

PEOPLES FINANCIAL CORP /MS/
Form 10-Q
November 13, 2017

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

**QUARTERLY REPORT PURSUANT TO SECTION 13 or 15 (D) OF THE SECURITIES EXCHANGE
ACT OF 1934**

For the quarterly period ended September 30, 2017

or

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

Commission File Number 001-12103

PEOPLES FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

Mississippi
(State or other jurisdiction of incorporation or
organization)

64-0709834
(I.R.S. Employer Identification No.)

Lameuse and Howard Avenues, Biloxi, Mississippi
(Address of principal executive offices)

39533
(Zip Code)

(228) 435-5511
(Registrant's telephone number, including area code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the last practicable date. Peoples Financial Corporation has only one class of common stock authorized. At October 31, 2017, there were 15,000,000 shares of \$1 par value common stock authorized, with 5,123,186 shares issued and outstanding.

Part 1 - Financial Information**Item 1: Financial Statements****Peoples Financial Corporation and Subsidiaries****Consolidated Statements of Condition****(in thousands except share data)**

	September 30, 2017 (unaudited)	December 31, 2016 (audited)
Assets		
Cash and due from banks	\$ 42,278	\$ 41,116
Available for sale securities	245,788	233,578
Held to maturity securities, fair value of \$49,303 at September 30, 2017; \$46,935 at December 31, 2016	49,405	48,150
Other investments	2,729	2,693
Federal Home Loan Bank Stock, at cost	544	539
Loans	272,823	315,355
Less: Allowance for loan losses	6,152	5,466
Loans, net	266,671	309,889
Bank premises and equipment, net of accumulated depreciation	20,541	21,644
Other real estate	8,081	8,513
Accrued interest receivable	1,991	1,855
Cash surrender value of life insurance	18,153	19,249
Other assets	806	788
Total assets	\$ 656,987	\$ 688,014

Peoples Financial Corporation and Subsidiaries

Consolidated Statements of Condition (continued)

(in thousands except share data)

	September 30, 2017 (unaudited)	December 31, 2016 (audited)
Liabilities and Shareholders Equity Liabilities:		
Deposits:		
Demand, non-interest bearing	\$ 147,975	\$ 132,381
Savings and demand, interest bearing	310,725	364,975
Time, \$100,000 or more	55,719	38,650
Other time deposits	30,648	39,010
Total deposits	545,067	575,016
Borrowings from Federal Home Loan Bank	1,216	6,257
Employee and director benefit plans liabilities	17,217	16,768
Other liabilities	1,688	1,512
Total liabilities	565,188	599,553
Shareholders Equity:		
Common stock, \$1 par value, 15,000,000 shares authorized, 5,123,186 shares issued and outstanding at September 30, 2017 and December 31, 2016	5,123	5,123
Surplus	65,780	65,780
Undivided profits	20,730	19,318
Accumulated other comprehensive income (loss), net of tax	166	(1,760)
Total shareholders equity	91,799	88,461
Total liabilities and shareholders equity	\$ 656,987	\$ 688,014

See notes to consolidated financial statements.

Peoples Financial Corporation and Subsidiaries

Consolidated Statements of Income

(in thousands except per share data) (unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Interest income:				
Interest and fees on loans	\$ 3,165	\$ 3,568	\$ 9,734	\$ 10,833
Interest and dividends on securities:				
U.S. Treasuries	413	283	1,203	740
U.S. Government agencies	126	161	404	728
Mortgage-backed securities	343	137	876	414
States and political subdivisions	420	333	1,199	954
Corporate bonds		7	8	23
Other investments	8	9	14	19
Interest on balances due from depository institutions	148	95	384	212
Total interest income	4,623	4,593	13,822	13,923
Interest expense:				
Deposits	381	237	981	661
Borrowings from Federal Home Loan Bank	8	30	32	115
Total interest expense	389	267	1,013	776
Net interest income	4,234	4,326	12,809	13,147
Provision for allowance for loan losses	29		85	137
Net interest income after provision for allowance for loan losses	\$ 4,205	\$ 4,326	\$ 12,724	\$ 13,010

Peoples Financial Corporation and Subsidiaries

Consolidated Statements of Income (continued)

(in thousands except per share data) (unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Non-interest income:				
Trust department income and fees	\$ 430	\$ 429	\$ 1,224	\$ 1,192
Service charges on deposit accounts	947	946	2,799	2,796
Gain on liquidation, sales and calls of securities		67	137	158
Income (loss) from other investments	7	(14)	36	(27)
Increase in cash surrender value of life insurance	98	102	326	295
Gain from death benefits from life insurance			429	
Other income	128	236	376	523
Total non-interest income	1,610	1,766	5,327	4,937
Non-interest expense:				
Salaries and employee benefits	2,746	2,776	8,344	8,305
Net occupancy	493	559	1,548	1,798
Equipment rentals, depreciation and maintenance	722	763	2,251	2,229
FDIC and state banking assessments	130	232	327	661
Data processing	322	334	972	1,006
ATM expense	141	147	399	422
Other real estate expense	305	26	635	500
Other expense	720	849	2,450	2,405
Total non-interest expense	5,579	5,686	16,926	17,326
Income before income taxes	236	406	1,125	621
Income tax expense (benefit)			(338)	78
Net income	\$ 236	\$ 406	\$ 1,463	\$ 543
Basic and diluted earnings per share	\$.05	\$.08	\$.29	\$.10
Dividends declared per share	\$.01	\$	\$.01	\$

See notes to consolidated financial statements.

Peoples Financial Corporation and Subsidiaries
Consolidated Statements of Comprehensive Income (Loss)**(in thousands) (unaudited)**

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2017	2016	2017	2016
Net income	\$ 236	\$ 406	\$ 1,463	\$ 543
Other comprehensive income (loss):				
Net unrealized gain (loss) on available for sale securities	(319)	(598)	2,063	2,132
Reclassification adjustment for realized gain on available for sale securities called or sold		(67)	(137)	(158)
Total other comprehensive income (loss)	(319)	(665)	1,926	1,974
Total comprehensive income (loss)	\$ (83)	\$ (259)	\$ 3,389	\$ 2,517

See notes to consolidated financial statements.

Peoples Financial Corporation and Subsidiaries
Consolidated Statement of Changes in Shareholders' Equity

(in thousands except share and per share data)

	Number of Common Shares	Common Stock	Surplus	Undivided Profits	Accumulated Other Comprehensive Income (Loss)	Total
Balance, January 1, 2017	5,123,186	\$ 5,123	\$ 65,780	\$ 19,318	\$ (1,760)	\$ 88,461
Net income				1,463		1,463
Dividend declared (\$.01 per share)				(51)		(51)
Other comprehensive income					1,926	1,926
Balance, September 30, 2017	5,123,186	\$ 5,123	\$ 65,780	\$ 20,730	\$ 166	\$ 91,799

Note: Balances as of January 1, 2017 were audited.

See notes to consolidated financial statements.

Peoples Financial Corporation and Subsidiaries

Consolidated Statements of Cash Flows

(in thousands) (unaudited)

	Nine Months Ended September 30,	
	2017	2016
Cash flows from operating activities:		
Net income	\$ 1,463	\$ 543
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	1,426	1,356
Provision for allowance for loan losses	85	137
Writedown of other real estate	397	420
(Gains) losses on sales of other real estate	95	(199)
(Income) loss from other investments	(36)	27
Gain from death benefits from life insurance	(429)	
Amortization of held to maturity securities	190	111
Amortization of available for sale securities	130	17
Gain on sales and calls of securities	(137)	(158)
Change in accrued interest receivable	(136)	155
Increase in cash surrender value of life insurance	(326)	(295)
Change in other assets	(18)	(274)
Change in other liabilities	574	217
Net cash provided by operating activities	\$ 3,278	\$ 2,057

Peoples Financial Corporation and Subsidiaries
Consolidated Statements of Cash Flows (continued)
(in thousands) (unaudited)

	Nine Months Ended September 30,	
	2017	2016
Cash flows from investing activities:		
Proceeds from maturities, sales and calls of available for sale securities	\$ 58,201	\$ 141,834
Proceeds from maturities of held to maturity securities	7,725	510
Purchases of available for sale securities	(68,478)	(145,832)
Purchases of held to maturity securities	(9,170)	(17,120)
(Purchase) redemption of Federal Home Loan Bank stock	(5)	1,101
Proceeds from sales of other real estate	1,296	2,017
Loans, net change	41,777	10,431
Acquisition of bank premises and equipment	(323)	(583)
Investment in cash surrender value of life insurance	(78)	(85)
Proceeds from death benefits from life insurance	1,929	
Net cash provided by (used in) investing activities	32,874	(7,727)
Cash flows from financing activities:		
Demand and savings deposits, net change	(38,656)	47,707
Time deposits, net change	8,707	3,146
Borrowings from Federal Home Loan Bank		98,920
Repayments to Federal Home Loan Bank	(5,041)	(110,990)
Net cash provided by (used in) financing activities	(34,990)	38,783
Net increase in cash and cash equivalents	1,162	33,113
Cash and cash equivalents, beginning of period	41,116	31,396
Cash and cash equivalents, end of period	\$ 42,278	\$ 64,509

See notes to consolidated financial statements.

PEOPLES FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

For the Nine Months Ended September 30, 2017 and 2016

1. Basis of Presentation:

Peoples Financial Corporation (the Company) is a one-bank holding company headquartered in Biloxi, Mississippi. It has two operating subsidiaries, PFC Service Corp., an inactive company, and The Peoples Bank, Biloxi, Mississippi (the Bank). The Bank provides a full range of banking, financial and trust services to state, county and local government entities and individuals and small and commercial businesses operating in those portions of Mississippi, Louisiana and Alabama which are within a fifty mile radius of the Waveland, Wiggins and Gautier branches, the Bank's three most outlying locations (the trade area).

The accompanying unaudited consolidated financial statements and notes thereto contain all adjustments, consisting only of normal recurring adjustments, necessary to present fairly, in accordance with accounting principles generally accepted in the United States of America (GAAP), the financial position of the Company and its subsidiaries as of September 30, 2017 and the results of their operations and their cash flows for the periods presented. The interim financial information should be read in conjunction with the annual consolidated financial statements and the notes thereto included in the Company's 2016 Annual Report and Form 10-K.

The results of operations for the quarter or nine months ended September 30, 2017, are not necessarily indicative of the results to be expected for the full year.

Use of Estimates - The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates common to the banking industry that are particularly susceptible to significant change in the near term include, but are not limited to, the determination of the allowance for loan losses, the valuation of other real estate acquired in connection with foreclosure or in satisfaction of loans and valuation allowances associated with the realization of deferred tax assets, which are based on future taxable income.

Summary of Significant Accounting Policies - The accounting and reporting policies of the Company conform to GAAP and general practices within the banking industry. There have been no material changes or developments in the application of principles or in our evaluation of the accounting estimates and the underlying assumptions or methodologies that we believe to be Critical Accounting Policies as disclosed in our Form 10-K for the year ended December 31, 2016.

New Accounting Pronouncements - In January 2017, the Financial Accounting Standards Board (the FASB) issued Accounting Standards Update (ASU) 2017-03, *Accounting Changes and Error Corrections (Topic 250) and Investments - Equity Method and Joint Ventures (Topic 323): Amendments to SEC Paragraphs Pursuant to Staff Announcements at the September 22, 2016 and November 17, 2016 EITF Meetings*. ASU 2017-03 incorporates into the Accounting Standards

Codification recent SEC guidance about disclosing the effect on financial statements of adopting the revenue, leases and credit losses standards. This update is effective upon issuance. The adoption of this ASU is not expected to have a material effect on the Company's financial position, results of operations or cash flows.

In February 2017, the FASB issued ASU 2017-05, *Other Income - Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*. ASU 2017-05 conforms the derecognition guidance on nonfinancial assets with the model for transactions in the new revenue standard. This update will be effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. The adoption of this ASU is not expected to have a material effect on the Company's financial position, results of operations or cash flows.

In March 2017, the FASB issued ASU 2017-07, *Compensation - Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. ASU 2017-07 amends the requirements related to the income statement presentation of the components of net periodic benefit cost for an entity's sponsored defined benefit pension and other postretirement plans. This update will be effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. The adoption of this ASU is not expected to have a material effect on the Company's financial position, results of operations or cash flows.

In March 2017, the FASB issued ASU 2017-08, *Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities*. ASU 2017-08 shortens the amortization period for the premium on such securities to the earliest call date. This update will be effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The adoption of this ASU is not expected to have a material effect on the Company's financial position, results of operations or cash flows.

2. Earnings Per Share:

Per share data is based on the weighted average shares of common stock outstanding of 5,123,186 for the quarters and nine months ended September 30, 2017 and 2016.

3. Statements of Cash Flows:

The Company has defined cash and cash equivalents as cash and due from banks. The Company paid \$1,006,350 and \$761,440 for the nine months ended September 30, 2017 and 2016, respectively, for interest on deposits and borrowings. No income tax payments were made during the nine months ended September 30, 2017. Income tax payments of \$78,435 were made during the nine months ended September 30, 2016. Loans transferred to other real estate amounted to \$1,355,642 and \$1,758,764 during the nine months ended September 30, 2017 and 2016, respectively.

4. Investments:

The amortized cost and fair value of securities at September 30, 2017 and December 31, 2016, are as follows (in thousands):

September 30, 2017	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale securities:				
Debt securities:				
U.S. Treasuries	\$ 134,806	\$ 5	\$ (1,234)	\$ 133,577
U.S. Government agencies	19,988	70	(86)	19,972
Mortgage-backed securities	77,415	349	(561)	77,203
States and political subdivisions	14,176	402		14,578
Total debt securities	246,385	826	(1,881)	245,330
Equity securities	458			458
Total available for sale securities	\$ 246,843	\$ 826	\$ (1,881)	\$ 245,788
Held to maturity securities:				
U.S. Government agencies	\$ 8,185	\$	\$ (220)	\$ 7,965
States and political subdivisions	41,220	424	(306)	41,338
Total held to maturity securities	\$ 49,405	\$ 424	\$ (526)	\$ 49,303

December 31, 2016	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale securities:				
Debt securities:				
U.S. Treasuries	\$ 149,676	\$ 39	\$ (2,091)	\$ 147,624
U.S. Government agencies	24,973	58	(206)	24,825
Mortgage-backed securities	43,939	74	(1,305)	42,708
States and political subdivisions	17,513	450		17,963
Total debt securities	236,101	621	(3,602)	233,120
Equity securities	458			458
Total available for sale securities	\$ 236,559	\$ 621	\$ (3,602)	\$ 233,578
Held to maturity securities:				
U.S. Government agencies	\$ 10,009	\$	\$ (315)	\$ 9,694
States and political subdivisions	36,677	29	(927)	35,779
Corporate bond	1,464		(2)	1,462
Total held to maturity securities	\$ 48,150	\$ 29	\$ (1,244)	\$ 46,935

The amortized cost and fair value of debt securities at September 30, 2017 (in thousands), by contractual maturity, are shown on the following page. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Fair Value
Available for sale securities:		
Due in one year or less	\$ 46,961	\$ 46,895
Due after one year through five years	98,693	98,384
Due after five years through ten years	22,983	22,496
Due after ten years	333	352
Mortgage-backed securities	77,415	77,203
Totals	\$ 246,385	\$ 245,330
Held to maturity securities:		
Due in one year or less	\$ 696	\$ 697
Due after one year through five years	11,641	11,724
Due after five years through ten years	20,588	20,576
Due after ten years	16,480	16,306
Totals	\$ 49,405	\$ 49,303

Available for sale and held to maturity securities with gross unrealized losses at September 30, 2017 and December 31, 2016, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows (in thousands):

	Less Than Twelve Months		Over Twelve Months		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
September 30, 2017:						
U.S. Treasuries	\$ 113,777	\$ 1,058	\$ 9,815	\$ 176	\$ 123,592	\$ 1,234
U.S. Government agencies	8,085	90	9,783	216	17,868	306
Mortgage-backed securities	31,326	382	3,902	179	35,228	561
States and political subdivisions	4,729	168	4,054	138	8,783	306
TOTAL	\$ 157,917	\$ 1,698	\$ 27,554	\$ 709	\$ 185,471	\$ 2,407
December 31, 2016:						
U.S. Treasuries	\$ 97,634	\$ 2,091	\$	\$	\$ 97,634	\$ 2,091
U.S. Government agencies	24,478	521			24,478	521
Mortgage-backed securities	37,663	1,305			37,663	1,305
States and political subdivisions	24,627	926	589	1	25,216	927
Corporate bond			1,462	2	1,462	2
TOTAL	\$ 184,402	\$ 4,843	\$ 2,051	\$ 3	\$ 186,453	\$ 4,846

At September 30, 2017, 25 of 27 securities issued by the U.S. Treasury, 4 of the 6 securities issued by U.S. Government agencies, 27 of the 155 securities issued by states and political subdivisions and 16 of the 32 mortgage-backed securities contained unrealized losses.

Management evaluates securities for other-than-temporary impairment on a monthly basis. In performing this evaluation, the length of time and the extent to which the fair value has been less than cost, the fact that the Company's securities are primarily issued by U.S. Treasury and U.S. Government Agencies and the cause of the decline in value are considered. In addition, the Company does not intend to sell and it is not more likely than not that it will be required to sell these securities before maturity. While some available for sale securities have been sold for liquidity purposes or for gains, the Company has traditionally held its securities, including those classified as available for sale, until maturity. As a result of the evaluation of these securities, the Company has determined that the unrealized losses summarized in the tables above are not deemed to be other-than-temporary.

Proceeds from sales and calls of available for sale securities were \$23,703,484 and \$29,250,806 during the nine months ended September 30, 2017 and 2016, respectively. Available for sale debt securities were sold or called for a realized gain of \$136,781 and \$157,918 for the nine months ended September 30, 2017 and 2016, respectively.

Securities with a fair value of \$180,107,293 and \$180,659,168 at September 30, 2017 and December 31, 2016, respectively, were pledged to secure public deposits, federal funds purchased and other balances required by law.

5. Loans:

The composition of the loan portfolio at September 30, 2017 and December 31, 2016, is as follows (in thousands):

	September 30, 2017	December 31, 2016
Gaming	\$ 18,824	\$ 31,311
Residential and land development	273	291
Real estate, construction	30,998	32,503
Real estate, mortgage	190,003	206,172
Commercial and industrial	26,009	37,035
Other	6,716	8,043
Total	\$ 272,823	\$ 315,355

The age analysis of the loan portfolio, segregated by class of loans, as of September 30, 2017 and December 31, 2016, is as follows (in thousands):

	Number of Days Past Due			Total Past Due	Current	Total Loans	Loans Past Due Greater Than 90 Days & Still Accruing
	30 - 59	60 - 89	Greater Than 90				
September 30, 2017:							
Gaming	\$	\$	\$	\$	\$ 18,824	\$ 18,824	\$
Residential and land development			273	273		273	
Real estate, construction	1,343	130	747	2,220	28,778	30,998	
Real estate, mortgage	4,640	139	7,815	12,594	177,409	190,003	256
Commercial and industrial	882	1,364	668	2,914	23,095	26,009	
Other	45	8		53	6,663	6,716	
Total	\$ 6,910	\$ 1,641	\$ 9,503	\$ 18,054	\$ 254,769	\$ 272,823	\$ 256
December 31, 2016:							
Gaming	\$	\$	\$	\$	\$ 31,311	\$ 31,311	\$
Residential and land development			291	291		291	
Real estate, construction	902	216	1,082	2,200	30,303	32,503	
Real estate, mortgage	4,608	1,923	4,471	11,002	195,170	206,172	
Commercial and industrial	867		8	875	36,160	37,035	
Other	44	36	80	160	7,883	8,043	
Total	\$ 6,421	\$ 2,175	\$ 5,932	\$ 14,528	\$ 300,827	\$ 315,355	\$

The Company monitors the credit quality of its loan portfolio through the use of a loan grading system. A score of 1 5 is assigned to the loan on factors including repayment ability, trends in net worth and/or financial condition of the borrower and guarantors, employment stability, management ability, loan to value fluctuations, the type and structure of the loan, conformity of the loan to bank policy and payment performance. Based on the total score, a loan grade of A, B, C, S, D, E or F is applied. A grade of A will generally be applied to loans for customers that are well known to the Company and that have excellent sources of repayment. A grade of B will generally be applied to loans for customers that have excellent sources of repayment which have no identifiable risk of collection. A grade of C will generally be applied to loans for customers that have adequate sources of repayment which have little identifiable risk of collection. A grade of S will generally be applied to loans for customers who meet the criteria for a grade of C but also warrant additional monitoring by placement on the watch list. A grade of D will generally be applied to loans for customers that are inadequately protected by current sound net worth, paying capacity of the borrower, or pledged collateral. Loans with a grade of D have unsatisfactory characteristics such as cash flow deficiencies, bankruptcy filing by the borrower or dependence on the sale of collateral for the primary source of repayment, causing more than acceptable levels of risk. Loans 60 to 89 days past due receive a grade of D. A grade of E will generally be applied to loans for customers with weaknesses inherent in the D classification and in which collection or liquidation in full is questionable. In addition, on a monthly basis the Company determines which loans are 90 days or more past due and assigns a grade of E to them. A grade of F is applied to

loans which are considered uncollectible and of such little value that their continuance in an active bank is not warranted. Loans with this grade are charged off, even though partial or full recovery may be possible in the future.

An analysis of the loan portfolio by loan grade, segregated by class of loans, as of September 30, 2017 and December 31, 2016, is as follows (in thousands):

	Loans With A Grade Of:					Total
	A, B or C	S	D	E	F	
September 30, 2017:						
Gaming	\$ 18,824	\$	\$	\$	\$	\$ 18,824
Residential and land development				273		273
Real estate, construction	29,323		368	1,307		30,998
Real estate, mortgage	142,805	15,833	20,861	10,504		190,003
Commercial and industrial	13,720	9,132	271	2,886		26,009
Other	6,688		24	4		6,716
Total	\$ 211,360	\$ 24,965	\$ 21,524	\$ 14,974	\$	\$ 272,823
December 31, 2016:						
Gaming	\$ 31,311	\$	\$	\$	\$	\$ 31,311
Residential and land development				291		291
Real estate, construction	29,954	435	517	1,597		32,503
Real estate, mortgage	155,671	17,651	22,901	9,949		206,172
Commercial and industrial	13,926	21,680	867	562		37,035
Other	7,996		42	5		8,043
Total	\$ 238,858	\$ 39,766	\$ 24,327	\$ 12,404	\$	\$ 315,355

A loan may be impaired but not on nonaccrual status when the loan is well secured and in the process of collection. Total loans on nonaccrual as of September 30, 2017 and December 31, 2016, are as follows (in thousands):

	September 30, 2017	December 31, 2016
Residential and land development	\$ 273	\$ 291
Real estate, construction	1,307	1,598
Real estate, mortgage	9,992	9,445
Commercial and industrial	2,808	515
Other	4	5
Total	\$ 14,384	\$ 11,854

Prior to 2016, certain loans were modified by granting interest rate concessions to these customers with such loans being classified as troubled debt restructurings. During 2016 and 2017, the Company did not restructure any additional loans. Specific reserves of \$88,000 and \$100,000 were allocated to troubled debt restructurings as of September 30, 2017 and December 31, 2016, respectively. The Bank had no commitments to lend additional amounts to customers with outstanding loans classified as troubled debt restructurings as of September 30, 2017 and December 31, 2016.

Impaired loans, which include loans classified as nonaccrual and troubled debt restructurings, segregated by class of loans, as of September 30, 2017 and December 31, 2016, are as follows (in thousands):

	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
September 30, 2017:					
With no related allowance recorded:					
Real estate, construction	\$ 1,562	\$ 1,088	\$	\$ 1,132	\$
Real estate, mortgage	9,354	8,382		9,053	21
Commercial and industrial	2,797	2,758		2,780	
Other	4	4		4	
Total	13,717	12,232		12,969	21
With a related allowance recorded:					
Residential and land development	273	273	49	278	
Real estate, construction	219	219	112	230	
Real estate, mortgage	3,653	2,769	722	2,751	23
Commercial and industrial	50	50	15	49	
Total	4,195	3,311	898	3,308	23
Total by class of loans:					
Residential and land development	273	273	49	278	
Real estate, construction	1,781	1,307	112	1,362	
Real estate, mortgage	13,007	11,151	722	11,804	44
Commercial and industrial	2,847	2,808	15	2,829	
Other	4	4		4	
Total	\$ 17,912	\$ 15,543	\$ 898	\$ 16,277	\$ 44

	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2016:					
With no related allowance recorded:					
Real estate, construction	\$ 2,023	\$ 1,331	\$	\$ 1,395	\$
Real estate, mortgage	11,811	9,282		10,582	23
Commercial and industrial	553	515		538	
Total	14,387	11,128		12,515	23
With a related allowance recorded:					
Residential and land development	291	291	66	304	
Real estate, construction	267	267	141	283	
Real estate, mortgage	1,347	1,347	195	1,080	30
Other	5	5	1	1	
Total	1,910	1,910	403	1,668	30
Total by class of loans:					
Residential and land development	291	291	66	304	
Real estate, construction	2,290	1,598	141	1,678	
Real estate, mortgage	13,158	10,629	195	11,662	53
Commercial and industrial	553	515		538	
Other	5	5	1	1	
Total	\$ 16,297	\$ 13,038	\$ 403	\$ 14,183	\$ 53

6. Allowance for Loan Losses:

Transactions in the allowance for loan losses for the quarters and nine months ended September 30, 2017 and 2016, and the balances of loans, individually and collectively evaluated for impairment, as of September 30, 2017 and 2016, are as follows (in thousands):

	Gaming	Residential and Land Development	Real Estate, Construction	Real Estate, Mortgage	Commercial and Industrial	Other	Total
For the Nine Months Ended							
September 30, 2017:							
Allowance for Loan Losses:							
Beginning balance	\$ 545	\$ 66	\$ 199	\$ 3,800	\$ 651	\$ 205	\$ 5,466
Charge-offs				(8)	(32)	(158)	(198)
Recoveries		685	31	12	11	60	799
Provision	(119)	(701)	43	854	(99)	107	85
Ending Balance	\$ 426	\$ 50	\$ 273	\$ 4,658	\$ 531	\$ 214	\$ 6,152
For the Quarter Ended							
September 30, 2017:							
Allowance for Loan Losses:							
Beginning Balance	\$ 396	\$ 58	\$ 232	\$ 3,916	\$ 672	\$ 207	\$ 5,481
Charge-offs					(32)	(63)	(95)
Recoveries		685	19	4		29	737
Provision	30	(693)	22	738	(109)	41	29
Ending Balance	\$ 426	\$ 50	\$ 273	\$ 4,658	\$ 531	\$ 214	\$ 6,152
Allowance for Loan Losses,							
September 30, 2017:							
Ending balance: individually evaluated for impairment	\$	\$ 50	\$ 112	\$ 999	\$ 211	\$ 14	\$ 1,386
Ending balance: collectively evaluated for impairment	\$ 426	\$	\$ 161	\$ 3,659	\$ 320	\$ 200	\$ 4,766
Total Loans, September 30, 2017:							
Ending balance: individually evaluated for impairment	\$	\$ 273	\$ 1,675	\$ 31,365	\$ 3,157	\$ 28	\$ 36,498
Ending balance: collectively evaluated for impairment	\$ 18,824	\$	\$ 29,323	\$ 158,638	\$ 22,852	\$ 6,688	\$ 236,325

	Gaming	Residential and Land Development	Real Estate, Construction	Real Estate, Mortgage	Commercial and Industrial	Other	Total
For the Nine Months Ended September 30, 2016:							
Allowance for Loan Losses:							
Beginning balance	\$ 582	\$ 189	\$ 589	\$ 5,382	\$ 1,075	\$ 253	\$ 8,070
Charge-offs			(173)	(700)	(509)	(153)	(1,535)
Recoveries			57	107	61	50	275
Provision	48	20	(113)	(24)	127	79	137
Ending Balance	\$ 630	\$ 209	\$ 360	\$ 4,765	\$ 754	\$ 229	\$ 6,947
For the Quarter Ended September 30, 2016:							
Allowance for Loan Losses:							
Beginning Balance	\$ 582	\$ 202	\$ 375	\$ 4,976	\$ 718	\$ 256	\$ 7,109
Charge-offs				(147)		(59)	(206)
Recoveries			19	8	1	16	44
Provision	48	7	(34)	(72)	35	16	
Ending Balance	\$ 630	\$ 209	\$ 360	\$ 4,765	\$ 754	\$ 229	\$ 6,947
Allowance for Loan Losses, September 30, 2016:							
Ending balance: individually evaluated for impairment	\$	\$ 109	\$ 239	\$ 1,311	\$ 218	\$ 17	\$ 1,894
Ending balance: collectively evaluated for impairment	\$ 630	\$ 100	\$ 121	\$ 3,454	\$ 536	\$ 212	\$ 5,053
Total Loans, September 30, 2016:							
Ending balance: individually evaluated for impairment	\$	\$ 300	\$ 2,285	\$ 35,260	\$ 1,733	\$ 33	\$ 39,611
Ending balance: collectively evaluated for impairment	\$ 33,442	\$ 610	\$ 38,062	\$ 167,348	\$ 37,359	\$ 7,675	\$ 284,496

7. Deposits:

Time deposits of \$100,000 or more at December 31, 2016 included brokered deposits of \$5,000,000, which matured in 2017.

Time deposits of \$250,000 or more totaled approximately \$32,483,000 and \$25,143,000 at September 30, 2017 and December 31, 2016, respectively.

8. Shareholders Equity:

On September 20, 2017, the Company declared a dividend of \$.01 per share. The dividend had a record date of October 2, 2017 and a payment date of October 13, 2017.

9. Fair Value Measurements and Disclosures:

The Company utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Available for sale securities are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to

record other assets at fair value on a non-recurring basis, such as impaired loans and ORE. These non-recurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets. Additionally, the Company is required to disclose, but not record, the fair value of other financial instruments.

Fair Value Hierarchy

The Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1 - Valuation is based upon quoted prices for identical instruments traded in active markets.

Level 2 - Valuation is based upon quoted market prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 - Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include the use of option pricing models, discounted cash flow models and similar techniques.

Following is a description of valuation methodologies used to determine the fair value of financial assets and liabilities.

Cash and Due from Banks

The carrying amount shown as cash and due from banks approximates fair value.

Available for Sale Securities

The fair value of available for sale securities is based on quoted market prices. The Company's available for sale securities are reported at their estimated fair value, which is determined utilizing several sources. The primary source is Interactive Data Corporation, which utilizes pricing models that vary based on asset class and include available trade, bid and other market information and whose methodology includes broker quotes, proprietary models and vast descriptive databases. Another source for determining fair value is matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark securities. The Company's available for sale securities for which fair value is determined through the use of such pricing models and matrix pricing are classified as Level 2 assets. If the fair value of available for sale securities is generated through model-based techniques, including the discounting of estimated cash flows, such securities are classified as Level 3 assets.

Held to Maturity Securities

The fair value of held to maturity securities is based on quoted market prices.

Other Investments

The carrying amount shown as other investments approximates fair value.

Federal Home Loan Bank Stock

The carrying amount shown as Federal Home Loan Bank Stock approximates fair value.

Loans

The fair value of fixed rate 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 for the remaining maturities. The cash flows considered in computing the fair value of such loans are segmented into categories relating to the nature of the contract and collateral based on contractual principal maturities. Appropriate adjustments are made to reflect probable credit losses. Cash flows have not been adjusted for such factors as prepayment risk or the effect of the maturity of balloon notes. The fair value of floating rate loans is estimated to be its carrying value. At each reporting period, the Company determines which loans are impaired. Accordingly, the Company's impaired loans are reported at their estimated fair value on a non-recurring basis. An allowance for each impaired loan, which are generally collateral-dependent, is calculated based on the fair value of its collateral. The fair value of the collateral is based on appraisals performed by third-party valuation specialists. Factors including the assumptions and techniques utilized by the appraiser are considered by Management. If the recorded investment in the impaired loan exceeds the measure of fair value of the collateral, a valuation allowance is recorded as a component of the allowance for loan losses. Impaired loans are non-recurring Level 3 assets.

Other Real Estate

In the course of lending operations, Management may determine that it is necessary to foreclose on the related collateral. Other real estate acquired through foreclosure is carried at fair value, less estimated costs to sell. The fair value of the collateral is based on appraisals performed by third-party valuation specialists. Factors including the assumptions and techniques utilized by the appraiser are considered by Management. If the current appraisal is more than one year old and/or the loan balance is more than \$200,000, a new appraisal is obtained. Otherwise, the Bank's in-house property evaluator and Management will determine the fair value of the collateral, based on comparable sales, market conditions, Management's plans for disposition and other estimates of fair value obtained from principally independent sources, adjusted for estimated selling costs. Other real estate is a non-recurring Level 3 asset.

Cash Surrender Value of Life Insurance

The carrying amount of cash surrender value of bank-owned life insurance approximates fair value.

Deposits

The fair value of non-interest bearing demand and interest bearing savings and demand deposits is the amount reported in the financial statements. The fair value of time deposits is estimated by discounting the cash flows using current rates of time deposits with similar remaining maturities. The cash flows considered in computing the fair value of such deposits are based on contractual maturities, since approximately 98% of time deposits provide for automatic renewal at current

interest rates.

Borrowings from Federal Home Loan Bank

The fair value of Federal Home Loan Bank (FHLB) fixed rate borrowings is estimated using discounted cash flows based on current incremental borrowing rates for similar types of borrowing arrangements. The fair value of FHLB variable rate borrowings is estimated to be its carrying value.

The balances of available for sale securities, which are the only assets measured at fair value on a recurring basis, by level within the fair value hierarchy and by investment type, as of September 30, 2017 and December 31, 2016 are as follows (in thousands):

	Total	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
September 30, 2017:				
U.S. Treasuries	\$ 133,577	\$	\$ 133,577	\$
U.S. Government agencies	19,972		19,972	
Mortgage-backed securities	77,203		77,203	
States and political subdivisions	14,578		14,578	
Equity securities	458		458	
Total	\$ 245,788	\$	\$ 245,788	\$
December 31, 2016:				
U.S. Treasuries	\$ 147,624	\$	\$ 147,624	\$
U.S. Government agencies	24,825		24,825	
Mortgage-backed securities	42,708		42,708	
States and political subdivisions	17,963		17,963	
Equity securities	458		458	
Total	\$ 233,578	\$	\$ 233,578	\$

Impaired loans, which are measured at fair value on a non-recurring basis, by level within the fair value hierarchy as of September 30, 2017 and December 31, 2016 are as follows (in thousands):

	Total	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
September 30, 2017	\$ 5,134	\$	\$	\$ 5,134
December 31, 2016	5,006			5,006

Other real estate, which is measured at fair value on a non-recurring basis, by level within the fair value hierarchy as of September 30, 2017 and December 31, 2016 are as follows (in thousands):

	Fair Value Measurements Using			
	Total	Level 1	Level 2	Level 3
September 30, 2017	\$ 8,081	\$	\$	\$ 8,081
December 31, 2016	8,513			8,513

The following table presents a summary of changes in the fair value of other real estate which is measured using level 3 inputs (in thousands):

	For the Nine Months Ended September 30, 2017	For the Year Ended December 31, 2016
Balance, beginning of period	\$ 8,513	\$ 9,916
Loans transferred to ORE	1,356	1,903
Sales	(1,391)	(2,524)
Writedowns	(397)	(782)
Balance, end of period	\$ 8,081	\$ 8,513

The carrying value and estimated fair value of financial instruments, by level within the fair value hierarchy, at September 30, 2017 and December 31, 2016, are as follows (in thousands):

	Carrying Amount	Fair Value Measurements Using			Total
		Level 1	Level 2	Level 3	
September 30, 2017:					
Financial Assets:					
Cash and due from banks	\$ 42,278	\$ 42,278	\$	\$	\$ 42,278
Available for sale securities	245,788		245,788		245,788
Held to maturity securities	49,405		49,303		49,303
Other investments	2,729	2,729			2,729
Federal Home Loan Bank stock	544		544		544
Loans, net	266,671			262,170	262,170
Other real estate	8,081			8,081	8,081
Cash surrender value of life insurance	18,153		18,153		18,153
Financial Liabilities:					
Deposits:					
Non-interest bearing	147,975	147,975			147,975
Interest bearing	397,092			397,562	397,562
Borrowings from Federal Home Loan Bank	1,216		1,509		1,509

	Carrying Amount	Fair value Level 1	Measurements Level 2	Using Level 3	Total
December 31, 2016:					
Financial Assets:					
Cash and due from banks	\$ 41,116	\$ 41,116	\$	\$	\$ 41,116
Available for sale securities	233,578		233,578		233,578
Held to maturity securities	48,150		46,935		46,935
Other investments	2,693	2,693			2,693
Federal Home Loan Bank stock	539		539		539
Loans, net	309,889			313,613	313,613
Other real estate	8,513			8,513	8,513
Cash surrender value of life insurance	19,249		19,249		19,249
Financial Liabilities:					
Deposits:					
Non-interest bearing	132,381	132,381			132,381
Interest bearing	442,635			442,937	442,937
Borrowings from Federal Home Loan Bank	6,257		6,491		6,491

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

GENERAL

The Company is a one-bank holding company headquartered in Biloxi, Mississippi. The Company has two operating subsidiaries, PFC Service Corp., an inactive company, and The Peoples Bank, Biloxi, Mississippi (the Bank). The Bank provides a full range of banking, financial and trust services to state, county and local government entities and individuals and small and commercial businesses operating in those portions of Mississippi, Louisiana and Alabama which are within a fifty mile radius of the Waveland, Wiggins and Gautier branches, the Bank's three most outlying locations (the trade area).

The following presents Management's discussion and analysis of the consolidated financial condition and results of operations of Peoples Financial Corporation and Subsidiaries. These comments should be considered in combination with the Consolidated Financial Statements and Notes to Consolidated Financial Statements included in this report on Form 10-Q and the Consolidated Financial Statements, Notes to Consolidated Financial Statements and Management's Discussion and Analysis included in the Company's Form 10-K for the year ended December 31, 2016.

Forward-Looking Information

Congress passed the Private Securities Litigation Act of 1995 in an effort to encourage corporations to provide information about a company's anticipated future financial performance. This act provides a safe harbor for such disclosure which protects the companies from unwarranted litigation if actual results are different from management expectations. This report contains forward-looking statements and reflects industry conditions, company performance and financial results. These forward-looking statements are subject to a number of factors and uncertainties which could cause the Company's actual results and experience to differ from the anticipated results and expectations expressed in such forward-looking statements. Such factors and uncertainties include, but are not limited to: changes in interest rates and market prices, changes in local economic and business conditions, increased competition for deposits and loans, a deviation in actual experience from the underlying assumptions used to determine and establish the allowance for loan losses, changes in the availability of funds resulting from reduced liquidity, changes in government regulations and acts of terrorism, weather or other events beyond the Company's control.

New Accounting Pronouncements

The Financial Accounting Standards Board (FASB) has issued several new accounting standards updates for the first three quarters of 2017 which are disclosed in the Notes to Unaudited Consolidated Financial Statements. The Company does not generally expect that these updates will have a material effect on its financial position or results of operations but the effect of ASU 2016-13 is still being considered.

Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires Management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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. The Company evaluates these estimates and assumptions on an on-going basis using historical experience and other factors, including the current economic environment. We adjust such estimates and assumptions when facts and circumstances dictate. Certain critical accounting policies affect the more significant estimates and assumptions used in the preparation of the consolidated financial statements.

Investments

Investments which are classified as available for sale are stated at fair value. A decline in the market value of an investment below cost that is deemed to be other-than-temporary is charged to earnings for the decline in value deemed to be credit related and a new cost basis in the security is established. The decline in value attributed to non-credit related factors is recognized in other comprehensive income. The determination of the fair value of securities may require Management to develop estimates and assumptions regarding the amount and timing of cash flows.

Allowance for loan losses

The Company's allowance for loan losses (ALL) reflects the estimated losses resulting from the inability of its borrowers to make loan payments. The ALL is established and maintained at an amount sufficient to cover the estimated loss associated with the loan portfolio of the Company as of the date of the financial statements. Credit losses arise not only from credit risk, but also from other risks inherent in the lending process including, but not limited to, collateral risk, operation risk, concentration risk and economic risk. As such, all related risks of lending are considered when assessing the adequacy of the ALL. On a quarterly basis, Management estimates the probable level of losses to determine whether the allowance is adequate to absorb reasonably foreseeable, anticipated losses in the existing portfolio based on our past loan loss experience, known and inherent risk in the portfolio, adverse situations that may affect the borrowers' ability to repay and the estimated value of any underlying collateral and current economic conditions. Management believes that the ALL is adequate and appropriate for all periods presented in these financial statements. If there was a deterioration of any of the factors considered by Management in evaluating the ALL, the estimate of loss would be updated, and additional provisions for loan losses may be required. The analysis divides the portfolio into two segments: a pool analysis of loans based upon a five year average loss history which is updated on a quarterly basis and which may be adjusted by qualitative factors by loan type and a specific reserve analysis for those loans considered impaired under GAAP. All credit relationships with an outstanding balance of \$100,000 or greater that are included in Management's loan watch list are individually reviewed for impairment. All losses are charged to the ALL when the loss actually occurs or when a determination is made that a loss is likely to occur; recoveries are credited to the ALL at the time of receipt.

Other Real Estate

Other real estate (ORE) includes real estate acquired through foreclosure. Each ORE property

is carried at fair value, less estimated costs to sell. Fair value is principally based on appraisals performed by third-party valuation specialists. If Management determines that the fair value of a property has decreased subsequent to foreclosure, the Company records a write down which is included in non-interest expense.

Employee Benefit Plans

Employee benefit plan liabilities and pension costs are determined utilizing actuarially determined present value calculations. The valuation of the benefit obligation and net periodic expense is considered critical, as it requires Management and its actuaries to make estimates regarding the amount and timing of expected cash outflows including assumptions about mortality, expected service periods and the rate of compensation increases.

Income Taxes

GAAP requires the asset and liability approach for financial accounting and reporting for deferred income taxes. We use the asset and liability method of accounting for deferred income taxes and provide deferred income taxes for all significant income tax temporary differences. As part of the process of preparing our consolidated financial statements, the Company is required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items, such as the provision for the allowance for loan losses, for tax and financial reporting purposes. These differences result in deferred tax assets and liabilities that are included in our consolidated statement of condition. We must also assess the likelihood that our deferred tax assets will be recovered from future taxable income, and to the extent we believe that recovery is not likely, we must establish a valuation allowance. Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. To the extent the Company establishes a valuation allowance or adjusts this allowance in a period, we must include an expense or benefit within the tax provision in the consolidated statement of income.

GAAP Reconciliation and Explanation

This Form 10-Q contains non-GAAP financial measures determined by methods other than in accordance with GAAP. Such non-GAAP financial measures include taxable equivalent interest income and taxable equivalent net interest income. Management uses these non-GAAP financial measures because it believes they are useful for evaluating our operations and performance over periods of time, as well as in managing and evaluating our business and in discussions about our operations and performance. Management believes these non-GAAP financial measures provide users of our financial information with a meaningful measure for assessing our financial results, as well as comparison to financial results for prior periods. These non-GAAP financial measures should not be considered as a substitute for operating results determined in accordance with GAAP and may not be comparable to other similarly titled financial measures used by other companies. A reconciliation of these operating performance measures to GAAP performance measures for the three months and nine months ended September 30, 2017 and 2016 is included in the table on the following page.

RECONCILIATION OF NON-GAAP PERFORMANCE MEASURES (In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Interest income reconciliation:				
Interest income - taxable equivalent	\$ 4,751	\$ 4,753	\$ 14,232	\$ 14,401
Taxable equivalent adjustment	(128)	(160)	(410)	(478)
Interest income (GAAP)	\$ 4,623	\$ 4,593	\$ 13,822	\$ 13,923
Net interest income reconciliation:				
Net interest income - taxable equivalent	\$ 4,362	\$ 4,486	\$ 13,219	\$ 13,625
Taxable equivalent adjustment	(128)	(160)	(410)	(478)
Net interest income (GAAP)	\$ 4,234	\$ 4,326	\$ 12,809	\$ 13,147

OVERVIEW

The Company is a community bank serving the financial and trust needs of its customers in our trade area, which is defined as those portions of Mississippi, Louisiana and Alabama which are within a fifty mile radius of the Waveland, Wiggins and Gautier branches, the bank subsidiary's three most outlying locations. Maintaining a strong core deposit base and providing commercial and real estate lending in our trade area are the traditional focuses of the Company. Growth has largely been achieved through de novo branching activity, and it is expected that these strategies will continue to be emphasized in the future.

The Company earned net income of \$236,000 for the third quarter of 2017 compared with net income of \$406,000 for the third quarter of 2016 and net income of \$1,463,000 for the first three quarters of 2017 compared with net income of \$543,000 for the first three quarters of 2016. Results for the first three quarters of 2017 were significantly impacted by a non-recurring gain of \$429,000 from the redemption of death benefits on bank owned life insurance and a tax benefit of \$338,000, which reflects a correction to expected refunds for prior years.

Managing the net interest margin in the Company's highly competitive market and in the context of larger economic conditions has been very challenging and will continue to be so, for the foreseeable future. Net interest income for the third quarter of 2017 as compared with the third quarter of 2016 decreased \$92,000 as the reduction in interest and fees on loans was offset by the increase in interest and dividends on securities. Net interest income for the three quarters ended September 30, 2017, decreased \$338,000 as compared with the three quarters ended September 30, 2016 as the reduction in interest and fees on loans decreased more than the increase in interest expense on deposits.

Monitoring asset quality, estimating potential losses in our loan portfolio and addressing non-performing loans continue to be emphasized during these difficult economic times, as the local economy continues to negatively impact collateral values and borrowers' ability to repay their

loans. The provision for the allowance for loan losses was \$29,000 and \$85,000 for the third quarter and first three quarters of 2017, respectively, compared with no provision and \$137,000, respectively, for the third quarter and first three quarters of 2016. The Company is working diligently to address and reduce its non-performing assets. The Company's nonaccrual loans totaled \$14,384,000 and \$11,854,000 at September 30, 2017 and December 31, 2016, respectively. Most of these loans are collateral-dependent, and the Company has rigorously evaluated the value of its collateral to determine potential losses.

Non-interest income decreased \$156,000 and increased \$390,000 for the third quarter and first three quarters of 2017 as compared with 2016. The decrease for the third quarter of 2017 as compared with the third quarter of 2016 was primarily the result of the prior year including a gain from the sale of bank premises. The increase for the first three quarters of 2017 as compared with the first three quarters of 2016 was a result of the gain discussed in the Overview.

Non-interest expense decreased \$107,000 and \$400,000 for the third quarter and first three quarters of 2017 as compared with 2016 results. The decrease for the third quarter of 2017 was primarily the result of decreases in net occupancy expenses of \$66,000 and FDIC and state banking assessments of \$102,000, which were partially offset by an increase in Other real estate expense of \$279,000 as compared with 2016. This decrease for the first three quarters of 2017 was the result of decreases in net occupancy expenses of \$250,000 and FDIC and state banking assessments of \$334,000, which were partially offset by an increase in Other real estate expense of \$135,000 as compared with 2016.

Total assets at September 30, 2017 decreased \$31,027,000 as compared with December 31, 2016. Available for sale securities increased \$12,210,000 as excess funds were invested to increase earnings. Total loans decreased \$42,532,000 as principal payments, maturities, charge-offs and foreclosures relating to existing loans outpaced new loans. Total deposits decreased \$29,949,000 at September 30, 2017 as compared with December 31, 2016 as customers in the casino industry and county and municipal entities reallocate their resources periodically.

RESULTS OF OPERATIONS

Net Interest Income

Net interest income, the amount by which interest income on loans, investments and other interest-earning assets exceeds interest expense on deposits and other borrowed funds, is the single largest component of the Company's income. Management's objective is to provide the largest possible amount of income while balancing interest rate, credit, liquidity and capital risk. Changes in the volume and mix of interest-earning assets and interest-bearing liabilities combined with changes in market rates of interest directly affect net interest income.

Quarter Ended September 30, 2017 as Compared with Quarter Ended September 30, 2016

The Company's average interest-earning assets decreased approximately \$12,876,000, or 2%, from approximately \$604,008,000 for the third quarter of 2016 to approximately \$591,132,000 for the third quarter of 2017. Average held to maturity taxable securities increased approximately

\$21,538,000 and average available for sale taxable securities increased approximately \$46,819,000 as a result of the decrease in average balances due from financial institutions and average loans. Average balances due from financial institutions decreased \$29,325,000 as the Company's liquidity needs decreased. The Company's average loans decreased approximately \$44,389,000 as principal payments, maturities, charge-offs and foreclosures relating to existing loans outpaced new loans.

The average yield on earning assets increased by 6 basis points, from 3.15% for the third quarter of 2016 to 3.21% for the third quarter of 2017. The yield on average loans increased from 4.40% for the third quarter of 2016 to 4.53% for the third quarter of 2017 primarily as a result of the effect of the increase in prime rate during 2016 and 2017 on the Company's floating rate loans. The yield on average taxable available for sale securities increased from 1.27% for the third quarter of 2016 to 1.52% for the third quarter of 2017 as the Company has changed its investment strategy to improve yield while not compromising duration and credit risk.

Average interest-bearing liabilities decreased approximately \$10,639,000, or 2%, from approximately \$443,591,000 for the third quarter of 2016 to approximately \$432,952,000 for the third quarter of 2017. Average savings and interest-bearing DDA balances decreased \$7,850,000 primarily as a result of one large public fund reallocating most of their balance to another institution. Average borrowings from the Federal Home Loan Bank decreased approximately \$5,694,000 due to the reduced liquidity needs of the bank subsidiary.

The average rate paid on interest-bearing liabilities for the third quarter of 2016 was .24% as compared with .36% for the third quarter of 2017. The increase was the result of time deposit rates increasing in our trade area and the Company being able to pay off lower rate borrowings from FHLB.

The Company's net interest margin on a tax-equivalent basis, which is net interest income as a percentage of average earning assets, was 2.97% for the third quarter of 2016 as compared with 2.95% for the third quarter of 2017.

Nine Months Ended September 30, 2017 as Compared with Nine Months Ended September 30, 2016

The Company's average interest-earning assets increased approximately \$13,349,000, or 2%, from approximately \$592,372,000 for the first three quarters of 2016 to approximately \$605,721,000 for the first three quarters of 2017. Average held to maturity taxable securities increased approximately \$24,538,000 and average available for sale taxable securities increased approximately \$27,743,000 as a result of the decrease in average loans. The Company's average loans decreased approximately \$36,530,000 as principal payments, maturities, charge-offs and foreclosures relating to existing loans outpaced new loans.

The average yield on earning assets decreased by 11 basis points, from 3.24% for the first three quarters of 2016 to 3.13% for the first three quarters of 2017. This decrease was the result of the increase in volume in lower yielding assets, such as investment securities, as compared with higher yielding assets, such as loans.

Average interest-bearing liabilities increased approximately \$638,000, or 1%, from approximately \$446,475,000 for the first three quarters of 2016 to approximately \$447,113,000 for the first three quarters of 2017. Average savings and interest bearing DDA balances increased approximately \$4,605,000 and average time deposits increased \$3,483,000 primarily as customers in the casino industry and county and municipal entities reallocate their balances periodically. Average borrowings from the Federal Home Loan Bank decreased approximately \$7,450,000 due to the liquidity needs of the bank subsidiary.

The average rate paid on interest-bearing liabilities for the first three quarters of 2016 was .23% compared with .30% for the first three quarters of 2017 as a result of the increase in prime rate.

The Company's net interest margin on a tax-equivalent basis, which is net interest income as a percentage of average earning assets, was 3.07% for the first three quarters of 2016 as compared with 2.91% for the first three quarters of 2017.

The tables on the following pages analyze the changes in tax-equivalent net interest income for the quarters and nine months ended September 30, 2017 and 2016.

Analysis of Average Balances, Interest Earned/Paid and Yield

(In Thousands)

	Quarter Ended September 30, 2017			Quarter Ended September 30, 2016		
	Average Balance	Interest Earned/Paid	Rate	Average Balance	Interest Earned/Paid	Rate
Loans (2)(3)	\$ 279,771	\$ 3,165	4.53%	\$ 324,160	\$ 3,568	4.40%
Balances due from depository institutions	25,409	148	2.33%	54,734	95	0.69%
HTM:						
Taxable	30,131	207	2.75%	8,593	60	0.01%
Non taxable (1)	18,802	177	3.77%	19,981	191	3.82%
AFS:						
Taxable	221,196	842	1.52%	174,377	553	1.27%
Non taxable (1)	14,821	204	5.51%	20,422	277	5.43%
Other	1,002	8	3.19%	1,741	9	2.07%
Total	\$ 591,132	\$ 4,751	3.21%	\$ 604,008	\$ 4,753	3.15%
Savings & interest-bearing DDA	\$ 350,100	\$ 218	0.25%	\$ 357,950	\$ 116	0.13%
Time deposits	81,632	163	0.80%	78,727	121	0.61%
Borrowings from FHLB	1,220	8	2.62%	6,914	30	1.74%
Total	\$ 432,952	\$ 389	0.36%	\$ 443,591	\$ 267	0.24%
Net tax-equivalent spread			2.86%			2.91%
Net tax-equivalent margin on earning assets			2.95%			2.97%

(1) All interest earned is reported on a taxable equivalent basis using a tax rate of 34% in 2017 and 2016. See disclosure of Non-GAAP financial measures on pages 31 and 32.

(2) Loan fees of \$59 and \$119 for 2017 and 2016, respectively, are included in these figures.

(3) Includes nonaccrual loans.

Analysis of Average Balances, Interest Earned/Paid and Yield

(In Thousands)

	Nine Months Ended September 30, 2017			Nine Months Ended September 30, 2016		
	Average Balance	Interest Earned/Paid	Rate	Average Balance	Interest Earned/Paid	Rate
Loans (2)(3)	\$ 294,492	\$ 9,734	4.41%	\$ 331,022	\$ 10,833	4.36%
Balances due from depository institutions	34,050	384	1.50%	29,814	212	0.95%
HTM:						
Taxable	28,449	524	2.46%	3,911	61	2.08%
Non taxable (1)	19,239	541	3.75%	19,473	541	3.70%
AFS:						
Taxable	212,435	2,370	1.49%	184,692	1,870	1.35%
Non taxable (1)	16,055	665	5.52%	21,482	865	5.37%
Other	1,001	14	1.86%	1,978	19	1.28%
Total	\$ 605,721	\$ 14,232	3.13%	\$ 592,372	\$ 14,401	3.24%
Savings & interest-bearing DDA	\$ 364,732	\$ 535	0.20%	\$ 360,127	\$ 330	0.12%
Time deposits	80,928	446	0.73%	77,445	331	0.57%
Borrowings from FHLB	1,453	32	2.94%	8,903	115	1.72%
Total	\$ 447,113	\$ 1,013	0.30%	\$ 446,475	\$ 776	0.23%
Net tax-equivalent spread			2.83%			3.01%
Net tax-equivalent margin on earning assets			2.91%			3.07%

(1) All interest earned is reported on a taxable equivalent basis using a tax rate of 34% in 2017 and 2016. See disclosure of Non-GAAP financial measures on pages 31 and 32.

(2) Loan fees of \$238 and \$314 for 2017 and 2016, respectively, are included in these figures.

(3) Includes nonaccrual loans.

Analysis of Changes in Interest Income and Interest Expense

(In Thousands)

	For the Quarter Ended September 30, 2017 compared with September 30, 2016			
	Volume	Rate	Rate/Volume	Total
Interest earned on:				
Loans	\$ (489)	\$ 99	\$ (13)	\$ (403)
Balances due from financial institutions	(51)	224	(120)	53
Held to maturity securities:				
Taxable	150	(1)	(2)	147
Non taxable	(11)	(3)		(14)
Available for sale securities:				
Taxable	148	111	30	289
Non taxable	(76)	4	(1)	(73)
Other	(4)	5	(2)	(1)
Total	\$ (333)	\$ 439	\$ (108)	\$ (2)
Interest paid on:				
Savings & interest-bearing DDA	\$ (3)	\$ 107	\$ (2)	\$ 102
Time deposits	4	36	2	42
Borrowings from FHLB	(25)	15	(12)	(22)
Total	\$ (24)	\$ 158	\$ (12)	\$ 122

Analysis of Changes in Interest Income and Interest Expense

(In Thousands)

	For the Nine Months Ended			
	September 30, 2017 compared with September 30, 2016			
	Volume	Rate	Rate/Volume	Total
Interest earned on:				
Loans	\$ (1,195)	\$ 108	\$ (12)	\$ (1,099)
Balances due from financial institutions	30	124	18	172
Held to maturity securities:				
Taxable	383	11	69	463
Non taxable	(7)	7		
Available for sale securities:				
Taxable	281	190	29	500
Non taxable	(219)	25	(6)	(200)
Other	(9)	8	(4)	(5)
Total	\$ (736)	\$ 473	\$ 94	\$ (169)
Interest paid on:				
Savings & interest-bearing DDA	\$ 4	\$ 198	\$ 3	\$ 205
Time deposits	15	96	4	115
Borrowings from FHLB	(96)	81	(68)	(83)
Total	\$ (77)	\$ 375	\$ (61)	\$ 237

Provision for the Allowance for Loan Losses

In the normal course of business, the Company assumes risk in extending credit to its customers. This credit risk is managed through compliance with the loan policy, which is approved by the Board of Directors. The policy establishes guidelines relating to underwriting standards, including but not limited to financial analysis, collateral valuation, lending limits, pricing considerations and loan grading. The Company's Loan Review and Special Assets Departments play key roles in monitoring the loan portfolio and managing problem loans. New loans and, on a periodic basis, existing loans are reviewed to evaluate compliance with the loan policy. Loan customers in concentrated industries such as gaming and hotel/motel, as well as the exposure for out of area; residential and land development; construction and commercial real estate loans, and their direct and indirect impact on its operations are evaluated on a monthly basis. Loan delinquencies and deposit overdrafts are closely monitored in order to identify developing problems as early as possible. Lenders experienced in workout scenarios consult with loan officers and customers to address non-performing loans. A watch list of credits which pose a potential loss to the Company is prepared based on the loan grading system. This list forms the foundation of the Company's allowance for loan loss computation.

Management relies on its guidelines and existing methodology to monitor the performance of its loan portfolio and identify and estimate potential losses based on the best available information. The potential effect of the continuing decline in real estate values and actual losses incurred by the Company were key factors in our analysis. Much of the Company's loan portfolio is collateral-dependent, requiring careful consideration of changes in the value of the collateral.

The Company's analysis includes evaluating the current values of collateral securing all nonaccrual loans. Even though nonaccrual loans were \$14,384,000 and \$11,854,000 at September 30, 2017 and December 31, 2016, respectively, specific reserves of only \$810,000 and \$303,000, respectively, have been allocated to these loans as collateral values appear sufficient to cover loan losses or the loan balances have been charged down to their realizable value.

The Company's on-going, systematic evaluation resulted in the Company recording a provision for the allowance for loan losses of \$29,000 for the third quarter of 2017 and \$85,000 and \$137,000 for the first three quarters of 2017 and 2016, respectively. The allowance for loan losses as a percentage of loans was 2.25% and 1.73% at September 30, 2017 and December 31, 2016, respectively. The Company believes that its allowance for loan losses is appropriate as of September 30, 2017.

The allowance for loan losses is an estimate, and as such, events may occur in the future which may affect its accuracy. The Company anticipates that it is possible that additional information will be gathered in future quarters which may require an adjustment to the allowance for loan losses. Management will continue to closely monitor its portfolio and take such action as it deems appropriate to accurately report its financial condition and results of operations.

Non-interest income

Quarter Ended September 30, 2017 as Compared with Quarter Ended September 30, 2016

Non-interest income decreased \$156,000 for the third quarter of 2017 as compared with the third quarter of 2016 primarily as the result of the decrease in gain on liquidation, sales and calls of securities and other income. The Company had opportunities to sell securities in order to generate gains in the prior year and, as a result, recognized \$67,000 in 2016. Other income decreased \$108,000 in 2017 as compared with 2016 primarily as a result of the prior year including a gain of \$88,000 from the sale of bank premises.

Nine Months Ended September 30, 2017 as Compared with Nine Months Ended September 30, 2016

Non-interest income increased \$390,000 for the first three quarters of 2017 as compared with the first three quarters of 2016 primarily as the result of the increase in income from other investments as well as the gain from death benefits from life insurance. These increases were partially offset by the decrease in other income of \$147,000 in 2017 as compared with 2016. Income from other investments increased \$63,000 from operations of the investment in a low income housing partnership as a result of increased occupancy in 2017 as compared with 2016. As a result of the death of a participant in the Company's deferred compensation plans during 2017, a non-recurring

gain of \$429,000 from the redemption of bank owned life insurance was recorded. Other income decreased \$108,000 in 2017 as compared with 2016 primarily as a result of the prior year including a gain of \$88,000 from the sale of bank premises.

Non-interest expense

Quarter Ended September 30, 2017 as Compared with Quarter Ended September 30, 2016

Total non-interest expense decreased \$107,000 for the third quarter of 2017 as compared with the third quarter of 2016. Net occupancy decreased \$66,000, Equipment rentals, depreciation and maintenance decreased \$41,000, FDIC and state banking assessments decreased \$102,000 and other expense decreased \$129,000 while other real estate expense increased \$279,000 in 2017 as compared with 2016.

Net occupancy expense decreased as result of the Company's efforts to decrease its telecommunication and insurance costs.

Equipment rentals, depreciation and maintenance primarily decreased as a result of the Company reducing its janitorial costs.

FDIC and state banking assessments decreased as the regulators decreased the premiums for deposit insurance in the current year.

ORE expense increased due to the increase in writedowns in the value of ORE.

Other expense decreased as a result of the reduction of legal, advertising and other costs largely due to the time in which services were performed.

Nine Months Ended September 30, 2017 as Compared with Nine Months Ended September 30, 2016

Total non-interest expense decreased \$400,000 for the first three quarters of 2017 as compared with the first three quarters of 2016. Net occupancy decreased \$250,000 and FDIC and state banking assessments decreased \$334,000, while other real estate expense increased \$135,000 in 2017 as compared with 2016.

Net occupancy expense decreased as result of the Company's efforts to decrease its telecommunication and insurance costs.

FDIC and state banking assessments decreased as the regulators decreased the premiums for deposit insurance in the current year.

ORE expense increased due to the increase in writedowns in the value of ORE.

Income Taxes

At December 31, 2014, the Company established a full valuation allowance on its deferred tax assets. Until such time as the Company returns to sustained earnings, and it is determined that it is more likely than not that the deferred tax asset will be realized, no income tax benefit or expense will generally be recorded.

The Company did record income tax expense of \$78,000 during the second quarter of 2016 relating to the resolution of a recent examination by the Internal Revenue Service.

For the year ended December 31, 2014, the Company estimated it would be able to carryback net operating losses and general business credits resulting in Federal refunds totaling \$300,000. Accordingly, a \$300,000 income tax receivable was recorded at December 31, 2014. Upon preparation of the amended 2011 and 2012 Federal tax returns, the actual refunds recoverable were \$642,000. As a result, the Company recorded an income tax benefit of \$338,000 during the second quarter of 2017 as an immaterial correction of an error.

FINANCIAL CONDITION

Available for sale securities increased \$12,210,000 at September 30, 2017, as compared with December 31, 2016. This is the result of the Company investing excess funds not needed currently for loans in order to improve earnings.

Loans decreased \$42,532,000 at September 30, 2017, as compared with December 31, 2016 as principal payments, maturities, charge-offs and foreclosures relating to existing loans outpaced new loans.

Total deposits decreased \$29,949,000 at September 30, 2017, as compared with December 31, 2016. Typically, significant increases or decreases in total deposits and/or significant fluctuations among the different types of deposits from quarter to quarter are anticipated by Management as customers in the casino industry and county and municipal entities reallocate their resources periodically.

SHAREHOLDERS EQUITY AND CAPITAL ADEQUACY

Strength, security and stability have been the hallmark of the Company since its founding in 1985 and of its bank subsidiary since its founding in 1896. A strong capital foundation is fundamental to the continuing prosperity of the Company and the security of its customers and shareholders.

As of September 30, 2017, the most recent notification from the Federal Deposit Insurance Corporation categorized the bank subsidiary as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the bank subsidiary must have a Total risk-based capital ratio of 10.00% or greater, a Common Equity Tier 1 Capital ratio of 6.50% or greater, a Tier 1 risk-based capital ratio of 8.00% or greater and a Leverage capital ratio

of 5.00% or greater. As of January 1, 2017, the Company must have a capital conservation buffer above these requirements of 1.25% for 2017. There are no conditions or events since that notification that Management believes have changed the bank subsidiary's category.

The Company's actual capital amounts and ratios and required minimum capital amounts and ratios as of September 30, 2017 and December 31, 2016, are as follows (in thousands):

	Actual		For Capital Adequacy Purposes	
	Amount	Ratio	Amount	Ratio
September 30, 2017 :				
Total Capital (to Risk Weighted Assets)	\$ 96,231	25.41%	\$ 30,293	8.00%
Common Equity Tier 1 Capital (to Risk Weighted Assets)	91,480	24.16%	17,040	4.50%
Tier 1 Capital (to Risk Weighted Assets)	91,480	24.16%	22,719	6.00%
Tier 1 Capital (to Average Assets)	91,480	13.13%	27,863	4.00%
December 31, 2016:				
Total Capital (to Risk Weighted Assets)	\$ 95,262	22.94%	\$ 33,220	8.00%
Common Equity Tier 1 Capital (to Risk Weighted Assets)	90,068	21.69%	18,687	4.50%
Tier 1 Capital (to Risk Weighted Assets)	90,068	21.69%	24,915	6.00%
Tier 1 Capital (to Average Assets)	90,068	13.12%	27,464	4.00%

The actual capital amounts and ratios and required minimum capital amounts and ratios for the Bank as of September 30, 2017 and December 31, 2016, are as follows (in thousands):

	For Capital Adequacy Purposes				To Be Well Capitalized	
	Actual Amount	Actual Ratio	Purposes Amount	Purposes Ratio	Amount	Ratio
September 30, 2017 :						
Total Capital (to Risk Weighted Assets)	\$ 92,980	24.68%	\$ 30,142	8.00%	\$ 37,678	10.00%
Common Equity Tier 1 Capital (to Risk Weighted Assets)	88,252	23.42%	16,955	4.50%	24,491	6.50%
Tier 1 Capital (to Risk Weighted Assets)	88,252	23.42%	22,607	6.00%	30,142	8.00%
Tier 1 Capital (to Average Assets)	88,252	13.13%	26,876	4.00%	33,596	5.00%
December 31, 2016:						
Total Capital (to Risk Weighted Assets)	\$ 91,882	22.29%	\$ 32,975	8.00%	\$ 41,219	10.00%
Common Equity Tier 1 Capital (to Risk Weighted Assets)	86,726	21.04%	18,548	4.50%	26,792	6.50%
Tier 1 Capital (to Risk Weighted Assets)	86,726	21.04%	24,731	6.00%	32,975	8.00%
Tier 1 Capital (to Average Assets)	86,726	12.47%	27,820	4.00%	34,775	5.00%

Management continues to emphasize the importance of maintaining the appropriate capital levels of the Company and has established the goal of being well-capitalized by the banking regulatory authorities.

LIQUIDITY

Liquidity represents the Company's ability to adequately provide funds to satisfy demands from depositors, borrowers and other commitments by either converting assets to cash or accessing new or existing sources of funds. Management monitors these funds requirements in such a manner as to satisfy these demands and provide the maximum earnings on its earning assets. The Company manages and monitors its liquidity position through a number of methods, including through the computation of liquidity risk targets and the preparation of various analyses of its funding sources and utilization of those sources on a monthly basis. The Company also uses proforma liquidity projections which are updated on a monthly basis in the management of its liquidity needs and also conducts periodic contingency testing on its liquidity plan.

Deposits, payments of principal and interest on loans, proceeds from maturities of investment securities and earnings on investment securities are the principal sources of funds for the Company. Borrowings from the FHLB, federal funds sold and federal funds purchased are utilized by the Company to manage its daily liquidity position. The Company has also been approved to participate in the Federal Reserve Bank's Discount Window Primary Credit Program, which it intends to use only as a contingency.

REGULATORY MATTERS

During 2016, Management identified opportunities for improving information technology operations and security, risk management and earnings, addressing asset quality concerns, analyzing and assessing the Bank's management and staffing needs, and managing concentrations of credit risk as a result of its own investigation as well as examinations performed by certain bank regulatory agencies. In concert with the regulators, the Company had identified specific corrective steps and actions to enhance its information technology operations and security, risk management, earnings, asset quality and staffing. The Company and the Bank may not declare or pay any cash dividends without the prior written approval of their regulators.

Item 4: Controls and Procedures

As of September 30, 2017, an evaluation was performed under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer of the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e)). Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that the Company's disclosure controls and procedures are effective to ensure that the information required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms.

There were no changes in the Company's internal control over financial reporting that occurred during the period ended September 30, 2017 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1: Legal Proceedings

The Bank is involved in various legal matters and claims which are being defended and handled in the ordinary course of business. None of these matters is expected, in the opinion of Management, to have a material adverse effect upon the financial position or results of operations of the Company.

Item 5: Other Information

None.

Item 6 - Exhibits and Reports on Form 8-K

(a) Exhibits

Exhibit 31.1: Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 31.2: Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 32.1: Certification of Chief Executive Officer Pursuant to 18 U.S.C. ss. 1350

Exhibit 32.2: Certification of Chief Financial Officer Pursuant to 18 U.S.C. ss. 1350

Exhibit 101 The following materials from the Company's quarterly report on Form 10-Q for the quarter ended September 30, 2017, formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Statements of Condition at September 30, 2017 and December 31, 2016, (ii) Consolidated Statements of Income for the quarters and nine months ended September 30, 2017 and 2016, (iii) Consolidated Statements of Comprehensive Income for the quarters and nine months ended September 30, 2017 and 2016, (iv) Consolidated Statement of Changes in Shareholders' Equity for the nine months ended September 30, 2017, (v) Consolidated Statements of Cash Flows for the nine months ended September 30, 2017 and 2016 and (vi) Notes to the Unaudited Consolidated Financial Statements for the nine months ended September 30, 2017 and 2016.

(b) Reports on Form 8-K

A Form 8-K was filed on July 26, 2017, September 20, 2017 and October 25, 2017.

SIGNATURES

Pursuant to the requirement of Section 13 of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PEOPLES FINANCIAL CORPORATION
(Registrant)

Date: November 13, 2017

By: /s/ Chevis C. Swetman
Chevis C. Swetman
Chairman, President and Chief Executive
Officer
(principal executive officer)

Date: November 13, 2017

By: /s/ Lauri A. Wood
Lauri A. Wood
Chief Financial Officer and Controller
(principal financial and accounting officer)

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General and administrative

(9,257
)
Interest expense

(29,515

)

Other income

442

Gain on sale of real estate

570

Discontinued operations:

Income from operations of properties sold or held for sale

546

Gain on sale of real estate

105,985

Net income

105,634

Less: Net loss attributable to noncontrolling interests in subsidiaries

7

Net income attributable to the controlling interests

\$
105,641

Capital expenditures
\$
23,170

\$
1,120

\$
4,657

\$
41

\$
28,988

NOTE 10: SUBSEQUENT EVENT

On July 1, 2015, we closed on the purchase of The Wellington, a multifamily property with three buildings totaling 711 units in Arlington, Virginia, and an adjacent undeveloped land parcel, for \$167.0 million. We funded the purchase with borrowings on our New Credit Facility. The initial accounting for the acquisition is incomplete due to the timing of the acquisition relative to the filing date of this report and, therefore, the purchase price accounting and pro forma disclosures are not included.

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

The following discussion should be read in conjunction with our consolidated financial statements and the notes thereto appearing in Item 1 of this report and the more detailed information contained in our Annual Report on Form 10-K for the year ended December 31, 2014 filed with the Securities and Exchange Commission on March 2, 2015.

We refer to the three months ended June 30, 2015 and June 30, 2014 as the "2015 Quarter" and the "2014 Quarter," respectively, and the six months ended June 30, 2015 and June 30, 2014 as the "2015 Period" and the "2014 Period," respectively.

Forward-Looking Statements

This Form 10-Q contains forward-looking statements which involve risks and uncertainties. Forward-looking statements include statements in this report preceded by, followed by or that include the words "believe," "expect," "intend," "anticipate," "potential," "project," "will" and other similar expressions. We claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 for these statements. The following important factors, in addition to those discussed elsewhere in this Form 10-Q, could affect our future results and could cause those results to differ materially from those expressed in the forward-looking statements: (a) the effect of credit and financial market conditions; (b) the availability and cost of capital; (c) fluctuations in interest rates; (d) the economic health of our tenants; (e) the timing and pricing of lease transactions; (f) the economic health of the greater Washington metro region, or other markets we may enter; (g) changes in real estate and zoning laws and increases in property tax rates; (h) the effects of changes in federal government spending; (i) the supply of competing properties; (j) consumer confidence; (k) unemployment rates; (l) consumer tastes and preferences; (m) our future capital requirements; (n) inflation; (o) compliance with applicable laws, including those concerning the environment and access by persons with disabilities; (p) governmental or regulatory actions and initiatives; (q) changes in general economic and business conditions; (r) terrorist attacks or actions; (s) acts of war; (t) weather conditions and natural disasters; (u) failure to qualify as a REIT; (v) the availability of and our ability to attract and retain qualified personnel; and (w) other factors discussed under the caption "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2014 filed with the Securities and Exchange Commission on March 2, 2015. We undertake no obligation to update our forward-looking statements or risk factors to reflect new information, future events, or otherwise.

General

Introductory Matters

We provide our Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") in addition to the accompanying consolidated financial statements and notes to assist readers in understanding our results of operations and financial condition. We organize the MD&A as follows:

• **Overview.** Discussion of our business, operating results, investment activity and capital requirements, and summary of our significant transactions to provide context for the remainder of MD&A.

• **Results of Operations.** Discussion of our financial results comparing the 2015 Quarter to the 2014 Quarter and the 2015 Period to the 2014 Period.

• **Liquidity and Capital Resources.** Discussion of our financial condition and analysis of changes in our capital structure and cash flows.

• **Critical Accounting Policies and Estimates.** Descriptions of accounting policies that reflect significant judgments and estimates used in the preparation of our consolidated financial statements.

When evaluating our financial condition and operating performance, we focus on the following financial and non-financial indicators:

• Net operating income (“NOI”), calculated as real estate rental revenue less real estate expenses excluding depreciation and amortization and general and administrative expenses. NOI is a non-GAAP supplemental measure to net income;

• NAREIT Funds From Operations (“NAREIT FFO”), calculated as set forth below under the caption “Funds from Operations.” FFO is a non-GAAP supplemental measure to net income;

• Occupancy, calculated as occupied square footage as a percentage of total square footage as of the last day of that period;

• Leased percentage, calculated as the percentage of available physical net rentable area leased for our commercial segments and percentage of apartments leased for our multifamily segment;

Rental rates; and
Leasing activity, including new leases, renewals and expirations.

For purposes of evaluating comparative operating performance, we categorize our properties as “same-store”, “non-same-store” or discontinued operations. A “same-store” property is one that was owned for the entirety of the periods being evaluated and excludes properties under redevelopment or development and properties purchased or sold at any time during the periods being compared. A “non-same-store” property is one that was acquired, under redevelopment or development, or placed into service during either of the periods being evaluated. We define redevelopment properties as those for which we expect to spend significant development and construction costs on existing or acquired buildings pursuant to a formal plan which has a current impact on operating results, occupancy and the ability to lease space with the intended result of a higher economic return on the property. Properties under redevelopment or development are included within the non-same-store properties beginning in the period during which redevelopment or development activities commence. Redevelopment and development properties are included in the same-store pool upon completion of the redevelopment or development, and the earlier of achieving 90% occupancy or two years after completion.

Overview

Business

Our revenues are derived primarily from the ownership and operation of income-producing properties in the greater Washington metro region. As of June 30, 2015, we owned a diversified portfolio of 55 properties, totaling approximately 7.4 million square feet of commercial space and 2,826 multifamily units, and land held for development. These 55 properties consisted of 25 office properties, 17 retail centers and 13 multifamily properties.

Operating Results

Real estate rental revenue, NOI, net income attributable to the controlling interests and NAREIT FFO for the three months ended June 30, 2015 and 2014 were as follows (in thousands):

	Three Months Ended June 30,				
	2015	2014	\$ Change	% Change	
Real estate rental revenue	\$74,226	\$72,254	\$1,972	2.7	%
NOI ⁽¹⁾	\$46,997	\$46,726	\$271	0.6	%
Net (loss) income attributable to the controlling interests	\$(2,546)	\$1,087	\$(3,633)	(334.2))%
NAREIT FFO ⁽²⁾	\$22,617	\$25,199	\$(2,582)	(10.2))%

⁽¹⁾ See page 25 of the MD&A for a reconciliation of NOI to net income.

⁽²⁾ See page 35 of the MD&A for a reconciliation of NAREIT FFO to net income.

The increase in real estate rental revenue is primarily due to acquisitions (\$1.6 million), higher occupancy at same-store properties (\$0.9 million) and the partial lease-up of The Maxwell (\$0.4 million), partially offset by the sale of Country Club Towers (\$1.0 million) during the first quarter of 2015.

The increase in NOI is primarily due to acquisitions (\$1.2 million), partially offset by the sale of Country Club Towers (\$0.5 million), lower NOI at the recently-renovated Silverline Center (\$0.2 million) and lower NOI from same-store properties (\$0.2 million). Same-store occupancy increased to 92.8% from 92.5% one year ago, with increases in the office and multifamily segments partially offset by lower occupancy in the retail segment.

The net loss attributable to the controlling interests and lower NAREIT FFO are primarily attributable to a real estate impairment (\$5.9 million) recognized on our suspended development at 1225 First Street (see note 3 to the consolidated financial statements).

Investment Activity

During the 2015 Quarter, we received \$2.0 million as compensation for 15,000 square feet of land at Montrose Shopping Center taken in an eminent domain action, recognizing a gain on sale of real estate of \$1.5 million. Subsequent to the end of the 2015 Quarter, we closed on the purchase of The Wellington, a multifamily property with three buildings totaling 711 units in Arlington,

Virginia, and an adjacent undeveloped land parcel, for \$167.0 million. We funded the purchase price with borrowings on our New Credit Facility.

Capital Requirements

We repaid the remaining \$150.0 million of our 5.35% unsecured notes on their maturity date of May 1, 2015 using borrowings on Prior Credit Facility No. 2.

On June 23, 2015, we terminated Prior Credit Facility No. 1 and Prior Credit Facility No. 2 and executed the New Credit Facility, a \$600.0 million unsecured credit agreement that matures in June 2019, unless extended pursuant to one or both of the two six-month extension options. The New Credit Facility has an accordion feature that allows us to increase the facility to \$1.0 billion, subject to the extent the lenders agree to provide additional revolving loan commitments or term loans. The New Credit Facility bears interest at a rate of either LIBOR plus a margin ranging from 0.875% to 1.55% (depending on Washington REIT's credit rating) or the base rate plus a margin ranging from 0.0% to 0.55% (based upon Washington REIT's credit rating). The base rate is the highest of the administrative agent's prime rate, the federal funds rate plus 0.50% and the LIBOR market index rate plus 1.0%. In addition, the New Credit Facility requires the payment of a facility fee ranging from 0.125% to 0.30% (depending on Washington REIT's credit rating) on the \$600.0 million committed capacity, without regard to usage. As of June 30, 2015, the interest rate on the facility is LIBOR plus 1.00% and the facility fee is 0.20%. As of August 3, 2015, our New Credit Facility has a borrowing capacity of \$244.5 million.

Significant Transactions

Our significant transactions during the 2015 and 2014 Periods are summarized as follows:

2015 Period

The execution of the New Credit Facility, a \$600.0 million unsecured credit facility maturing in June 2019 that replaces Prior Credit Facility No. 1 and Prior Credit Facility No. 2, which had a combined borrowing capacity of \$500.0 million. The New Credit Facility has the terms set forth above under "Capital Requirements".

The disposition of Country Club Towers, a 277-unit multifamily building in Arlington, Virginia, for a contract sales price of \$37.8 million, resulting in a gain on sale of \$30.3 million.

- The execution of new and renewal leases for 0.3 million square feet of commercial space with an average rental rate increase of 15.2% over expiring leases.

2014 Period

The disposition of the Woodburn Medical Park I and II and Prosperity Medical Center I, II and III medical office buildings with a combined 427,000 square feet, for a contract sales price of \$193.6 million, resulting in a gain on sale of \$106.0 million. These sales transactions completed the disposition of the medical office segment.

The acquisition of Yale West, a 216-unit multifamily property in Washington, DC, for a contract purchase price of \$73.0 million. We assumed a \$48.2 million mortgage with this acquisition. We incurred \$1.8 million of acquisition costs related to this transaction.

The acquisition of The Army Navy Club Building, a 108,000 square foot office property in Washington, DC, for a contract purchase price of \$79.0 million. We assumed a \$52.7 million mortgage with this acquisition. We incurred \$1.4 million of acquisition costs related to this transaction.

- The acquisition of 1775 Eye Street, NW, a 185,000 square foot office property in Washington, DC, for a contract purchase price of \$104.5 million. We incurred \$1.7 million of acquisition costs with this transaction.
- The execution of new and renewal leases for 0.4 million square feet of commercial space with an average rental rate increase of 10.6% over expiring leases.

Results of Operations

The discussion that follows is based on our consolidated results of operations for the 2015 and 2014 Quarters and Periods. The ability to compare one period to another may be significantly affected by acquisitions completed and dispositions made during those periods. To provide more insight into our operating results, we divide our discussion into two main sections:

• Consolidated Results of Operations: Overview analysis of results on a consolidated basis.

• Net Operating Income: Detailed analysis of same-store and non-same-store NOI results by segment.

Consolidated Results of Operations

Real Estate Rental Revenue

Real estate rental revenue for properties classified as continuing operations for the three and six months ended June 30, 2015 and 2014 were as follows (in thousands):

	Three Months Ended				Six Months Ended				
	June 30,		Change		June 30,		Change		
	2015	2014	\$	%	2015	2014	\$	%	
Minimum base rent	\$62,844	\$61,247	\$1,597	2.6	% \$125,271	\$118,993	\$6,278	5.3	%
Recoveries from tenants	8,190	7,575	615	8.1	% 17,383	15,636	1,747	11.2	%
Provisions for doubtful accounts	(492)	(418)	(74)	(17.7)%	(891)	(1,135)	244	21.5	%
Lease termination fees	154	317	(163)	(51.4)%	342	797	(455)	(57.1)%	
Parking and other tenant charges	3,530	3,533	(3)	(0.1)%	6,977	6,574	403	6.1	%
	\$74,226	\$72,254	\$1,972	2.7	% \$149,082	\$140,865	\$8,217	5.8	%

Minimum Base Rent: Minimum base rent increased by \$1.6 million in the 2015 Quarter primarily due to acquisitions (\$1.5 million) and higher occupancy (\$0.9 million) at same-store properties, partially offset by the sale of Country Club Towers (\$0.9 million) during the first quarter of 2015.

Minimum base rent increased by \$6.3 million in the 2015 Period primarily due to acquisitions (\$5.2 million) and higher occupancy (\$2.7 million) at same-store properties, partially offset by the sale of Country Club Towers (\$0.9 million) during the first quarter of 2015 and higher amortization of capitalized lease incentives (\$0.6 million) at same-store properties.

Recoveries from Tenants: Recoveries from tenants increased by \$0.6 million in the 2015 Quarter primarily due to acquisitions (\$0.3 million) and higher reimbursements for real estate taxes (\$0.2 million) at same-store properties.

Recoveries from tenants increased by \$1.7 million in the 2015 Period primarily due to acquisitions (\$1.4 million) and higher reimbursements for real estate taxes (\$0.5 million) at same-store properties, partially offset by lower reimbursements for property operating expenses (\$0.2 million) at same-store properties.

Provisions for Doubtful Accounts: Provisions for doubtful accounts increased by \$0.1 million in the 2015 Quarter primarily due to higher net provisions in the office segment.

Provisions for doubtful accounts decreased by \$0.2 million in the 2015 Period primarily due to lower net provisions in the retail segment (\$0.4 million) due to fewer tenants requiring reserves, partially offset by higher net provisions in the

office segment (\$0.1 million).

Lease Termination Fees: Lease termination fees decreased by \$0.2 million in 2015 Quarter primarily due to lower lease termination fees in the office segment.

Lease termination fees decreased by \$0.5 million in 2015 Period primarily due to lower lease termination fees in the office segment.

Parking and Other Tenant Charges: Parking and other tenant charges slightly decreased in the 2015 Quarter as lower charges due to the sale of Country Club Towers (\$0.1 million) were offset by acquisitions (\$0.1 million).

Parking and other tenant charges increased by \$0.4 million in the 2015 Period primarily due to acquisitions (\$0.5 million), partially offset by the sale of Country Club Towers (\$0.1 million).

Occupancy by segment for properties classified as continuing operations as of June 30, 2015 and 2014 was as follows:

	As of June 30,		Change	
	2015	2014		
Office	87.6	% 86.2	% 1.4	%
Retail	92.9	% 94.2	% (1.3))%
Multifamily	91.7	% 93.7	% (2.0))%
Total	90.0	% 90.1	% (0.1))%

Occupancy represents occupied square footage indicated as a percentage of total square footage as of the last day of that period.

A detailed discussion of occupancy by segment can be found in the Net Operating Income section.

Real Estate Expenses

Real estate expenses for the three and six months ended June 30, 2015 and 2014 for properties classified as continuing operations were as follows (in thousands):

	Three Months Ended				Six Months Ended				
	June 30,		Change		June 30,		Change		
	2015	2014	\$	%	2015	2014	\$	%	
Property operating expenses	\$ 18,053	\$ 17,448	\$ 605	3.5	% \$ 37,802	\$ 36,003	\$ 1,799	5.0	%
Real estate taxes	9,176	8,080	1,096	13.6	% 18,635	15,867	2,768	17.4	%
	\$ 27,229	\$ 25,528	\$ 1,701	6.7	% \$ 56,437	\$ 51,870	\$ 4,567	8.8	%

Real estate expenses as a percentage of revenue were 36.7% and 35.3% for the 2015 and 2014 Quarters, respectively, and 37.9% and 36.8% for the 2015 and 2014 Periods, respectively.

Property Operating Expenses: Property operating expenses include utilities, repairs and maintenance, property administration and management, operating services, common area maintenance, property insurance, bad debt and other operating expenses.

Property operating expenses increased by \$0.6 million in the 2015 Quarter primarily due to higher bad debt expense (\$0.5 million) at same-store properties, placing The Maxwell into service (\$0.3 million) and acquisitions (\$0.2 million), partially offset by the sale of Country Club Towers (\$0.3 million).

Property operating expenses increased by \$1.8 million in the 2015 Period primarily due to acquisitions (\$1.2 million), higher bad debt expense (\$0.7 million) at same-store properties and placing The Maxwell into service (\$0.5 million), partially offset by the sale of Country Club Towers (\$0.4 million).

Real Estate Taxes: Real estate taxes increased by \$1.1 million in the 2015 Quarter primarily due to higher assessments (\$0.7 million) at same-store properties and acquisitions (\$0.3 million).

Real estate taxes increased by \$2.8 million in the 2015 Period primarily due to acquisitions (\$1.4 million) and higher assessments (\$1.1 million) at same-store properties.

Other Operating Expenses

Other operating expenses for the three and six months ended June 30, 2015 and 2014 were as follows (in thousands):

	Three Months Ended				Six Months Ended				
	June 30,		Change		June 30,		Change		
	2015	2014	\$	%	2015	2014	\$	%	
Depreciation and amortization	\$25,503	\$24,401	\$1,102	4.5	% \$50,778	\$47,154	\$3,624	7.7	%
Interest expense	14,700	14,985	(285	) (1.9	)% 30,048	29,515	533	1.8	%
Acquisition costs	992	1,933	(941	) (48.7	)% 1,008	4,978	(3,970	) (79.8)%
Real estate impairment	5,909	—	5,909	N/A	5,909	—	5,909	N/A	
General and administrative	4,306	4,828	(522	) (10.8	)% 10,386	9,257	1,129	12.2	%
	\$51,410	\$46,147	\$5,263	11.4	% \$98,129	\$90,904	\$7,225	7.9	%

Depreciation and amortization: Depreciation and amortization increased by \$1.1 million in the 2015 Quarter primarily due to acquisitions (\$1.0 million).

Depreciation and amortization increased by \$3.6 million in the 2015 Period primarily due to acquisitions (\$1.9 million) and placing The Maxwell (\$1.2 million) and a portion of the Silverline Center redevelopment (\$0.3 million) into service.

Interest Expense: Interest expense by debt type for the three and six months ended June 30, 2015 and 2014 was as follows (in thousands):

	Three Months Ended				Six Months Ended				
	June 30,		Change		June 30,		Change		
	2015	2014	\$	%	2015	2014	\$	%	
Notes payable	\$7,914	\$9,302	\$(1,388	) (14.9	)% \$17,210	\$18,824	\$(1,614	) (8.6)%
Mortgages	5,657	5,554	103	1.9	% 11,281	10,368	913	8.8	%
Lines of credit	1,249	590	659	111.7	% 2,016	1,177	839	71.3	%
Capitalized interest	(120	) (461	) 341	(74.0	)% (459	) (854	) 395	(46.3)%
Total	\$14,700	\$14,985	\$(285	) (1.9	)% \$30,048	\$29,515	\$533	1.8	%

Interest expense from notes payable decreased in the 2015 Quarter and Period primarily due to the repayment of \$150.0 million of 5.35% unsecured notes in May 2015. Interest expense from mortgage notes increased primarily due to the assumption of mortgages with the acquisitions of Yale West and The Army Navy Club Building during the 2014 Period. Interest expense from our unsecured lines of credit increased due to higher borrowing activity during the 2015 Period. Capitalized interest decreased because we placed The Maxwell and a portion of the Silverline Center redevelopment into service.

Acquisition Costs: Acquisition costs decreased by \$0.9 million in the 2015 Quarter primarily due to closing on the acquisition of 1775 Eye Street during the 2014 Quarter, partially offset by costs associated with the acquisition of The Wellington, which closed after the 2015 Quarter.

Acquisition costs decreased by \$4.0 million in the 2015 Period primarily due to closing on the acquisitions of Yale West, The Army Navy Club Building and 1775 Eye Street during the 2014 Period, partially offset by costs associated with the acquisition of The Wellington, which closed after the 2015 Period.

Real estate impairment: In November 2011, we executed a joint venture operating agreement with a real estate development company to develop a high-rise multifamily property at 1225 First Street in Alexandria, Virginia. During the 2015 Quarter, we determined that we would not develop 1225 First Street and began negotiations to sell our 95%

interest in the joint venture that owns the property. We recognized a \$5.9 million impairment charge for the 2015 Quarter in order to reduce the carrying value of the property to its estimated fair value. We based this fair value on the \$14.5 million sale price in the purchase and sale agreement to sell our 95% interest in the joint venture that we executed subsequent to the 2015 Quarter.

General and Administrative Expenses: General and administrative expenses decreased by \$0.5 million in the 2015 Quarter, primarily due to lower severance (\$0.5 million) and employee share based compensation (\$0.4 million), partially offset by higher professional fees (\$0.4 million).

General and administrative expenses increased by \$1.1 million in the 2015 Period, primarily due to higher professional fees (\$1.3 million) and trustee compensation expense (\$0.5 million), partially offset by lower severance expense (\$0.5 million).

Discontinued Operations

Operating results of the properties classified as discontinued operations for the six months ended June 30, 2015 and 2014 were as follows (in thousands):

	Six Months Ended June 30,		Change		
	2015	2014	\$	%	
Revenues	\$—	\$892	\$(892	) (100.0)%
Property expenses	—	(346	) 346	(100.0)%
Total	\$—	\$546	\$(546	) (100.0)%

The decrease in income from discontinued operations in the 2015 Period is due to the completion of the sale of the medical office segment in January 2014 (see note 3 to the consolidated financial statements).

Net Operating Income

NOI is the primary performance measure we use to assess the results of our operations at the property level. We believe that NOI is useful as a performance measure because, when compared across periods, NOI reflects the impact on operations of trends in occupancy rates, rental rates and operating costs on an unleveraged basis, providing perspective not immediately apparent from net income. NOI excludes certain components from net income in order to provide results more closely related to a property's results of operations. For example, interest expense is not necessarily linked to the operating performance of a real estate asset. In addition, depreciation and amortization, because of historical cost accounting and useful life estimates, may distort operating performance at the property level. As a result of the foregoing, we provide NOI as a supplement to net income or income from continuing operations, calculated in accordance with GAAP. NOI does not represent net income or income from continuing operations, in either case calculated in accordance with GAAP. As such, it should not be considered an alternative to these measures as an indication of our operating performance. NOI is calculated as real estate rental revenue less real estate expenses excluding depreciation and amortization, interest expense and general and administrative expenses. A reconciliation of NOI to net income follows.

2015 Quarter Compared to 2014 Quarter

The following tables of selected operating data reconcile NOI to net income and provide the basis for our discussion of NOI in the 2015 Quarter compared to the 2014 Quarter (in thousands).

	Three Months Ended June 30,				
	2015	2014	\$ Change	% Change	
Real Estate Rental Revenue					
Same-store	\$68,629	\$67,682	\$947	1.4	%
Non-same-store ⁽¹⁾	5,597	4,572	1,025	22.4	%
Total real estate rental revenue	\$74,226	\$72,254	\$1,972	2.7	%
Real Estate Expenses					
Same-store	\$24,242	\$23,145	\$1,097	4.7	%
Non-same-store ⁽¹⁾	2,987	2,383	604	25.3	%
Total real estate expenses	\$27,229	\$25,528	\$1,701	6.7	%
NOI					
Same-store	\$44,387	\$44,537	\$(150)	(0.3)	%
Non-same-store ⁽¹⁾	2,610	2,189	421	19.2	%
Total NOI	\$46,997	\$46,726	\$271	0.6	%
Reconciliation to Net Income					
NOI	\$46,997	\$46,726			
Depreciation and amortization	(25,503)	(24,401)			
Gain on sale of real estate (classified as continuing operations)	1,454	570			
General and administrative expenses	(4,306)	(4,828)			
Interest expense	(14,700)	(14,985)			
Other income	192	219			
Acquisition costs	(992)	(1,933)			
Loss on extinguishment of debt	(119)	—			
Real estate impairment	(5,909)	—			
Discontinued operations:					
Gain on sale of real estate	—	(288)			
Net (loss) income	(2,886)	1,080			
Less: Net loss attributable to noncontrolling interests	340	7			
Net (loss) income attributable to the controlling interests	\$(2,546)	\$1,087			

(1) Non-same-store properties classified as continuing operations include:

2015 Multifamily disposition – Country Club Towers

2014 Multifamily development – The Maxwell

2014 Office acquisition – 1775 Eye Street, NW

2014 Retail acquisition – Spring Valley Retail Center

2014 Retail disposition – 5740 Columbia Road (parcel at Gateway Overlook)

2013 Office redevelopment – Silverline Center

Real estate rental revenue from same-store properties increased by \$0.9 million in the 2015 Quarter primarily due to higher occupancy (\$0.9 million) and rental rates (\$0.6 million), partially offset by higher rent abatements (\$0.5 million).

Real estate expenses from same-store properties increased by \$1.1 million in the 2015 Quarter primarily due to higher real estate taxes (\$0.7 million), bad debt (\$0.5 million) and administrative (\$0.2 million) expenses, partially offset by lower utilities expense (\$0.3 million).

	As of June 30,			
	2015		2014	
Occupancy				
Same-store	92.8	%	92.5	%
Non-same-store	63.5	%	65.5	%
Total	90.0	%	90.1	%

Same-store occupancy increased to 92.8%, with increases in the office and multifamily segments partially offset by a decrease in the retail segment. During the 2015 Quarter, 62.1% of the commercial square footage expiring was renewed as compared to 49.8% in the 2014 Quarter. During the 2015 Quarter, we executed new and renewal leases for 0.3 million commercial square feet at an average rental rate of \$30.25 per square foot, an increase of 15.2%, with average tenant improvements and leasing commissions and incentives (including free rent) of \$24.08 per square foot.

An analysis of NOI by segment follows.

Office Segment:

	Three Months Ended June 30,			
	2015	2014	\$ Change	% Change
Real Estate Rental Revenue				
Same-store	\$38,929	\$38,276	\$653	1.7%
Non-same-store ⁽¹⁾	4,214	3,600	614	17.1%
Total real estate rental revenue	\$43,143	\$41,876	\$1,267	3.0%
Real Estate Expenses				
Same-store	\$14,514	\$13,916	\$598	4.3%
Non-same-store ⁽¹⁾	2,328	1,901	427	22.5%
Total real estate expenses	\$16,842	\$15,817	\$1,025	6.5%
NOI				
Same-store	\$24,415	\$24,360	\$55	0.2%
Non-same-store ⁽¹⁾	1,886	1,699	187	11.0%
Total NOI	\$26,301	\$26,059	\$242	0.9%

(1) Non-same-store properties include:
2014 acquisition – 1775 Eye Street, NW
2013 redevelopment – Silverline Center

Real estate rental revenue from same-store properties increased by \$0.7 million in the 2015 Quarter primarily due to higher occupancy (\$0.6 million) and rental rates (\$0.7 million), partially offset by higher rent abatements (\$0.5 million).

Real estate expenses from same-store properties increased by \$0.6 million in the 2015 Quarter primarily due to higher real estate taxes.

	As of June 30,			
	2015		2014	
Occupancy				
Same-store	91.8	%	90.9	%
Non-same-store	63.6	%	59.0	%
Total	87.6	%	86.2	%

Same-store occupancy increased to 91.8% primarily due to higher occupancy at 1227 25th Street, Monument II and Wayne Plaza. During the 2015 Quarter, 56.1% of the square footage that expired was renewed compared to 48.9% in the 2014 Quarter. During the 2015 Quarter, we executed new and renewal leases for 0.1 million square feet of office space at an average rental rate of \$36.55 per square foot, an increase of 9.6%, with average tenant improvements and

leasing commissions and incentives (including free rent) of \$37.35 per square foot.

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Retail Segment:

	Three Months Ended June 30,		\$ Change	% Change	
	2015	2014			
Real Estate Rental Revenue					
Same-store	\$14,766	\$14,748	\$18	0.1	%
Non-same-store ⁽¹⁾	974	11	963	8,754.5	%
Total real estate rental revenue	\$15,740	\$14,759	\$981	6.6	%
Real Estate Expenses					
Same-store	\$3,496	\$3,231	\$265	8.2	%
Non-same-store ⁽¹⁾	206	6	200	3,333.3	%
Total real estate expenses	\$3,702	\$3,237	\$465	14.4	%
NOI					
Same-store	\$11,270	\$11,517	\$(247)	(2.1)	%
Non-same-store ⁽¹⁾	768	5	763	15,260.0	%
Total NOI	\$12,038	\$11,522	\$516	4.5	%

(1) Non-same-store properties include:

2014 acquisition – Spring Valley Retail Center

2014 disposition – 5740 Columbia Road (parcel at Gateway Overlook)

Real estate rental revenue from same-store properties slightly increased in the 2015 Quarter as higher rental rates (\$0.3 million) were offset by lower occupancy (\$0.2 million) and lower reimbursements for operating expenses (\$0.1 million).

Real estate expenses from same-store properties increased by \$0.3 million in the 2015 Quarter primarily due to higher bad debt expense (\$0.5 million), partially offset by lower common area maintenance (\$0.1 million).

	As of June 30,			
	2015	2014		
Occupancy				
Same-store	92.8	% 94.2		%
Non-same-store	96.6	% N/A		
Total	92.9	% 94.2		%

Same-store occupancy decreased to 92.8% primarily due to lower occupancy at Chevy Chase Metro Plaza. During the 2015 Quarter, 66.4% of the square footage expiring was renewed compared to 100.0% in the 2014 Quarter. During the 2015 Quarter, we executed new and renewal leases for 0.1 million square feet of retail space at an average rental rate of \$24.03, an increase of 24.9%, with average tenant improvements and leasing commissions and incentives (including free rent) of \$10.94 per square foot.

Multifamily Segment:

	Three Months Ended June 30,		\$ Change	% Change	
	2015	2014			
Real Estate Rental Revenue					
Same-store	\$ 14,934	\$ 14,658	\$ 276	1.9	%
Non-same-store ⁽¹⁾	409	961	(552)	(57.4))%
Total real estate rental revenue	\$ 15,343	\$ 15,619	\$(276)	(1.8))%
Real Estate Expenses					
Same-store	\$ 6,232	\$ 5,998	\$ 234	3.9	%
Non-same-store ⁽¹⁾	453	476	(23)	(4.8))%
Total real estate expenses	\$ 6,685	\$ 6,474	\$ 211	3.3	%
NOI					
Same-store	\$ 8,702	\$ 8,660	\$ 42	0.5	%
Non-same-store ⁽¹⁾	(44)	) 485	(529)	(109.1))%
Total NOI	\$ 8,658	\$ 9,145	\$(487)	(5.3))%

(1) Non-same-store properties include:

2015 Multifamily disposition – Country Club Towers

2014 Multifamily development – The Maxwell

Real estate rental revenue from same-store properties increased by \$0.3 million in the 2015 Quarter primarily due to higher occupancy (\$0.5 million) and lower rent abatements (\$0.1 million), partially offset by lower rental rates (\$0.4 million).

Real estate expenses from same-store properties increased \$0.2 million by in the 2015 Quarter primarily due to higher administrative expenses.

	As of June 30,			
	2015	2014		
Occupancy				
Same-store	94.5	% 93.6		%
Non-same-store	45.3	% 94.5		%
Total	91.7	% 93.7		%

Same-store occupancy increased to 94.5% primarily due to higher occupancy at Yale West. The decrease in non-same-store occupancy is primarily due to The Maxwell, which was in lease-up and had occupancy of 45.3% as of the end of the 2015 Quarter.

2015 Period Compared to 2014 Period

The following tables of selected operating data reconcile NOI to net income and provide the basis for our discussion of NOI in the 2015 Period compared to the 2014 Period (in thousands).

	Six Months Ended June 30,		\$ Change	% Change	
	2015	2014			
Real Estate Rental Revenue					
Same-store	\$131,117	\$128,405	\$2,712	2.1	%
Non-same-store ⁽¹⁾	17,965	12,460	5,505	44.2	%
Total real estate rental revenue	\$149,082	\$140,865	\$8,217	5.8	%
Real Estate Expenses					
Same-store	\$47,559	\$46,031	\$1,528	3.3	%
Non-same-store ⁽¹⁾	8,878	5,839	3,039	52.0	%
Total real estate expenses	\$56,437	\$51,870	\$4,567	8.8	%
NOI					
Same-store	\$83,558	\$82,374	\$1,184	1.4	%
Non-same-store ⁽¹⁾	9,087	6,621	2,466	37.2	%
Total NOI	\$92,645	\$88,995	\$3,650	4.1	%
Reconciliation to Net Income					
NOI	\$92,645	\$88,995			
Depreciation and amortization	(50,778)	(47,154)			
Gain on sale of real estate	31,731	570			
General and administrative expenses	(10,386)	(9,257)			
Interest expense	(30,048)	(29,515)			
Other income	384	442			
Acquisition costs	(1,008)	(4,978)			
Loss on extinguishment of debt	(119)	—			
Real estate impairment	(5,909)	—			
Discontinued operations:					
Income from operations of properties sold or held for sale ⁽²⁾	—	546			
Gain on sale of real estate	—	105,985			
Net income	26,512	105,634			
Less: Net loss attributable to noncontrolling interests	448	7			
Net income attributable to the controlling interests	\$26,960	\$105,641			

(1) Non-same-store properties classified as continuing operations include:

2015 Multifamily disposition – Country Club Towers

2014 Multifamily acquisition – Yale West

2014 Multifamily development – The Maxwell

2014 Office acquisitions – The Army Navy Club Building and 1775 Eye Street, NW

2014 Retail acquisition – Spring Valley Retail Center

2014 Retail disposition – 5740 Columbia Road (parcel at Gateway Overlook)

2013 Office redevelopment – Silverline Center

(2) Sold properties classified as discontinued operations include:

2014 Medical Office dispositions – Woodburn Medical Park I and II and Prosperity Medical Center I, II and III

Real estate rental revenue from same-store properties increased by \$2.7 million in the 2015 Period primarily due to higher occupancy (\$2.7 million), higher rental rates (\$0.7 million) and lower reserves for uncollectible revenue (\$0.2

million), partially offset by higher rent abatements (\$0.9 million).

Real estate expenses from same-store properties increased by \$1.5 million in the 2015 Period primarily due to higher real estate taxes (\$1.1 million), bad debt (\$0.7 million), administrative (\$0.3 million) and repairs and maintenance (\$0.1 million) expenses, partially offset by lower utilities expense (\$1.0 million).

During the 2015 Period, 66.7% of the commercial square footage expiring was renewed as compared to 65.1% in the 2014 Period. During the 2015 Period, we executed new and renewal leases for 0.6 million commercial square feet at an average rental rate of \$30.49 per square foot, an increase of 11.9%, with average tenant improvements and leasing commissions and incentives (including free rent) of \$25.23 per square foot.

An analysis of NOI by segment follows.

Office Segment:

	Six Months Ended June 30,		\$ Change	% Change	
	2015	2014			
Real Estate Rental Revenue					
Same-store	\$73,848	\$72,574	\$1,274	1.8	%
Non-same-store ⁽¹⁾	11,791	8,365	3,426	41.0	%
Total real estate rental revenue	\$85,639	\$80,939	\$4,700	5.8	%
Real Estate Expenses					
Same-store	\$27,969	\$27,525	\$444	1.6	%
Non-same-store ⁽¹⁾	6,016	3,987	2,029	50.9	%
Total real estate expenses	\$33,985	\$31,512	\$2,473	7.8	%
NOI					
Same-store	\$45,879	\$45,049	\$830	1.8	%
Non-same-store ⁽¹⁾	5,775	4,378	1,397	31.9	%
Total NOI	\$51,654	\$49,427	\$2,227	4.5	%

(1)Non-same-store properties include:

2014 acquisitions – The Army Navy Club Building and 1775 Eye Street, NW

2013 redevelopment – Silverline Center

Real estate rental revenue from same-store properties increased by \$1.3 million in the 2015 Period primarily due to higher occupancy (\$1.9 million) and higher reimbursements for real estate taxes (\$0.5 million), partially offset by higher rent abatements (\$1.0 million).

Real estate expenses from same-store properties increased by \$0.4 million in the 2015 Period primarily due to higher real estate taxes (\$0.8 million), repairs and maintenance expenses (\$0.1 million) and operating services and supplies (\$0.1 million), partially offset by lower utilities expense (\$0.8 million).

During the 2015 Period, 60.1% of the square footage that expired was renewed compared to 62.4% in the 2014 Period. During the 2015 Period, we executed new and renewal leases for 0.3 million square feet of office space at an average rental rate of \$36.93 per square foot, an increase of 9.3%, with average tenant improvements and leasing commissions and incentives (including free rent) of \$35.80 per square foot.

Retail Segment:

	Six Months Ended June 30,		\$ Change	% Change	
	2015	2014			
Real Estate Rental Revenue					
Same-store	\$30,239	\$29,339	\$900	3.1	%
Non-same-store ⁽¹⁾	1,831	45	1,786	3,968.9	%
Total real estate rental revenue	\$32,070	\$29,384	\$2,686	9.1	%
Real Estate Expenses					
Same-store	\$8,049	\$7,449	\$600	8.1	%
Non-same-store ⁽¹⁾	440	19	421	2,215.8	%
Total real estate expenses	\$8,489	\$7,468	\$1,021	13.7	%
NOI					
Same-store	\$22,190	\$21,890	\$300	1.4	%
Non-same-store ⁽¹⁾	1,391	26	1,365	5,250.0	%
Total NOI	\$23,581	\$21,916	\$1,665	7.6	%

(1) Non-same-store properties include:

2014 acquisition – Spring Valley Retail Center

2014 disposition – 5740 Columbia Road (parcel at Gateway Overlook)

Real estate rental revenue from same-store properties increased by \$0.9 million in the 2015 Period primarily due to higher rental rates (\$0.7 million) and lower reserves for uncollectible revenue (\$0.4 million), partially offset by lower occupancy (\$0.1 million).

Real estate expenses from same-store properties increased by \$0.6 million in the 2015 Period primarily due to higher bad debt expense (\$0.8 million), partially offset by lower common area maintenance (\$0.1 million) and legal (\$0.1 million) expenses.

During the 2015 Period, 70.9% of the square footage expiring was renewed compared to 93.9% in the 2014 Period. During the 2015 Period, we executed new and renewal leases for 0.3 million square feet of retail space at an average rental rate of \$22.19, an increase of 17.8%, with average tenant improvements and leasing commissions and incentives (including free rent) of \$11.60 per square foot.

Multifamily Segment:

	Six Months Ended June 30,				
	2015	2014	\$ Change	% Change	
Real Estate Rental Revenue					
Same-store	\$27,030	\$26,492	\$538	2.0	%
Non-same-store ⁽¹⁾	4,343	4,050	293	7.2	%
Total real estate rental revenue	\$31,373	\$30,542	\$831	2.7	%
Real Estate Expenses					
Same-store	\$11,541	\$11,057	\$484	4.4	%
Non-same-store ⁽¹⁾	2,422	1,833	589	32.1	%
Total real estate expenses	\$13,963	\$12,890	\$1,073	8.3	%
NOI					
Same-store	\$15,489	\$15,435	\$54	0.3	%
Non-same-store ⁽¹⁾	1,921	2,217	(296)	(13.4))%
Total NOI	\$17,410	\$17,652	\$(242)	(1.4))%

(1) Non-same-store properties include:

2015 Multifamily disposition – Country Club Towers

2014 Multifamily acquisition – Yale West

2014 Multifamily development – The Maxwell

Real estate rental revenue from same-store properties increased by \$0.5 million in the 2015 Period primarily due to higher occupancy (\$0.8 million) and lower rent abatements (\$0.2 million), partially offset by lower rental rates (\$0.6 million).

Real estate expenses from same-store properties increased \$0.5 million by in the 2015 Period primarily due to higher administrative expenses (\$0.3 million) and real estate taxes (\$0.2 million).

Liquidity and Capital Resources

Capital Requirements

During 2015, we expect that we will have significant capital requirements, including the following items:

- Funding dividends and distributions to our shareholders;

- Approximately \$55 - \$60 million to invest in our existing portfolio of operating assets, including approximately \$30 - \$35 million to fund tenant-related capital requirements and leasing commissions;

- Approximately \$15 - \$20 million to invest in our development and redevelopment projects; and

- Funding for potential property acquisitions throughout the remainder of 2015, offset by proceeds from potential property dispositions.

We also repaid the remaining \$150.0 million of our 5.35% unsecured notes on their maturity date of May 1, 2015 using borrowings on our unsecured lines of credit.

Debt Financing

Our total debt at June 30, 2015 and December 31, 2014 is as follows (in thousands):

	June 30, 2015	December 31, 2014
Mortgage notes payable	\$419,755	\$418,525
Lines of credit	185,000	50,000
Notes payable	597,442	747,208
	\$1,202,197	\$1,215,733

Mortgage Notes Payable

At June 30, 2015, our \$419.8 million in mortgage notes payable, which include \$4.1 million in net unamortized discounts due to fair value adjustments, bore an effective weighted average fair value interest rate of 5.2% and had an estimated weighted average maturity of 2.4 years. We may either assume mortgage debt from time-to-time in conjunction with property acquisitions or initiate mortgage debt on existing properties.

Our mortgage notes contain covenants with which we must comply. Failure to comply with any of the covenants under our mortgage notes could result in a default under one or more of our debt instruments. This could cause our debt holders to accelerate the timing of payments and would therefore have a material adverse effect on our business, operations, financial condition and liquidity. As of June 30, 2015, we were in compliance with our mortgage notes covenants.

Lines of Credit

On June 23, 2015, we terminated Prior Credit Facility No. 1 and Prior Credit Facility No. 2 and executed the New Credit Facility, a \$600.0 million unsecured credit agreement that matures in June 2019, unless extended pursuant to one or both of the two six-month extension options. The New Credit Facility has an accordion feature that allow us to increase the facility to \$1.0 billion, subject to the extent the lenders agree to provide additional revolving loan commitments or term loans. The New Credit Facility bears interest at a rate of either LIBOR plus a margin ranging from 0.875% to 1.55% (depending on Washington REIT's credit rating) or the base rate plus a margin ranging from 0.0% to 0.55% (based upon Washington REIT's credit rating). The base rate is the highest of the administrative agent's prime rate, the federal funds rate plus 0.50% and the LIBOR market index rate plus 1.0%. In addition, the New Credit Facility requires the payment of a facility fee ranging from 0.125% to 0.30% (depending on Washington REIT's credit rating) on the \$600.0 million committed capacity, without regard to usage. As of June 30, 2015, the interest rate on the

facility is LIBOR plus 1.00% and the facility fee is 0.20%. We had \$185.0 million in borrowings outstanding as of June 30, 2015.

Our unsecured credit facility contains financial and other covenants with which we must comply. Failure to comply with any of the covenants under our unsecured credit facility or other debt instruments could result in a default under one or more of our debt instruments. This could cause our lenders to accelerate the timing of payments and would therefore have a material adverse effect on our business, operations, financial condition and liquidity. In addition, our ability to draw on our unsecured credit facility or incur other unsecured debt in the future could be restricted by the loan covenants. As of June 30, 2015, we were in compliance with our loan covenants.

Notes Payable

We generally issue unsecured notes to fund our real estate assets long term. In issuing future unsecured notes, we intend to ladder the maturities of our debt to mitigate exposure to interest rate risk in future years.

Our unsecured notes contain covenants with which we must comply. Failure to comply with any of the covenants under our unsecured notes could result in a default under one or more of our debt instruments. This could cause our debt holders to accelerate the timing of payments and would therefore have a material adverse effect on our business, operations, financial condition and liquidity. As of June 30, 2015, we were in compliance with our unsecured notes covenants.

From time to time, we may seek to repurchase and cancel our outstanding notes through open market purchases, privately negotiated transactions or otherwise. Such repurchases, if any, will depend on prevailing market conditions, our liquidity requirements, contractual restrictions and other factors.

Common Equity

We have authorized for issuance 100.0 million common shares, of which 68.2 million shares were outstanding at June 30, 2015.

On June 23, 2015, we entered into four separate equity distribution agreements (collectively, the "Equity Distribution Agreements") with each of Wells Fargo Securities, LLC, BNY Mellon Capital Markets, LLC, Citigroup Global Markets Inc. and RBC Capital Markets, LLC relating to the issuance and sale of up to \$200.0 million of our common shares from time to time. Sales of our common shares are made at market prices prevailing at the time of sale. We use net proceeds from the sale of common shares under this program for general corporate purposes, including, without limitation, working capital, the acquisition, renovation, expansion, improvement, development or redevelopment of income producing properties or the repayment of debt. We did not issue any shares under the Equity Distribution Agreements during the 2015 Quarter.

The Equity Distribution Agreements replace Washington REIT's prior sales agency financing agreement ("Prior ATM") with BNY Mellon Capital Markets, LLC, which expired by its terms in June 2015. As of the date of its expiration, Washington REIT had issued 1.3 million common shares under this program at a weighted average share price of \$27.93 for gross proceeds of \$36.5 million.

We have a dividend reinvestment program, whereby shareholders may use their dividends and optional cash payments to purchase common shares. The common shares sold under this program may either be common shares issued by us or common shares purchased in the open market. We did not issue any shares under this program during the 2015 Period.

Preferred Equity

Washington REIT's Board of Trustees can, at its discretion, authorize the issuance of up to 10.0 million shares of preferred stock. The ability to issue preferred equity provides Washington REIT an additional financing tool that may be used to raise capital for future acquisitions or other business purposes. As of June 30, 2015, no shares of preferred stock had been issued.

Dividends

We currently pay dividends quarterly at a rate of \$0.30 per share. The maintenance of our dividend level is subject to various factors reviewed by the Board of Trustees in its discretion. These factors include our results of operations, the

availability of cash to make the necessary dividend payments and the effect of REIT distribution requirements, which require at least 90% of our taxable income to be distributed to shareholders. When setting the dividend level, our Board looks in particular at trends in our level of funds from operations, together with associated recurring capital improvements, tenant improvements, leasing commissions and tenant incentives, and adjustments to straight-line rents to reflect cash rents received.

Our dividend and distribution payments for the three and six months ended June 30, 2015 and 2014 are as follows (in thousands):

	Three Months Ended June 30,				Six Months Ended June 30,				
	2015	2014	Change		2015	2014	Change		
			\$	%	\$		\$	%	%
Common dividends	\$20,500	\$20,043	\$457	2.3	% \$41,019	\$40,134	\$885	2.2	%
Distributions to noncontrolling interests	—	3,454	(3,454)	(100.0)%	—	3,454	(3,454)	(100.0)%	
	\$20,500	\$23,497	\$(2,997)	(12.8)%	\$41,019	\$43,588	\$(2,569)	(5.9)%	

The increase in dividends paid is primarily due to shares issued under the Prior ATM during the fourth quarter of 2014 and the first quarter of 2015. The decrease in distributions to noncontrolling interests is related to the disposition of 4661 Kenmore Avenue as part of the Medical Office Portfolio sale (see note 3 to the consolidated financial statements).

Historical Cash Flows

Cash flows from operations are an important factor in our ability to sustain our dividend at its current rate. If our cash flows from operations were to decline significantly from current levels, we may have to reduce our dividend.

Consolidated cash flow information is summarized as follows (in thousands):

	Six Months Ended June 30,		Change	
	2015	2014	\$	%
Net cash provided by operating activities	\$54,332	\$39,123	\$15,209	38.9
Net cash provided by (used in) investing activities	6,108	(7,168)	13,276	185.2
Net cash used in financing activities	(53,489)	(139,289)	85,800	61.6

Cash provided by operating activities increased primarily due to income from properties acquired in 2014.

Cash provided by investing activities increased primarily due to lower capital expenditures.

Cash used in financing activities decreased primarily due to higher net borrowings on our unsecured line of credit.

Funds From Operations

NAREIT FFO is a widely used measure of operating performance for real estate companies. We provide NAREIT FFO as a supplemental measure to net income calculated in accordance with GAAP. Although NAREIT FFO is a widely used measure of operating performance for REITs, NAREIT FFO does not represent net income calculated in accordance with GAAP. As such, it should not be considered an alternative to net income as an indication of our operating performance. In addition, NAREIT FFO does not represent cash generated from operating activities in accordance with GAAP, nor does it represent cash available to pay distributions and should not be considered as an alternative to cash flow from operating activities, determined in accordance with GAAP, as a measure of our liquidity. The National Association of Real Estate Investment Trusts, Inc. ("NAREIT") defines NAREIT FFO (April, 2002 White Paper) as net income (computed in accordance with GAAP) excluding gains (or losses) from sales of property and impairments of depreciable real estate, if any, plus real estate depreciation and amortization. We consider NAREIT FFO to be a standard supplemental measure for REITs because it facilitates an understanding of the operating performance of our properties without giving effect to real estate depreciation and amortization, which historically assumes that the value of real estate assets diminishes predictably over time. Since real estate values have instead historically risen or fallen with market conditions, we believe that NAREIT FFO more accurately provides investors an indication of our ability to incur and service debt, make capital expenditures and fund other needs. Our NAREIT

FFO may not be comparable to FFO reported by other REITs. These other REITs may not define the term in accordance with the current NAREIT definition or may interpret the current NAREIT definition differently.

The following table provides the calculation of our NAREIT FFO and a reconciliation of NAREIT FFO to net income for the three and six months ended June 30, 2015 and 2014 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Net income	\$ (2,886)	\$ 1,080	\$ 26,512	\$ 105,634
Adjustments:				
Depreciation and amortization	25,503	24,401	50,778	47,154
Net gain on sale of depreciable real estate	—	(282)	(30,277)	(106,555)
Income from operations of properties sold or held for sale	—	—	—	(546)
Funds from continuing operations	22,617	25,199	47,013	45,687
Discontinued operations:				
Income from operations of properties sold or held for sale	—	—	—	546
Funds from discontinued operations	—	—	—	546
NAREIT FFO	\$ 22,617	\$ 25,199	\$ 47,013	\$ 46,233

Critical Accounting Policies and Estimates

We base the discussion and analysis of our financial condition and results of operations upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. We discuss the most critical estimates in our Annual Report on Form 10-K for the year ended December 31, 2014 filed with the Securities and Exchange Commission on March 2, 2015.

ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The principal material financial market risk to which we are exposed is interest-rate risk. Our exposure to market risk for changes in interest rates relates primarily to refinancing long-term fixed rate obligations, the opportunity cost of fixed rate obligations in a falling interest rate environment and our variable rate lines of credit. We primarily enter into debt obligations to support general corporate purposes including acquisition of real estate properties, capital improvements and working capital needs.

As the majority of our outstanding debt is long-term, fixed rate debt, our interest rate risk has not changed significantly from what was disclosed in our Annual Report on Form 10-K for the year ended December 31, 2014 filed with the Securities and Exchange Commission on March 2, 2015. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources – Debt Financing.”

ITEM 4: CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Securities Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer, Chief Financial Officer and Executive Vice President of Accounting, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer, Chief Financial Officer and Executive Vice President of Accounting, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on the foregoing, our Chief Executive Officer, Chief Financial Officer and Executive Vice President of Accounting concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

There have been no changes in Washington REIT's internal control over financial reporting (as defined by Rule 13a-15(f)) that occurred during the period covered by the report that have materially affected, or are reasonably likely to materially affect, Washington REIT's internal control over financial reporting.

PART II
OTHER INFORMATION

ITEM 1: LEGAL PROCEEDINGS

None.

ITEM 1A: RISK FACTORS

None.

ITEM 2: UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

A summary of our repurchases of shares of our common stock for the three months ended June 30, 2015 was as follows:

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares that May Yet be Purchased
April 1 - April 30, 2015	5,654	\$26.15	N/A	N/A
May 1 - May 31, 2015	—	N/A	N/A	N/A
June 1 - June 30, 2015	—	N/A	N/A	N/A
Total	5,654	26.15	N/A	N/A

(1) Represents restricted shares surrendered by employees to Washington REIT to satisfy such employees' applicable statutory minimum tax withholding obligations in connection with the vesting of restricted shares.

ITEM 3: DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4: MINE SAFETY DISCLOSURES

None.

ITEM 5: OTHER INFORMATION

As previously reported on a Form 8-K filed with the SEC on February 20, 2015, Laura M. Franklin will resign from her position as Executive Vice President - Accounting and Administration after the filing of this Form 10-Q. As previously reported on a Form 8-K filed with the SEC on July 23, 2015, the Board of Trustees of Washington REIT elected W. Drew Hammond as Vice President - Chief Accounting Officer and Controller, such election to take effect on the day after the filing of this Form 10-Q. Upon effectiveness of such election, Mr. Hammond will serve as Washington REIT's principal accounting officer.

ITEM 6: EXHIBITS

Exhibit Number	Exhibit Description	Incorporated by Reference			Filing Date	Filed Herewith
		Form	File Number	Exhibit		
10.59	Credit Agreement, dated as of June 23, 2015, by and among Washington REIT, as borrower, the financial institutions party thereto as lenders, and Wells Fargo Bank, National Association, as administrative agent, with Wells Fargo Securities, LLC, and KeyBanc Capital Markets Inc., as joint lead arrangers and joint bookrunners, KeyBank National Association, as syndication agent, and Royal Bank of Canada and SunTrust Bank, as documentation agents	8-K	001-06622	10.1	6/23/2015	
12	Computation of Ratios					X
31.1	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended (“the Exchange Act”)					X
31.2	Certification of the Executive Vice President – Accounting and Administration pursuant to Rule 13a-14(a) of the Exchange Act					X
31.3	Certification of the Executive Vice President and Chief Financial Officer pursuant to Rule 13a-14(a) of the Exchange Act					X
32	Certification of the Chief Executive Officer, Executive Vice President – Accounting and Administration and Chief Financial Officer pursuant to Rule 13a-14(b) of the Exchange Act and 18U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002					X
101	The following materials from our Quarterly Report on Form 10–Q for the quarter ended June 30, 2015 formatted in eXtensible Business Reporting Language (“XBRL”): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Shareholders’ Equity, (iv) the Consolidated Statements of Cash Flows, and (v) notes to these consolidated financial statements					X

SIGNATURES

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

WASHINGTON REAL ESTATE INVESTMENT TRUST

/s/ Paul T. McDermott
Paul T. McDermott
President and Chief Executive Officer

/s/ Laura M. Franklin
Laura M. Franklin
Executive Vice President
Accounting and Administration
(Principal Accounting Officer)

/s/ Stephen E. Riffie
Stephen E. Riffie
Executive Vice President and Chief Financial Officer
(Principal Finance Officer)

DATE: August 5, 2015