaluates loans individually. The detail of loans evaluated for impairment at December 31, 2014 is presented below:

<i>(In thousands)</i>	Recorded Investment	Unpaid Contractual Principal Balance	Allocated Allowance
<b>December 31, 2014</b>			
Loans without a specific valuation allowance:			
Construction and land development	\$ 339	\$ 339	\$ –
Commercial real estate	3,086	3,059	–
Commercial and industrial loans (except those secured by real estate)	121	120	–
Loans with a specific valuation allowance:			
Construction and land development	6	6	5
Commercial Real Estate	1,487	1,479	189
Consumer Real Estate	648	646	282
Commercial and industrial loans (except those secured by real estate)	605	600	178
Consumer and other	26	26	26
Total	\$ 6,318	\$ 6,275	\$ 680

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In 2013, the Company had \$12.6 million of impaired loans. The detail of loans evaluated for impairment as of December 31, 2013 is presented below:

<i>(In thousands)</i>	Recorded Investment	Unpaid Contractual Principal Balance	Allocated Allowance
<b>December 31, 2013</b>			
Loans without a specific valuation allowance:			
Construction and land development	\$ 655	\$ 699	\$ –
Commercial Real Estate	3,313	3,332	–
Consumer Real Estate	1,255	1,273	–
Commercial and industrial loans (except those secured by real estate)	152	166	–
Consumer and other	214	614	–
Loans with a specific valuation allowance:			
Construction and land development	5,631	5,631	300
Commercial Real Estate	–	–	–
Consumer Real Estate	–	–	–
Commercial and industrial loans (except those secured by real estate)	1,402	1,403	491
Consumer and other	–	–	–
<b>Total</b>	<b>\$ 12,622</b>	<b>\$ 13,118</b>	<b>\$ 791</b>

The average recorded investment balance of impaired loans during 2014 and 2013 is as follows:

<i>(In thousands)</i>	<b>2014</b>	<b>2013</b>
Construction and land development	\$ 1,725	\$ 15,002
Commercial real estate	3,704	7,284
Consumer real estate	939	1,249
Commercial and industrial loans (except those secured by real estate)	941	1,604
Consumer and other	180	296
<b>Total loans</b>	<b>\$ 7,489</b>	<b>\$ 25,435</b>

When the Bank cannot reasonably expect full and timely repayment of its loan, the loan is placed on nonaccrual. The Bank will continue to track the contractual interest for purposes of customer reporting and any potential litigation or later collection of the loan but accrual of interest for the Company's financial statement purposes is to be discontinued. Subsequent payments of interest can be recognized as income on a cash basis provided that full collection of principal is expected. Otherwise, all

payments received are to be applied to principal only. At the time of non-accrual, past due or accrued interest is reversed from income.

Loans over 90 days past due will automatically be placed on non-accrual. Loans that are less delinquent may also be placed on non-accrual if full collection of principal and interest is unlikely.

The following table presents the recorded investment in nonaccrual and loans past due more than 90 days still accruing by portfolio segment as of December 31:

<i>(In thousands)</i>	Nonaccrual		Loans Past Due Over 90 Days Still Accruing	
	2014	2013	2014	2013
Construction and land development	\$ 276	\$ 307	\$ –	\$ –
Commercial real estate	–	264	–	–
Consumer real estate	69	72	–	–
Commercial and industrial loans (except those secured by real estate)	49	732	–	–
Consumer and other	26	214	–	–
<b>Total</b>	<b>\$ 420</b>	<b>\$ 1,589</b>	<b>\$ –</b>	<b>\$ –</b>

If interest had been earned on non-accrual loans, such income would have approximated \$54,000 and \$591,000 for the years ended December 31, 2014 and 2013, respectively.

The following table presents the aging of the recorded investment in past due loans as of December 31, 2014 and 2013 by portfolio segment:

<i>(In thousands)</i>	30-59 Days	60-89 Days	Greater Than	Nonaccrual	Total	Current	Total
	Past Due	Past Due	90 Days Past Due				
<b>December 31, 2014</b>							
Construction and land development	\$ –	\$ –	\$ –	\$ 276	\$ 276	\$ 62,541	\$ 62,817
Commercial real estate	–	–	–	–	–	487,231	487,231
Consumer real estate	185	–	–	69	254	195,261	195,515
Commercial and industrial loans (except those secured by real estate)	71	–	–	49	120	117,006	117,126
Consumer and other	–	–	–	26	26	5,696	5,722
<b>Total</b>	<b>\$ 256</b>	<b>\$ –</b>	<b>\$ –</b>	<b>\$ 420</b>	<b>\$ 676</b>	<b>\$ 867,735</b>	<b>\$ 868,411</b>
<b>December 31, 2013</b>							
Construction and land development	\$ –	\$ –	\$ –	\$ 307	\$ 307	\$ 81,009	\$ 81,316
Commercial real estate	–	–	–	264	264	438,203	438,467
Consumer real estate	–	818	–	72	890	144,687	145,577
Commercial and industrial loans (except those secured by real estate)	–	–	–	732	732	93,109	93,841
Consumer and other	31	–	–	214	245	8,260	8,505
<b>Total</b>	<b>\$ 31</b>	<b>\$ 818</b>	<b>\$ –</b>	<b>\$ 1,589</b>	<b>\$ 2,438</b>	<b>\$ 765,268</b>	<b>\$ 767,706</b>

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Credit Quality Indicators

The Company utilizes its nine point grading system in order to evaluate the level of inherent risk in the loan portfolio as part of its allowance for loan losses methodology. Loans collectively evaluated for impairment are grouped by loan type and, in the case of commercial and construction loans, by risk rating. Each loan type is assigned an allowance factor based on risk grade, historical loss experience, economic conditions, overall portfolio quality including delinquency rates and commercial real estate loan concentrations (as applicable). As risk grades increase, additional reserves are applied stated in basis points in order to account for the added inherent risk.

The Company categorizes all business and commercial purpose loans into risk 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. The Company analyzes loans individually by setting the risk grade at the inception of a loan through the approval process. A certain percentage of loan dollars is reviewed each year by a third party loan review company. The risk rating process is inherently subjective and based upon management's evaluation of the specific facts and circumstances for individual borrowers. As such, the assigned risk ratings are subject to change based upon changes in borrower status and changes in the external environment affecting the borrower. The Company uses the following definitions for risk ratings:

**Risk Grade 1 – Minimal:** Credits in this category are virtually risk-free and are well-collateralized by cash-equivalent instruments. The repayment program is well-defined and achievable. Repayment sources are numerous.

**Risk Grade 2 – Modest:** Loans to borrowers of significantly better than average financial strength or loans secured by readily marketable securities. Earnings performance is consistent and primary and secondary sources of repayment are well established. The borrower exhibits excellent asset quality and liquidity with very strong debt servicing capacity and coverage. Company management has depth, is experienced and well regarded in the industry.

**Risk Grade 3 – Average:** Loans in this category are to borrowers of satisfactory financial strength. Earnings performance is consistent. Primary and secondary sources of repayment are well defined and adequate to

retire the debt in a timely and orderly fashion. These borrowers would generally exhibit satisfactory asset quality and liquidity. They have moderate leverage and experienced management in key positions.

**Risk Grade 4 – Acceptable:** Loans in this category are to borrowers involving more than average risk which contain certain characteristics that require some supervision and attention by the lender. Asset quality is acceptable, but debt capacity is modest. Little excess liquidity is available. The borrower may be fully leveraged and unable to sustain major setbacks. Covenants are structured to ensure adequate protection. Management may have limited experience and depth. This category includes loans which are highly leveraged transactions due to regulatory constraints and also includes loans involving reasonable exceptions to policy.

**Risk Grade 5 - Acceptable with Care:** A loan in this category is sound and collectible but contains considerable risk. Although asset quality remains acceptable, the borrower has a smaller and/or less diverse asset base, very little liquidity and limited debt capacity. Earnings performance is inconsistent and the borrower is not strong enough to sustain major setbacks. The borrower may be highly leveraged and below average size or a lower-tier competitor. There might be limited management experience and depth. These loans may be to a well-conceived start-up venture but repayment is still dependent upon a successful operation. This category includes loans with significant documentation or policy exceptions, improper loan structure, or inadequate loan servicing procedures and may also include a loan in which strong reliance for a secondary repayment source is placed on a guarantor who exhibits the ability and willingness to repay or loans which are highly leveraged transactions due to the obligor's financial status.

**Risk Grade 6 - Special Mention or Critical:** Loans in this category have potential weaknesses which may, if not checked or corrected, weaken the asset or inadequately protect the Bank's credit position at some future date. These may also include loans of marginal quality and liquidity that if not corrected may jeopardize the liquidation of the debt and the Bank's credit position. These loans require close supervision and must be monitored to ensure there is not a pattern of deterioration in the credit that may lead to further downgrade. These characteristics include but are not limited to:

- Repayment performance has not been demonstrated to prudent standards and;
- Repayment performance is inconsistent and highly sensitive to business and operating cycle swings;
- Fatal documentation errors.
- Performing as agreed without documented capacity or collateral protection.

**Risk Grade 7 – Substandard:** A substandard loan is inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified as substandard must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

**Risk Grade 8 – Doubtful:** Loans classified Doubtful have all the weaknesses inherent in loans classified Substandard, plus the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. However, these loans are not yet rated as loss because certain events may occur which would salvage the debt. Among these events are:

- Injection of capital
- Alternative financing

- Liquidation of assets or the pledging of additional collateral.

The ability of the borrower to service the debt is extremely weak, overdue status is constant, the debt has been placed on non-accrual status and no definite repayment schedule exists. Doubtful is a temporary grade where a loss is expected but is presently not quantified with any degree of accuracy. Once the loss position is determined, the amount is charged off. There were no 8 rated loans as of December 31, 2014 or 2013.

**Risk Grade 9 – Loss:** Loans classified Loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value but rather that it is not practical or desirable to defer writing off this worthless loan even though partial recovery may be affected in the future. Probable Loss portions of Doubtful assets should be charged against the Reserve for Loan Losses. Loans may reside in this classification for administrative purposes for a period not to exceed the earlier of thirty (30) days or calendar quarter-end. There were no 9 rated loans as of December 31, 2014 or 2013.

As of December 31, and based on the most recent analysis performed, the risk category of unimpaired loans by class of loans is as follows:

	Risk Grade							Total
	1	2	3	4	5	6	7	
<b>Balance at December 31, 2014</b>								
Construction and land development	\$ 47	\$ 1,069	\$ 3,207	\$ 13,112	\$ 44,935	\$ 102	\$ –	\$ 62,472
Commercial real estate	–	2,336	167,850	214,413	91,026	7,068	–	482,693
Consumer real estate	–	6,808	91,368	67,677	29,016	–	–	194,869
Commercial and industrial loans (except those secured by real estate)	2,479	1,849	14,123	61,806	35,522	627	–	116,406
Consumer and other	200	68	1,031	2,068	2,141	188	–	5,696
Total	\$ 2,726	\$ 12,130	\$ 277,579	\$ 359,076	\$ 202,640	\$ 7,985	\$ –	\$ 862,136
<b>Balance at December 31, 2013</b>								
Construction and land development	\$ 67	\$ –	\$ 4,831	\$ 14,637	\$ 54,120	\$ 1,452	\$ 271	\$ 75,378
Commercial real estate	1,006	2,511	126,678	198,182	91,800	14,551	426	435,154
Consumer real estate	–	1,190	65,501	49,739	27,170	222	–	143,822
Commercial and industrial loans (except those secured by real estate)	3,412	200	13,145	44,706	30,114	862	–	92,439
Consumer and other	101	12	2,330	3,675	2,076	97	–	8,291
Total	\$ 4,586	\$ 3,913	\$ 212,485	\$ 310,939	\$ 205,280	\$ 17,184	\$ 697	\$ 755,084

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Bank has granted loans to certain directors and executive officers of the Bank and their related interests. Such loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other borrowers and, in management's opinion, do not involve more than the normal risk of collectability. All loans to directors and executive officers or their interests are submitted to the Board of Directors for approval. A summary of loans to directors, executive officers and their related interests follows:

<i>(In thousands)</i>		
Loans to directors and officers		
as a group at December 31, 2013	\$	3,145
Disbursements during 2014		3,766
Amounts collected during 2014		(209)
Amounts reclassified		(411)
Loans to directors and officers		
as a group at December 31, 2014	\$	6,291

## NOTE E – BANK PREMISES AND EQUIPMENT

Following is a summary of bank premises and equipment at December 31, 2014 and 2013:

<i>(In thousands)</i>	2014	2013
Building	\$ 16,096	\$ 14,084
Furniture and equipment	5,888	4,040
Leasehold improvements	349	177
Construction in progress	107	1,543
Less accumulated depreciation and amortization	(5,369)	(4,576)
	\$ 17,071	\$ 15,268

Depreciation and amortization expense amounting to \$1.1 million and \$831,000 for the years ended December 31, 2014 and 2013 are included in occupancy and equipment expenses.

## NOTE F – DEPOSITS

At December 31, 2014, the scheduled maturities of time deposits are as follows:

<i>(In thousands)</i>	
2015	\$ 264,511
2016	69,858
2017	26,754
2018	24,429
2019	3,360
	\$ 388,912

At December 31, 2014 and 2013, time deposits in denominations of \$100,000 or more were \$351.0 million and \$370.5 million, respectively. Interest expense on time deposits in denominations of \$100,000 or more aggregated to \$4.7 million in 2014 and \$5.6 million in 2013.

In the normal course of business, certain directors and executive officers of the Company, including their immediate families and companies in which they have an interest, may be deposit customers.

## NOTE G – BORROWINGS

### Repurchase Agreements and Federal Funds Purchased

Securities sold under agreements to repurchase, which are classified as secured borrowings, generally mature within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction. The Bank may be required to provide additional collateral based on the fair value of the underlying securities.

Following is an analysis of short-term borrowed funds at December 31, 2014 and 2013:

**December 31, 2014**

<i>(In thousands)</i>	End of Period	
	Balance	Weighted Avg. Rate
Federal funds purchased	\$ 901	0.55%
Repurchase agreements	26,581	0.19%
	\$ 27,482	0.20%

<i>(In thousands)</i>	Daily Average Balance	
	Balance	Interest Rate
Federal funds purchased	\$ 421	0.54%
Repurchase agreements	24,301	0.18%
	\$ 24,722	0.19%

<i>(In thousands)</i>	Maximum Outstanding at any Month End
Federal funds purchased	\$ 12,137
Repurchase agreements	29,571

**December 31, 2013**

<i>(In thousands)</i>	End of Period	
	Balance	Weighted Avg. Rate
Federal funds purchased	\$ –	0.00%
Repurchase agreements	28,012	0.18%
	\$ 28,012	0.18%

<i>(In thousands)</i>	Daily Average Balance	
	Balance	Interest Rate
Federal funds purchased	\$ 242	0.63%
Repurchase agreements	26,132	0.18%
	\$ 26,374	0.18%

<i>(In thousands)</i>	Maximum Outstanding at any Month End
Federal funds purchased	\$ 2,581
Repurchase agreements	28,011

Interest expense on securities sold under agreements to repurchase totaled \$43,800 in 2014 and \$46,000 in 2013.

Interest on federal funds purchased totaled \$2,200 in 2014 and \$1,600 in 2013.

Repurchase agreements are collateralized by mortgage-backed securities with carrying values and fair values of \$37.2 million at December 31, 2014. The fed funds lines with the bank's correspondent banks are all unsecured.

At December 31, 2014, the Company had available lines of credit of approximately \$82.5 million at various financial institutions for borrowing on a short-term basis.

**Federal Home Loan Bank Advances**

Advances from the FHLB had a weighted average rate of 0.23% and 0.20% and total outstanding balances averaged \$114.6 million and \$102.9 million for the years ended December 31, 2014 and 2013, respectively. Included in amounts due to the FHLB as of December 2014 were five term borrowings totaling \$135.0 million. The term borrowings were all short term notes all maturing by March 2015 with note rates varying from 0.20% to 0.26%.

The line of credit and all other advances were collateralized by certain 1-4 family mortgages, multifamily first mortgage loans and qualifying commercial loans totaling \$425.7 million and by mortgage-backed securities with carrying values of \$17.2 million at December 31, 2014. The line offers a borrowing capacity of \$285.1 million at year end 2014.

At December 31, 2014, the Company had an available credit line at the FHLB of up to 30% of assets contingent upon adequate collateralization. These lines are subject to annual renewal and are at varying interest rates. No amounts were outstanding on these lines at December 31, 2014.

**Holding Company Loan**

The Company has a \$10.0 million holding company loan with an unaffiliated institution secured by the stock of the Bank with an outstanding balance of \$7.3 million and \$9.6 million at December 31, 2014 and December 31, 2013, respectively. The balance is included in other borrowings on the Consolidated Balance Sheets. The loan accrues interest at prime plus 0.75% and expires in November 2017. The note called for interest only payments until November 2013 with principal payments starting after that and amortized over the remaining four year term.

**Subordinated Debentures**

In 2004, the Company issued \$10.3 million of junior subordinated debentures to Paragon Commercial Capital Trust I in exchange for the proceeds of trust preferred securities issued by the Trust. The junior subordinated debentures accrue interest quarterly at an annual rate, reset quarterly, equal to LIBOR plus 2.65% however, the interest payments were deferred until October 2013, when the entire deferred interest amount was repaid.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The debentures are redeemable in whole or in part, on any October 23, January 23, April 23, or July 23. Redemption is mandatory at July 23, 2034.

In 2006, the Company issued \$8.2 million of junior subordinated debentures to Paragon Commercial Capital Trust II in exchange for the proceeds of trust preferred securities issued by the Trust. The junior subordinated debentures accrue interest quarterly at an annual rate, reset quarterly, equal to LIBOR plus 1.70% however, the interest payments were deferred until September 2013, when the entire deferred interest amount was repaid. The debentures are redeemable on June 20, 2011 or afterwards, in whole or in part, on any March 30, June 30, September 30, or December 30. Redemption is mandatory at June 30, 2036.

In October 2008, the Company issued \$11.8 million of subordinated debentures at the Bank level. \$7.3 million of the debentures paid interest quarterly at a fixed rate of 9.14% and the remaining \$4.5 million paid at an annual rate, reset quarterly, equal to LIBOR plus 5.00%. The debentures were redeemable on November 1, 2013 or any time afterwards, in whole or in part. Redemption was mandatory at November 1, 2018. The debentures were included in long-term debt in 2013 and qualified as Tier 2 regulatory capital at the Bank level. In January 2014, the Company repaid these debentures, reducing total risk based capital by this amount.

The junior subordinated debentures are included in debt and the Company's equity interest in the trust is included in other assets. The Company guarantees the trust preferred securities through the combined operation of the junior subordinated debentures and other related documents. The Company's obligation under the guarantee is unsecured and subordinate to senior and subordinated indebtedness of the Company.

The trust preferred securities presently qualify as Tier 1 regulatory capital and are reported in Federal Reserve regulatory reports as a minority interest in a consolidated subsidiary. The junior subordinated debentures do not qualify as Tier 1 regulatory capital. On March 1, 2005, the Board of Governors of the Federal Reserve issued a final rule stating that trust preferred securities will continue to be included in Tier 1 capital, subject to stricter quantitative and qualitative standards. For Bank Holding Companies, trust preferred securities will continue to be included in

Tier 1 capital up to 25% of core capital elements (including trust preferred securities) net of goodwill less any associated deferred tax liability.

## NOTE H – LEASES

The Company purchased a building in Raleigh in 2005 and relocated its headquarters in March 2007. The acquired building resides on land subject to a land lease which renews every five years with the next renewal in 2018. The assumed life of the lease for the land is the expected life of the building. In addition the Bank has entered into non-cancelable operating leases for its Charlotte office expiring in February 2019, its Cary office expiring in June 2019 and its operations center expiring in August 2016. Future minimum lease payments under these leases for the years ending December 31 are as follows:

<i>(In thousands)</i>	
2015	\$ 649
2016	614
2017	524
2018	534
2019	240
Thereafter	4,418
Total	\$ 6,979

Total rent expense for the years ended December 31, 2014 and 2013 amounted to \$272,000 and \$849,000 respectively.

## NOTE I – RELATED PARTY TRANSACTIONS

In addition to those transactions discussed in Note D and F, the Bank has entered into an agreement for accounting, data processing, and administrative services with a stockholder corporation that owned approximately 18% of the Company's common stock at December 31, 2014 and 2013. Expenses related to this agreement totaled \$588,000 and \$530,000 during the years ended December 31, 2014 and 2013, respectively.

## NOTE J – EMPLOYEE BENEFIT PLANS

### 401(k) Retirement Plan

The Bank has adopted a 401(k) retirement plan that covers all eligible employees. The Bank's contribution is limited to 6% of each employee's salary. Matching contributions are funded when accrued. The Bank matches the first 6% of employee contributions. Matching expenses totaled \$471,000 and \$213,000 for the years ended December 31, 2014 and 2013, respectively.

### Employee Stock Purchase Plan

On September 23, 2003, the Board of Directors adopted, subject to shareholder approval, the 2003 Employee Stock Purchase Plan (the "2003 ESPP"). A split adjusted aggregate of 200,000 shares of common stock of the Company has been reserved for issuance by the Company upon exercise of options to be granted from time to time under the 2003 ESPP.

The 2003 ESPP as amended provided employees of the Company the right to purchase, annually, shares of the Company's common stock at 95% of fair market value. The number of shares that could be purchased in any calendar year by any individual was limited to shares with a fair market value of \$25,000.

During 2014 and 2013 there were no shares issued under the plan.

### Supplemental Retirement Plan

In May 2004, the Company established a non-qualifying supplemental retirement plan for the benefit of certain key executives. Under the Plan, the participants will receive a fixed retirement benefit over a 20 year period following that participant's retirement. The Plan also provides for payment of death or disability benefits in the event a participating officer becomes permanently disabled or dies prior to attainment of retirement age. Benefits vested over a ten year period beginning at Plan inception and are now fully vested. The discount rate used to compute the liability for the expected benefits was 6%.

In July 2007, the Company established another non-qualifying supplemental retirement plan for the benefit of certain other key employees. The terms of the plan were the same as those for the 2004 Plan. In addition, at the same time, the Company established a deferred compensation plan for certain key executives. Terms of the deferred compensation plan were the same as those of the other two plans except that in addition to a service requirement, certain financial objectives had to be met.

In 2012, the Company amended the deferred compensation plan to remove the financial objectives for the remaining participants. In 2014, the deferred compensation plan was merged into the supplemental retirement plan and all benefits became fully vested.

For the year ended December 31, 2014 and 2013, the Company recognized an expense of \$415,000 and

\$411,000, respectively, related to the Plans. The accrued liability related to these plans was approximately \$2.3 million and \$1.9 million as of December 31, 2014 and 2013, respectively, and is included in Other liabilities on the Consolidated Balance Sheet.

At December 31, 2014, the Company had \$27.4 million in cash surrender value invested in bank-owned life insurance policies ("BOLI"). Income earned on these policies may be used, at the Company's sole discretion, to fund the benefits payable under the Plans.

### Stock-Based Compensation Plans

The 2006 Omnibus Stock Ownership and Long Term Incentive Plan (the "Omnibus Plan"), as amended, approved an aggregate of 312,500 split adjusted shares of the common stock of the Company, subject to adjustment, were reserved for issuance under the terms of the Omnibus Plan pursuant to the grant of incentive stock options, non-qualified stock options, restricted stock grants, long-term incentive compensation units and stock appreciation rights.

Options granted under both plans become exercisable in accordance with the vesting schedule specified in the stock option agreements. All unexercised options expire ten years after the date of grant.

The following table summarizes the components and classification of stock-based compensation expense for the years ended December 31, 2014 and 2013:

<i>(In thousands)</i>	2014	2013
Stock options	\$ 23	\$ 20
Restricted stock	314	—
Total stock-based compensation	\$ 337	\$ 20

As of December 31, 2014, there was no unrecognized compensation expense related to the Company's stock option plans. Unrecognized stock-based compensation expense at December 31, 2014 for the restricted stock plan is as follows:

<i>(In thousands)</i>	
2015	\$ 287
2016	90
2017	26
Total	\$ 403

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Stock Options** A split adjusted summary of the transactions for the Company's option plans as of and for the years ended December 31, 2014 and 2013, including the weighted average exercise price ("WAEP") is as follows:

	2014			2013		
	Available for Future Grants	Shares	WAEP	Available for Future Grants	Shares	WAEP
Outstanding at beginning of year	283,000	111,000	\$ 43.27	272,125	139,875	\$ 36.62
Granted	(6,000)	6,000	10.00	–	–	–
Exercised	–	(6,000)	10.00	–	(18,000)	6.20
Expired and forfeited	10,000	(10,000)	46.03	10,875	(10,875)	6.20
Outstanding at end of year	287,000	101,000	\$ 43.00	283,000	111,000	\$ 43.27
Options exercisable at year-end		101,000	\$ 43.00		111,000	\$ 43.27

There were no unvested shares as of December 31, 2014 or 2013.

The following table summarizes information about the Company's stock options at December 31, 2014:

Exercise Price	Number Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life in Years	Number Exercisable
\$9.20 - \$39.99	10,000	\$ 17.60	0.53	10,000
\$40.00 - \$45.00	38,750	42.35	2.69	38,750
\$45.01 - \$50.00	51,250	48.27	2.14	51,250
\$50.01 - \$52.00	1,000	52.00	1.39	1,000
	101,000	\$ 43.00	2.18	101,000

The following table lists the stock option grants from the Plan for the year ended December 31, 2014:

2014	Number of Options Granted	Exercise Price	Fair Value
August 1, 2014 - Directors	6,000	\$ 10.00	\$ 3.77

There were no options granted during 2013.

The fair value of each option is estimated as of the date of grant using the Black-Scholes Option Pricing Model. This model requires the input of subjective assumptions that will usually have a significant impact on the fair value estimate. The assumptions for the grants were developed based on ASC 718 and SEC guidance contained in Staff Accounting Bulletin (SAB) No. 107, "Share-Based Payment."

The following table summarizes the weighted average assumptions used to compute the grant-date fair value of options granted during the year ended December 31, 2014:

Dividend yield	0.00%
Expected volatility	31.7% - 31.7%
Weighted average volatility	31.69%
Risk free interest rate	2.160%
Expected life	7 years

- The dividend yield assumption is consistent with management expectations of dividend distributions based upon the Company's business plan. An increase in dividend yield will decrease stock compensation expense.
- The risk-free interest rate was developed using the U.S. Treasury yield curve for periods equal to the expected life of the options on the grant date. An increase in the

risk-free interest rate will increase stock compensation expense.

- The expected option life for the current period grants was estimated using the vesting period, the term of the option and estimates of future exercise behavior patterns. An increase in the option life will increase stock compensation expense.
- The volatility was estimated using a peer group assessment for periods approximating the expected option life. Appropriate weight is attributed to financial theory, according to which the volatility of an institution's equity should be related to the volatility of its assets and the entity's financial leverage. An increase in the volatility will increase stock compensation expense.

At December 31, 2014, there was no aggregate intrinsic value of options outstanding and exercisable. The aggregate intrinsic value of options exercised during 2013 was \$32,000. There was no aggregate intrinsic value of options exercised during 2014.

### Restricted Stock

Restricted stock provides the grantee with voting, dividend and anti-dilution rights equivalent to common shareholders, but is restricted from transfer until vested, at which time all restrictions are removed. The terms of the restricted stock awards granted to employees during 2014 are 100% cliff vesting period 3 years from the date of the grant. The terms of the restricted stock awards granted to directors during 2014 are a vesting period 2 years from the date of the grant with immediate vesting upon retirement of the director.

The following table lists the various restricted stock awards under our Plan for the year ended December 31, 2014:

	Number of	Fair Value
2014	Options Granted	
February 1, 2014 - Directors	68,750	\$ 8.00
August 1, 2014 - Employees	6,250	10.00
December 1, 2014 - Employees	12,500	10.00

There were no restricted stock grants during 2013.

The fair value of the restricted stock awards granted to employees for the year ended December 31, 2014 was estimated to be equal to the closing stock price on the grant date. The value of the restricted stock is being amortized on a straight-line basis over the implied service periods.

The following table summarizes unvested restricted stock award activity for the years ended December 31, 2014:

	Shares	Weighted Average Grant-Date Fair Value Per Share
2014		
Outstanding at beginning of year	–	\$ –
Granted	87,500	8.43
Vested	(12,500)	8.00
Expired or forfeited	–	–
Outstanding at end of year	75,000	\$ 8.50

### NOTE K – INCOME TAXES

Allocation of federal and state income tax benefit between current and deferred portions for the years ended December 31 is as follows:

(In thousands)	2014	2013
Current		
Federal	\$ 1,430	\$ 636
State	496	–
Total Current	1,926	636
Deferred		
Federal	2,042	1,560
State	435	558
Total Deferred	2,477	2,118
	\$ 4,403	\$ 2,754

A reconciliation of income tax benefit computed at the statutory federal income tax rate to income tax expense included in the Consolidated Statements of Income is as follows:

(In thousands)	2014	2013
Expense computed at		
statutory rate of 35%	\$ 4,203	\$ 2,611
Effect of state income taxes	327	209
Tax exempt income	(622)	(413)
Other	495	347
	\$ 4,403	\$ 2,754

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The components of the net deferred tax assets as of December 31, 2014 and 2013 are as follows:

<i>(In thousands)</i>	2014	2013
Deferred tax assets:		
Allowance for loan losses	\$ 2,628	\$ 2,725
Recorded impairment of assets	1,190	1,643
Operating loss carryforwards	2,527	3,964
Deferred compensation	881	995
Net unrealized loss		
on available for sale securities	–	1,272
Net unrealized loss on cash flow hedges	311	–
Other	800	404
Total deferred tax assets	8,337	11,003
Deferred tax liabilities:		
Premises and equipment	(999)	(709)
Deferred loan costs	(1,048)	(763)
Prepaid expenses	(208)	(152)
Net unrealized gain		
on available for sale securities	(1,015)	–
Net unrealized gain on cash flow hedges	–	(902)
Other	(142)	–
Total deferred tax liabilities	(3,412)	(2,526)
Net recorded deferred tax assets	\$ 4,925	\$ 8,477

No valuation allowances were required relating to deferred tax assets at December 31, 2014 or 2013 as management believes that realization of the net deferred tax asset is more likely than not.

The Company's net operating loss carry-forwards will begin to expire in 2030.

As of December 31, 2014 and 2013, there were no uncertain tax positions. The amount of uncertain tax positions may increase or decrease in the future for various reasons including adding amounts for current tax positions, expiration of open tax returns due to statutes of limitations, changes in management's judgment about the level of uncertainty, status of examinations, litigation and legislative activity and the addition or elimination of uncertain tax positions. The Company's policy is to report interest and penalties, if any, related to uncertain tax positions in income tax expense in the Consolidated Statements of Income. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2011.

## NOTE L – OTHER NON-INTEREST EXPENSE

The major components of other non-interest expense for the years ended December 31, 2014 and 2013 are as follows:

<i>(In thousands)</i>	2014	2013
Equipment and software related expense	\$ 1,341	\$ 903
Director related fees and expenses	978	399
Advertising and public relations	876	577
Franchise and other taxes	402	304
Postage printing and office supplies	276	184
Insurance	205	223
Travel related expenses	175	129
Correspondent bank fees	155	148
Charitable contributions	120	75
Telephone	119	106
Other	661	921
Total	\$ 5,308	\$ 3,969

## NOTE M – REGULATORY MATTERS

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

The ability of the Company to pay dividends is subject to statutory and regulatory restrictions on the payment of cash dividends, including the requirement under the North Carolina banking laws that cash dividends be paid only out of undivided profits and only if the bank has surplus of a specified level. The Federal Reserve also imposes limits on the Company's payment of dividends.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2014 and 2013, that the Company and the Bank met all capital adequacy requirements to which they are subject.

The most recent notification from the Federal Deposit Insurance Corporation categorized Paragon Commercial

Bank as well capitalized under the published regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following tables. There are no conditions or events since the notification that management believes have changed the Bank's category. The Company's and the Bank's actual capital amounts and ratios as of December 31, 2014 and 2013 are presented in the table below.

<i>(In thousands)</i>	Actual		Minimum Requirements to be:			
	Amount	Ratio	Adequately Capitalized		Well Capitalized	
			Amount	Ratio	Amount	Ratio
<b>2014</b>						
Total Capital (to Risk Weighted Assets)						
Consolidated	\$ 111,704	12.4%	\$ 72,207	8.0%	\$ N/A	N/A
Bank	118,028	13.1%	72,115	8.0%	90,144	10.0%
Tier I Capital (to Risk Weighted Assets)						
Consolidated	104,524	11.6%	36,104	4.0%	N/A	N/A
Bank	110,848	12.3%	36,058	4.0%	54,087	6.0%
Tier I Capital (to Average Assets)						
Consolidated	104,524	9.0%	46,340	4.0%	N/A	N/A
Bank	110,848	9.6%	46,160	4.0%	57,700	5.0%
<b>2013</b>						
Total Capital (to Risk Weighted Assets)						
Consolidated	\$ 111,290	13.9%	\$ 64,154	8.0%	\$ N/A	N/A
Bank	119,689	15.0%	64,060	8.0%	80,074	10.0%
Tier I Capital (to Risk Weighted Assets)						
Consolidated	92,167	11.5%	32,077	4.0%	N/A	N/A
Bank	100,566	12.6%	32,030	4.0%	48,045	6.0%
Tier I Capital (to Average Assets)						
Consolidated	92,167	9.1%	40,401	4.0%	N/A	N/A
Bank	100,566	9.9%	40,527	4.0%	50,659	5.0%

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE N – OFF-BALANCE SHEET RISK

The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of conditions established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank, upon extension of credit is based on management's credit evaluation of the borrower. Collateral obtained varies but may include real estate, stocks, bonds, and certificates of deposit.

A summary of the contract amounts of the Bank's exposure to off-balance sheet credit risk as of December 31, 2013 and 2014 is as follows:

<i>(In thousands)</i>	2014	2013
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	\$ 16,886	\$ 21,750
Undisbursed lines of credit	128,819	80,978
Standby letters of credit	3,207	4,058
Total	\$ 148,912	\$ 106,786

## NOTE O – FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair value is a market-based measurement and is defined as the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. The transaction to sell the asset or transfer the liability is a

hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. In general, the transaction price will equal the exit price and, therefore, represent the fair value of the asset or liability at initial recognition. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, each reporting entity is required to consider factors specific to the transaction and the asset or liability, the principal or most advantageous market for the asset or liability, and market participants with whom the entity would transact in the market.

Outlined below is the application of the fair value hierarchy applied to the Company's financial assets that are carried at fair value.

**Level 1** – Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets. An active market for the asset or liability is a market in which the transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. As of December 31, 2014, the types of financial assets and liabilities the Company carried at fair value hierarchy Level 1 included marketable equity securities with readily available market values.

**Level 2** – Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument. As of December 31, 2014, the types of financial assets and liabilities the Company carried at fair value hierarchy Level 2 included agency bonds, collateralized mortgage obligations, mortgage backed securities, municipal bonds and derivatives.

**Level 3** – Inputs to the valuation methodology are unobservable and significant to the fair value measurement. Unobservable inputs are supported by little or no market activity or by the entity's own assumptions. As of December 31, 2014, the Company did value certain financial assets including one corporate subordinated debenture, measured on both a recurring and a non-recurring basis, at fair value hierarchy Level 3.

The Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs.

### Fair Value on a Recurring Basis

The Company measures certain assets at fair value on a recurring basis, as described below.

### Investment Securities Available-for-Sale

Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities

issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

### Derivative Assets and Liabilities

Derivative instruments held or issued by the Company for risk management purposes are traded in over-the-counter markets where quoted market prices are not readily available. For those derivatives, the Company measures fair value using models that use primarily market observable inputs, such as yield curves and option volatilities, and include the value associated with counterparty credit risk. The Company classifies derivative instruments held or issued for risk management purposes as Level 2. As of December 31, 2014 the Company's derivative instruments consist solely of interest rate forward swaps and interest rate caps.

Below is a table that presents information about assets measured at fair value on a recurring basis at December 31, 2014 and 2013:

<i>(In thousands)</i>	Fair Value Measurements Using			
	Total Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>December 31, 2014</b>				
Securities available-for-sale:				
U.S. agency obligations	\$ 31,842	\$ —	\$ 31,842	\$ —
Collateralized mortgage obligations	70,056	—	70,056	—
Mortgage-backed securities	34,548	—	34,548	—
Municipal bonds	45,180	—	45,180	—
Other	2,049	2,049	—	—
	183,675	2,049	181,626	—
Interest rate caps	6,029	—	6,029	—
Total assets at fair value	\$ 189,704	\$ 2,049	\$ 187,655	\$ —
<b>December 31, 2013</b>				
Securities available-for-sale:				
U.S. agency obligations	\$ 29,143	\$ —	\$ 29,143	\$ —
Collateralized mortgage obligations	52,610	—	52,610	—
Mortgage-backed securities	39,593	—	39,593	—
Municipal bonds	22,971	—	22,971	—
Other	2,879	2,279	—	600
	147,196	2,279	144,317	600
Interest rate forward swaps	2,285	—	2,285	—
Total assets at fair value	\$ 149,481	\$ 2,279	\$ 146,602	\$ 600

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The table below presents a reconciliation and income statement classification of gains and losses for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended December 31, 2014.

<i>(In thousands)</i>	Level 3 Investment Securities
Balance at December 31, 2013	\$ 600
Sales, calls or maturities	(1000)
Unrealized gains	400
Balance at December 31, 2014	\$ –

### Fair Value on a Nonrecurring Basis

The Company measures certain assets at fair value on a nonrecurring basis, as described below.

### Impaired Loans

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures the impairment. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring

an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At December 31, 2014, substantially all of the total impaired loans were evaluated based on the fair value of the collateral. Impaired loans require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as nonrecurring Level 2. When current appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as nonrecurring Level 3. Impaired loans totaled \$6.3 million and \$12.6 million at December 31, 2014 and 2013, respectively.

### Other Real Estate Owned

Other real estate, which includes foreclosed assets, is adjusted to fair value upon transfer of loans and premises to other real estate. Subsequently, other real estate is carried at the lower of carrying value or fair value.

At the date of transfer, losses are charged to the allowance for credit losses. Subsequent write-downs are charged to expense in the period they are incurred.

Below is a table that presents information about assets measured at fair value on a nonrecurring basis at December 31, 2014 and 2013:

<i>(In thousands)</i>	Fair Value Measurements Using			
	Total Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>December 31, 2014</b>				
Impaired loans	\$ 5,595	\$ –	\$ –	\$ 5,595
Other real estate owned	14,991	–	–	14,991
Total	\$ 20,586	\$ –	\$ –	\$ 20,586
<b>December 31, 2013</b>				
Impaired loans	\$ 11,831	\$ –	\$ –	\$ 11,831
Other real estate owned	18,174	–	–	18,174
Total	\$ 30,005	\$ –	\$ –	\$ 30,005

For Level 3 assets and liabilities measured at fair value on a recurring or nonrecurring basis as of December 31, 2014 and 2013, the significant unobservable inputs used in the fair value measurements were as follows:

<b>December 31, 2014 and 2013</b>			
	<b>Valuation Technique</b>	<b>Significant Observable Inputs</b>	<b>Significant Unobservable Inputs</b>
Impaired loans	Appraisal value	Appraisals and or sales of comparable properties	Appraisals discounted 5% to 10% for sales commissions and other holding costs
Other real estate owned	Appraisal value/ Comparison sale/ Other estimates	Appraisals and or sales of comparable properties	Appraisals discounted 5% to 10% for sales commissions and other holding costs

The Bank provides certain disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows.

In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. Accordingly, certain financial instruments and all nonfinancial instruments are excluded from disclosure. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Bank.

The following methods and assumptions were used by the Bank in estimating its fair value disclosures for financial instruments:

**Cash and Due from Banks**

The carrying amounts for cash and due from banks approximate fair value because of the short maturities of those instruments.

**Federal Home Loan Bank Stock**

The carrying value of Federal Home Loan Bank stock approximates fair value based on the redemption provisions of the Federal Home Loan Bank.

**Bank-owned life insurance**

The carrying value of bank-owned life insurance approximates fair value because this investment is carried at cash surrender value, as determined by the insurer.

**Loans**

The fair value of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

**Deposits**

The fair value of demand deposits is the amount payable on demand at the reporting date. The fair value of time deposits is estimated by discounting expected cash flows using the rates currently offered for instruments of similar remaining maturities.

**Accrued Interest**

The carrying amount is a reasonable estimate of fair value.

**Short-Term Borrowings and Long-Term Debt**

The fair values are based on discounting expected cash flows using the current interest rates for debt with the same or similar remaining maturities and collateral requirements.

**Financial Instruments with Off-Balance Sheet Risk**

With regard to financial instruments with off-balance sheet risk discussed in Note N, it is not practicable to estimate the fair value of future financing commitments.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the estimated fair values and carrying amounts of the Bank's financial instruments, none of which are held for trading purposes, at December 31:

<i>(In thousands)</i>	<b>2014</b>				
	Carrying Amount	Fair Value			
		Total	Level 1	Level 2	Level 3
<b>Financial Assets:</b>					
Cash and due from banks	\$ 36,395	\$ 36,395	\$ 36,395	\$ –	\$ –
Investment securities available-for-sale	183,675	183,675	–	183,675	–
Loans, net	861,536	867,569	–	861,974	5,595
Accrued interest receivable	3,636	3,636	3,636	–	–
Federal Home Loan Bank stock	7,006	7,006	–	–	7,006
Bank-owned life insurance	27,421	27,421	–	27,421	–
Interest rate caps	6,029	6,029	–	6,029	–
<b>Financial Liabilities:</b>					
Non-maturing deposits	\$ 494,728	\$ 494,728	\$ –	\$ 494,728	–
Time deposits	388,912	389,240	–	389,240	–
Accrued interest payable	405	405	405	–	–
Repurchase agreements and federal funds purchased	27,482	27,482	–	27,482	–
FHLB advances and other borrowings	142,256	142,256	–	142,256	–
Subordinated debt	18,558	15,449	–	15,449	–
<b>2013</b>					
<i>(In thousands)</i>	Carrying Amount	Fair Value			
		Total	Level 1	Level 2	Level 3
<b>Financial Assets:</b>					
Cash and due from banks	\$ 45,137	\$ 45,137	\$ 45,137	\$ –	\$ –
Investment securities available-for-sale	147,196	147,196	–	147,196	–
Loans, net	760,453	757,575	–	745,744	11,831
Accrued interest receivable	3,130	3,130	3,130	–	–
Federal Home Loan Bank stock	6,323	6,323	–	–	6,323
Bank-owned life insurance	26,622	26,622	–	26,622	–
Interest rate forward swaps	2,285	2,285	–	2,285	–
<b>Financial Liabilities:</b>					
Non-maturing deposits	\$ 361,102	\$ 361,102	\$ –	\$ 361,102	–
Time deposits	409,050	410,283	–	410,283	–
Accrued interest payable	624	624	624	–	–
Repurchase agreements and federal funds purchased	28,012	28,012	–	28,012	–
FHLB advances and other borrowings	123,616	124,402	–	124,402	–
Subordinated debt	30,338	23,253	–	23,253	–

## NOTE P – PARENT COMPANY FINANCIAL DATA

Following are the condensed financial statements of Paragon Commercial Corporation as of and for the years ended December 31, 2014 and 2013:

### CONDENSED BALANCE SHEETS

*(In thousands)*

At December 31:	2014	2013
<b>ASSETS</b>		
Cash and due from banks:	\$ 413	\$ 710
Investment in Paragon Commercial Bank	111,986	104,002
Investment in unconsolidated subsidiaries	558	558
Other assets	590	617
Total Assets	\$ 113,547	\$ 105,887
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Subordinated debentures	\$ 18,558	\$ 18,558
Other borrowings	7,256	9,616
Accrued interest payable and other liabilities	71	110
Total Liabilities	25,885	28,284
Stockholders' Equity:		
Common stock	36	35
Additional paid-in capital	52,358	51,963
Accumulated other comprehensive income (loss)	1,142	(562)
Retained earnings	34,126	26,167
Total Stockholders' Equity	87,662	77,603
Total Liabilities and Stockholders' Equity	\$ 113,547	\$ 105,887

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## CONDENSED STATEMENTS OF INCOME

(In thousands)

For the Years Ended December 31:	2014	2013
Equity in earnings of subsidiary	\$ 8,706	\$ 5,707
Interest expense	(802)	(909)
Other operating income	22	22
Other operating expenses	(352)	(320)
Income tax benefit	385	424
Net Income	\$ 7,959	\$ 4,924

## CONDENSED STATEMENTS OF CASH FLOWS

(In thousands)

For the Years Ended December 31:	2014	2013
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 7,959	\$ 4,924
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Equity in earnings of subsidiary	(8,706)	(5,707)
Impairment on securities	-	39
Stock based compensation	337	20
Changes in assets and liabilities:		
Increase in other assets	25	(30)
Increase in other liabilities	(39)	(986)
Net cash used in operating activities	(424)	(1,740)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Investment in subsidiaries and trusts	(23)	(20)
Dividends received from subsidiary	2,450	1,250
Net cash provided by investing activities	2,427	1,230
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Repayment of long term debt	(2,361)	(384)
Proceeds from exercise of stock options	61	111
Net cash used in financing activities	(2,300)	(273)
Net decrease in cash and cash equivalents	(297)	(783)
Cash and cash equivalents, beginning of year	710	1,493
Cash and cash equivalents, end of year	\$ 413	\$ 710

## NOTE Q – SUPPLEMENTAL CASH FLOW DISCLOSURE

(In thousands)

At December 31:	2014	2013
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION</b>		
Interest paid	\$ 8,897	\$ 10,625
Income taxes paid	\$ 1,650	\$ 636
<b>SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES</b>		
Change in fair value of securities available-for-sale, net of taxes	\$ 3,590	\$ (4,820)
Change in fair value of cash flow hedges, net of taxes	\$ (1,886)	\$ 1,383
Transfer from loans to foreclosed real estate	\$ 1,104	\$ 10,652
Transfer of SBIC investment from other assets to investments	\$ –	\$ 1,342

## NOTE R – SUBSEQUENT EVENTS

The Company has evaluated subsequent events through March 25, 2015 the date these consolidated financial statements were available to be issued and has determined that there are no subsequent events that would require recognition or disclosure in the Company's consolidated financial statements.

Information in this annual report contains forward-looking statements. These statements involve risks and uncertainties that could cause actual results to differ materially, including without limitation, the effects of future economic conditions, governmental fiscal and monetary policies, legislative and regulatory changes, the risks of changes in interest rates, and the effects of competition. Paragon Commercial Corporation does not undertake a duty to update any forward-looking statements in this annual report.

# MANAGEMENT'S REPORT ON THE FINANCIAL STATEMENTS AND THE INTERNAL CONTROL OVER FINANCIAL REPORTING

March 25, 2015

## FINANCIAL STATEMENTS

Management of Paragon Commercial Corporation is responsible for the preparation, integrity and fair presentation of the consolidated financial statements as of December 31, 2014, and the year then ended. The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and, as such, include amounts, some of which are based on judgments and estimates of management.

## INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

Management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) which includes the preparation of the Consolidated Financial Statements of Bank Holding Companies (Form Y-9C) in accordance with the relevant instructions of the Board of Governors of the Federal Reserve System (Federal Reserve instructions) to comply with the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act.



**Robert C. Hatley**  
President and Chief Executive Officer  
Paragon Commercial Corporation



**Steven E. Crouse**  
Executive Vice President and Chief Financial Officer  
Paragon Commercial Corporation

# MANAGEMENT'S ASSESSMENT OF PARAGON COMMERCIAL BANK'S COMPLIANCE WITH LAWS AND REGULATIONS

March 25, 2015

## COMPLIANCE WITH LAWS AND REGULATIONS

Management of Paragon Commercial Corporation is responsible for compliance with the federal and state laws and regulations concerning dividend restrictions and federal laws and regulations concerning loans to insiders designated by the FDIC as safety and soundness laws and regulations (the "Designated Laws").

Management assessed its compliance with the Designated Laws and based on this assessment, management concludes that Paragon Commercial Corporation complied with the designated laws and regulations relating to safety and soundness during the year ended December 31, 2014.



**Robert C. Hatley**  
President and Chief Executive Officer  
Paragon Commercial Corporation



**Steven E. Crouse**  
Executive Vice President and Chief Financial Officer  
Paragon Commercial Corporation



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