Primo Water Corp
Form 10-K
March 17, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)
þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2013

OR

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

COMMISSION FILE NUMBER 001-34850

PRIMO WATER CORPORATION
(Exact name of registrant as specified in its charter)

Delaware (State of incorporation)	30-0278688 (I.R.S. Employer Identification No.)
104 Cambridge Plaza Drive, Winston-Salem, NC (Address of principal executive office)	27104 (Zip code)

(336) 331-4000
(Registrant's telephone number, including area code)

Securities Registered Pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
$0.001 Par Value Common Stock	The NASDAQ Stock Market LLC

Securities Registered Pursuant to Section 12(g) of the Act: NONE

Indicate by checkmark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by checkmark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

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 þ No o

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

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

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 o	Accelerated filer o
Non-accelerated filer o (Do not check if smaller reporting company)	Smaller reporting company þ

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

The aggregate market value of voting and non-voting common equity held by non-affiliates of the registrant, as of June 30, 2013, was approximately $36,558,604 based on the closing sales price of the common stock on such date as reported on the NASDAQ Global Market.

As of March 7, 2014, there were 24,076,244 shares of our Common Stock, par value $0.001 per share, outstanding.

Documents Incorporated by Reference

Portions of the Proxy Statement for the Annual Meeting of Stockholders to be held on May 1, 2014 are incorporated by reference into Part III of this Form 10-K.

PRIMO WATER CORPORATION

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PART 1

Note: Items 10-14 are incorporated by reference from the Proxy Statement.

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PART I

Cautionary Note Regarding Forward-Looking Statements

This document includes "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include statements about our estimates, expectations, beliefs, intentions or strategies for the future, and the assumptions underlying such statements. We use the words "anticipates," "believes," "estimates," "expects," "intends," "forecasts," "may," "will," "should," and similar expressions to identify our forward-looking statements. Forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from historical experience or our present expectations. Factors that could cause these differences include, but are not limited to, the factors set forth under Part I, Item 1A - Risk Factors.

Caution should be taken not to place undue reliance on our forward-looking statements, which reflect the expectations of management only as of the time such statements are made. Except as required by law, we undertake no obligation to update publicly or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

Item 1. Business

Company Background

Primo Water Corporation (together with its consolidated subsidiaries, "Primo", "we", "our," "us") is a leading provider of multi-gallon purified bottled water, self-service refill water and water dispensers sold through major retailers in the United States and Canada. We believe the market for purified water is growing due to evolving taste preferences, perceived health benefits and concerns regarding the quality of municipal tap water. Our products provide an environmentally friendly, economical, convenient and healthy solution for consuming purified and filtered water. We are a Delaware corporation that was founded in 2004 and is headquartered in Winston-Salem, North Carolina.

Our business is designed to generate recurring demand for our purified bottled water or self-serve filtered drinking water through the sale of innovative water dispensers. This business strategy is commonly referred to as "razor-razorblade" because the initial sale of a product creates a base of users who frequently purchase complementary consumable products. We believe dispenser owners consume an average of 35 multi-gallon bottles of water annually. Once our bottled water is consumed using a water dispenser, empty bottles are exchanged at our recycling center displays, which provide a recycling ticket that offers a discount toward the purchase of a new bottle of Primo purified water ("Exchange") or they are refilled at a self-serve filtered drinking water location ("Refill"). Each of our multi-gallon water bottles can be sanitized and reused up to 40 times before being taken out of use, crushed and recycled, substantially reducing landfill waste compared to consumption of equivalent volumes of single-serve bottled water. As of December 31, 2013, our products and services were offered in each of the contiguous United States and in Canada at approximately 22,900 combined retail locations, including Lowe's Home Improvement, Walmart, Kmart, Meijer, Kroger, Food Lion, H-E-B Grocery, Sobeys and Walgreens.

We provide major retailers throughout the United States and Canada with single-vendor solutions for Exchange and Refill services, addressing a market demand that we believe was previously unmet. Our solutions are easy for retailers to implement, require minimal management supervision and store-based labor, and provide centralized billing and detailed performance reports. Our Exchange solution offers retailers attractive financial margins and the ability to optimize typically unused retail space with our displays. Our Refill solution provides filtered water through the installation and servicing of reverse osmosis water filtration systems in the back room of the retailer's store location, which minimizes the usage of the customer's retail space. The refill machine, which is typically accompanied by a sales display containing empty reusable bottles, is located within the retailer customer's floor space. Additionally, due to the recurring nature of water consumption, retailers benefit from year-round customer traffic and highly predictable revenue.

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On November 12, 2013, we entered into a strategic alliance agreement (the "DS Agreement") with DS Waters of America, Inc. ("DS Waters") pursuant to which DS Waters will act as the primary bottler and distributor and provider of exchange and supply services for the Exchange business in the United States. Pursuant to the agreement, DS Waters will become our primary bottler and distributor in the United States in all territories for which we do not currently have an existing distributor agreement and in other territories as existing distributor arrangements expire or are terminated. We currently expect the transition from our current network of distributors to DS Waters to occur over a two year period.

Business Segments

We have two operating segments and two reportable segments: Primo Water ("Water") and Primo Dispensers ("Dispensers"). See Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations and "Note 14 – Segments" in the Notes to Consolidated Financial Statements in Item 8 herein.

Industry Overview

We believe there are several trends that support consumer demand for our Exchange and Refill services and water dispensers including the following:

Emphasis on Health and Wellness. As part of a desire to live a healthier lifestyle, we believe consumers are increasingly focused on drinking greater quantities of water.

Concerns Regarding Quality of Municipal Tap Water. Many consumers purchase bottled water because of concerns regarding municipal tap water quality. Municipal water is typically surface water that is treated centrally and pumped to homes, which can allow chemical contaminants to dissolve into the water through municipal or household pipes impacting taste and quality and present microbiological contaminants from cracks in municipal pipes.

Growing Preference for Purified Water. We believe consumer preference toward purified water relative to tap water continues to grow as purified water has become accepted on a mainstream basis. While it is difficult to quantify purified water consumption in all of its forms, according to a 2012 report by industry consulting firm Beverage Marketing Corp. Americans spent $21.7 billion on bottled water in 2011.

Increasing Demand for Products with Lower Environmental Impact. We believe that consumers are increasingly favoring products with a lower environmental impact with a "reuse, recycle, reduce" mindset becoming a common driver of consumer behavior. Most single-serve polyethylene terephthalate ("PET") water bottles are produced using fossil fuels and contribute to landfill waste given that only 29% of PET bottles are recycled according to a May 2013 Environmental Protection Agency report. Governmental legislation also reflects these concerns with the passage of "bottle bills" in many jurisdictions that tax the purchase of plastic water bottles, require deposits with the purchase of certain plastic bottles, prohibit the use of government funds to purchase plastic water bottles and ban certain plastic bottles from landfills.

Availability of an Economical Exchange Service, Refill Service and Innovative Water Dispensers. Based on estimates derived from industry data, we believe the current household penetration rate of multi-gallon water dispensers is estimated to be 4.4% in the United States, with the vast majority of these households utilizing traditional home delivery services. We believe the lack of innovation, design enhancement and functionality and the retail pricing structure of our competitors' dispenser models have prevented greater household adoption. Compounding these issues, we believe there previously was no economical water bottle exchange and refill service with major retailer relationships throughout the United States and Canada to promote dispenser usage beyond the traditional home delivery model. We believe our Exchange and Refill services provide this alternative and we believe we are currently the only provider delivering a solution to retailers throughout United States and Canada. We believe there are over 200,000 major retail locations throughout the United States and Canada that we can target to sell our dispensers or offer our Exchange service and Refill services.

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Our Competitive Strengths

We believe that Primo's competitive strengths include the following:

Appeal to Consumer Preferences

- Environmental Awareness. Both our Exchange and Refill services incorporate the reuse of existing bottles, recycle water bottles when their lifecycle is complete and reduce landfill waste and fossil fuel usage compared to alternative methods of bottled water consumption.

- Value. We provide consumers the opportunity for cost savings when consuming our bottled water compared to both single-serve bottled water and typical home and office delivery services. Our water dispensers are sold at attractive retail prices in order to enhance consumer awareness and adoption of our Exchange and Refill services, increase household penetration and drive sales of our purified and filtered water.

- Convenience. Our Exchange and Refill services and water dispensers are available at major retail locations in the United States and Canada. In addition, our Exchange and Refill services provide consumers the convenience of either exchanging empty bottles and purchasing full bottles or refilling the empty bottles at any participating retailer.

- Taste. We have dedicated significant time and effort to develop our water purification process and formulate the proprietary blend of mineral ingredients included in our Primo purified water offered through our Exchange service. We believe that Primo purified water has a silky smooth taste profile.

- Health and Wellness. As part of a desire to live a healthier lifestyle, we believe that consumers are increasingly focused on drinking more water relative to consumption of other beverages. As we raise our brand awareness, we believe consumers will recognize that our water bottle exchange and refill services are an effective option for their water consumption needs.

Key Retail Relationships Served by a Single-Vendor Solution. We believe we are the only provider of Exchange and Refill services with a single-vendor solution for retailers in the United States and Canada. Our direct sales force actively pursues headquarters-based retail relationships to better serve our retail customers and to minimize layers of approval and decision-making with regard to the addition of new retail locations. Our bottling and distribution network utilizes our MIS tools and processes to optimize their production and distribution assets while servicing our retail customers. We believe the combination of our major retail relationships, unique single-vendor solution for retail customers, bottling and distribution network and our MIS tools is difficult to replicate. We anticipate these factors will facilitate our introduction of new purified water-related products in the future.

Ability to Attract and Retain Consumers. We offer "razor-razorblade" products designed to generate recurring demand for Primo water (the razorblade) through the initial sale of our innovative water dispensers (the razor), which often include a coupon for a free multi-gallon bottle of Primo Exchange or Refill services. We acquire new consumers and enhance recycling efforts by accepting most dispenser-compatible water bottles in exchange for a recycle ticket discount toward the purchase of a full bottle of Primo purified water. In addition, we believe our offering of high-quality water dispensers enhances consumer awareness and adoption of our Exchange and Refill services, increases household penetration and drives sales of our Water.

Efficient Business Model. Our business model allows us to efficiently offer our solutions to our retail partners and centrally manage our bottling and distribution network without a substantial capital investment. We believe our business processes and MIS tools enable us to manage the bottling and distribution of our Water, servicing of our refill locations, our product quality, retailer inventory levels and the return of used bottles on a centralized basis, leveraging our invested capital and personnel.

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Benefit from Management's Proven Track Record. We benefit greatly from management experience gained over the last 20 years in exchange businesses to implement and refine best practices and develop and maintain key business relationships. In addition to our Chief Executive Officer, our Chief Financial Officer and Senior VP / General Manager – Consumer Innovation and Global Sourcing all held comparable positions within the Blue Rhino organization during its rapid sales and location growth. Our Chief Operating Officer, who joined the Company in December 2012, was previously employed by Coinstar, Inc. where he was instrumental in building the Redbox exchange business.

Growth Strategy

We seek to increase our market share and drive further growth in our business by pursuing the following strategies:

Increase Penetration with Existing Retail Relationships and Develop New Retail Relationships. We believe we have significant opportunities to increase store penetration with our existing retail relationships. As of December 31, 2013, our Exchange and Refill services were offered at approximately a combined 15,700 of our top ten retailers' locations. Such retailers present us an opportunity of approximately 25,000 additional Exchange or Refill locations. There is minimal overlap where our Exchange and Refill services are offered. We intend to further penetrate our other existing retail customers with our supplementary hydration solutions which collectively provide us the opportunity to be present in more than 50,000 additional Exchange or Refill locations.

Our long-term strategy includes increasing our locations to 50,000 to 60,000 retail store locations (which includes new locations with our existing retail customers) within our primary retail categories of home centers, hardware stores, mass merchants, membership warehouses, grocery stores, office supply stores, drug stores and discount general merchandise stores for our Exchange and Refill services. We believe that the introduction of additional hydration solutions to our product portfolio will allow us to cross-sell products to our existing and newly-acquired retail customers.

Drive Consumer Adoption Through Innovative Water Dispenser Models. We intend to continue to develop and sell innovative water dispensers at attractive retail prices, which we believe is critical to increasing consumer awareness and driving consumer adoption of our Water services. We believe the current household penetration rate of multi-gallon water dispensers is approximately 4.4% in the United States. Our long term strategy is to provide multiple purified water-based-beverages from a single Primo water dispenser, which we believe will lead to greater household penetration, with consistent promotion of our Exchange and Refill services to supply the purified water. At December 31, 2013, we offered our water dispensers at approximately 7,200 locations in the United States, including Lowes Home Improvement, Walmart, Kmart, Target, Sam's Club, and Costco.

Increase Same Store Sales. We sell our water dispensers at minimal margin and often provide a coupon for a free multi-gallon bottle of water with the sale of various water dispensers at certain retailers to drive consumer demand for our Exchange and Refill services. We believe increasing unit sales of Primo Water is dependent on generating greater consumer awareness of the environmentally friendly and economical aspects of and the convenience associated with our purified bottled water and our Exchange and Refill services. We expect that our branding, cross-promotion marketing and sales efforts will result in greater usage of our Exchange and Refill services.

Develop and Install Other Hydration Solutions. We believe we have significant opportunities to leverage our bottling and distribution network and our systems and processes to offer other environmentally friendly, economical, convenient and healthy hydration solutions to our retail partners without significant increases in our centralized costs.

Pursue Strategic Acquisitions to Augment Geographic and Retail Relationships. We believe opportunities exist to expand through selective acquisitions, including smaller water bottle exchange businesses with established retail accounts, other on-premises self-service water refill machine networks and retail accounts, ice dispenser machine networks and retail accounts and water dispenser or other beverage-related appliance companies.

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Product Overview

Water. We have dedicated significant time and effort in developing our water purification process and formulating the proprietary blend of mineral ingredients included in the purified bottled water offered through our Exchange service. Our proprietary blend of mineral ingredients was developed with the assistance of consultants and several months of lab work and taste tests and has what we believe to be a silky smooth taste. To ensure that our safety standards are met and United States Food and Drug Administration ("FDA") and industry standards are met or exceeded, each production lot of our purified water undergoes chemical and microbiological testing by the bottler and all facilities bottling Primo purified water undergo regular hygiene audits by a third party hired by us. Our Refill service consists of carbon filtration and a reverse osmosis water filtration system that provides filtered drinking water, which is periodically tested for quality. All state or industry standards related to our purified or filtered water are met or exceeded.

Water Bottles. We currently source three- and five-gallon water bottles from multiple independent vendors for use in our Exchange service. Each of our Primo water bottles includes a handle designed for easy transportation and lifting when installing the bottle onto or into one of our water dispensers. Our bottles also include a specially designed cap that prevents spills when carrying or installing. For our Refill service, we offer empty reusable one-, two-, three- and five-gallon bottles for a sales display that typically accompany a refill machine, which are sourced from several manufacturers.

Water Dispensers. We currently source and market two lines of water dispensers comprised of approximately 29 models. Our dispensers are designed to dispense Primo and other dispenser-compatible bottled water. Our dispensers have manufacturer suggested retail prices that range from $299.99 for our top-of-the-line bottom-loading model with a coffee maker to $9.99 for a simple pump that can be installed on a bottle and operated by hand. Currently, more than 75% of our dispenser sales are attributable to our bottom- and top-loading products. Consistent with our environmental focus, our electric dispensers are Energy Star® rated, and, we believe, utilize less energy than competing water dispensers without this industry rating. Currently, all of our water dispensers are manufactured by independent suppliers in China.

Primo Water Marketing

Our marketing efforts focus primarily on developing and maintaining a brand identity synonymous with an environmentally friendly, economical, convenient and healthy solution for purified water consumption. We direct our marketing efforts as close as possible to the point of sale to strengthen our brand and promote consumer awareness of our Exchange service. We believe our Exchange service develops consumer loyalty through the use of our recycling tickets, while our Refill services develop consumer loyalty through preferred pricing. Our marketing efforts include the following initiatives: (i) prominent display of our Primo logo and distinctive four-bubble design on water bottles, sales and recycling displays and water dispensers; (ii) highly visible sales and recycling center displays; and (iii) regular cross marketing promotions.

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The Primo Supply Chain

Water Purification and Bottling

In our Exchange services our independent bottlers are responsible for the water purification and bottling process and use their own equipment to complete this process. Our bottling process begins with either spring water or water from a public source that is processed through a pre-filtration stage to remove large particles. The water is then passed through polishing filters to catch smaller particles followed by a carbon filtration process that removes odors, tastes, sanitization by-products and pharmaceutical chemicals. A microfiltration process then removes microbes before the water is passed through a softener to increase the purification efficiency. The water next passes through the last phase of reverse osmosis or distillation, completing the purification process. After the purification process is complete, our proprietary blend of mineral ingredients is injected into the water followed by the final ozonation process to sanitize the water. Each of our production lots is placed on a 48-hour hold to allow for testing by the bottler and to ensure successful compliance with chemical and microbiological standards. We have the ability to trace each bottle of Primo water to its bottling and distributor sources, and we regularly perform recall tests to ensure our ability to react to a contamination event should it occur.

Our distributors are responsible for collecting empty Primo bottles and other dispenser-compatible bottles that are deposited into our recycling center displays. At the completion of the delivery cycle, a distributor inspects the exchanged bottles for reusability and coordinates the recycling efforts with our operations personnel to ensure that reuse of each water bottle we receive in the exchange process is being optimized. Our water bottles can be sanitized and reused up to 40 times before being taken out of use, crushed and recycled, substantially reducing landfill waste compared to consumption of similar amounts of single-serve PET bottled water. Bottles that pass a distributor’s initial inspection are subject to three washing cycles to wash and disinfect. Bottles are then passed through two sanitization stages before a final rinse with hyper-ozonated water to kill or inactivate any microbes that remain at that point in the sanitization process. The water bottles are then ready to be filled with our purified water.

Reverse Osmosis Water Filtration Systems

The reverse osmosis water filtration systems used in our Refill service are placed under services agreements with retail customers who pay fees based on the number of gallons of water used or dispensed by the system. Under this program we own the water filtration system and the required service and maintenance on the systems is performed by our independent distributors or company service technicians. Meter read data necessary for billing our retail customers is transmitted to us electronically or obtained by the distributor or company service technician during a visit to the retail location.

The reverse osmosis water filtration system is comprised of two components: reverse osmosis water filtration equipment and a refill machine. The water filtration equipment is typically installed in the back room of a retail location and all such equipment generally has the same component filters and parts. A water line is installed from the water filtration equipment to the refill machine. The retail customer will specify the location of the refill machine, which is typically in the water aisle or back wall of the store. The retail customer is responsible for the plumbing, electrical and drainage requirements of an installation.

The regular maintenance, completed by our distributors or company service technicians, generally includes a monthly sanitization of the refill machine, a monthly system component check and any necessary preventative maintenance resulting from such component check and may include a water test for regulatory purposes. The various jurisdictions in which we operate have specific weekly, bimonthly, monthly, quarterly or annual water testing reporting requirements with which our distributors comply, but they perform water tests on each refill machine unit at least quarterly.

We outsource an operations team which assembles, refurbishes and repairs the refill machines. This team routinely refurbishes equipment that has been in service for several years or when a customer requests a refreshed system. The operations team also procures new filtration systems component parts and assembles the units and ships them to locations for installation by our distributors. The component parts are generally sourced from multiple suppliers.

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Distribution Network

We rely on our bottling and distribution network to deliver our Exchange and Refill solutions to retailers. Our Exchange process begins when a distributor is directed through our proprietary MIS tool, PrimoLink, to stock or replenish Exchange locations. PrimoLink enables our distributors to review delivery quantities and tentative scheduling requirements in their territory. Our systems provide anticipated demand based on historical sales and, to the extent available, retailer point of sale ("POS") data. Each distributor is provided information to enable the distributor to load a truck with the appropriate inventory to stock or restock the Exchange sales displays on its route, including a tailored amount of excess bottles as safety stock. Upon arrival at each retail location, the driver first visits the recycling center display to collect empty Primo and other dispenser-compatible bottles. The driver enters data related to empty bottles on a handheld device to collect exchange efficiency information and potential customer conversion data and then loads empty bottles onto the truck. The driver next checks the in-store sales display to compare the number of remaining bottles of water with the anticipated demand report generated by our MIS tools. After entering current stock levels, the driver replenishes the sales display.

At the completion of the delivery cycle and after inspection of the bottles, our distributors are responsible for coordinating the sanitization and bottling process with our bottlers. In addition, distributors must run end-of-day reports on their handheld devices which transmit crucial data points into our databases and validate daily activity. Our handheld devices also capture electronic signatures, significantly reducing paper exchange. This greatly improves our verification procedures and enhances our environmental efforts. We have the ability to test and refine procedures through our Company-operated distribution system before implementing them with our independent distributors nationwide. In addition, we regularly solicit feedback from our independent distributors to improve processes.

As described above, we entered into a strategic alliance agreement with DS Waters in November 2013 pursuant to which DS Waters will act as the primary bottler and distributor and provider of exchange and supply services for the Exchange business in the United States. We expect to transition the majority of the distribution responsibilities in our Exchange services to DS Waters over the course of the next two years.

Our Refill process begins when a distributor is directed through a proprietary dispatching MIS Tool, to schedule meter readings, quality testing, preventative maintenance and repairs. Our systems allow the distributor to see the previous meter read or previous performed preventative maintenance. For certain customers, meter readings and other data are transmitted to us electronically, allowing for proactive, remote monitoring and reducing unnecessary visits to customer locations. The distributors are responsible for the initial installation of the reverse osmosis water filtration systems, the regular maintenance of the systems, any necessary repairs, routine water testing and monthly meter reading to determine retail customer water usage. In certain regions with a dense retail footprint we utilize company service technicians rather than independent distributors to service Refill customer locations. In these regions, we believe that this approach results in lower costs and improved service and brand presence.

Flow of Payments and Capital Requirements

We control the flow of payments between our retail customers and our bottlers and distributors through electronic data interchange. Depending on the retailer, our distributors either present the store manager with an invoice for the bottles delivered or meter reading or our systems electronically bill the retailer. We believe our Exchange service provides five-gallon bottles of purified water that typically cost a consumer between $5.99 and $6.99, after giving effect to the discount provided by our recycling ticket, while our Refill service typically costs a consumer between $0.25 and $0.50 per gallon, depending upon the location and the retailer's overall pricing strategy.

We generally compensate our distributors with a fixed payment per delivered Exchange water bottle. We compensate our independent Refill services providers on a fixed service fee per location or a commission based upon a percentage of total revenues at the locations for which the distributor is responsible, subject to minimum and maximum amounts. Due to the high degree of automation during our billing and inventory management procedures, we are able to leverage our centralized personnel and believe we will be able to significantly expand our business with minimal increases in variable costs.

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We focus our capital investments on developing new retail relationships, installing new store locations, raising brand awareness, research and development for new products and maintaining our MIS tools. We are also responsible for the centralized operations and personnel, sales and recycling displays, bottles, closures, transportation racks, mineral packets and mineral injectors, reverse osmosis equipment and parts, displays and handheld devices. Our bottling and distribution network typically has made the capital investment required to operate our services, including a majority of the capital expenditures related to the bottling, sanitization and refill process and the distribution assets such as delivery trucks and warehouse storage. Participation in our Exchange or Refill service does not typically require the independent bottlers and distributors to make substantial new investments because they often are able to augment their current production capacity and leverage their existing bottling and distribution assets. In addition, many of our major retail customers have invested their capital to expand store locations and generate customer traffic.

Retailer Relationships

We target major retailers with either a national footprint or a significant regional concentration. Our relationships are diversified among the following retail categories and major accounts:

Retail Category	Major Accounts
Home Centers / Hardware Stores	Lowe’s Home Improvement, Ace Hardware, True Value
Mass Merchants	Walmart, Target, Kmart, Meijer
Grocery Stores	Kroger, Food Lion, Safeway, Sobeys, H-E-B, Hy-Vee
Membership Warehouses	Sam’s Club, Costco
Drug Stores	Walgreens
Office retail	Office Depot

Retailer Opportunity. We offer retailers a single-vendor solution for our Exchange and Refill services. Our services provide retailers with a year-round consumer product and an opportunity to increase sales and profits with minimal labor and financial investment. Through our bottling and distribution network, we are able to service major retailers nationwide. Retailers benefit from our Exchange and Refill services that offer high margin and generate productivity from often underutilized interior and exterior retail space. In addition, these services have the potential to increase retailers’ sales of ancillary products through increased traffic from repeat water consumers, who we believe purchase an average of 35 water bottles annually.

Account Set-Up. We actively pursue headquarters-based retail relationships to better serve our retail partners and minimize layers of approval and decision-making with regard to the roll-out of our Exchange or Refill service to multiple locations. Upon confirmation of new retail locations, we coordinate with the retailer and distributor to schedule openings in a timely manner. We actively assist retailers in developing site plans for the setup of our sales and recycling center displays and reverse osmosis water filtration systems. While retailer setup preferences may vary, retailers often like to locate the recycling center display prominently on the exterior of their store to ease the transaction process, showcase their recycling and environmental efforts and conserve inside floor space while at the same time promoting the Primo brand.

Account Service. Our Exchange and Refill services are turn-key programs for retailers in which we and our distributors actively service each retail account. After the retail location is established, our distributors complete on-site training and have an economic interest in supporting and growing the business relationship to increase product throughput.

Sales Support. While distributors service our retail accounts, the customer relationship is “owned” and maintained by our experienced retail sales organization, which allows us to develop strong brand affinity and maintain key headquarters-based relationships to secure and maintain our retail network. Our retail relationships are divided into regions and managed by our sales personnel. This combined team is responsible for selling and supporting our Exchange and Refill services to targeted retailers.

Significant Customers. For the year ended December 31, 2013, Walmart and Lowe’s Home Improvement represented approximately 45% and 25% of our consolidated net sales, respectively.

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Bottler and Distributor Network

Bottler and Distributor Opportunity. We provide independent bottlers and distributors with an attractive business opportunity, complementing many of their existing operations. As described above, we entered into a strategic alliance agreement with DS Waters in November 2013 pursuant to which DS Waters will act as the primary bottler and distributor and provider of exchange and supply services for the U.S. Exchange business. We continually pursue new relationships and additional locations with existing retail partners to increase the production at each bottler's manufacturing facility and the retail customer density within each distributor's territory.

Bottler and Distributor Standards. We work very closely with our bottling and distribution network to ensure their production and storage standards meet or exceed the requirements of the FDA and other industry regulations. As we seek to promote our brand, we believe it is critical to provide bottled water that has consistent taste and is produced in a manner that exceeds current industry requirements. We regularly monitor, test and arrange for third-party audits of each bottling facility.

In addition, we regularly monitor our distributors' performance to ensure a high level of account service. Distributors are generally required to develop an infrastructure sufficient to complete customer installations within 30 days of the notification of a newly established account, monitor and maintain inventory levels with assigned retail accounts and resolve water bottle stock-outs within 36 hours.

Bottler and Distributor Selection Process. We have selectively identified and pursued high quality independent bottlers and distributors that can support our major retailers nationwide. We screen all independent bottler and distributor candidates by reviewing credit reports, safety records and manufacturing compliance reports, and conducting management reference checks. As a result of this thorough selection process, we have established what we believe to be highly dependable relationships with our independent bottlers and distributors. We believe we have a positive relationship with each of these parties and our senior executives have maintained a business relationship with many of our key distributors since they were managing operations at Blue Rhino Corporation. As a result of our entry into the strategic alliance agreement with DS Waters, we expect that the number of independent bottlers and distributors that support our Exchange business will decrease substantially over the course of the next two years.

Bottler and Distributor Services. We currently employ raw material procurement and supply chain personnel who perform periodic inventory audits and month-end review procedures. In addition we have operations personnel who manage our independent bottler and distributor relationships, including training and monitoring personnel and activities. We also employ customer service personnel who handle bottler, distributor, retailer and end-user phone calls.

Company-Owned Distribution Operations. As of December 31, 2013, we owned and operated a single distributor that has Exchange distribution responsibilities for certain regions of North Carolina.

Independent Distributor Agreements. With respect to our Exchange service, we have entered into distributor agreements with each of our independent distributors on substantially similar terms. While individual agreements contain variances and exceptions, the material terms of such agreements are described generally below. As of December 31, 2013, no individual bottler or distributor is material to our overall financial condition or results of operations. As described above, we expect DS Waters will become our primary bottler and distributor in the United States in all territories for which we do not currently have an existing distributor agreement and in other territories as existing regional operator arrangements expire or are terminated. As this transition occurs, we expect that DS Waters will become material to our overall financial condition and results of operations.

Independent Bottler Certification Agreement. In our independent bottler certification agreement, we appoint a bottler as a non-exclusive supplier of our purified drinking water. The bottler is restricted from competing with us during the term of the agreement and for a specified period after the term in a specified geography.

The bottler is required to bottle and deliver product in conformance with our specifications, including our proprietary mineral formula. The bottler must ensure that our bottled water products comply with applicable state, provincial and local laws, rules and regulations (including those of the FDA and Health Canada) and our quality requirements. The agreement also imposes requirements on the bottler with respect to the maintenance of its facilities and equipment that are intended to ensure the quality of our products.

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Besides requiring that bottlers meet all of the food safety product requirements and the Primo quality standards, the bottler certification agreement also requires the bottlers to follow the Primo brand specifications in all fashions. The bottlers must ensure that the product meets all of the brand standards. Bottlers are also bound in the agreement to keep all Primo intellectual property and trade secrets confidential.

Historically, we have provided the necessary bottles, caps, labels, transportation racks, mineral injectors and formula minerals at no charge to the bottler to support the bottling and supply of our bottled water products. The bottler is required to maintain inventory levels necessary to satisfy our production requirements. Product may not be released for shipment until the bottler meets all applicable quality requirements.

Exchange Distribution Agreement. In our independent distributor agreement for the Exchange service, we grant a distributor the right to serve as our exclusive delivery and service agent and representative with respect to our bottled water exchange service for a specified term in a specified geographic territory. The distributor is restricted from competing with us during the term of the agreement and for a specified period after the term in the specified geography. We have the right, at any time, to purchase a distributor's rights under the agreement, along with related distribution equipment, for an amount based on the distributor's revenues under the agreement for the prior twelve-month period and the fair market value of the equipment being purchased.

The distributor must perform its services under the agreement in conformance with our distributor manual and all applicable laws and regulations, including those of the FDA and Health Canada.

We compensate a distributor for its services while maintaining a direct relationship with and collecting payments from our retailer customers within the distributor's service territory. Pricing is set forth in the agreement, and we have the right to modify pricing and payment terms on thirty days' notice to the distributor.

The agreements generally have a ten-year term, and if not otherwise terminated, automatically renew for successive one-year terms after the initial ten-year term. Either party may terminate the agreement for, among other reasons, an uncured material breach by the other party.

Refill Standards. We work very closely with our distributors of our refill services to ensure operation and sanitation standards meet or exceed the requirements of state regulations, requirements, NAMA standards, other industry standards and the Primo Water standard. As we seek to promote our brand, we believe it is critical to provide filtered drinking water and is produced in a manner that exceeds current industry requirements. We regularly monitor, test and arrange for third-party hygiene testing of production and dispenser units.

In addition, we regularly monitor our distributors' performance to ensure a high level of account service. Our distributors are generally required to develop an infrastructure sufficient to complete customer installations within 30 days of the notification of a newly established account, monitor and maintain production and dispenser operation and quality and resolve production unit and dispenser failures within 36 hours.

Refill Services Agreements. Our independent distributors of our Refill services are responsible for the initial installation of the reverse osmosis water filtration systems, the regular maintenance of the systems, any necessary repairs, routine water testing and monthly meter reading to determine retail customer water usage.

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Management Information Systems

We have made a substantial investment in MIS tools which enhance our ability to process orders, manage inventory and accounts receivable, maintain distributor and customer information, maintain cost-efficient operations and assist distributors in delivering products and services on a timely basis. Our technology utilizes highly integrated, scalable software applications that cost-effectively support our network of retail partners. Our MIS tools also allow us to analyze historical trends and data to further enhance the execution, service and identification of new markets and marketing opportunities. The primary components of our systems include the following:

Sales and Marketing Support Systems. We operate a single customer relationship management database that integrates all financial and transaction-based data with respect to each retail account. Our MIS tools provide our account managers and customer service specialists access to crucial data to effectively manage each bottler, distributor and retail relationship.

Bottler and Distributor Level Technology. Our distribution process is highly automated and scalable. Our technology allows bottlers and distributors timely access to information for customer support needs and provides access to real-time data to enhance decisions. In addition, each distributor is electronically linked to our systems with our proprietary PrimoLink software. PrimoLink enables distributors to review Exchange delivery quantities and tentative scheduling requirements across our entire bottling and distribution network. In addition, our MIS tools allow drivers to update delivery, inventory and invoicing information through handheld devices. This technology provides retailers with accurate and timely Exchange inventory and invoices and assists each distributor in managing its responsibilities.

Financial Integration. We utilize Microsoft’s Dynamics GP software as our core platform which interfaces with all of our systems. Each handheld device is based on Microsoft’s operating system and ensures integration within our reporting and financial databases. All transactions are validated and data is imported into our database tables and mapped to corresponding accounting ledgers.

Manufacturing and Sourcing

Our manufacturing strategy is to utilize independent manufacturers to produce empty water bottles, sales displays and recycle centers, refill machines and water dispensers at a reasonable cost. We believe that using independent manufacturers has several advantages over our manufacturing these items directly, including (i) decreased capital investment in manufacturing plants and equipment and working capital, (ii) the ability to leverage independent manufacturers’ purchasing relationships for lower materials costs, (iii) minimal fixed costs of maintaining unused manufacturing capacity and (iv) the ability to utilize our suppliers’ broad technical and process expertise.

Currently, all of our water dispensers are assembled by independent manufacturers in China, which utilize several sub-suppliers to provide components and subassemblies. We have the sole North American rights to develop products with certain manufacturers and each dispenser unit is produced to our design specifications. Each unit is inspected and tested for quality by the manufacturer’s personnel prior to shipment and any units returned by consumers or retailers are reported to the manufacturer, who issues a credit, replacement or refund.

Our water bottles and caps are produced by multiple independent vendors throughout the United States. We select suppliers based on price, quality and geographic proximity to our bottlers and retail customers. We only purchase water bottles for our Exchange services with handles as a convenience feature for consumers.

Our sales displays, recycle centers and refill machines are made to our design. We frequently request bids from multiple independent manufacturers to achieve optimal pricing.

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Product Design and Development

A primary focus of our product research and development efforts is developing innovative water dispensers as part of our strategy to enhance consumer awareness and adoption of our Exchange and Refill services, increase household penetration and drive sales of our water. We continually work to improve water dispenser features, seek to lower manufacturing costs so that our innovative products are more affordable and introduce new models. Innovative improvements developed in cooperation with our manufacturing partners include bottom-loading dispensers, self-cleaning and faster water dispensing capabilities. Our water dispenser models are designed to appeal to consumers of diverse demographic audiences. In 2012, we began selling the first water dispenser model that includes a 12-cup drip coffee maker. In addition, we are developing a water dispenser product that provides consumers the ability to dispense hot and cold still water as well as brew hot single-serve beverages.

Competition

We participate in the highly competitive bottled water segment of the nonalcoholic beverage industry. While the industry is dominated by large and well-known international companies, numerous smaller firms are also seeking to establish market niches. We believe we have a unique business model in the bottled water market in the United States in that we not only offer three- and five-gallon bottled water on a nationwide basis but also provide consumers the ability to exchange their used containers as part of our Exchange service. We believe that we are one of the first companies to provide a national Exchange service at retail. While we are aware of a few direct competitors that operate similar networks, we believe they operate on a much smaller scale than we do and do not have equivalent MIS tools or bottler and distributor capabilities to effectively support major retailers nationwide. Competitive factors with respect to our business include pricing, taste, advertising, sales promotion programs, product innovation, efficient production and distribution techniques, introduction of new packaging, and brand and trademark development and protection.

Our primary competitor in our United States Exchange business is Nestlé. Nestlé offers this service on a regional basis, but not on a national basis. However, Nestlé is a leading consumer products company, has substantially greater financial and other resources than we do, has established a strong brand presence with consumers and has established relationships with retailers, manufacturers, bottlers and distributors necessary to start an exchange business at retail locations nationwide should they decide to do so. In addition to competition between firms within the bottled water industry, the industry itself faces significant competition from other non-alcoholic beverages, including carbonated and non-carbonated soft drinks and waters, juices, sport and energy drinks, coffees, teas and spring and tap water.

We also compete directly and indirectly in the water dispenser marketplace. This marketplace is diverse and faces competition from other methods of purified water consumption such as countertop filtration systems, faucet mounted filtration systems, in-line whole-house filtration systems, water filtration dispensing products such as pitchers and jugs, standard and advanced feature water coolers and refrigerator-dispensed filtered and unfiltered water.

Our Refill service also participates in the highly competitive purified water segment of the nonalcoholic beverage industry. While the industry is dominated by large and well-known international companies, numerous smaller firms are also seeking to establish market niches. Our Refill service business model is differentiated from most of the participants in the North American nonalcoholic beverage industry in that it offers self-service refill of drinking water. There are a few direct competitors that offer similar refill services, but with the exception of Glacier Water Services, Inc., we believe these direct competitors generally operate on a smaller geographical and operational scale than our Refill service. Our Refill service faces two levels of competition: (i) competition at the retail customer level to secure placement of its reverse osmosis water filtration systems in the store; and (ii) competition at an end-user level to convince consumers to purchase its water versus other options. Competitive factors with respect to our Refill service include pricing, taste, advertising, sales promotion programs, retail placement, introduction of new packaging and branding.

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Many of the indirect competitors in the bottled water segment of the nonalcoholic beverage industry are leading consumer products companies, have substantially greater financial and other resources than us, have established a strong brand presence with consumers and have established relationships with retailers, manufacturers, bottlers and distributors necessary to start a self-service drinking water refill business at North American retail locations should they decide to do so. In addition to competition between firms within the bottled water industry, the industry itself faces significant competition from other nonalcoholic beverages, including carbonated and non-carbonated soft drinks and waters, juices, sport and energy drinks, coffees, teas and spring and tap water.

Intellectual Property and Trademarks

We believe that our intellectual property provides a competitive advantage and we have invested substantial time, effort and capital in establishing and protecting our intellectual property rights. We have filed certain patent applications and trademark registration applications and intend to seek additional patents, to develop additional trademarks and seek federal registrations for such trademarks and to develop other intellectual property. We consider our Primo name and related trademarks and our other intellectual property to be valuable to our business and the establishment of a national branded bottled water exchange service. We rely on a combination of patent, copyright, trademark and trade secret laws and other arrangements to protect our proprietary rights. We own ten United States federal trademark registrations, including registrations for our Primo® and Taste Perfection® trademarks, our Primo® logo and our distinctive four bubble design. U.S. federal trademark registrations generally have a perpetual duration if they are properly maintained and renewed. We also own a pending application to register our Zero Waste. Perfect Tastetm trademark in the United States and Canada for use in association with drinking water dispensers, bottled drinking water and a variety of other non-alcoholic beverages. In addition, the design of our recycling center displays is protected by four United States design patents and two Canadian industrial design registrations. The United States design patents expire between May 2021 and April 2022 and, the Canadian industrial design registrations expire in May 2017.

In addition to patent protection, we also rely on trade secrets and other non-patented proprietary information relating to our product development, business processes and operating activities. We regard portions of our proprietary MIS tools, various algorithms used in our business and the composition of our mineral formula to be valuable trade secrets of Primo. We seek to protect this information through appropriate efforts to maintain its secrecy, including confidentiality agreements.

Governmental Regulation

The conduct of our businesses and the production, distribution, advertising, promotion, labeling, safety, transportation, sale and use of our products are subject to various laws and regulations administered by federal, state, provincial and local governmental agencies in the United States and Canada. It is our policy to abide by the laws and regulations that apply to us, and we require our bottling, manufacturing, and distributing partners to comply with all laws and regulations applicable to them.

We are required to comply with:

- federal laws, such as the US Federal Food, Drug and Cosmetic Act, the Canadian Food and Drug Act and the US Occupational Safety and Health Act;
- customs and foreign trade laws and regulations;
- state and provincial consumer protection laws;

- federal, state, provincial and local environmental, health and safety laws;
- laws governing equal employment opportunity and workplace activities; and
- various other federal, state, provincial and local statutes and regulations.

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We maintain environmental, health and safety policies and a quality, environmental, health and safety program designed to ensure compliance with applicable laws and regulations.

The FDA regulates bottled water as a food under the federal Food, Drug and Cosmetic Act. Our bottled water must meet FDA requirements of safety for human consumption, identity, quality and labeling. The Canadian Health Canada Division 12 regulates bottled water in Canada. Our bottled water must meet FDA and Health Canada ("HC") requirements of safety for human consumption, identity, quality and labeling. Further, the sale and marketing of our products is subject to FDA's and HC's and the US FTC and Canadian Competition Bureau advertising and promotion requirements and restrictions. In addition, FDA and HC has established current "good manufacturing practice" regulations, which govern the facilities, methods, practices and controls used for the processing, bottling and distribution of bottled drinking water. We and our third-party supply, bottling and distribution partners are subject to these requirements. We also must comply with overlapping and sometimes inconsistent state and provincial regulations in various jurisdictions. As a result, we must expend resources to continuously monitor state and provincial legislative and regulatory activities for purposes of identifying and ensuring compliance with the laws and regulations that apply to our bottled water business in each state in which we operate. While we must meet the government-mandated standards, we believe that our self-imposed standards meet or exceed those set by federal, state, provincial and local regulations.

Additionally, the manufacture, sale and use of resins used to make water bottles are subject to regulation by the FDA and HC. Those regulations are concerned with substances used in food packaging materials, not with specific finished food packaging products. We believe our beverage containers are in compliance with FDA and HC regulations. Additionally, the use of polycarbonates in food containers used by children under three years of age is subject to certain state and local restrictions.

Measures have been enacted in various localities, provinces and states that require a deposit or tax to be charged for certain non-refillable beverage containers. The precise requirements imposed by these measures vary. Other deposit, recycling or product stewardship proposals have been introduced in various jurisdictions. We anticipate that similar legislation or regulations may be proposed in the future at the local, state, provincial and federal levels.

The refill machines used with the reverse osmosis water filtration systems are certified by the National Automatic Merchandising Association ("NAMA"). NAMA maintains a certification program which evaluates food and beverage machines against current requirements of the U.S. Public Health Service Ordinance and Code. Currently, there are no US or Canadian regulations that cover our refill machines. However, certain states, provinces and other regional localities have permit and testing requirements for the operation of the refill machines.

Seasonality

We have experienced and expect to continue to experience seasonal fluctuations in our sales and operating income. Our sales and operating income have been highest in the spring and summer, and lowest in the fall and winter. Our Exchange and Refill services, which generally enjoy higher margins than our sales of water dispensers, experience higher sales and operating income in the spring and summer. We have historically experienced higher sales and operating income from our water dispensers in spring and summer; however, we believe the seasonality of dispenser sales are more dependent on retailer inventory management and purchasing cycles and not correlated to weather. Sustained periods of poor weather, particularly in the spring and summer, can negatively impact our sales in our higher margin Exchange and Refill services. Accordingly, our results of operations in any quarter will not necessarily be indicative of the results that we may achieve for a fiscal year or any future quarter.

Employees

As of December 31, 2013, we had 95 employees, all of whom were full time. We believe that our continued success will depend on our ability to continue to attract and retain skilled personnel. We have never had a work stoppage and none of our employees are represented by a labor union. We believe our relationship with our employees is good.

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Exchange Act Reports

We make available free of charge through our Internet website, www.primowater.com, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports as soon as reasonably practicable after such materials are electronically filed with or furnished to the Securities and Exchange Commission (“SEC”). The SEC maintains an Internet website, www.sec.gov, which contains reports, proxy and information statements, and other information filed electronically with the SEC. Any materials that the we file with the SEC may also be read and copied at the SEC's Public Reference Room, 100 F Street, N.E., Room 1580, Washington, D. C. 20549. Information on the operations of the Public Reference Room is available by calling the SEC at 1-800-SEC-0330. The information provided on our website is not part of this report and is not incorporated herein by reference.

Item 1A. Risk Factors

Risks Relating to Our Business and Industry

We have incurred operating losses in the past and may incur operating losses in the future.

We have incurred operating losses in the past and expect to incur operating losses in the future. As of December 31, 2013, our accumulated deficit was $249.8 million. Our losses from continuing operations were $8.8 million for the year ended December 31, 2013 and $93.3 million for the year ended December 31, 2012. We have not been profitable since our inception, and we may not become profitable in the future. Our losses may continue as we incur additional costs and expenses related to branding and marketing, expansion of operations, strategic acquisitions, product development, development of relationships with strategic business partners, regulatory compliance and litigation. If our operating expenses exceed our expectations, our financial performance will be adversely affected. If our sales do not grow to offset these increased expenses, we may not become profitable. If we do not achieve sustained profitability, we may be unable to continue operations.

We depend on a small number of large retailers for most of our consumer sales. Our arrangements with these retailers for our bottled water exchange services and sales of our water dispensers are nonexclusive and may be terminated at will.

Certain retailers make up a significant percentage of our retail sales volume, such that if one or more of these retailers were to materially reduce or terminate its business with us, our sales would suffer. For 2013, Walmart and Lowe’s Home Improvement represented approximately 45% and 25% of our consolidated net sales, respectively. While we sell a small percentage of our dispensers directly to consumers through our online store and other direct sales channels, the vast majority of our sales are made through our retail partners.

We have arrangements with certain retailers for our products and services, but we cannot provide any assurance of any future sales. None of our significant retail accounts are contractually bound to offer our Exchange service or water dispensers. As a result, retailers can discontinue our Exchange services or products at any time and offer a competitor’s services or products, or none at all. Additionally, the contractual commitments of retail customers of our refill services are not long-term in nature. Continued positive relations with a retailer depend upon various factors, including price, customer service, consumer demand and competition. Certain of our retailers have multiple vendor policies and may seek to offer a competitor’s products or services at new or existing locations. If any significant retailer materially reduces, terminates or is unwilling to expand its relationship with us, or requires price reductions or other adverse modifications in our selling terms, our sales would suffer.

Additionally, most major retailers continually evaluate and often modify their in-store retail strategies, including product placement, store set-up and design, promotions and demographic targets. Our business could suffer significant setbacks in net sales and operating income if one or more of our major retail customers modified its current retail strategy resulting in a termination or reduction of its business relationship with us, a reduction in store penetration or an unfavorable product placement within such retailer's stores, any or all of which could materially adversely affect our business, financial condition, results of operations and cash flows.

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We may experience difficulties in realizing the anticipated benefits associated with our strategic alliance agreement with DS Waters of America, Inc. ("DS Waters") and transitioning the services to be provided thereunder from our existing bottling and distribution network.

We may not be able to realize all of the anticipated benefits and synergies associated with the strategic alliance agreement (the "DS Agreement") that we recently entered into with DS Waters. The ability to realize the anticipated benefits of this arrangement (including incremental revenue, reduced distribution costs and improved gross margins over time) will depend, to a large extent, on our ability to successfully transition the services provided by our existing bottling and distribution network to DS Waters and to integrate the bottling, distribution, exchange and supply services to be provided by DS Waters into our water bottle exchange business. The transition to and integration of a new primary service provider is a complex, costly and time-consuming process. As a result, we are devoting significant management attention and resources to a transition plan that will implement these new bottling, distribution and service arrangements. Both our entering into the DS Agreement and this transition process may disrupt our existing bottling and distributor network, which could negatively impact our business and results of operations and otherwise preclude realization of the full benefits we expect to realize from the new arrangements. The failure to transition our bottling and distribution arrangements to DS Waters or to otherwise integrate the services to be provided by DS Waters into our business could cause an interruption of, or a loss of momentum in, our business activities, and could negatively impact our results of operations. In addition, if we are not successful in transitioning a certain volume of service rights to DS Waters in the prescribed time period, the compensation we are required to pay to DS Waters under the DS agreement will negatively impact the anticipated benefits of this arrangement. The transition of our bottling and distribution requirements to DS Waters may result in unanticipated problems, expenses, liabilities, competitive responses, loss of bottler, distributor and customer relationships, and a diversion of management's attention. If any of our retailer customers are not satisfied with the performance of services provided by DS Waters, we could lose the business of that retailer customer which would negatively impact our business. Finally, we expect to incur costs in connection with assuming account management, billing and collections responsibility for DS Waters' current three and five gallon retail exchange customers and, if we do not realize the anticipated benefits of the business arrangement with DS Waters, including the anticipated revenues related to the addition of existing retail customers of DS Waters' three and five gallon retail bottled water exchange business as new customers of our water bottle exchange business, these costs could have a material adverse effect on our business, result of operations and financial condition.

The success of our business depends on retailer and consumer acceptance of our products and services.

We are a consumer products and services company operating in the highly-competitive bottled water market and rely on continued consumer demand or preference for our products and services. To generate sales and profits, we must sell products that appeal to retailers and to consumers. Our future success depends on consumer acceptance, particularly at the household level, of our products and services. There is no guarantee that there will be significant market acceptance of our Exchange and Refill services or that we will be successful in selling our water dispensers on a scale necessary to achieve sustained profitability.

As a result of our "razor-razorblade" business strategy, we are reliant on consumer adoption of our "razors" (water dispensers) to drive sales of the "razorblades" (Exchange and Refill services). If we are unable to generate consumer adoption of our water dispensers, we will face significant difficulties growing sales of our Exchange and Refill services, which would materially adversely affect our business, financial condition, results of operations and cash flows.

The markets for our products and services are evolving rapidly and we may not be able to accurately assess the size of the markets or trends that may emerge and affect our businesses. Consumer preference can change due to a variety of factors, including social trends, negative publicity and economic changes. If we are unable to convince current and potential retail customers and individual consumers of the advantages of our products and services, our ability to sell our products and services will be limited. Consumer acceptance also will affect, and be affected by, our existing retail partners' and potential new retail partners' decisions to sell our products and services and their perception of the likelihood of consumers purchasing our products and services. Even if retail customers purchase our products or services, there is no guarantee that they will be successful in selling our products or services to consumers on a scale necessary for us to achieve sustained profitability. Any significant changes in consumer preferences for purified bottled water could result in reduced demand for our products and services and erosion of our competitive and financial position.

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We may not be able to obtain capital when desired on favorable terms, if at all, or without dilution to our stockholders.

At December 31, 2013, our cash totaled $0.4 million and we had $0.5 million in additional availability under the Senior Revolving Credit Facility. We anticipate that our current cash and cash equivalents, availability under the Senior Revolving Credit Facility and cash flow from operations will be sufficient to meet our current capital needs for general corporate purposes. However, we may need or desire additional capital to finance our operations or to execute on our current or future business strategies, including to:

- expand the number of retail store locations in which our products and services are offered;
- enhance our operating infrastructure;
- acquire new businesses, products or technologies; or
- otherwise respond to competitive pressures.

If we raise additional funds through the issuance of equity or convertible debt securities, the percentage ownership of our stockholders could be significantly diluted, and these newly issued securities may have rights, preferences or privileges senior to those of existing stockholders. We cannot assure you that additional financing will be available on terms favorable to us, or at all, particularly in light of the current economic downturn and the restrictions included in the documents governing our current indebtedness. If adequate funds are not available or are not available on acceptable terms, when we desire them, our ability to invest in our operations, take advantage of unanticipated opportunities, develop or enhance our services, or otherwise respond to competitive pressures would be significantly limited and we could be forced to reduce, delay or cancel capital expenditures, sell assets, or scale down our operations, all of which could harm our ability to generate revenues and reduce the value of our stock.

We operate in a highly competitive industry, face competition from companies with far greater resources than we have and could encounter significant competition from these companies in our niche markets of water bottle exchange services and related products and refill services.

We primarily participate in the highly competitive bottled water segment of the nonalcoholic beverage industry. The industry is dominated by large and well-known international companies, and numerous smaller firms are also seeking to establish market niches. In our business model, we not only offer three- and five-gallon bottled water but also provide consumers the ability to exchange their used containers as part of our Exchange service. While we are aware of a few direct competitors that operate water bottle exchange networks at retail, we believe they operate on a much smaller scale than we do and we believe they do not have equivalent MIS tools or bottling and distribution capabilities to effectively support major retailers nationwide. Competitive factors with respect to our business include pricing, taste, advertising, sales promotion programs, product innovation, increased efficiency in production and distribution techniques, the introduction of new packaging and brand and trademark development and protection.

Our primary competitors in our bottled water business include Nestlé, The Coca-Cola Company, PepsiCo and Dr Pepper Snapple Group. While none of these companies currently offers a nationwide water bottle exchange service at retail, Nestlé offers this service on a regional basis. Many of these competitors are leading consumer products companies, have substantially greater financial and other resources than we do, have established a strong brand presence with consumers and have established relationships with retailers, manufacturers, bottlers and distributors necessary to start an exchange business at retail locations nationwide should they decide to do so. Our Refill services business faces direct competition in its industry and for its retail customers from Glacier Water Services, Inc., which has a strong brand presence and greater financial and other resources than we have. Competitors with greater financial resources may put pressure on the prices at which we offer our products and services which would have a negative impact on our margins. In addition to competition between companies within the bottled water industry, the industry itself faces significant competition from other non-alcoholic beverages, including carbonated and non-carbonated soft drinks and waters, juices, sport and energy drinks, coffees, teas and spring and tap water.

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Our bottled water business also faces competition from other methods of purified water consumption such as countertop filtration systems, faucet mounted filtration systems, in-line whole-house filtration systems, water filtration dispensing products such as pitchers and jugs, standard and advanced feature water coolers and refrigerator dispensed filtered and unfiltered water.

We also compete directly and indirectly in the water dispenser marketplace. There are many large consumer products companies with substantially greater financial and other resources, a larger brand presence with consumers and established relationships with retailers that could decide to enter the marketplace. Should any of these consumer products companies so decide to enter the water dispenser marketplace, sales of our water dispensers could be materially and adversely impacted, which, in turn, could materially and adversely affect our sales of bottled water.

In our bottled water exchange business, we depend on independent bottlers, distributors and suppliers for our business to operate.

While we expect the actual number of independent bottlers, distributers and suppliers we use to provide our Exchange service to decrease in connection with our strategic alliance with DS Waters, we will continue to be substantially dependent on independent bottlers, distributors and suppliers to bottle and deliver our bottled water products and provide our Exchange service to our retail customers. We do not have our own manufacturing facilities to produce bottled water products. We are and will continue to be for the foreseeable future, entirely dependent on third parties to supply the bottle pre-forms, bottles, water and other materials necessary to operate our bottled water business. We rely on third-party supply companies to manufacture our three- and five-gallon water bottles and deliver them to our bottlers. In turn, we rely on bottlers to properly purify the water, include our mineral enhancements and bottle the finished product without contamination and pursuant to our quality standards and preparation procedures. Finally, we rely upon our distributors to deliver bottled water to our retail partners in a timely manner, accurately enter information regarding the delivery of the bottles into our management information system, manage our recycling center displays and return used bottles to the bottlers to be sanitized or crushed and recycled.

We can make no assurance that we will be able to maintain these third-party relationships until the transition of their responsibilities to DS Waters is complete. As independent companies, these bottlers, distributors and suppliers make their own business decisions. Suppliers may choose not to do business with us for a variety of reasons, including competition, brand identity, product standards and concerns regarding our economic viability. They may have the right to determine whether, and to what extent, they produce and distribute our products, our competitors' products and their own products. Some of the business for these bottlers, distributors and suppliers comes from producing or selling our competitors' products. These bottlers, distributors and suppliers may devote more resources to other products or take other actions detrimental to our brands. In addition, their financial condition could also be adversely affected by conditions beyond our control and our business could suffer. In addition, we will face risks associated with any bottler's or distributor's or DS Waters' failure to adhere to quality control and service guidelines we establish or failure to ensure an adequate and timely supply of product and services at retail locations. Additionally, once we have transitioned the majority of the bottling and distribution responsibilities in our Exchange services to DS Waters, we will be substantially dependent on DS Waters' ability to provide bottling and distribution services to our retail partners. Should our strategic arrangement with DS Waters not be successful or should the strategic alliance agreement not be extended beyond its seven year term, we may be unable to re-establish our relationships with our current independent bottlers, distributors and suppliers or establish additional relationships as necessary to support growth and profitability of our business on economically viable terms. Any of these factors could negatively affect our business and financial performance. If we are unable to obtain and maintain a source of supply for bottles, water and other materials, our business will be materially and adversely affected.

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In our bottled water exchange business, if our distributors do not perform to our retailers' expectations, if we encounter difficulties in managing our distributor operations or if we or our distributors are not able to manage growth effectively, our retail relationships may be adversely impacted and business may suffer.

We currently rely on our independent distributors to deliver our three- and five-gallon bottled water and provide our Exchange service to retailers, but we plan to transition these responsibilities to DS Waters. Accordingly, our success depends on our ability to manage our retail relationships through the performance of our distributor partners and the performance of DS Waters. The majority of our current distributors and DS Waters are independent and we exercise only limited influence over the resources they devote to delivery and exchange of our three- and five-gallon water bottles. Our retailers impose demanding service requirements on us and we could suffer a loss of consumer or retailer goodwill if our distributors or DS Waters do not adhere to our quality control and service guidelines or fail to ensure an adequate and timely supply of bottled water at retail locations. The poor performance of services provided to a major retailer could jeopardize our entire relationship with that retailer and cause our bottled water sales and Exchange service to suffer. In addition, the number of retail locations offering our Exchange service and our corresponding sales have grown significantly over the past several years along with our national distributor network. Accordingly, our current distributors and DS Waters must be able to adequately service an increasing number of retail accounts. If our growth is not managed effectively, our bottled water sales and Exchange service may suffer.

If the providers of our Refill services do not perform to retailer expectations, our retail relationships may be adversely impacted and business may suffer.

With respect to our Refill services, at December 31, 2013 we primarily relied on independent service providers to install, maintain and repair the reverse osmosis water systems at our retail customers' locations. These independent service providers are also responsible for providing retail customer training with respect to the reverse osmosis water systems, submitting water for testing and conducting monthly meter readings to determine water usage for billing purposes. Accordingly, the success of our Refill services depends on our ability to manage our retail relationships through the performance of these service providers. The significant majority of these service providers are independent dealers and we exercise only limited influence over the resources they devote to their responsibilities with respect to our retail customers. Our success with respect to our Refill services currently depends on our ability to establish and maintain relationships with these independent service providers and on the service providers' ability to operate viable businesses. There can be no assurance that we will be able to continue to maintain such relationships. Retail customers of our Refill services impose demanding service requirements and we could suffer a loss of retailer or consumer goodwill if these service providers do not perform to the retail customers' expectations. The poor performance of a single service provider to a major retailer could jeopardize our entire relationship with that retailer potentially preventing future installations at additional retail locations and causing sales to suffer.

If we lose key personnel or are unable to recruit qualified personnel, our ability to implement our business strategies could be delayed or hindered. In addition, we may not be able to attract and retain the highly skilled employees we need to support our planned growth.

We are highly dependent upon the services of our senior management because of their experience, industry relationships and knowledge of the business. We are particularly dependent on the services of Billy D. Prim, our Chairman and Chief Executive Officer. We do not have a formal succession plan in place for Mr. Prim.

The loss of one or more of our key employees could seriously harm our business and we may not be able to attract and retain individuals with the same or similar level of experience or expertise. We face competition for qualified employees from numerous sources and there can be no assurance that we will be able to attract and retain qualified personnel on acceptable terms. Our ability to recruit and retain such personnel will depend upon a number of factors, such as our results of operations, prospects and the level of competition then prevailing in the market for qualified personnel. Failure to recruit and retain such personnel could materially adversely affect our business, financial condition and results of operations. While our employment agreements with members of our senior management include customary confidentiality, non-competition and non-solicitation covenants, there can be no assurance that such provisions will be enforceable or adequately protect us.

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We have substantial Canadian operations and are exposed to fluctuations in currency exchange rates and political uncertainties.

We have substantial Canadian operations, and as a result, we are subject to risks associated with doing business internationally. Risks inherent to operating internationally include: changes in a country's economic or political conditions; changes in foreign currency exchange rates; and unexpected changes in regulatory requirements.

To the extent the United States dollar strengthens against the Canadian dollar, our foreign revenues and profits will be reduced when translated into United States dollars.

In our water dispenser business, because all of our dispensers are manufactured in China, a significant disruption in the operations of these manufacturers or political unrest in China could materially adversely affect us.

We have only three manufacturers of water dispensers. Any disruption in production or inability of our manufacturers to produce quantities of water dispensers adequate to meet our needs could significantly impair our ability to operate our water dispenser business on a day-to-day basis. Our manufacturers are located in China, which exposes us to the possibility of product supply disruption and increased costs in the event of changes in the policies of the Chinese government, political unrest or unstable economic conditions in China, changes in currency exchange rates or developments in the U.S. that are adverse to trade, including enactment of protectionist legislation. In addition, our dispensers are shipped directly from the manufacturer to our retail partners. Although we routinely inspect and monitor our manufacturing partners' activities and products, we rely heavily upon their quality controls when producing and delivering the dispensers to our retail partners. Any of these matters could materially adversely affect our water dispenser business and, as a result, our profitability.

If the water we sell became contaminated, our business could be seriously harmed.

We have adopted various quality, environmental, health and safety standards. However, our products may still not meet these standards or could otherwise become contaminated. A failure to meet these standards or contamination could occur in our operations or those of our bottlers, distributors or suppliers. Such a failure or contamination could result in expensive production interruptions, recalls and liability claims. A widespread product recall could result in losses due to the costs of a recall, the destruction of product inventory and lost sales due to the unavailability of product for a period of time. We could also suffer losses from a significant product liability judgment against us. Moreover, negative publicity could be generated even from false, unfounded or nominal liability claims or limited recalls. Any of these failures or occurrences could negatively affect our business and financial performance.

If any component of the water dispensers we sell is misused, the appliance may fail and cause personal injury or property damage. We may be subject to product liability claims as a result of any such failure, which will likely increase our costs and adversely affect our business and reputation.

Although we include explicit instructions for the operation of our water dispensers we sell and safety warnings are included on all of the products we sell, consumers may misuse these products, including by tampering with the hot water safety lock devices, which could expose consumers to hot liquids. The misuse of any of the components of our water dispensers we sell may cause personal injury and damage to property.

Our product liability insurance for personal injury and damage to property may not be sufficient or available to cover any successful product liability claim, or similar claims, against us, which could materially adversely impact our financial condition. Whether or not a claim against us would be successful, defense of the claim may be costly and the existence of any claim may adversely impact our reputation, financial condition or results of operations.

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Interruption or disruption of our supply chain, distribution channels, bottling and distribution network or third-party services providers could adversely affect our business, financial condition and results of operations.

Our ability and that of our business partners, including suppliers, bottlers, distributors, retailers and third-party distributors and service providers, to manufacture, sell and deliver products and services is critical to our success. Interruption or disruption of our supply chain, distribution channels or service network due to unforeseen events, including war, terrorism and other international conflicts, public health issues, natural disasters such as earthquakes, fires, hurricanes or other adverse weather and climate conditions, strikes and other labor disputes, whether occurring in the United States or abroad, could impair our ability to manufacture, sell or deliver our products and services.

The consolidation of retail customers may adversely impact our operating margins and profitability.

Our customers, such as mass merchants, supermarkets, warehouse clubs, food distributors and drug and pharmacy stores, have consolidated in recent years and consolidation may continue. These consolidations have produced large, sophisticated customers with increased buying power. As a result, we are increasingly dependent on key retailers, which have significant bargaining power. If we fail to respond to these trends in our industry, our volume growth could slow or we may need to lower prices or increase trade promotions and consumer marketing for our products and services, both of which would adversely affect our margins and our financial results. These retailers may use floor or shelf space currently used for our products and services for their own private label products and services. In addition, retailers are increasingly carrying fewer brands in any one category and our results of operations will suffer if we are not selected by our significant customers to remain a vendor. In the event of consolidation involving our current retailers, we may lose key business if the surviving entities do not continue to purchase products or services from us.

While many members of our senior management have experience as executives of a products and exchange services business, there can be no assurances that this experience and past success will result in our business becoming profitable.

Many members of our senior management have had experience as senior managers of a company engaged in the supply, distribution and exchange of propane gas cylinders. While the business model for that company and the model for our business are similar, the propane gas industry and the bottled water industry are very different. For example, there are no assurances that consumer demand will exist for our products and services. While we believe our business model will be successful, any similarity between our business model and that of our senior management's predecessor employer should not be viewed as an indication that we will be profitable.

We depend on key management information systems.

We depend on our management information systems (MIS) to process orders, manage inventory and accounts receivable, maintain distributor and customer information, maintain cost-efficient operations and assist distributors in delivering products and services on a timely basis. Any disruption in the operation of our MIS tools, the loss of employees knowledgeable about such systems, the termination of our relationships with third-party MIS partners or our failure to continue to effectively modify such systems as business expands could require us to expend significant additional resources or to invest additional capital to continue to manage our business effectively, and could even affect our compliance with public reporting requirements. Additionally, our MIS tools are vulnerable to interruptions or other failures resulting from, among other things, natural disasters, terrorist attacks, software, equipment or telecommunications failures, processing errors, computer viruses, hackers, other security issues or supplier defaults. Security, backup and disaster recovery measures may not be adequate or implemented properly to avoid such disruptions or failures. Any disruption or failure of these systems or services could cause substantial errors, processing inefficiencies, security breaches, inability to use the systems or process transactions, loss of customers or other business disruptions, all of which could negatively affect our business and financial performance.

We are subject to inventory loss and theft.

We are subject to the risk of inventory loss and theft. We have experienced inventory shrinkage in the past, and we cannot assure you that incidences of inventory loss and theft will decrease in the future or that the measures we are taking will effectively address the problem of inventory shrinkage. Although some level of inventory shrinkage is a necessary and unavoidable cost of doing business, if we were to experience higher rates of inventory shrinkage or incur increased security costs to combat inventory theft, our financial condition could be affected adversely.

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Our results of operations could be adversely affected as a result of the impairment of intangibles.

In accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”), we must identify and value intangible assets that we acquire in business combinations, such as customer arrangements, customer relationships and non-compete agreements, that arise from contractual or other legal rights or that are capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented or exchanged. The fair value of identified intangible assets is based upon an estimate of the future economic benefits expected to result from ownership, which represents the amount at which the assets could be bought or sold in a current transaction between willing parties, other than in a forced or liquidation sale.

U.S. GAAP provides that intangible assets that have indefinite useful lives not be amortized, but instead must be tested at least annually for impairment, and intangible assets that have finite useful lives should continue to be amortized over their useful lives. U.S. GAAP also provides specific guidance for testing goodwill and other non-amortized intangible assets for impairment. Absent any impairment indicators, we perform our impairment tests annually during the fourth quarter.

We review our intangible assets with definite lives for impairment when events or changes in business conditions indicate the carrying value of the assets may not be recoverable, as required by U.S. GAAP. An impairment of intangible assets with definite lives exists if the sum of the undiscounted estimated future cash flows expected is less than the carrying value of the assets. If this measurement indicates a possible impairment, we compare the estimated fair value of the asset to the net book value to measure the impairment charge, if any.

We cannot predict the occurrence of certain future events that might adversely affect the reported value of intangible assets that totaled $10.9 million at December 31, 2013. Such events include strategic decisions made in response to economic and competitive conditions, the impact of the economic environment on our customer base, material negative changes in our relationships with material customers and other parties breaching their contractual obligations under non-compete agreements. Future impairments, if any, will be recognized as operating expenses.

If we are unable to build and maintain our brand image and corporate reputation, our business may suffer.

We are a relatively new company, having been formed in late 2004 and commenced operations in June 2005. Our success depends on our ability to build and maintain the brand image for our existing products and services and effectively build the brand image for any new products. We cannot assure you, however, that any additional expenditures on advertising and marketing will have the desired impact on our products’ brand image and on consumer preferences. Actual or perceived product quality issues or allegations of product contamination, even if false or unfounded, could tarnish the image of our brand and may cause consumers to choose other products. Allegations of product defects or product contamination, even if untrue, may require us from time to time to recall a product from all of the markets in which the affected product was distributed. Product recalls would negatively affect our profitability and brand image. Also, adverse publicity surrounding water usage and any campaigns by activists attempting to connect our system to environmental issues, water shortages or workplace or human rights violations in certain developing countries in which we or our business partners operate, could negatively affect our overall reputation and our products’ acceptance by consumers.

Adverse weather conditions could negatively impact our business.

Unseasonable or unusual weather may negatively impact demand for our products. The sales of our bottled water products, water dispensers and refill services are influenced to some extent by weather conditions in the markets in which we operate. Unusually cool or rainy weather may reduce temporarily the demand for our products and contribute to lower sales, which would have an adverse effect on our results of operations for such periods.

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Water scarcity and poor quality could negatively impact our long-term profitability.

Water is a limited resource facing unprecedented challenges from overexploitation, population growth, increasing pollution, poor management and climate change. As demand for water continues to increase and as water becomes scarcer and the quality of available water deteriorates, our business may incur increasing costs or face capacity constraints which could adversely affect our profitability or net sales in the long run.

Our financial results and achievement of our growth strategy is dependent on our continued innovation and the successful development and launch of new products and product extensions.

Achievement of our growth strategy is dependent, among other things, on our ability to extend the product offerings of our existing brands and introduce innovative new products. Although we devote significant focus to the development of new products, we may not be successful in developing innovative new products or our new products may not be commercially successful. Our financial results and our ability to maintain or improve our competitive position will depend on our ability to effectively gauge the direction of our key marketplaces and successfully identify, develop, manufacture, market and sell new or improved products in these changing marketplaces. In addition, our introduction of new products or product extensions may generate litigation or other legal proceedings against us by competitors claiming infringement of their intellectual property or other rights, which could negatively impact our results of operations.

We may pursue acquisitions and investments in new product lines, businesses or technologies that involve numerous risks, which could disrupt our business or adversely affect our financial condition and results of operations.

We may in the future acquire or invest in new product lines, businesses or technologies to expand our current products and services. Acquisitions present a number of potential risks and challenges that could disrupt our business operations, increase our operating costs or capital expenditure requirements and reduce the value of the acquired product line, business or technology. For example, if we identify an acquisition candidate, we may not be able to successfully negotiate or finance the acquisition on favorable terms or at all. The process of negotiating acquisitions and integrating acquired products, services, technologies, personnel or businesses might result in significant transaction costs, operating difficulties or unexpected expenditures and might require significant management attention that would otherwise be available for ongoing development of our business. If we are successful in consummating an acquisition, we may not be able to integrate the acquired product line, business or technology into our existing business and products and we may not achieve the anticipated benefits of any acquisition. Furthermore, potential acquisitions and investments may divert our management's attention, require considerable cash outlays and require substantial additional expenses that could harm our existing operations and adversely affect our results of operations and financial condition. To complete future acquisitions, we may issue equity securities, incur debt, assume contingent liabilities or incur amortization expenses and write-downs of acquired assets, any of which could dilute the interests of our stockholders or adversely affect our profitability or cash flow.

Economic conditions and other economic factors could impact our business adversely in various respects.

A slowdown in the U.S. economy or other economic factors affecting disposable consumer income, such as employment levels, inflation, business conditions, fuel and energy costs, consumer debt levels, lack of available credit, interest rates, and tax rates, may affect our business adversely by reducing overall consumer spending or by shifting the purchasing habits of our target consumers, both of which could result in lower net sales, decreases in inventory turnover or a reduction in profitability due to lower margins. The current global economic uncertainty, the impact of recessions, and the potential for failures or realignments of financial institutions and the related impact on available credit may impact our suppliers, our distributors, our retail customers, and our operations in an adverse manner including, but not limited to, the inability of our retail customers to timely pay their obligations to us, thus reducing our cash flow, increased costs related to our distribution channels, the inability of our vendors to timely supply materials and an increased likelihood that our lender may be unable to honor its commitments under our senior revolving credit facility.

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Risks Relating to Regulatory and Legal Issues

Our products and services are heavily regulated in the United States and Canada. If we are unable to continue to comply with applicable regulations and standards in any jurisdiction, we might not be able to sell our products in that jurisdiction or they could be recalled, and our business could be seriously harmed.

The production, distribution and sale of our products in the United States are subject to regulation by the FDA under the Federal Food, Drug and Cosmetic Act (the "FDCA"), and by other regulatory authorities under the Occupational Safety and Health Act, the Lanham Act and various environmental statutes. In Canada, these activities are subject to regulation by Health Canada and the Canadian Food Inspection Agency (the "CFIA") under the Canadian Food and Drugs Act. We are also subject to various other federal, state, provincial and local statutes and regulations applicable to the production, transportation, sale, safety, advertising, promotion, labeling and ingredients of such products. For example, measures have been enacted in various localities and states that require a deposit to be charged for certain non-refillable beverage containers. The precise requirements imposed by these measures vary. Other deposit, recycling or product stewardship proposals have been introduced in various jurisdictions. We anticipate that similar legislation or regulations may be proposed in the future at the local, state and federal levels.

The FDA regulates bottled water as a food under the FDCA. Our bottled water must meet FDA and CFIA requirements of safety for human consumption, identity, quality and labeling. Further, any claims we make in marketing our products, such as claims related to the beneficial health effects of drinking water, are subject to FDA's and Canadian Competition Bureau's advertising and promotion requirements and restrictions. In addition, the FDA and HC have established current good manufacturing practices, regulations which govern the facilities, methods, practices and controls used for the processing, bottling and distribution of bottled drinking water. We are subject to additional or changing requirements under the recently enacted Federal Food Safety Modernization Act of 2011, which requires among other things, that food facilities conduct contamination hazard analyses, implement risk-based preventive controls and develop track and trace capabilities. We and our third-party bottling and distribution partners are subject to these requirements. In addition, all public drinking water must meet Environmental Protection Agency standards established under the Safe Drinking Water Act for mineral and chemical concentration and drinking water quality and treatment. We also must comply with overlapping and, in some cases, inconsistent state regulations in a variety of areas. These state-level regulations, among other things, set standards for approved water sources and the information that must be provided and the basis on which any therapeutic claims for water may be made. In Canada, we are subject to similar regulations administered by Health Canada and the CFIA, as well as provincial authorities. We must expend resources to continuously monitor national, state and provincial legislative and regulatory activities in order to identify and ensure compliance with laws and regulations that apply to our bottled water business in each state and province in which we operate.

Additionally, the manufacture, sale and use of resins used to make water bottles are subject to regulation by the FDA and HC. These regulations relate to substances used in food packaging materials, not with specific finished food packaging products. Our beverage containers are deemed to be in compliance with FDA regulations if the components used in the containers: (i) are approved by the FDA and HC as indirect food additives for their intended uses and comply with the applicable FDA indirect food additive regulations; or (ii) are generally recognized as safe for their intended uses and are of suitable purity for those intended uses.

The Consumer Product Safety Commission, FDA, Health Canada, CFIA or other applicable regulatory bodies may require the recall, repair or replacement of our products if those products are found not to be in compliance with applicable standards or regulations. The failure of our third party manufacturers or bottlers to produce merchandise that adheres to our quality control standards could damage our reputation and lead to customer litigation against us. If our manufacturers or distributors are unable or unwilling to recall products failing to meet our quality standards, we may be required to remove merchandise or recall those products at a substantial cost to us. We may be unable to recover costs related to product recalls.

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We believe that our self-imposed standards meet or exceed those set by federal, state, provincial and local regulations. In addition, we voluntarily comply with the Federal Trade Commission's "Green Guides" concerning the making of environmental claims in marketing materials. Nevertheless, our failure or the failure of our suppliers, bottlers, distributors or third-party service providers to comply with federal, state, provincial or local laws, rules or regulations could subject us to potential governmental enforcement action for violation of such regulations, which could result in warning letters, fines, product recalls or seizures, civil or criminal penalties and/or temporary or permanent injunctions, each of which could materially harm our business, financial condition and results of operations. In addition, our failure, or even our perceived failure, to comply with applicable laws, rules or regulations could cause retailers and others to determine not to do business with us or reduce the amount of business they do with us.

There can be no assurance that we will comply with all applicable laws and regulations to which we and our products are subject. If we fail to comply, we may be subject to civil remedies, including fines, injunctions, recalls or seizures, as well as potential criminal sanctions, which could have a material adverse effect on our business, results of operations and reputation.

Litigation or legal proceedings could expose us to significant liabilities, including product liability claims, occupy a significant amount of our management's time and attention and damage our reputation.

We are from time to time party to various litigation claims and legal proceedings. We evaluate these claims and proceedings to assess the likelihood of unfavorable outcomes and estimate, if possible, the amount of potential losses. If our products are not properly manufactured or designed, personal injuries or property damage could result, which could subject us to claims for damages. The costs associated with defending product liability and other claims, and the payment of damages, could be substantial. Our reputation could also be adversely affected by such claims, whether or not successful.

We are currently party to various legal and other proceedings. See Item 3, Legal Proceedings. These matters may involve substantial expense to us and occupy a significant amount of our management's time and attention, which could have a material adverse impact on our financial position and our results of operations. In addition, there could be an increase in the scope of these matters and there could be additional lawsuits, claims, proceedings or investigations in the future. We can provide no assurances as to the outcome of any litigation.

We may establish reserves as appropriate based upon assessments and estimates in accordance with our accounting policies. We base our assessments, estimates and disclosures on the information available to us at the time and rely on legal and management judgment. Actual outcomes or losses may differ materially from assessments and estimates. Actual settlements, judgments or resolutions of these claims or proceedings may negatively affect our business and financial performance. A successful claim against us that is not covered by insurance or is in excess of our available insurance limits could require us to make significant payments of damages and could materially adversely affect our results of operations and financial condition.

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Our inability to protect our intellectual property, or our involvement in damaging and disruptive intellectual property litigation, could adversely affect our business, results of operations and financial condition or result in the loss of use of products or services.

We have filed certain patent applications and trademark registration applications and intend to seek additional patents, to develop additional trademarks and seek federal registrations for such trademarks and to develop other intellectual property. We consider our Primo name and related trademarks and our other intellectual property to be valuable to our business, including the establishment of a national branded bottled water exchange program. We rely on a combination of patent, copyright, trademark and trade secret laws and other arrangements to protect our proprietary rights and could incur substantial expense to enforce our rights under such laws. A number of other companies, however, use trademarks similar or identical to the Primo® mark to identify their products, and we may not be able to stop these other companies from using such trademarks. The requirement to change any of our trademarks, service marks or trade names could entail significant expense and result in the loss of any goodwill associated with that trademark, service mark or trade name. While we have filed, and intend to file in the future, patent applications, where appropriate, and to pursue such applications with the patent authorities, we cannot be sure that patents will be issued on such applications or that any issued patents will not be successfully contested by third parties. Also, since issuance of a patent does not prevent other companies from using alternative, non-infringing technology or designs, we cannot be sure that any issued patents, or patents that may be issued to others and licensed to us, will provide significant or any commercial protection, especially as new competitors enter the market.

In addition to patent protection, we also rely on trade secrets and other non-patented proprietary information relating to our product development, business processes and operating activities. We seek to protect this information through appropriate efforts to maintain its secrecy, including confidentiality agreements. We cannot be sure that these efforts will be successful or that confidentiality agreements will not be breached. We also cannot be sure that we would have adequate remedies for any breach of such agreements or other misappropriation of our trade secrets, or that our trade secrets and proprietary know-how will not otherwise become known or be independently discovered by others. Our failure to successfully develop intellectual property, or to successfully obtain, maintain and enforce patents, trademarks and other intellectual property, could affect our ability to distinguish our products and services from those of our competitors and could cause our sales to suffer.

Where necessary, we may initiate litigation to enforce our patent or other intellectual property rights. Any such litigation may require us to spend a substantial amount of time and money and could distract management from its day-to-day operations. Moreover, there is no assurance that we will be successful in any such litigation or that such litigation will not result in successful counterclaims or challenges to the validity of our intellectual property rights.

Our business and our ability to provide products and services may be impaired by claims that we infringe the intellectual property rights of others. Vigorous protection and pursuit of intellectual property rights characterize the consumer products industry. These traits can result in significant, protracted and materially expensive litigation. In addition, parties making infringement and other claims may be able to obtain injunctive or other equitable relief that could effectively block our ability to provide our products, services or utilize our business methods and could cause us to pay substantial damages. In the event of a successful claim of infringement, we may need to obtain one or more licenses from third parties, which may not be available at a reasonable cost, or at all. It is possible that our intellectual property rights may not be valid or that we may infringe existing or future proprietary rights of others. Any successful infringement claims could subject us to significant liabilities, require us to seek licenses on unfavorable terms, prevent us from manufacturing or selling products, providing services and utilizing business methods and require us to redesign or, in the case of trademark claims, re-brand our Company, products or services, any of which could have a material adverse effect on our business, results of operations or financial condition.

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The three- and five-gallon polycarbonate plastic bottles that we use to bottle our water and sell in connection with our exchange business contain bisphenol A (“BPA”), a chemical that can possibly have adverse health effects on consumers, particularly young children. Any significant change in state, provincial or federal legislation, government regulation or perception by our customers of polycarbonate plastic in food and beverage products could adversely affect our operations and financial results.

Our three- and five-gallon polycarbonate plastic bottles contain BPA. The use of BPA in food packaging materials has been subject to safety assessments by several international, federal and state authorities. Pursuant to the March 30, 2012 FDA ruling, “the Food and Drug Administration’s assessment is that the scientific evidence at this time does not suggest that the very low levels of human exposure to BPA through the diet are unsafe. The most appropriate course of action at this time is to continue scientific study and review of all new evidence regarding the safety of BPA.”

Health Canada's Food Directorate has concluded that the current dietary exposure to BPA through food packaging uses is not expected to pose a health risk to the general population, including newborns and infants. However, due to the uncertainty raised in some animal studies relating to the potential effects of low levels of BPA, the Government of Canada is taking action to enhance the protection of infants and young children. It is therefore recommended that the general principle of ALARA (as low as reasonably achievable) be applied to continue efforts on limiting BPA exposure from food packaging applications to infants and newborns, specifically from pre-packaged infant formula products as a sole source food and baby bottles, for this sensitive segment of the population.

Media reports and the FDA report have prompted concern in our marketplace among existing and potential customers. It is possible that developments surrounding this issue could lead to adverse effects on our business. Such developments could include:

- increased publicity that changes public or regulatory perception regarding packaging that uses BPA, so that significant numbers of consumers stop purchasing products that are packaged in polycarbonate plastic;

- the emergence of new scientific evidence that suggests that the low doses of BPA to which consumers may be exposed when using polycarbonate plastic is unsafe;

- interpretations of existing evidence by the FDA or other regulatory agencies that lead to prohibitions on the use of polycarbonate plastic as packaging for consumable products;

- the listing of BPA by California’s Office of Environmental Health Hazard Assessment on the state’s Proposition 65 list, which would require us to label our products with information about BPA content and could obligate us to evaluate the levels of exposure to BPA associated with the use of our products; and

- the inability of sellers of consumable products to find an adequate supply of alternative packaging if polycarbonate plastic containing BPA becomes an undesirable or prohibited packaging material.

In addition, federal, state, provincial and local governmental authorities have and continue to introduce, and in certain states and provinces enact proposals intended to restrict or ban the use of BPA in food and beverage packaging materials.

If any of these events were to occur, our sales and operating results could be materially adversely affected.

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Legislative and executive action in state and local governments enacting local taxes on bottled water to include multi-gallon bottled water could adversely affect our business and financial results.

Regulations have been enacted or proposed in some localities where we operate to enact local taxes on bottled water. These actions are purportedly designed to discourage the use of bottled water due in large part to concerns about the environmental effects of producing and discarding large numbers of plastic bottles. While we have not to date directly experienced any adverse effects from these concerns, and we believe that our products are sufficiently different from those affected by recent enactments, there is no assurance that our products will not be subject to future legislative and executive action by state and local governments, which could have a material adverse effect on our business, results of operations or financial condition.

Changes in taxation requirements could affect our financial results.

We are subject to income tax in the numerous jurisdictions in which we generate net sales. In addition, our water dispensers we sell are subject to certain import duties and sales taxes in certain jurisdictions in which we operate. Increases in income and other tax rates could reduce our after-tax income from affected jurisdictions, while increases in indirect taxes could affect our products' and services' affordability and therefore reduce demand for our products and services.

Our ability to use net operating loss carryforwards in the United States may be limited.

As of December 31, 2013, we had net operating losses of approximately $118.6 million for federal income tax purposes, which expire at various dates through 2033. To the extent available and not otherwise utilized, we intend to use any net operating loss carryforwards to reduce the U.S. corporate income tax liability associated with our operations. Section 382 of the Internal Revenue Code of 1986, as amended, generally imposes an annual limitation on the amount of net operating loss carryforwards that may be used to offset taxable income when a corporation has undergone certain changes in stock ownership. Our ability to utilize net operating loss carryforwards may be limited, under this section or otherwise, in the future. To the extent our use of net operating loss carryforwards is significantly limited, our income could be subject to U.S. corporate income tax earlier than it would if we were able to use net operating loss carryforwards, which could result in lower profits.

Risks Relating to Our Common Stock

The value of our common stock could be volatile.

The overall market and the price of our common stock may fluctuate greatly. Shares of our common stock were sold in our November 2010 initial public offering at a price of $12.00 per share, and, as of March 7, 2014, our common stock has subsequently traded as high as $16.45 and as low as $0.69 per share. An active, liquid and orderly market for our common stock may not be sustained, which could depress the trading price of our common stock. The trading price of our common stock may be significantly affected by various factors, including:

- quarterly fluctuations in our operating results;
- changes in investors' and analysts' perception of the business risks and conditions of our business;
- our ability to meet the earnings estimates and other performance expectations of financial analysts or investors;
- unfavorable commentary or downgrades of our stock by equity research analysts; and

- general economic or political conditions.

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Future sales of our common stock, or the perception in the public markets that these sales may occur, may depress our stock price.

The market price of our common stock could decline as a result of sales of shares of our common stock in the market or the perception that these sales could occur. These sales, or the possibility that these sales may occur, also might make it more difficult for us to sell equity securities in the future at a time and at a price that we deem appropriate.

Additionally, we have filed a "shelf" registration statement with the SEC pursuant to which we may sell common stock, preferred stock, debt securities, warrants, rights and units at any time in one or more offerings up to a total public offering price of $75.0 million. The registration statement was declared effective by the SEC on January 13, 2012. The offer or sale of all or a portion of the above described securities may have an adverse effect on the market price of our common stock.

Concentration of ownership among our existing executive officers, directors and their affiliates may prevent new investors from influencing significant corporate decisions.

As of March 7, 2014, our executive officers, directors and their affiliates beneficially own, in the aggregate, approximately 20% of our outstanding shares of common stock. In particular, Billy D. Prim, our Chairman and Chief Executive Officer, beneficially owns approximately 11% of our outstanding shares of common stock as of March 7, 2014. As a result, these stockholders will be able to exercise a significant level of control over all matters requiring stockholder approval, including the election of directors, amendment of our certificate of incorporation and approval of significant corporate transactions. This control could have the effect of delaying or preventing a change of control of our Company or changes in management and will make the approval of certain transactions difficult or impossible without the support of these stockholders.

If securities or industry analysts do not publish research or publish inaccurate or unfavorable research about our business, our stock price and trading volume could decline.

The trading market for our common stock depends in part on the research and reports that securities or industry analysts publish about us or our business. We currently have research coverage by four securities and industry analysts. If one or more of the analysts who covers us downgrades our stock or publishes inaccurate or unfavorable research about our business, our stock price would likely decline. If one or more of these analysts ceases coverage of us or fails to publish reports on us regularly, demand for our stock could decrease, which could cause our stock price and trading volume to decline.

Anti-takeover provisions in our charter documents and Delaware law might discourage or delay acquisition attempts for us that you might consider favorable.

Our amended and restated certificate of incorporation and amended and restated bylaws contain provisions that may make the acquisition of our Company more difficult without the approval of our Board of Directors. These provisions:

- authorize the issuance of undesignated preferred stock, the terms of which may be established and the shares of which may be issued without stockholder approval, and which may include super voting, special approval, dividend, or other rights or preferences superior to the rights of the holders of common stock;
- eliminate the ability of our stockholders to act by written consent in most circumstances;
- eliminate the ability of our stockholders to remove a member of our Board of Directors without cause;

- eliminate the ability of our stockholders to call a special meeting of the stockholders;
- establish advance notice requirements for nominations for elections to our Board of Directors or for proposing matters that can be acted upon by stockholders at stockholder meetings;
- provide that the Board of Directors is expressly authorized to make, alter or repeal our amended and restated bylaws; and
- establish a classified board of directors the members of which serve staggered three-year terms.

As a Delaware corporation, we are also subject to provisions of Delaware law, including Section 203 of the Delaware General Corporation Law, which prevents some stockholders holding more than 15% of our outstanding common stock from engaging in certain business combinations without approval of the holders of substantially all of our outstanding common stock.

These anti-takeover provisions and other provisions under Delaware law could discourage, delay or prevent a transaction involving a change in control of our Company, including actions that our stockholders may deem advantageous, or negatively affect the trading price of our common stock. These provisions could also discourage proxy contests and make it more difficult for you and other stockholders to elect directors of your choosing and to cause us to take other corporate actions you desire.

Failure to maintain effective internal controls in accordance with Section 404 of the Sarbanes-Oxley Act could result in a restatement of our financial statements, cause investors to lose confidence in our financial statements and our company and have a material adverse effect on our business and stock price.

Effective internal controls are necessary for us to provide reliable financial reports and to operate successfully as a publicly traded company. As a public company, we are required to document and test our internal control procedures in order to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, or Section 404, which requires annual management assessments of the effectiveness of our internal controls over financial reporting.

Testing and maintaining internal controls can divert our management's attention from other matters that are important to our business. We may not be able to conclude on an ongoing basis that we have effective internal controls over financial reporting in accordance with Section 404. If we are unable to conclude that we have effective internal controls over financial reporting, investors could lose confidence in our reported financial information and our company, which could result in a decline in the market price of our common stock, and cause us to fail to meet our reporting obligations in the future, which in turn could impact our ability to raise additional financing if needed in the future.

Risks Relating to Our Indebtedness

Restrictive covenants in our Senior Revolving Credit Facility and Term Loan restrict or prohibit our ability to engage in or enter into a variety of transactions, which could adversely restrict our financial and operating flexibility and subject us to other risks.

At December 31, 2013, we had a $20.0 million senior revolving credit facility (the “Senior Revolving Credit Facility”) with TD Bank, N.A. and $21.0 million of term loans (the “Term Loans”) with Comvest Capital II, L.P. Our Senior Revolving Credit Facility and Term Loans contain various restrictive covenants that limit our and our subsidiaries’ ability to take certain actions. In particular, these agreements limit our and our subsidiaries’ ability to, among other things:

- incur additional indebtedness;
- make restricted payments (including paying dividends on, redeeming or repurchasing capital stock);
- make certain expenditures, investments or acquisitions;
- create liens on our assets to secure debt;
- make certain prepayments without penalties;

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- engage in certain types of transactions with affiliates;
- apply the proceeds of certain debt and equity financing transactions at our discretion;
- engage in sale-and-leaseback or similar transactions; and
- transfer or sell assets, merge, liquidate or wind-up.

Any or all of these covenants could have a material adverse effect on our business by limiting our ability to take advantage of financing, merger and acquisition or other corporate opportunities and to fund our operations. Any future debt could also contain financial and other covenants more restrictive than those to be imposed under our Senior Revolving Credit Facility and Term Loans.

A breach of a covenant or other provision in any debt instrument governing our current or future indebtedness could result in a default under that instrument and, due to customary cross-default and cross-acceleration provisions, could result in a default under any other debt instrument that we may have. If the lenders under our indebtedness were to so accelerate the payment of the indebtedness, we cannot assure you that our assets or cash flow would be sufficient to repay in full our outstanding indebtedness, in which event we likely would seek reorganization or protection under bankruptcy or other, similar laws.

We may be unable to generate sufficient cash flow to service our debt obligations. In addition, our inability to generate sufficient cash flows to support operations and other activities without debt financing could prevent future growth and success.

Our ability to generate cash, make scheduled payments or refinance our obligations depends on our successful financial and operating performance. Our financial and operating performance, cash flow and capital resources depend upon prevailing economic conditions and various financial, business and other factors, many of which are beyond our control. If our cash flow and capital resources are insufficient to fund our debt service obligations, we may be forced to reduce or delay capital expenditures, sell material assets or operations, obtain additional capital or restructure our debt, any or all of which could have a material adverse effect on our business, financial condition and results of operations. In addition, we cannot assure you that we would be able to take any of these actions on terms acceptable to us, or at all, that these actions would enable us to continue to satisfy our capital requirements or that these actions would be permitted under the terms of our various debt agreements.

If we are unable to generate sufficient cash flows to support capital expansion, business acquisition plans and general operating activities, and are unable obtain the necessary funding for these items through debt financing, our business could be negatively affected and we may be unable to expand into existing and new markets. Our ability to generate cash flows is dependent in part upon obtaining necessary financing at favorable interest rates. Interest rate fluctuations and other capital market conditions may prevent us from doing so.

Global capital and credit market issues could negatively affect our liquidity, increase our costs of borrowing and disrupt the operations of our suppliers, bottlers, distributors and customers.

The global capital and credit markets have experienced increased volatility and disruption in recent years, making it more difficult for companies to access those markets. There can be no assurance that continued or increased volatility and disruption in the capital and credit markets will not impair our liquidity or increase our costs of borrowing. Our business could also be negatively impacted if our suppliers, bottlers, distributors or retail customers experience disruptions resulting from tighter capital and credit markets or a slowdown in the general economy.

Item 1B. Unresolved Staff Comments

None.

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Item 2. Properties

Our corporate headquarters, including our principal administrative, marketing, sales, technical support and research and development facilities, are located in Winston-Salem, North Carolina where we lease approximately 15,750 square feet under an agreement that expires on July 31, 2014. We also lease approximately 20,250 square feet of office and warehouse space in Eagan, Minnesota under an agreement that expires in October 2014. Effective December 2011, the Eagan facility was permanently closed and the assembly and refurbishing operations were transferred to a third-party supplier.

We believe that our current facilities are suitable and adequate to meet our current needs, and that suitable additional or substitute space will be available as needed to accommodate expansion of our operations.

Item 3. Legal Proceedings

From time to time, we are involved in various claims and legal actions that arise in the normal course of business. Management believes that the outcome of such legal actions will not have a significant adverse effect on our financial position, results of operations or cash flows.

On October 14, 2011, Primo, through a wholly-owned subsidiary, filed a complaint against Electrotemp Technologies China, Inc. ("Electrotemp") in Mecklenburg County (North Carolina) Superior Court, alleging breach of contract, quantum meruit/unjust enrichment, and violation of the North Carolina Products Liability Act/breach of implied warranty. The parties filed a Joint Motion to stay litigation so that they could proceed with mediation and arbitration pursuant to the dispute resolution clause in their agreement. On May 1, 2012, the Court ordered that the litigation would be stayed once the parties formally enter into arbitration. Electrotemp asserted counterclaims in the arbitration. On September 26, 2013, the parties reached a settlement that resulted in termination of the arbitration and dismissal of the lawsuit. The lawsuit was dismissed with prejudice on October 3, 2013.

On October 16, 2012, Primo was served with the Summons and Complaint in a suit filed in the Florida state courts on September 26, 2012. Plaintiffs in the suit are Florida Concentrates International, LLC (a Florida limited liability company), Florida Sparkling DS, LLC (a Florida limited liability company), and Didier Hardy (a Florida resident and apparently the principal of the LLC plaintiffs). Also named as defendants are Susan and Scott Ballantyne (alleged to be Florida residents) and SDS-IC. The suit was filed in the Circuit Court for the Twentieth Judicial District (Collier County, Florida). Plaintiffs' allegations include breach of contract, misappropriation of trade secrets and certain additional claims and plaintiffs seek monetary damages. We filed a motion to dismiss all claims, which was granted in part and denied in part on June 21, 2013. Plaintiffs filed an amended complaint on July 10, 2013 to which we responded on August 28, 2013. We do not believe that the suit has any merit whatsoever, and plan to vigorously contest and defend against it.

Item 4. Mine Safety Disclosures

Not applicable.

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PART II

Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

We completed the initial public offering of our common stock on November 5, 2010. The principal United States market in which our common stock is listed and traded is the Nasdaq Global Market under the symbol "PRMW."

The table below presents the high and low sales prices per share of our common stock as reported on the Nasdaq Global Market for the periods indicated:

	High	Low
Year ended December 31, 2013		
Fourth Quarter	$ 3.25	$ 2.17
Third Quarter	$ 2.96	$ 1.67
Second Quarter	$ 2.07	$ 1.05
First Quarter	$ 1.30	$ 0.98

	High	Low
Year ended December 31, 2012		
Fourth Quarter	$ 1.30	$ 0.69
Third Quarter	$ 1.75	$ 1.05
Second Quarter	$ 1.93	$ 1.10
First Quarter	$ 3.45	$ 1.93

We have never paid or declared cash dividends on our common stock. We currently intend to retain any future earnings to finance the growth, development and expansion of our business. Accordingly, we do not expect to declare or pay any cash dividends on our common stock in the foreseeable future. Any future determination to pay dividends will be at the discretion of our Board of Directors and will depend upon various factors, including our results of operations, financial condition, capital requirements, investment opportunities and other factors that our Board of Directors deems relevant.

As of March 7, 2014, there were 56 shareholders of record of our common stock.

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Item 6. Selected Financial Data

The following selected financial data should be read in conjunction with "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and consolidated financial statements and notes thereto contained in "Item 8. Financial Statements and Supplementary Data" of this report.

	Years ended December 31,				
	2013	2012	2011	2010	2009
	(in thousands, except per share data)				
Consolidated statements of operations data:					
Net sales	$91,209	$91,479	$83,062	$44,607	$46,981
Operating costs and expenses:					
Cost of sales	68,367	70,081	63,201	34,213	38,771
Selling, general and administrative expenses	15,151	17,708	18,206	12,621	9,922
Non-recurring costs	777	743	2,091	2,491	–
Depreciation and amortization	11,333	11,102	8,863	4,759	4,205
Goodwill and other impairments	–	82,013	–	–	–
Total operating costs and expenses	95,628	181,647	92,361	54,084	52,898
Loss from operations	(4,419)	(90,168)	(9,299)	(9,477)	(5,917)
Interest expense and other, net	4,425	4,043	1,690	3,416	2,257
Loss from continuing operations before income taxes	(8,844)	(94,211)	(10,989)	(12,893)	(8,174)
Income tax (benefit) provision	-	(961)	961	–	–
Loss from continuing operations	(8,844)	(93,250)	(11,950)	(12,893)	(8,174)
Loss from discontinued operations, net of income taxes	(1,862)	(17,779)	(2,429)	-	(3,650)
Net loss	(10,706)	(111,029)	(14,379)	(12,893)	(11,824)
Preferred dividends, beneficial conversion and warrant modification charges	–	–	–	9,831	3,042
Net loss attributable to common shareholders	$(10,706)	$(111,029)	$(14,379)	$(22,724)	$(14,866)
Basic and diluted loss per common share:					
Loss from continuing operations attributable to common shareholders	$(0.37)	$(3.93)	$(0.55)	$(5.81)	$(7.72)
Loss from discontinued operations attributable to common shareholders	(0.08)	(0.75)	(0.11)	–	(2.51)
Net loss attributable to common shareholders	$(0.45)	$(4.68)	$(0.66)	$(5.81)	$(10.23)
Basic and diluted weighted average common shares outstanding	23,935	23,725	21,652	3,910	1,453

	As of December 31,				
	2013	2012	2011	2010	2009
Consolidated balance sheet data:					
Cash	$394	$234	$751	$443	–
Total assets	70,971	81,775	184,449	139,611	22,368
Current portion of long-term debt	16	15	14,514	11	426

Long-term debt, net of current maturities	22,654	21,251	44	17,945	14,403
Other long-term obligations	330	352	4,710	748	1,048

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion of our financial condition and results of operations should be read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this report.

Overview

Primo Water Corporation (together with its consolidated subsidiaries, "Primo", "we", "our," "us") is a leading provider of multi-gallon purified bottled water, self-service refill water and water dispensers sold through major retailers in the United States and Canada. We believe the market for purified water is growing due to evolving taste preferences, perceived health benefits and concerns regarding the quality of municipal tap water. Our products provide an environmentally friendly, economical, convenient and healthy solution for consuming purified and filtered water. We are a Delaware corporation that was founded in 2004 and is headquartered in Winston-Salem, North Carolina.

Our business is designed to generate recurring demand for our purified bottled water or self-serve filtered drinking water through the sale of innovative water dispensers. This business strategy is commonly referred to as "razor-razorblade" because the initial sale of a product creates a base of users who frequently purchase complementary consumable products. We believe dispenser owners consume an average of 35 multi-gallon bottles of water annually. Once our bottled water is consumed using a water dispenser, empty bottles are exchanged at our recycling center displays, which provide a recycling ticket that offers a discount toward the purchase of a new bottle of Primo purified water ("Exchange") or they are refilled at a self-serve filtered drinking water location ("Refill"). Each of our multi-gallon water bottles can be sanitized and reused up to 40 times before being taken out of use, crushed and recycled, substantially reducing landfill waste compared to consumption of equivalent volumes of single-serve bottled water. As of December 31, 2013, our products and services were offered in each of the contiguous United States and in Canada at approximately 22,900 combined retail locations, including Lowe's Home Improvement, Walmart, Kmart, Meijer, Kroger, Food Lion, H-E-B Grocery, Sobeys and Walgreens.

We provide major retailers throughout the United States and Canada with single-vendor solutions for Exchange and Refill services, addressing a market demand that we believe was previously unmet. Our solutions are easy for retailers to implement, require minimal management supervision and store-based labor, and provide centralized billing and detailed performance reports. Our Exchange solution offers retailers attractive financial margins and the ability to optimize typically unused retail space with our displays. Our Refill solution provides filtered water through the installation and servicing of reverse osmosis water filtration systems in the back room of the retailer's store location, which minimizes the usage of the customer's retail space. The refill machine, which is typically accompanied by a sales display containing empty reusable bottles, is located within the retailer customer's floor space. Additionally, due to the recurring nature of water consumption, retailers benefit from year-round customer traffic and highly predictable revenue.

Business Segments

We have two operating segments and two reportable segments: Primo Water ("Water") and Primo Dispensers ("Dispensers").

Our Water segment sales consist of our Exchange and Refill services, which are offered through retailers in each of the contiguous United States and Canada. Our Water services are offered through point of purchase display racks or self-serve filtered water displays and recycling centers that are prominently located at major retailers in space that is often underutilized.

Our Dispensers segment sells water dispensers that are designed to dispense Primo and other dispenser-compatible bottled water. Our Dispensers sales are primarily generated through major U.S. retailers and are sold primarily through a direct-import model, where we recognize revenues for the sale of the water dispensers when title is transferred. We support retail sell-through with domestic inventory. We design, market and arrange for certification and inspection of our water dispensers.

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We evaluate the financial results of these segments focusing primarily on segment net sales and segment income (loss) from operations before depreciation and amortization ("segment income (loss) from operations"). We utilize segment net sales and segment income (loss) from operations because we believe they provide useful information for effectively allocating our resources between business segments, evaluating the health of our business segments based on metrics that management can actively influence and gauging our investments and our ability to service, incur or pay down debt.

Cost of sales for Water consists of costs for distribution, bottles and related packaging materials for our Exchange services and servicing and material costs for our Refill services. Cost of sales for Dispensers consists of contract manufacturing, freight and duties.

Selling, general and administrative expenses for Water and Dispensers consist primarily of personnel costs for sales, marketing, operations support and customer service, as well as other supporting costs for operating each segment.

Expenses not specifically related to operating segments are shown separately as Corporate. Corporate expenses are comprised mainly of compensation and other related expenses for corporate support, information systems and administration. Corporate expenses also include certain professional fees and expenses and compensation of our Board of Directors.

In this Management's Discussion and Analysis of Financial Condition and Results of Operations, when we refer to "same-store unit growth" for our Water segment, we are comparing retail locations at which our Exchange services have been available for at least 12 months at the beginning of the relevant period. In addition, "gross margin percentage" is defined as net sales less cost of sales, as a percentage of net sales.

Recent Developments

DS Waters' Agreement

On November 12, 2013, we entered into a strategic alliance agreement (the "DS Agreement") with DS Waters of America, Inc. ("DS Waters") pursuant to which DS Waters will act as our primary bottler and distributor and provider of exchange and supply services for the Exchange business in the United States. Pursuant to the DS Agreement, DS Waters will become our primary bottler and distributor in the United States in all territories for which we do not currently have an existing distributor agreement and in other territories as existing distributor arrangements expire or are terminated. We currently expect the transition from our current network of distributors to DS Waters to occur over a two year period.

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Results of Operations

The following table sets forth our results of operations:

	Years Ended December 31, 2013	2012
Consolidated statements of operations data:		
Net sales	$ 91,209	$ 91,479
Operating costs and expenses:		
Cost of sales	68,367	70,081
Selling, general and administrative expenses	15,151	17,708
Non-recurring costs	777	743
Depreciation and amortization	11,333	11,102
Goodwill and other impairments	–	82,013
Total operating costs and expenses	95,628	181,647
Loss from operations	(4,419)	(90,168)
Interest expense and other, net	4,425	4,043
Loss from continuing operations before income taxes	(8,844)	(94,211)
Income tax benefit	–	(961)
Loss from continuing operations	(8,844)	(93,250)
Loss from discontinued operations	(1,862)	(17,779)
Net loss	$ (10,706)	$ (111,029)

The following table sets forth our results of operations expressed as a percentage of net sales:

	Years Ended December 31, 2013	2012
Consolidated statements of operations data:		
Net sales	100.0 %	100.0 %
Operating costs and expenses:		
Cost of sales	75.0	76.6
Selling, general and administrative expenses	16.6	19.4
Non-recurring costs	0.9	0.8
Depreciation and amortization	12.4	12.1
Goodwill and other impairments	–	89.7
Total operating costs and expenses	104.9	198.6
Loss from operations	(4.8)	(98.6)
Interest expense and other, net	4.9	4.4
Loss from continuing operations before income taxes	(9.7)	(103.0)
Income tax provision	–	(1.1)
Loss from continuing operations	(9.7)	(101.9)
Loss from discontinued operations	(2.0)	(19.4)
Net loss	(11.7 %)	(121.3 %)

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The following table sets forth our segment net sales and segment income (loss) from operations presented on a segment basis and reconciled to our consolidated loss from operations.

	Years Ended December 31, 2013	2012
Segment net sales		
Water	$ 63,828	$ 62,667
Dispensers	27,381	28,812
Total net sales	$ 91,209	$ 91,479
Segment income (loss) from operations		
Water	$ 17,591	$ 16,477
Dispensers	827	(1,319)
Corporate	(10,727)	(11,468)
Non-recurring costs	(777)	(743)
Depreciation and amortization	(11,333)	(11,102)
Goodwill and other impairments	–	(82,013)
Loss from operations	$ (4,419)	$ (90,168)

Year Ended December 31, 2013 Compared to Year Ended December 31, 2012

Net Sales. Net sales decreased 0.3%, or $0.3 million, to $91.2 million for the year ended December 31, 2013 from $91.5 million for the year ended December 31, 2012. The decrease in net sales resulted from a $1.5 million decrease in Dispenser sales partially offset by a $1.2 million increase in Water sales.

Water. Water net sales increased 1.9% to $63.8 million, representing 70.0% of our total net sales for 2013. Five-gallon equivalent units for Water increased 0.7% to 27.8 million units for 2013 from 27.6 million units for 2012. The increase in Water net sales was primarily due to a 4.9% increase in U.S. Exchange sales, driven by same-store unit growth of 10.4% during 2013. Same-store sales increased greater than the overall increase in sales due to a decrease of 700 locations during the year. The increase in U.S. Exchange sales was partially offset by a reduction of 1.0% in Refill sales.

Dispensers. Dispensers net sales decreased 5.0% to $27.4 million, representing 30.0% of our total net sales for 2013. The decrease is primarily due to additional sales in 2012 related to the rollout of new dispenser retail locations for a major retailer and the tighter management of inventory levels by retailers during 2013. Despite the 6.2% decline in dispenser unit sell-in to retailers, dispenser unit sell-thru to consumers increased 11.1% for 2013 compared to 2012.

Gross Margin Percentage. Our overall gross margin percentage increased to 25.0% for 2013 from 23.4% for 2012 due to improvements in both Water and Dispensers margins.

Water. Gross margin as a percentage of net sales in our Water segment increased to 32.9% for 2013 compared to 32.5% for 2012. An improvement in Exchange gross margin percentage for the year, due primarily to improvements in supply chain costs, was partially offset by a slight reduction in Refill gross margin percentage. We currently expect supply chain costs to continue to decrease primarily as a result of the DS Agreement, which should result in an improved gross margin percentage. The improvement in supply chain costs should occur as we transition our current network of Exchange distributors to DS Waters in the United States, over the next two years.

Dispensers. Gross margin as a percentage of net sales in our Dispensers segment increased to 6.7% for 2013 from 3.7% for 2012. The increase in gross margin percentage was primarily due to price increases to our customers that became effective during the third quarter of 2012 and the mix of higher margin products being sold.

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Selling, General and Administrative Expenses (“SG&A”). SG&A decreased 14.4% to $15.2 million for 2013 from $17.7 million for 2012. As a percentage of net sales, SG&A decreased to 16.6% for 2013 from 19.4% for 2012.

Water. SG&A for our Water segment decreased 11.5% to $3.4 million for 2013 from $3.9 million for 2012. Water SG&A as a percentage of Water net sales decreased to 5.3% for 2013 compared to 6.2% for 2012. The decrease in Water SG&A was primarily a result of the reduction in advertising and marketing-related costs. We expect to continue to leverage costs with sales growth and the anticipated impact of the DS Agreement.

Dispensers. SG&A for our Dispensers segment decreased 57.5% to $1.0 million for 2013 from $2.4 million for 2012. SG&A as a percentage of Dispensers segment net sales decreased to 3.7% for 2013 from 8.3% for 2012. The change was primarily related to a decrease for adverstising and marketing expenses, partially attributable to a one-time expense of $0.35 million related to the rollout of new dispenser locations for 2012.

Corporate. Corporate SG&A decreased 6.5% to $10.8 million for 2013 from $11.4 million for 2012. Corporate SG&A as a percentage of consolidated net sales decreased to 11.8% for 2013 from 12.5% for 2012. We expect to continue to leverage Corporate SG&A costs with future sales growth.

Non-Recurring Costs. Non-recurring costs increased to $0.8 million for 2013 from $0.7 million for 2012. Non-recurring costs for 2013 were primarily related to legal and other expenses associated with our partnership with DS Waters as well as non-recurring severance and restructuring-related expenses. We expect to incur non-recurring, transition costs relating to the DS Agreement ranging between $2.0 million and $2.5 million for 2014. Non-recurring costs for 2012 were primarily related to employee severance costs associated with the elimination of duplicate management roles related to the Refill services business, the restructuring and consolidation of Water operations and litigation-related expenses.

Depreciation and Amortization. Depreciation and amortization increased 2.1% to $11.3 million for 2013 from $11.1 million for 2012. The increase was primarily due to increased depreciation on bottles used in our Exchange business attributable to our change in the estimated useful life of bottles from three years to two years effective July 1, 2012.

Goodwill and Other Impairments. We recorded non-cash goodwill impairment charges of $79.1 million for the Water reporting unit for 2012. We also recorded non-cash impairment charges of $2.9 million related to other current assets for 2012. No such charges were incurred for 2013.

Interest Expense and Other, net. Interest expense increased to $4.4 million for 2013 from $4.0 million for 2012. Lower deferred loan cost amortization was offset by the impact of supplier financing costs incurred in 2013 which were not incurred in 2012.

Income Tax Benefit. In 2012, the impairment of the goodwill (see Note 2 of the Notes to the Consolidated Financial Statements) resulted in a reversal of the related deferred tax liability recorded at December 31, 2011and the recognition of a deferred tax asset and an income tax benefit. We have provided valuation allowances to fully offset the net deferred tax assets at December 31, 2013 and 2012.

Discontinued Operations. Loss from discontinued operations was $1.9 million for 2013 compared to $17.8 million for 2012. The decrease is due primarily to the impact of impairment charges to goodwill and developed technology recorded for 2012.

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Liquidity and Capital Resources

Adequacy of Capital Resources

Since our inception, we have financed our operations primarily through the sale of stock, the issuance of debt and borrowings under credit facilities. While we had no material commitments for capital expenditures as of December 31, 2013, we anticipate net capital expenditures to range between $5.5 million and $7.5 million for 2014. Anticipated capital expenditures are related primarily to growth in Water locations. In addition, we expect to incur non-recurring, transition costs ranging between $2.0 million and $2.5 million for 2014 related to the DS Agreement.

At December 31, 2013, our cash totaled $0.4 million and we had approximately $0.5 million in additional availability under the Senior Revolving Credit Facility. This availability is subject to borrowing base requirements related to our eligible accounts receivable and inventory. In January 2014, we received the $2.5 million proceeds from the “Third Add-on Term Loan” described below. At February 28, 2014, we had approximately $2.7 million in additional availability under the Senior Revolving Credit Facility. We anticipate that our current cash and cash equivalents, availability under the Senior Revolving Credit Facility and cash flow from operations will be sufficient to meet our current capital needs for general corporate purposes.

Our future capital requirements may vary materially from those now anticipated and will depend on many factors including: the rate of growth in new Water locations and related display, rack and reverse osmosis filtration system costs, cost to develop new Dispenser product lines, sales and marketing resources needed to further penetrate our markets, the expansion of our operations in the United States and Canada, the response of competitors to our solutions and products, as well as acquisitions of other businesses. Historically, we have experienced increases in our capital expenditures consistent with the growth in our operations and personnel, and we anticipate that our expenditures will continue to increase as we grow our business, subject to limits related to our Term Loans and Senior Revolving Credit Facility.

Our ability to satisfy our obligations or to fund planned capital expenditures will depend on our future performance, which to a certain extent is subject to general economic, financial, competitive, legislative, regulatory and other factors beyond our control. We also believe that if we pursue any material acquisitions in the foreseeable future we will need to finance this activity through the issuance of equity or additional debt financing.

Changes in Cash Flows

The following table shows the components of our cash flows for the periods presented (in millions):

	Years Ended December 31, 2013	2012
Net cash provided by operating activities	$ 6.6	$ 5.9
Net cash used in investing activities	$ (7.3)	$ (5.9)
Net cash provided by financing activities	$ 0.9	$ 5.1

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Net Cash Flows from Operating Activities

Net cash provided by operating activities increased to $6.6 million for 2013 from $5.9 million for 2012, driven primarily by the lower loss from continuing operations partially offset by an increase in cash used to fund net working capital components.

Net Cash Flows from Investing Activities

Net cash used in investing activities increased to $7.3 million for 2013 from $5.9 million for 2012, caused by increases in cash used for capital expenditures.

Our primary investing activities are typically capital expenditures for property, equipment and bottles and include expenditures related to the installation of our recycle centers, display racks and reverse osmosis filtration systems at new Water locations. For 2013, investing activities also included capital expenditures for the implementation of a remote monitoring technology used in our Refill services business.

Net Cash Flows from Financing Activities

Net cash provided by financing activities decreased to $0.9 million for 2013 from $5.1 million for 2012. During 2013, cash provided by financing activities was primarily related to net borrowings on our credit facility and term loans of $1.6 million, which were partially offset by debt issuance costs of $0.8 million. During 2012, cash provided by financing activities was primarily related to net borrowings on our credit facilities and term loans of $7.7 million, which were partially offset by debt issuance costs of $2.2 million.

Senior Revolving Credit Facility

We entered into the Senior Revolving Credit Facility on April 30, 2012, as amended on February 21, 2013, that replaced our prior senior credit facility. The Senior Revolving Credit Facility provides for total borrowing availability of up to $20.0 million, subject to borrowing base requirements related to our eligible accounts receivable and inventory and subject to a $2.0 million reserve requirement. The Senior Revolving Credit Facility has a three and one-half year term and is secured either on a first priority or second priority basis by substantially all of our assets. The term of the Senior Revolving Credit Facility may be extended up to April 30, 2017 so long as the maturity of the Comvest Term Loans (as defined below) is extended to at least October 30, 2017. At December 31, 2013, we had $3.1 million in outstanding borrowings at a weighted-average interest rate of 6.0%, with $0.5 million in additional availability under the Senior Revolving Credit Facility after giving effect to the borrowing base requirements.

Interest on outstanding borrowings under the Senior Revolving Credit Facility is payable at our option at either a floating base rate or a one-, two- or three-month LIBOR rate. We are also required to pay a commitment fee on the unused amount of the commitment under the Senior Revolving Credit Facility. The Senior Revolving Credit Facility contains a limit on capital expenditures of $6.0 million for the year ended December 31, 2013 and for each year thereafter. The limit for capital expenditures may be increased based upon meeting the fixed charge coverage ratio, as stipulated and defined in the Senior Revolving Credit Facility. For the year ended December 31, 2013, the limit was increased based upon our fixed charge coverage ratio. In addition, the Senior Revolving Credit Facility does cross default to the Comvest Credit Agreement (as defined below). Life-to-date costs associated with the Senior Revolving Credit Facility were $0.9 million, which were capitalized and will be amortized as part of interest expense over the term of the debt. At December 31, 2013, accumulated amortization related to Senior Revolving Credit Facility deferred loan costs was $0.4 million.

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Comvest Term Loans

We entered into a credit and security agreement on April 30, 2012 (the "Credit Agreement") pursuant to which a $15.2 million term loan (the "Term Loan") was provided. The Credit Agreement was amended on November 6, 2012 (the "First Amendment") to contemplate the plan to exit the Flavorstation business (see Note 4 of the Notes to the Consolidated Financial Statements) and provide for the classification of the operating results related to the Disposal Group as discontinued operations. In connection with the amendment, the lender consented to our sale of inventory and other assets related to the Disposal Group outside the ordinary course of business. Also in connection with the First Amendment, we paid the lender a $0.15 million fee and agreed to certain changes to prepayment penalties and financial covenants.

The Credit Agreement was amended on June 14, 2013 (the "Second Amendment") to provide for an additional $3.0 million in borrowing under an additional term loan (the "First Add-On Term Loan", and together with the Term Loan, the "Second Add-On Term Loan" and the "Third Add-On Term Loan" described below, the "Comvest Term Loans"), adjust the interest rate on the Term Loan, eliminate certain financial covenants and make further adjustments to prepayment penalties. Under the terms of the Second Amendment, interest on outstanding amounts owed under the Comvest Term Loans is payable at the rate of 12.5% per annum in cash. Also in connection with the Second Amendment, we paid the lender amendment and funding fees of $0.4 million.

On December 24, 2013, we entered into an amendment (the "Third Amendment") to the Credit Agreement to provide for two additional term loans: the $2.5 million "Second Add-On Term Loan" provided on the date of the Third Amendment; and the $2.5 million "Third Add-On Term Loan" provided in January 2014. The interest and other terms of the Second and Third Add-On Term Loans are consistent with those described above for the First Add-On Term Loan. The Third Amendment also revised the Credit Agreement to make certain adjustments to the definition of EBITDA to contemplate the strategic alliance with DS Waters and the increasing minimum EBITDA thresholds applicable to Primo that are measured at the end of each quarter, as described below. Also in connection with the Third Amendment, we paid the lender amendment and funding fees of $0.3 million.

The outstanding balance of the Comvest Term Loans is due and payable in a single installment on April 30, 2016, subject to prepayment in specified circumstances, including sales or dispositions of assets outside the ordinary course of business and sales of equity or debt securities by the Company. The Comvest Term Loans are secured by substantially all of our assets on either a first priority or second priority basis. The first priority assets consist of substantially all of the assets related to our refill services business. The security interest in all of our other assets is subordinate to the security interest securing the Senior Revolving Credit Facility. At December 31, 2013, our outstanding balance under our Comvest Term Loans was $21.0 million and at January 31, 2014, our outstanding balance under our Comvest Term Loans increased to $23.5 million as a result of the Third Add-On Term Loan.

The Credit Agreement contains the following financial covenants: (i) a limit on capital expenditures of $12.0 million for the year ended December 31, 2013 and for each year thereafter; (ii) an increasing minimum adjusted earnings before interest, taxes, depreciation and amortization ("Adjusted EBITDA") threshold that is measured at the end of each quarter, and (iii) a decreasing total debt to Adjusted EBITDA ratio that is measured at the end of each quarter.

At December 31, 2013 we were in compliance with all covenants, including the following: the minimum Adjusted EBITDA threshold was $8.8 million and our Adjusted EBITDA was $9.1 million for the twelve months ended December 31, 2013; and the maximum allowed total debt to Adjusted EBITDA ratio was 3.7:1 and our ratio was 2.7:1 for the twelve months ended December 31, 2013.

Life-to-date costs associated with the Term Loan were $1.1 million, which were capitalized and will be amortized as part of interest expense over the term of the debt. Life-to-date costs associated with the Second and Third

Amendments were $0.8 million, which were reflected as adiscount on our debt and will be amortized as part of interest expense over the remaining term of the debt.

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Adjusted EBITDA U.S. GAAP Reconciliation

Adjusted EBITDA is a non-U.S. GAAP financial measure that is calculated as loss from continuing operations before income tax benefit, interest expense and other, net, depreciation and amortization, goodwill and other impairment, non-cash stock-based compensation expense, non-recurring costs, loss on disposal of assets and other.

Our Credit Agreement contains financial covenants that use Adjusted EBITDA. We believe Adjusted EBITDA provides useful information to management and investors regarding certain financial and business trends relating to our financial condition and results of operations. Adjusted EBITDA is used by management to compare our performance to that of prior periods for trend analyses and planning purposes and is presented to our board of directors.

Non-U.S. GAAP measures should not be considered a substitute for, or superior to, financial measures calculated in accordance with U.S. GAAP. Adjusted EBITDA excludes significant expenses that are required by U.S. GAAP to be recorded in our financial statements and is subject to inherent limitations. In addition, other companies in our industry may calculate this non-U.S. GAAP measure differently than we do or may not calculate it at all, limiting its usefulness as a comparative measure. The table below provides a reconciliation between loss from continuing operations and Adjusted EBITDA.

	Years ended December 31,	
	2013	2012
Loss from continuing operations	$ (8,844)	$ (93,250)
Depreciation and amortization	11,333	11,102
Interest expense and other, net	4,425	4,043
Income tax benefit	–	(961)
EBITDA	6,914	(79,066)
Goodwill and other impairments	–	82,013
Non-cash, stock-based compensation expense	1,034	1,252
Non-recurring costs	777	743
Loss on disposal of assets and other	342	509
Adjusted EBITDA	$ 9,067	$ 5,451

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements, investments in special purpose entities or undisclosed borrowings or debt. Additionally, we are not a party to any derivative contracts or synthetic leases.

Inflation

During the last four years, inflation and changing prices have not had a material effect on our business and we do not expect that inflation or changing prices will materially affect our business in the foreseeable future.

Seasonality; Fluctuations of Results

We have experienced and expect to continue to experience seasonal fluctuations in our sales and operating income. Our sales and operating income have been highest in the spring and summer and lowest in the fall and winter. Our Water segment, which generally enjoys higher margins than our Dispensers segment, experiences higher sales and operating income in the spring and summer. We have historically experienced higher sales and operating income from our water dispensers in spring and summer; however, we believe the seasonality of dispenser sales are more dependent on retailer inventory management and purchasing cycles and not correlated to weather. Sustained periods of poor weather, particularly in the spring and summer, can negatively impact our sales in our higher margin Water segment. Accordingly, our results of operations in any quarter will not necessarily be indicative of the results that we may achieve for a year or any future quarter.

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Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements and related notes, which have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”). The preparation of our financial statements in conformity with U.S. GAAP requires us to make certain estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions used to determine certain amounts that affect the financial statements are reasonable, based on information available at the time they are made. To the extent there are material differences between these estimates, judgments and assumptions and actual results, our consolidated financial statements may be affected. Some of the more significant estimates include allowances for doubtful accounts, valuation of inventories, depreciation, valuation of intangible assets and goodwill, valuation of deferred taxes and allowance for sales returns.

Revenue Recognition. Revenue is recognized for the sale of multi-gallon purified bottled water upon either the delivery of inventory to the retail store or the purchase by the consumer. Revenue is either recognized as an exchange transaction (where a discount is provided on the purchase of a multi-gallon bottle of purified water for the return of an empty multi-gallon bottle) or a non-exchange transaction. Revenues on exchange transactions are recognized net of the exchange discount. Self-service refill water revent;">
197

(986
)

156,847

Collateralized mortgage
obligations ("CMOs")

1,270,304

368

(38,242
)

1,232,430

1,113,019

121

(17,954
)

1,095,186

Other mortgage-backed
securities ("MBSs")

450,512

229

(13,105
)

437,636

373,676

201

(4,334
)

369,543

Municipal securities

222,034

152

(3,841
)

218,345

209,558

693

(1,260
)

208,991

Corporate debt securities

57,867

2

(857
)

57,012

—

—

—

—

Equity securities[1]

—

—

—

—

7,408

194

(305
)

7,297

Total securities available-for-sale	$ 2,200,615	$ 760	$ (58,510)	$ 2,142,865	$ 1,907,826	$ 1,406	$ (25,023)	$ 1,884,209

Securities Held-to-Maturity

Municipal securities

$
13,042

$
—

$
(2,124
)

$
10,918

$
13,760

$
—

$
(1,747
)

$
12,013

Equity Securities[1]

$
28,441

$

—

Trading Securities[1]

$
—

$
20,447

(1) As a result of accounting guidance adopted in the first quarter of 2018, equity securities are no longer presented within trading securities or securities available-for-sale and are now presented within equity securities in the Consolidated Statements of Financial Condition for the current period. For further discussion of this guidance, see Note 2, "Recent Accounting Pronouncements."

Remaining Contractual Maturity of Securities
(Dollar amounts in thousands)

	As of June 30, 2018			
	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
One year or less	$120,038	$118,287	$1,626	$1,361
After one year to five years	165,112	162,703	5,197	4,350
After five years to ten years	194,649	191,809	2,177	1,823
After ten years	—	—	4,042	3,384
Securities that do not have a single contractual maturity date	1,720,816	1,670,066	—	—
Total	$2,200,615	$2,142,865	$13,042	$10,918

The carrying value of securities available-for-sale that were pledged to secure deposits or for other purposes as permitted or required by law totaled $1.3 billion as of June 30, 2018 and $1.1 billion as of December 31, 2017. No securities held-to-maturity were pledged as of June 30, 2018 or December 31, 2017.

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Securities Available-for-Sale Gains
(Dollar amounts in thousands)

	Quarters Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Gains on sales of securities:				
Gross realized gains	$—	$284	$—	$284
Gross realized losses	—	—	—	—
Net realized gains on sales of securities	—	284	—	284
Non-cash impairment charges:				
Other-than-temporary securities impairment ("OTTI")	—	—	—	—
Net realized gains	$—	$284	$—	$284

Accounting guidance requires that the credit portion of an OTTI charge be recognized through income. If a decline in fair value below carrying value is not attributable to credit deterioration and the Company does not intend to sell the security or believe it would not be more likely than not required to sell the security prior to recovery, the Company records the non-credit related portion of the decline in fair value in other comprehensive income.
There was no outstanding balance of OTTI previously recognized on securities available-for-sale as of either June 30, 2018 or December 31, 2017. During the quarters and six months ended June 30, 2018 and 2017 no OTTI was recognized on securities available-for-sale.

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The following table presents the aggregate amount of unrealized losses and the aggregate related fair values of securities with unrealized losses as of June 30, 2018 and December 31, 2017.

Securities in an Unrealized Loss Position

(Dollar amounts in thousands)

		Less Than 12 Months		12 Months or Longer		Total	
	Number of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
As of June 30, 2018							
Securities Available-for-Sale							
U.S. treasury securities	22	$32,699	$252	$14,459	$ 47	$47,158	$ 299
U.S. agency securities	78	79,845	1,138	62,820	1,028	142,665	2,166
CMOs	242	562,594	13,295	568,315	24,947	1,130,909	38,242
MBSs	107	183,907	3,910	225,627	9,195	409,534	13,105
Municipal securities	451	122,847	1,872	58,580	1,969	181,427	3,841
Corporate debt securities	8	40,285	857	—	—	40,285	857
Total	908	$1,022,177	$21,324	$929,801	$ 37,186	$1,951,978	$ 58,510
Securities Held-to-Maturity							
Municipal securities	8	$—	$—	$10,918	$ 2,124	$10,918	$ 2,124
As of December 31, 2017							
Securities Available-for-Sale							
U.S. treasury securities	20	$19,918	$87	$26,427	$ 97	$46,345	$ 184
U.S. agency securities	72	66,899	300	58,021	686	124,920	986
CMOs	211	365,131	3,265	633,227	14,689	998,358	17,954
MBSs	86	126,136	902	210,017	3,432	336,153	4,334
Municipal securities	265	35,500	479	81,360	781	116,860	1,260
Equity securities[(1)]	2	391	214	6,386	91	6,777	305
Total	656	$613,975	$5,247	$1,015,438	$ 19,776	$1,629,413	$ 25,023
Securities Held-to-Maturity							
Municipal securities	8	$—	$—	$12,013	$ 1,747	$12,013	$ 1,747

(1) As a result of accounting guidance adopted in the first quarter of 2018, equity securities are no longer presented within securities available-for-sale and are now presented within equity securities in the Consolidated Statements of Financial Condition for the current period. For further discussion of this guidance, see Note 2, "Recent Accounting Pronouncements."

Substantially all of the Company's CMOs and other MBSs are either backed by U.S. government-owned agencies or issued by U.S. government-sponsored enterprises. Municipal securities are issued by municipal authorities, and the majority are supported by third-party insurance or some other form of credit enhancement. Management does not believe any of these securities with unrealized losses as of June 30, 2018 represent OTTI related to credit deterioration. These unrealized losses are attributed to changes in interest rates and temporary market movements. The Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell them before recovery of their amortized cost basis, which may be at maturity.

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5. LOANS
Loans Held-for-Investment
The following table presents the Company's loans held-for-investment by class.
Loan Portfolio
(Dollar amounts in thousands)

	As of	
	June 30, 2018	December 31, 2017
Commercial and industrial	$3,844,067	$3,529,914
Agricultural	433,175	430,886
Commercial real estate:		
Office, retail, and industrial	1,834,918	1,979,820
Multi-family	703,091	675,463
Construction	633,601	539,820
Other commercial real estate	1,337,396	1,358,515
Total commercial real estate	4,509,006	4,553,618
Total corporate loans	8,786,248	8,514,418
Home equity	847,903	827,055
1-4 family mortgages	880,181	774,357
Installment	377,233	321,982
Total consumer loans	2,105,317	1,923,394
Total loans	$10,891,565	$10,437,812
Deferred loan fees included in total loans	$5,444	$4,986
Overdrawn demand deposits included in total loans	8,163	8,587

The Company primarily lends to community-based and mid-sized businesses, commercial real estate customers, and consumers in its markets. Within these areas, the Company diversifies its loan portfolio by loan type, industry, and borrower.
It is the Company's policy to review each prospective credit to determine the appropriateness and the adequacy of security or collateral prior to making a loan. In the event of borrower default, the Company seeks recovery in compliance with state lending laws, the Company's lending standards, and credit monitoring and remediation procedures. A discussion of risk characteristics relevant to each portfolio segment is presented in Note 5, "Loans" to the Consolidated Financial Statements in the Company's 2017 10-K.

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Loan Sales

The following table presents loan sales for the quarters and six months ended June 30, 2018 and 2017.

Loan Sales

(Dollar amounts in thousands)

	Quarters Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Corporate loan sales				
Proceeds from sales	$3,991	$19,569	$12,312	$34,937
Less book value of loans sold	3,861	19,123	11,984	34,240
Net gains on corporate loan sales[1]	130	446	328	697
1-4 family mortgage loan sales				
Proceeds from sales	$65,715	$60,894	$130,900	$116,655
Less book value of loans sold	64,336	59,461	128,094	114,059
Net gains on 1-4 family mortgage loan sales[2]	1,379	1,433	2,806	2,596
Total net gains on loan sales	$1,509	$1,879	$3,134	$3,293

(1) Net gains on corporate loan sales are included in other service charges, commissions, and fees in the Condensed Consolidated Statements of Income.

(2) Net gains on 1-4 family mortgage loan sales are included in mortgage banking income in the Condensed Consolidated Statements of Income.

The Company retained servicing responsibilities for a portion of the 1-4 family mortgage loans sold and collects servicing fees equal to a percentage of the outstanding principal balance. For additional disclosure related to the Company's obligations resulting from the sale of certain 1-4 family mortgage loans, see Note 10, "Commitments, Guarantees, and Contingent Liabilities."

6. ACQUIRED AND COVERED LOANS

The significant accounting policies related to acquired and covered loans, which are classified as PCI and non-PCI, are presented in Note 1, "Summary of Significant Accounting Policies."

The following table presents the carrying amount of acquired and covered PCI and non-PCI loans as of June 30, 2018 and December 31, 2017.

Acquired and Covered Loans[1]

(Dollar amounts in thousands)

	As of June 30, 2018			As of December 31, 2017		
	PCI	Non-PCI	Total	PCI	Non-PCI	Total
Acquired loans	$106,218	$1,243,420	$1,349,638	$130,694	$1,512,664	$1,643,358
Covered loans	6,138	8,550	14,688	6,759	11,789	18,548
Total acquired and covered loans	$112,356	$1,251,970	$1,364,326	$137,453	$1,524,453	$1,661,906

(1) Included in loans in the Consolidated Statements of Condition.

The outstanding balance of PCI loans was $170.2 million and $210.7 million as of June 30, 2018 and December 31, 2017, respectively.

Acquired non-PCI loans that are renewed are no longer classified as acquired loans. These loans totaled $419.8 million and $366.0 million as of June 30, 2018 and December 31, 2017, respectively.

In connection with the FDIC Agreements, the Company recorded an indemnification asset. To maintain eligibility for the loss share reimbursement, the Company is required to follow certain servicing procedures as specified in the FDIC Agreements. The Company was in compliance with those requirements as of June 30, 2018 and December 31, 2017.

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Rollforwards of the carrying value of the FDIC indemnification asset for the quarters and six months ended June 30, 2018 and 2017 are presented in the following table.

Changes in the FDIC Indemnification Asset
(Dollar amounts in thousands)

	Quarters Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Beginning balance	$3,012	$4,220	$3,314	$4,522
Amortization	(302)	(302)	(604)	(604)
Change in expected reimbursements from the FDIC for changes in expected credit losses	29	(202)	175	(530)
Net payments (from) to the FDIC	(29)	202	(175)	530
Ending balance	$2,710	$3,918	$2,710	$3,918

Changes in the accretable yield for acquired and covered PCI loans were as follows.

Changes in Accretable Yield
(Dollar amounts in thousands)

	Quarters Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Beginning balances	$36,543	$41,249	$32,957	$19,385
Additions	—	—	—	27,316
Accretion	(2,922)	(3,888)	(6,540)	(7,843)
Other[1]	5,387	2,509	12,591	1,012
Ending balance	$39,008	$39,870	$39,008	$39,870

(1) Increases represent a rise in the expected future cash flows to be collected over the remaining estimated life of the underlying portfolio, while decreases result from the resolution of certain loans occurring earlier than anticipated.

Total accretion on acquired and covered PCI and non-PCI loans for the quarter and six months ended June 30, 2018 was $4.4 million and $9.6 million, respectively, and $8.8 million and $20.1 million, for the same periods in 2017.

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7. PAST DUE LOANS, ALLOWANCE FOR CREDIT LOSSES, IMPAIRED LOANS, AND TDRS
Past Due and Non-accrual Loans
The following table presents an aging analysis of the Company's past due loans as of June 30, 2018 and December 31, 2017. The aging is determined without regard to accrual status. The table also presents non-performing loans, consisting of non-accrual loans (the majority of which are past due) and loans 90 days or more past due and still accruing interest, as of each balance sheet date.
Aging Analysis of Past Due Loans and Non-performing Loans by Class
(Dollar amounts in thousands)

	Aging Analysis (Accruing and Non-accrual)					Non-performing Loans	
	Current[1]	30-89 Days Past Due	90 Days or More Past Due	Total Past Due	Total Loans	Non-accrual[2]	90 Days or More Past Due, Still Accruing Interest
As of June 30, 2018							
Commercial and industrial	$3,807,618	$18,230	$18,219	$36,449	$3,844,067	$22,672	$ 1,544
Agricultural	427,295	1,477	4,403	5,880	433,175	2,992	1,418
Commercial real estate:							
Office, retail, and industrial	1,820,408	5,366	9,144	14,510	1,834,918	9,007	1,402
Multi-family	696,920	3,530	2,641	6,171	703,091	3,551	2,269
Construction	633,043	107	451	558	633,601	208	243
Other commercial real estate	1,326,694	6,640	4,062	10,702	1,337,396	5,288	591
Total commercial real estate	4,477,065	15,643	16,298	31,941	4,509,006	18,054	4,505
Total corporate loans	8,711,978	35,350	38,920	74,270	8,786,248	43,718	7,467
Home equity	842,257	4,048	1,598	5,646	847,903	5,399	—
1-4 family mortgages	876,045	1,986	2,150	4,136	880,181	4,358	41
Installment	374,011	2,776	446	3,222	377,233	—	446
Total consumer loans	2,092,313	8,810	4,194	13,004	2,105,317	9,757	487
Total loans	$10,804,291	$44,160	$43,114	$87,274	$10,891,565	$53,475	$ 7,954
As of December 31, 2017							
Commercial and industrial	$3,490,783	$34,620	$4,511	$39,131	$3,529,914	$40,580	$ 1,830
Agricultural	430,221	280	385	665	430,886	219	177
Commercial real estate:							
Office, retail, and industrial	1,970,564	3,156	6,100	9,256	1,979,820	11,560	345
Multi-family	672,098	3,117	248	3,365	675,463	377	20
Construction	539,043	198	579	777	539,820	209	371
Other commercial real estate	1,353,263	2,545	2,707	5,252	1,358,515	3,621	317
Total commercial real estate	4,534,968	9,016	9,634	18,650	4,553,618	15,767	1,053
Total corporate loans	8,455,972	43,916	14,530	58,446	8,514,418	56,566	3,060
Home equity	820,099	4,102	2,854	6,956	827,055	5,946	98
1-4 family mortgages	770,120	2,145	2,092	4,237	774,357	4,412	—
Installment	319,178	2,407	397	2,804	321,982	—	397
Total consumer loans	1,909,397	8,654	5,343	13,997	1,923,394	10,358	495
Total loans	$10,365,369	$52,570	$19,873	$72,443	$10,437,812	$66,924	$ 3,555

(1) PCI loans with an accretable yield are considered current.

(2) Includes PCI loans of $748,000 and $763,000 as of June 30, 2018 and December 31, 2017, respectively, which no longer have an accretable yield as estimates of expected future cash flows have decreased since the acquisition due to credit deterioration.

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Allowance for Credit Losses

The Company maintains an allowance for credit losses at a level deemed adequate by management to absorb estimated losses inherent in the existing loan portfolio. See Note 1, "Summary of Significant Accounting Policies," for the accounting policy for the allowance for credit losses. A rollforward of the allowance for credit losses by portfolio segment for the quarters and six months ended June 30, 2018 and 2017 is presented in the table below.

Allowance for Credit Losses by Portfolio Segment
(Dollar amounts in thousands)

	Commercial, Industrial, and Agricultural	Office, Retail, and Industrial	Multi-family	Construction	Other Commercial Real Estate	Consumer	Reserve for Unfunded Commitments	Total Allowance for Credit Losses
Quarter ended June 30, 2018								
Beginning balance	$ 57,200	$ 10,607	$ 2,592	$ 1,972	$ 5,291	$ 17,192	$ 1,000	$ 95,854
Charge-offs	(8,662)	(305)	(4)	—	(1)	(2,337)	—	(11,309)
Recoveries	753	26	—	8	359	386	—	1,532
Net charge-offs	(7,909)	(279)	(4)	8	358	(1,951)	—	(9,777)
Provision for loan losses and other	10,752	(1,266)	(413)	144	(1,018)	3,415	—	11,614
Ending balance	$ 60,043	$ 9,062	$ 2,175	$ 2,124	$ 4,631	$ 18,656	$ 1,000	$ 97,691
Quarter ended June 30, 2017								
Beginning balance	$ 41,786	$ 17,701	$ 2,860	$ 4,110	$ 6,922	$ 14,784	$ 1,000	$ 89,163
Charge-offs	(2,957)	—	—	(39)	(307)	(1,556)	—	(4,859)
Recoveries	400	8	6	12	79	323	—	828
Net charge-offs	(2,557)	8	6	(27)	(228)	(1,233)	—	(4,031)
Provision for loan losses and other	7,042	(2,701)	53	11	785	3,049	—	8,239
Ending balance	$ 46,271	$ 15,008	$ 2,919	$ 4,094	$ 7,479	$ 16,600	$ 1,000	$ 93,371
Six months ended June 30, 2018								
Beginning balance	$ 55,791	$ 10,996	$ 2,534	$ 3,481	$ 6,381	$ 16,546	$ 1,000	$ 96,729
Charge-offs	(23,332)	(766)	(4)	—	(70)	(4,222)	—	(28,394)
Recoveries	1,291	123	—	21	398	728	—	2,561
Net charge-offs	(22,041)	(643)	(4)	21	328	(3,494)	—	(25,833)
Provision for loan losses and other	26,293	(1,291)	(355)	(1,378)	(2,078)	5,604	—	26,795
Ending balance	$ 60,043	$ 9,062	$ 2,175	$ 2,124	$ 4,631	$ 18,656	$ 1,000	$ 97,691
Six months ended June 30, 2017								
Beginning balance	$ 40,709	$ 17,595	$ 3,261	$ 3,444	$ 7,739	$ 13,335	$ 1,000	$ 87,083
Charge-offs	(7,031)	(127)	—	(44)	(715)	(3,220)	—	(11,137)
Recoveries	2,066	983	34	239	180	766	—	4,268
Net charge-offs	(4,965)	856	34	195	(535)	(2,454)	—	(6,869)
Provision for loan losses and other	10,527	(3,443)	(376)	455	275	5,719	—	13,157
Ending balance	$ 46,271	$ 15,008	$ 2,919	$ 4,094	$ 7,479	$ 16,600	$ 1,000	$ 93,371

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The table below provides a breakdown of loans and the related allowance for credit losses by portfolio segment as of June 30, 2018 and December 31, 2017.

Loans and Related Allowance for Credit Losses by Portfolio Segment
(Dollar amounts in thousands)

	Loans				Allowance for Credit Losses			
	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	PCI	Total	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	PCI	Total
As of June 30, 2018								
Commercial, industrial, and agricultural	$23,598	$4,248,880	$4,764	$4,277,242	$2,884	$ 56,725	$434	$60,043
Commercial real estate:								
Office, retail, and industrial	7,642	1,815,329	11,947	1,834,918	792	6,624	1,646	9,062
Multi-family	3,941	686,136	13,014	703,091	—	1,998	177	2,175
Construction	—	628,649	4,952	633,601	—	1,968	156	2,124
Other commercial real estate	3,165	1,276,791	57,440	1,337,396	—	3,823	808	4,631
Total commercial real estate	14,748	4,406,905	87,353	4,509,006	792	14,413	2,787	17,992
Total corporate loans	38,346	8,655,785	92,117	8,786,248	3,676	71,138	3,221	78,035
Consumer	—	2,085,078	20,239	2,105,317	—	17,167	1,489	18,656
Reserve for unfunded commitments	—	—	—	—	—	1,000	—	1,000
Total loans	$38,346	$10,740,863	$112,356	$10,891,565	$3,676	$ 89,305	$4,710	$97,691
As of December 31, 2017								
Commercial, industrial, and agricultural	$38,718	$3,909,380	$12,702	$3,960,800	$10,074	$ 45,293	$424	$55,791
Commercial real estate:								
Office, retail, and industrial	10,810	1,954,435	14,575	1,979,820	—	9,333	1,663	10,996
Multi-family	621	660,771	14,071	675,463	—	2,436	98	2,534
Construction	—	530,977	8,843	539,820	—	3,331	150	3,481
Other commercial real estate	1,468	1,291,723	65,324	1,358,515	—	5,415	966	6,381
Total commercial real estate	12,899	4,437,906	102,813	4,553,618	—	20,515	2,877	23,392
Total corporate loans	51,617	8,347,286	115,515	8,514,418	10,074	65,808	3,301	79,183
Consumer	—	1,901,456	21,938	1,923,394	—	15,533	1,013	16,546
Reserve for unfunded commitments	—	—	—	—	—	1,000	—	1,000
Total loans	$51,617	$10,248,742	$137,453	$10,437,812	$10,074	$ 82,341	$4,314	$96,729

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Loans Individually Evaluated for Impairment

The following table presents loans individually evaluated for impairment by class of loan as of June 30, 2018 and December 31, 2017. PCI loans are excluded from this disclosure.

Impaired Loans Individually Evaluated by Class

(Dollar amounts in thousands)

	As of June 30, 2018				As of December 31, 2017			
	Recorded Investment In				Recorded Investment In			
	Loans with No Specific Reserve	Loans with a Specific Reserve	Unpaid Principal Balance	Specific Reserve	Loans with No Specific Reserve	Loans with a Specific Reserve	Unpaid Principal Balance	Specific Reserve
Commercial and industrial	$5,777	$14,919	$40,033	$2,683	$4,234	$34,484	$53,192	$10,074
Agricultural	—	2,902	4,672	201	—	—	—	—
Commercial real estate:								
Office, retail, and industrial	3,303	4,339	8,125	792	7,154	3,656	14,246	—
Multi-family	3,941	—	3,941	—	621	—	621	—
Construction	—	—	—	—	—	—	—	—
Other commercial real estate	3,165	—	3,199	—	1,468	—	1,566	—
Total commercial real estate	10,409	4,339	15,265	792	9,243	3,656	16,433	—
Total impaired loans individually evaluated for impairment	$16,186	$22,160	$59,970	$3,676	$13,477	$38,140	$69,625	$10,074

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The following table presents the average recorded investment and interest income recognized on impaired loans by class for the quarters and six months ended June 30, 2018 and 2017. PCI loans are excluded from this disclosure.
Average Recorded Investment and Interest Income Recognized on Impaired Loans by Class
(Dollar amounts in thousands)

	Quarters Ended June 30,			
	2018		2017	
	Average Recorded Investment	Interest Income Recognized[(1)]	Average Recorded Investment	Interest Income Recognized[(1)]
Commercial and industrial	$31,787	$ 14	$33,648	$ 342
Agricultural	3,386	25	697	—
Commercial real estate:				
Office, retail, and industrial	9,509	656	13,612	169
Multi-family	2,166	48	396	—
Construction	—	—	—	—
Other commercial real estate	2,694	61	2,334	8
Total commercial real estate	14,369	765	16,342	177
Total impaired loans	$49,542	$ 804	$50,687	$ 519

	Six Months Ended June 30,			
	2018		2017	
	Average Recorded Investment	Interest Income Recognized[(1)]	Average Recorded Investment	Interest Income Recognized[(1)]
Commercial and industrial	$34,097	$ 36	$30,647	$ 556
Agricultural	2,257	25	464	—
Commercial real estate:				
Office, retail, and industrial	9,942	768	14,503	262
Multi-family	1,651	55	397	28
Construction	—	—	11	136
Other commercial real estate	2,285	113	1,984	20
Total commercial real estate	13,878	936	16,895	446
Total impaired loans	$50,232	$ 997	$48,006	$ 1,002

(1) Recorded using the cash basis of accounting.

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Credit Quality Indicators

Corporate loans and commitments are assessed for credit risk and assigned ratings based on various characteristics, such as the borrower's cash flow, leverage, and collateral. Ratings for commercial credits are reviewed periodically. The following tables present credit quality indicators by class for corporate and consumer loans, as of June 30, 2018 and December 31, 2017.

Corporate Credit Quality Indicators by Class
(Dollar amounts in thousands)

	Pass	Special Mention(1)(4)	Substandard(2)(4)	Non-accrual(3)	Total
As of June 30, 2018					
Commercial and industrial	$3,648,626	$ 122,881	$ 49,888	$ 22,672	$3,844,067
Agricultural	415,043	8,474	6,666	2,992	433,175
Commercial real estate:					
Office, retail, and industrial	1,770,908	23,602	31,401	9,007	1,834,918
Multi-family	687,065	10,460	2,015	3,551	703,091
Construction	607,142	18,915	7,336	208	633,601
Other commercial real estate	1,281,870	32,137	18,101	5,288	1,337,396
Total commercial real estate	4,346,985	85,114	58,853	18,054	4,509,006
Total corporate loans	$8,410,654	$ 216,469	$ 115,407	$ 43,718	$8,786,248
As of December 31, 2017					
Commercial and industrial	$3,388,133	$ 70,863	$ 30,338	$ 40,580	$3,529,914
Agricultural	413,946	10,989	5,732	219	430,886
Commercial real estate:					
Office, retail, and industrial	1,903,737	25,546	38,977	11,560	1,979,820
Multi-family	665,496	7,395	2,195	377	675,463
Construction	521,911	10,184	7,516	209	539,820
Other commercial real estate	1,304,337	29,624	20,933	3,621	1,358,515
Total commercial real estate	4,395,481	72,749	69,621	15,767	4,553,618
Total corporate loans	$8,197,560	$ 154,601	$ 105,691	$ 56,566	$8,514,418

(1) Loans categorized as special mention exhibit potential weaknesses that require the close attention of management since these potential weaknesses may result in the deterioration of repayment prospects in the future.

(2) Loans categorized as substandard exhibit well-defined weaknesses that may jeopardize the liquidation of the debt. These loans continue to accrue interest because they are well-secured and collection of principal and interest is expected within a reasonable time.

(3) Loans categorized as non-accrual exhibit well-defined weaknesses that may jeopardize the liquidation of the debt or result in a loss if the deficiencies are not corrected.

(4) Total special mention and substandard loans includes accruing TDRs of $645,000 as of June 30, 2018 and $657,000 as of December 31, 2017.

Consumer Credit Quality Indicators by Class
(Dollar amounts in thousands)

	Performing	Non-accrual	Total
As of June 30, 2018			
Home equity	$842,504	$ 5,399	$847,903
1-4 family mortgages	875,823	4,358	880,181
Installment	377,233	—	377,233
Total consumer loans	$2,095,560	$ 9,757	$2,105,317

As of December 31, 2017			
Home equity	$821,109	$ 5,946	$827,055
1-4 family mortgages	769,945	4,412	774,357
Installment	321,982	—	321,982
Total consumer loans	$1,913,036	$ 10,358	$1,923,394

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TDRs

TDRs are generally performed at the request of the individual borrower and may include forgiveness of principal, reduction in interest rates, changes in payments, and maturity date extensions. The table below presents TDRs by class as of June 30, 2018 and December 31, 2017. See Note 1, "Summary of Significant Accounting Policies," for the accounting policy for TDRs.

TDRs by Class

(Dollar amounts in thousands)

	As of June 30, 2018			As of December 31, 2017		
	Accruing	Non-accrual[1]	Total	Accruing	Non-accrual[1]	Total
Commercial and industrial	$255	$ 6,845	$7,100	$264	$ 18,959	$19,223
Agricultural	—	—	—	—	—	—
Commercial real estate:						
Office, retail, and industrial	—	501	501	—	4,236	4,236
Multi-family	566	—	566	574	149	723
Construction	—	—	—	—	—	—
Other commercial real estate	187	—	187	192	—	192
Total commercial real estate	753	501	1,254	766	4,385	5,151
Total corporate loans	1,008	7,346	8,354	1,030	23,344	24,374
Home equity	84	470	554	86	738	824
1-4 family mortgages	668	422	1,090	680	451	1,131
Installment	—	—	—	—	—	—
Total consumer loans	752	892	1,644	766	1,189	1,955
Total loans	$1,760	$ 8,238	$9,998	$1,796	$ 24,533	$26,329

[1] These TDRs are included in non-accrual loans in the preceding tables.

TDRs are included in the calculation of the allowance for credit losses in the same manner as impaired loans. There were $625,000 and $2.0 million specific reserves related to TDRs as of June 30, 2018 and December 31, 2017, respectively.

Accruing TDRs that do not perform in accordance with their modified terms are transferred to non-accrual. There were no material TDRs that defaulted within twelve months of the restructure date during the quarters and six months ended June 30, 2018 and 2017.

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A rollforward of the carrying value of TDRs for the quarters and six months ended June 30, 2018 and 2017 is presented in the following table.

TDR Rollforward
(Dollar amounts in thousands)

	Quarters Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Accruing				
Beginning balance	$1,778	$2,112	$1,796	$2,291
Additions	—	—	—	922
Net payments	(18)	(83)	(36)	(107)
Net transfers from (to) non-accrual	—	—	—	(1,077)
Ending balance	1,760	2,029	1,760	2,029
Non-accrual				
Beginning balance	20,466	3,112	24,533	6,297
Additions	—	—	355	—
Net payments	(9,865)	(75)	(12,978)	(4,225)
Charge-offs	(2,363)	(1)	(3,672)	(113)
Net transfers from accruing	—	—	—	1,077
Ending balance	8,238	3,036	8,238	3,036
Total TDRs	$9,998	$5,065	$9,998	$5,065

For TDRs to be removed from TDR status in the calendar year after the restructuring, the loans must (i) have an interest rate and terms that reflect market conditions at the time of restructuring, and (ii) be in compliance with the modified terms. Loans that were not restructured at market rates and terms, that are not in compliance with the modified terms, or for which there is a concern about the future ability of the borrower to meet its obligations under the modified terms, continue to be separately reported as restructured until paid in full or charged-off.

There were no material commitments to lend additional funds to borrowers with TDRs as of June 30, 2018 or December 31, 2017.

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8. EARNINGS PER COMMON SHARE

The table below displays the calculation of basic and diluted earnings per common share ("EPS").

Basic and Diluted EPS

(Amounts in thousands, except per share data)

	Quarters Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net income	$29,600	$34,950	$63,110	$57,805
Net income applicable to non-vested restricted shares	(240)	(336)	(551)	(570)
Net income applicable to common shares	$29,360	$34,614	$62,559	$57,235
Weighted-average common shares outstanding:				
Weighted-average common shares outstanding (basic)	102,159	101,743	102,041	101,081
Dilutive effect of common stock equivalents	—	20	8	20
Weighted-average diluted common shares outstanding	102,159	101,763	102,049	101,101
Basic EPS	$0.29	$0.34	$0.61	$0.57
Diluted EPS	$0.29	$0.34	$0.61	$0.57
Anti-dilutive shares not included in the computation of diluted EPS[1]	—	195	54	269

(1) This amount represents outstanding stock options for which the exercise price is greater than the average market price of the Company's common stock. The final outstanding stock options were exercised during the first quarter of 2018.

9. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

In the ordinary course of business, the Company enters into derivative transactions as part of its overall interest rate risk management strategy. The significant accounting policies related to derivative instruments and hedging activities are presented in Note 1, "Summary of Significant Accounting Policies."

Fair Value Hedges

The Company hedges the fair value of fixed rate commercial real estate loans using interest rate swaps through which the Company pays fixed amounts and receives variable amounts. These derivative contracts are designated as fair value hedges.

Fair Value Hedges

(Dollar amounts in thousands)

	As of June 30, 2018	December 31, 2017
Gross notional amount outstanding	$5,208	$ 5,458
Derivative liability fair value in other liabilities	(33)	(101)
Weighted-average interest rate received	4.00 %	3.38 %
Weighted-average interest rate paid	5.96 %	5.96 %
Weighted-average maturity (in years)	0.35	0.84
Fair value of derivative[1]	$40	$ 110

(1) This amount represents the fair value if credit risk related contingent features were triggered.

Changes in the fair value of fair value hedges are recognized in other noninterest income in the Condensed Consolidated Statements of Income.

Cash Flow Hedges

As of June 30, 2018, the Company hedged $1.1 billion of certain corporate variable rate loans using interest rate swaps through which the Company receives fixed amounts and pays variable amounts. The Company also hedged

$1.0 billion of borrowed funds using forward starting interest rate swaps through which the Company receives variable amounts and pays fixed amounts. These transactions allow the Company to add stability to net interest income and manage its exposure to interest rate movements.

Forward starting interest rate swaps totaling $710.0 million began on various dates between June of 2015 and May of 2018, and mature between June of 2019 and May of 2020. The remaining forward starting interest rate swaps totaling $320.0 million begin at various dates between December of 2018 and February of 2021 and mature between December of 2021 and February of 2023. The weighted-average fixed interest rate to be paid on these interest rate swaps that have not yet begun was 2.49% as of June 30, 2018. These derivative contracts are designated as cash flow hedges.

Cash Flow Hedges
(Dollar amounts in thousands)

	As of	
	June 30, 2018	December 31, 2017
Gross notional amount outstanding	$2,170,000	$1,960,000
Derivative asset fair value in other assets[1]	8,389	3,989
Derivative liability fair value in other liabilities[1]	(18,876)	(10,219)
Weighted-average interest rate received	2.01%	1.58%
Weighted-average interest rate paid	1.97%	1.61%
Weighted-average maturity (in years)	2.01	2.25

(1) Certain cash flow hedges are transacted through a clearinghouse ("centrally cleared") and their change in fair value is settled by the counterparties to the transaction, which results in no fair value.

Changes in the fair value of cash flow hedges are recorded in accumulated other comprehensive loss on an after-tax basis and are subsequently reclassified to interest income or expense in the period that the forecasted hedged item impacts earnings. As of June 30, 2018, the Company estimates that $2.0 million will be reclassified from accumulated other comprehensive loss as a decrease to interest income over the next twelve months.

Other Derivative Instruments

The Company also enters into derivative transactions through capital market products with its commercial customers and simultaneously enters into an offsetting interest rate derivative transaction with third-parties. This transaction allows the Company's customers to effectively convert a variable rate loan into a fixed rate loan. Due to the offsetting nature of these transactions, the Company does not apply hedge accounting treatment. The Company's credit exposure on these derivative transactions results primarily from counterparty credit risk. The credit valuation adjustment ("CVA") is a fair value adjustment to the derivative to account for this risk. As of June 30, 2018 and December 31, 2017, the Company's credit exposure was fully secured by the underlying collateral on customer loans and mitigated through netting arrangements with third-parties, therefore, no CVA was recorded. Capital market products income related to commercial customer derivative instruments totaled $2.8 million and $4.4 million for the quarter and six months ended June 30, 2018, respectively. There were $2.2 million and $3.6 million of capital market products income for the quarter and six months ended June 30, 2017, respectively.

Other Derivative Instruments
(Dollar amounts in thousands)

	As of	
	June 30, 2018	December 31, 2017
Gross notional amount outstanding	$3,060,888	$2,665,358
Derivative asset fair value in other assets[1]	26,691	17,079
Derivative liability fair value in other liabilities[1]	(29,131)	(14,930)
Fair value of derivative[2]	29,141	15,059

(1) Certain other derivative instruments are centrally cleared and their change in fair value is settled by the counterparties to the transaction, which results in no fair value.

(2) This amount represents the fair value if credit risk related contingent features were triggered.

The Company occasionally enters into risk participation agreements with counterparty banks to transfer or assume a portion of the credit risk related to customer transactions. The amounts of these instruments were not material for any periods presented. The Company had no other derivative instruments as of June 30, 2018 and December 31, 2017. The Company does not enter into derivative transactions for purely speculative purposes.

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The following table presents the impact of derivative instruments on comprehensive income and the reclassification of gains (losses) from accumulated other comprehensive loss to net interest income for the quarters and six months ended June 30, 2018 and 2017.

Cash Flow Hedge Accounting on AOCI
(Dollar amounts in thousands)

	Quarters Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Gains (losses) recognized in other comprehensive income				
Interest rate swaps in interest income	$3,577	$3,541	$10,573	$5,352
Interest rate swaps in interest expense	(2,860)	(3,089)	(10,043)	(3,391)
Reclassification of gains (losses) included in net income				
Interest rate swaps in interest income	$376	$1,531	$647	$3,387
Interest rate swaps in interest expense	(503)	(1,078)	(1,109)	(2,223)

The following table presents the impact of derivative instruments on net interest income for the quarters and six months ended June 30, 2018 and 2017.

Hedge Income
(Dollar amounts in thousands)

	Quarters Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Fair Value Hedges				
Interest rate swaps in interest income	$(18)	$(56)	$(59)	$(90)
Cash Flow Hedges				
Interest rate swaps in interest income	376	1,531	647	3,387
Interest rate swaps in interest expense	(503)	(1,078)	(1,109)	(2,223)
Total cash flow hedges	(127)	453	(462)	1,164
Total net (losses) gains on hedges	$(145)	$397	$(521)	$1,074

Credit Risk

Derivative instruments are inherently subject to credit risk, which represents the Company's risk of loss when the counterparty to a derivative contract fails to perform according to the terms of the agreement. Credit risk is managed by limiting and collateralizing the aggregate amount of net unrealized losses by transaction, monitoring the size and the maturity structure of the derivatives, and applying uniform credit standards. Company policy establishes limits on credit exposure to any single counterparty. In addition, the Company established bilateral collateral agreements with derivative counterparties that provide for exchanges of marketable securities or cash to collateralize either party's net losses above a stated minimum threshold. As of June 30, 2018 and December 31, 2017, these collateral agreements covered 100% of the fair value of the Company's outstanding fair value hedges. Derivative assets and liabilities are presented gross, rather than net, of pledged collateral amounts.

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Certain derivative instruments are subject to master netting agreements with counterparties. The Company records these transactions at their gross fair values and does not offset derivative assets and liabilities in the Consolidated Statements of Financial Condition. The following table presents the fair value of the Company's derivatives and offsetting positions as of June 30, 2018 and December 31, 2017.

Fair Value of Offsetting Derivatives
(Dollar amounts in thousands)

	As of June 30, 2018		As of December 31, 2017	
	Assets	Liabilities	Assets	Liabilities
Gross amounts recognized	$35,080	$48,040	$21,068	$25,250
Less: amounts offset in the Consolidated Statements of Financial Condition	—	—	—	—
Net amount presented in the Consolidated Statements of Financial Condition(1)	35,080	48,040	21,068	25,250
Gross amounts not offset in the Consolidated Statements of Financial Condition:				
Offsetting derivative positions	(14,704)	(14,704)	(16,880)	(16,880)
Cash collateral pledged	(17,360)	(4,480)	—	(8,370)
Net credit exposure	$3,016	$28,856	$4,188	$—

(1) Included in other assets or other liabilities in the Consolidated Statements of Financial Condition.

As of June 30, 2018 and December 31, 2017, the Company's derivative instruments generally contained provisions that require the Company's debt to remain above a certain credit rating by each of the major credit rating agencies or that the Company maintain certain capital levels. If the Company's debt were to fall below that credit rating or the Company's capital were to fall below the required levels, it would be in violation of those provisions, and the counterparties to the derivative instruments could terminate the swap transaction and demand cash settlement of the derivative instrument in an amount equal to the derivative liability fair value. As of June 30, 2018 and December 31, 2017 the Company was in compliance with these provisions.

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10. COMMITMENTS, GUARANTEES, AND CONTINGENT LIABILITIES

Credit Commitments and Guarantees

In the normal course of business, the Company enters into a variety of financial instruments with off-balance sheet risk to meet the financing needs of its customers and to conduct lending activities, including commitments to extend credit and standby and commercial letters of credit. These instruments involve elements of credit and interest rate risk in excess of the amount recognized in the Consolidated Statements of Financial Condition.

Contractual or Notional Amounts of Financial Instruments

(Dollar amounts in thousands)

	As of June 30, 2018	December 31, 2017
Commitments to extend credit:		
Commercial, industrial, and agricultural	$1,656,372	$ 1,729,426
Commercial real estate	349,861	377,551
Home equity	546,600	514,973
Other commitments[1]	244,752	244,222
Total commitments to extend credit	$2,797,585	$ 2,866,172
Letters of credit	$119,941	$ 128,801

[1] Other commitments includes installment and overdraft protection program commitments.

Commitments to extend credit are agreements to lend funds to a customer, subject to contractual terms and covenants. Commitments generally have fixed expiration dates or other termination clauses, variable interest rates, and fee requirements, when applicable. Since many of the commitments are expected to expire without being drawn, the total commitment amounts do not necessarily represent future cash flow requirements.

In the event of a customer's non-performance, the Company's credit loss exposure is equal to the contractual amount of the commitments. The credit risk is essentially the same as extending loans to customers for the full contractual amount. The Company uses the same credit policies for credit commitments as its loans and minimizes exposure to credit loss through various collateral requirements.

Letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third-party. Letters of credit generally are contingent on the failure of the customer to perform according to the terms of the contract with the third-party and are often issued in favor of a municipality where construction is taking place to ensure the borrower adequately completes the construction. Commercial letters of credit are issued to facilitate transactions between a customer and a third-party based on agreed upon terms.

The maximum potential future payments guaranteed by the Company under letters of credit arrangements are equal to the contractual amount of the commitment. If a commitment is funded, the Company may seek recourse through the liquidation of the underlying collateral, including real estate, production plants and property, marketable securities, or receipt of cash.

As a result of the sale of certain 1-4 family mortgage loans, the Company is contractually obligated to repurchase early payment default loans or loans that do not meet underwriting requirements at recorded value. In accordance with the sales agreements, there is no limitation to the maximum potential future payments or expiration of the Company's recourse obligation. There were no material loan repurchases during the quarters and six months ended June 30, 2018 and 2017.

Legal Proceedings

In the ordinary course of business, there were certain legal proceedings pending against the Company and its subsidiaries at June 30, 2018. While the outcome of any legal proceeding is inherently uncertain, based on information currently available, the Company's management does not expect that any liabilities arising from pending legal matters will have a material adverse effect on the Company's business, financial position, results of operations, or cash flows.

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11. FAIR VALUE

Fair value represents the amount expected to be received to sell an asset or paid to transfer a liability in its principal or most advantageous market in an orderly transaction between market participants at the measurement date. In accordance with fair value accounting guidance, the Company measures, records, and reports various types of assets and liabilities at fair value on either a recurring or non-recurring basis in the Consolidated Statements of Financial Condition. Those assets and liabilities are presented below in the sections titled "Assets and Liabilities Required to be Measured at Fair Value on a Recurring Basis" and "Assets and Liabilities Required to be Measured at Fair Value on a Non-Recurring Basis."

Other assets and liabilities are not required to be measured at fair value in the Consolidated Statements of Financial Condition, but must be disclosed at fair value. See the "Fair Value Measurements of Other Financial Instruments" section of this note. Any aggregation of the estimated fair values presented in this note does not represent the value of the Company.

Depending on the nature of the asset or liability, the Company uses various valuation methodologies and assumptions to estimate fair value. GAAP provides a three-tiered fair value hierarchy based on the inputs used to measure fair value. The hierarchy is defined as follows:

- Level 1 – Quoted prices in active markets for identical assets or liabilities.
- Level 2 – Observable inputs other than level 1 prices, such as quoted prices for similar instruments, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data.
- Level 3 – Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. These inputs require significant management judgment or estimation, some of which use model-based techniques and may be internally developed.

Assets and liabilities are assigned to a level within the fair value hierarchy based on the lowest level of significant input used to measure fair value. Assets and liabilities may change levels within the fair value hierarchy due to market conditions or other circumstances. Those transfers are recognized on the date of the event that prompted the transfer. There were no transfers of assets or liabilities required to be measured at fair value on a recurring basis between levels of the fair value hierarchy during the periods presented.

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Assets and Liabilities Required to be Measured at Fair Value on a Recurring Basis

The following table provides the fair value for assets and liabilities required to be measured at fair value on a recurring basis in the Consolidated Statements of Financial Condition by level in the fair value hierarchy.

Recurring Fair Value Measurements
(Dollar amounts in thousands)

	As of June 30, 2018			As of December 31, 2017		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Assets						
Trading securities:						
Money market funds	$ —	$ —	$ —	$ 1,685	$ —	$ —
Mutual funds	—	—	—	18,762	—	—
Total trading securities[1]	—	—	—	20,447	—	—
Equity securities[1]	21,308	7,310	—	—	—	—
Securities available-for-sale[1]						
U.S. treasury securities	49,158	—	—	46,345	—	—
U.S. agency securities	—	148,284	—	—	156,847	—
CMOs	—	1,232,430	—	—	1,095,186	—
MBSs	—	437,636	—	—	369,543	—
Municipal securities	—	218,345	—	—	208,991	—
Corporate debt securities	—	57,012	—	—	—	—
Equity securities	—	—	—	—	7,297	—
Total securities available-for-sale	49,158	2,093,707	—	46,345	1,837,864	—
Mortgage servicing rights ("MSRs")[2]	—	—	6,671	—	—	5,894
Derivative assets[2]	—	35,080	—	—	21,068	—
Liabilities						
Derivative liabilities[3]	$ —	$ 48,040	$ —	$ —	$ 25,250	$ —

(1) As a result of recently adopted accounting guidance, equity securities are no longer presented within trading securities or securities available-for-sale for the prior period and are now presented within equity securities for the current period. For further discussion of this guidance, see Note 2 of "Notes to the Condensed Consolidated Financial Statements" in Item 1 of this Form 10-Q.

(2) Included in other assets in the Consolidated Statements of Financial Condition.

(3) Included in other liabilities in the Consolidated Statements of Financial Condition.

The following sections describe the specific valuation techniques and inputs used to measure financial assets and liabilities at fair value.

Equity Securities

The Company's equity securities consist primarily of community development investments and certain diversified investment securities held in a grantor trust for participants in the Company's nonqualified deferred compensation plan that are invested in money market and mutual funds. The fair value of community development investments is based on quoted prices in active markets or market prices for similar securities obtained from external pricing services or dealer market participants and is classified in level 2 of the fair value hierarchy. The fair value of the money market and mutual funds is based on quoted market prices in active exchange markets and is classified in level 1 of the fair value hierarchy.

Securities Available-for-Sale

The Company's securities available-for-sale are primarily fixed income instruments that are not quoted on an exchange, but may be traded in active markets. The fair values for these securities are based on quoted prices in active markets or market prices for similar securities obtained from external pricing services or dealer market participants and are classified in level 2 of the fair value hierarchy. The fair value of U.S. treasury securities is based on quoted market prices in active exchange markets and is classified in level 1 of the fair value hierarchy. Quarterly, the Company evaluates the methodologies used by its external pricing services to estimate the fair value of these securities to determine whether the valuations represent an exit price in the Company's principal markets.

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MSRs

The Company services loans for others totaling $617.5 million and $607.0 million as of June 30, 2018 and December 31, 2017, respectively. These loans are owned by third-parties and are not included in the Consolidated Statements of Financial Condition. The Company determines the fair value of MSRs by estimating the present value of expected future cash flows associated with the mortgage loans being serviced and classifies them in level 3 of the fair value hierarchy. The following table presents the ranges of significant, unobservable inputs used by the Company to determine the fair value of MSRs as of June 30, 2018 and December 31, 2017.

Significant Unobservable Inputs Used in the Valuation of MSRs

	As of			
	June 30, 2018		December 31, 2017	
Prepayment speed	6.7%	-13.5%	4.2%	-13.1%
Maturity (months)	4	-106	6	-92
Discount rate	9.5%	-12.0%	9.5%	-12.0%

The impact of changes in these key inputs could result in a significantly higher or lower fair value measurement for MSRs. Significant increases in expected prepayment speeds and discount rates have negative impacts on the valuation. Higher maturity assumptions have a favorable effect on the estimated fair value.

A rollforward of the carrying value of MSRs for the quarters and six months ended June 30, 2018 and 2017 is presented in the following table.

Carrying Value of MSRs

(Dollar amounts in thousands)

	Quarters Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Beginning balance	$6,468	$6,245	$5,894	$6,120
New MSRs	393	205	569	361
Total gains (losses) included in earnings[1]:				
Changes in valuation inputs and assumptions	2	(260)	562	(88)
Other changes in fair value[2]	(192)	(265)	(354)	(468)
Ending balance	$6,671	$5,925	$6,671	$5,925
Contractual servicing fees earned[1]	$369	$384	$747	$779

(1) Included in mortgage banking income in the Condensed Consolidated Statements of Income and related to assets held as of June 30, 2018 and 2017.

(2) Primarily represents changes in expected future cash flows due to payoffs and paydowns.

Derivative Assets and Derivative Liabilities

The Company enters into interest rate swaps and derivative transactions with commercial customers. These derivative transactions are executed in the dealer market, and pricing is based on market quotes obtained from the counterparties. The market quotes were developed using market observable inputs, which primarily include LIBOR. Therefore, derivatives are classified in level 2 of the fair value hierarchy. For its derivative assets and liabilities, the Company also considers non-performance risk, including the likelihood of default by itself and its counterparties, when evaluating whether the market quotes from the counterparty are representative of an exit price.

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Assets and Liabilities Required to be Measured at Fair Value on a Non-Recurring Basis

The following table provides the fair value for each class of assets and liabilities required to be measured at fair value on a non-recurring basis in the Consolidated Statements of Financial Condition by level in the fair value hierarchy.

Non-Recurring Fair Value Measurements

(Dollar amounts in thousands)

	As of June 30, 2018			As of December 31, 2017		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Collateral-dependent impaired loans[1]	$—	$ —	$19,810	$—	$ —	$33,240
OREO[2]	—	—	5,177	—	—	12,340
Loans held-for-sale[3]	—	—	6,030	—	—	21,098
Assets held-for-sale[4]	—	—	3,899	—	—	2,208

(1) Includes impaired loans with charge-offs and impaired loans with a specific reserve during the periods presented.

(2) Includes OREO with fair value adjustments subsequent to initial transfer that occurred during the periods presented.

(3) Included in other assets in the Consolidated Statements of Financial Condition.

(4) Included in premises, furniture, and equipment in the Consolidated Statements of Financial Condition.

Collateral-Dependent Impaired Loans

Certain collateral-dependent impaired loans are subject to fair value adjustments to reflect the difference between the carrying value of the loan and the value of the underlying collateral. The fair values of collateral-dependent impaired loans are primarily determined by current appraised values of the underlying collateral. Based on the age and/or type, appraisals may be adjusted in the range of 0% to 15%. In certain cases, an internal valuation may be used when the underlying collateral is located in areas where comparable sales data is limited or unavailable. Accordingly, collateral-dependent impaired loans are classified in level 3 of the fair value hierarchy.

Collateral-dependent impaired loans for which the fair value is greater than the recorded investment are not measured at fair value in the Consolidated Statements of Financial Condition and are not included in this disclosure.

OREO

The fair value of OREO is measured using the current appraised value of the properties. In certain circumstances, a current appraisal may not be available or may not represent an accurate measurement of the property's fair value due to outdated market information or other factors. In these cases, the fair value is determined based on the lower of the (i) most recent appraised value, (ii) broker price opinion, (iii) current listing price, or (iv) signed sales contract. Given these valuation methods, OREO is classified in level 3 of the fair value hierarchy.

Loans Held-for-Sale

As of June 30, 2018 and December 31, 2017, loans held-for-sale consists of 1-4 family mortgage loans, which were originated with the intent to sell. These loans were recorded in the held-for-sale category at the contract price and, accordingly, are classified in level 3 of the fair value hierarchy.

Assets Held-for-Sale

Assets held-for-sale as of June 30, 2018 and December 31, 2017 consists of former branches that are no longer in operation and parcels of land previously purchased for expansion. These properties are being actively marketed and were transferred into the held-for-sale category at their fair value as determined by current appraisals. Based on these valuation methods, they are classified in level 3 of the fair value hierarchy.

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Financial Instruments Not Required to be Measured at Fair Value
For certain financial instruments that are not required to be measured at fair value in the Consolidated Statements of Financial Condition, the Company must disclose the estimated fair values and the level within the fair value hierarchy as shown in the following table.
Fair Value Measurements of Other Financial Instruments
(Dollar amounts in thousands)

		As of June 30, 2018		December 31, 2017	
	Fair Value Hierarchy Level	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Assets					
Cash and due from banks	1	$181,482	$181,482	$192,800	$192,800
Interest-bearing deposits in other banks	2	192,785	192,785	153,770	153,770
Securities held-to-maturity	2	13,042	10,918	13,760	12,013
FHLB and FRB stock	2	82,778	82,778	69,708	69,708
Loans	3	10,797,584	10,451,952	10,345,397	10,059,992
Investment in BOLI	3	282,664	282,664	279,900	279,900
Accrued interest receivable	3	48,542	48,542	45,261	45,261
Other interest-earning assets	3	78	78	228	228
Liabilities					
Deposits	2	$11,492,263	$11,470,263	$11,053,325	$11,038,819
Borrowed funds	2	981,044	981,044	714,884	714,884
Senior and subordinated debt	2	195,453	208,425	195,170	208,666
Accrued interest payable	2	7,115	7,115	4,704	4,704

Management uses various methodologies and assumptions to determine the estimated fair values of the financial instruments in the table above. The fair value estimates are made at a discrete point in time based on relevant market information and consider management's judgments regarding future expected economic conditions, loss experience, and specific risk characteristics of the financial instruments. Loans include the FDIC indemnification asset and net loans, which consists of loans held-for-investment, acquired loans, and the allowance for loan losses. As of both June 30, 2018 and December 31, 2017, the Company estimated the fair value of lending commitments outstanding to be immaterial.

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

INTRODUCTION

First Midwest Bancorp, Inc. is a bank holding company headquartered in Chicago, Illinois, with operations throughout the Chicago metropolitan area, northwest Indiana, central and western Illinois, and eastern Iowa. Our principal subsidiary, First Midwest Bank, and other affiliates provide a broad range of commercial, retail, treasury management, equipment leasing, wealth management, trust, and private banking products and services to commercial and industrial, commercial real estate, municipal, and consumer customers. We are committed to meeting the financial needs of the people and businesses in the communities where we live and work by providing customized banking solutions, quality products, and innovative services that fulfill those financial needs.

The following discussion and analysis is intended to address the significant factors affecting our Condensed Consolidated Statements of Income for the quarters and six months ended June 30, 2018 and 2017 and Consolidated Statements of Financial Condition as of June 30, 2018 and December 31, 2017. When we use the terms "First Midwest," the "Company," "we," "us," and "our," we mean First Midwest Bancorp, Inc. and its consolidated subsidiaries. When we use the term "Bank," we are referring to our wholly-owned banking subsidiary, First Midwest Bank. Management's discussion and analysis should be read in conjunction with the consolidated financial statements, accompanying notes thereto, and other information presented in Item 1 of this Quarterly Report on Form 10-Q ("Form 10-Q"), as well as in our 2017 Annual Report on Form 10-K ("2017 10-K"). The results of operations for the quarter and six months ended June 30, 2018 are not necessarily indicative of future results.

Our results of operations are affected by various factors, many of which are beyond our control, including interest rates, local and national economic conditions, business spending, consumer confidence, legislative and regulatory changes, certain seasonal factors, and changes in real estate and securities markets. Our management evaluates performance using a variety of qualitative and quantitative metrics. The primary quantitative metrics used by management include:

- Net Interest Income – Net interest income, our primary source of revenue, equals the difference between interest income and fees earned on interest-earning assets and interest expense incurred on interest-bearing liabilities.
- Net Interest Margin – Net interest margin equals tax-equivalent net interest income divided by total average interest-earning assets.
- Noninterest Income – Noninterest income is the income we earn from fee-based revenues, investment in bank-owned life insurance ("BOLI"), other income, and non-operating revenues.
- Noninterest Expense – Noninterest expense is the expense we incur to operate the Company, which includes salaries and employee benefits, net occupancy and equipment, professional services, and other costs.
- Asset Quality – Asset quality represents an estimation of the quality of our loan portfolio, including an assessment of the credit risk related to existing and potential loss exposure, and can be evaluated using a number of quantitative measures, such as non-performing loans to total loans.
- Regulatory Capital – Our regulatory capital is classified in one of the following tiers: (i) Common Equity Tier 1 capital ("CET1"), which consists of common equity and retained earnings, less goodwill and other intangible assets and a portion of disallowed deferred tax assets, (ii) Tier 1 capital, which consists of CET1 and qualifying trust-preferred securities and the remaining portion of disallowed deferred tax assets, and (iii) Tier 2 capital, which includes qualifying subordinated debt and the allowance for credit losses, subject to limitations.

Some of these metrics may be presented on a non-U.S. generally accepted accounting principles ("non-GAAP") basis. For detail on our non-GAAP metrics, see the discussion in the section titled "Non-GAAP Financial Information and Reconciliations." Unless otherwise stated, all earnings per common share data included in this section and throughout the remainder of this discussion are presented on a fully diluted basis.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Form 10-Q, as well as any oral statements made by or on behalf of First Midwest in connection herewith, may contain certain "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. In some cases, forward-looking statements can be identified by the use of words such as "may," "might," "will," "would," "should," "could," "expect," "plan," "intend," "anticipate," "believe," "estimate," "outlook," "predict," "project," "probable," "potential," "possible," "target," "continue," "look forward," or "assume" and words of similar import. Forward-looking statements are not historical facts or guarantees of future performance but instead express only management's beliefs regarding future results or events, many of which, by their nature, are inherently uncertain and outside of management's control. It is possible that actual results and events may differ, possibly materially, from the anticipated results or events indicated in these forward-looking statements. First Midwest cautions you not to place undue reliance on these statements. Forward-looking statements are made only as of the date of this report, and we undertake no obligation to update any forward-looking statements contained in this report to reflect new information or events or conditions after the date hereof.

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Forward-looking statements may be deemed to include, among other things, statements relating to our future financial performance, including the related outlook for 2018, the performance of our loan or securities portfolio, the expected amount of future credit reserves or charge-offs, corporate strategies or objectives, including the impact of strategic actions and initiatives, First Midwest's "Delivering Excellence" initiative, including actions, goals, and expectations, as well as costs and benefits therewith and the timing thereof, anticipated trends in our business, regulatory developments, the impact of the new federal income tax law, acquisition transactions, including estimated synergies, cost savings and financial benefits of pending or consummated transactions, including First Midwest's proposed acquisition of Northern States Financial Corporation ("Northern States"), and growth strategies, including possible future acquisitions. These statements are subject to certain risks, uncertainties and assumptions. For a discussion of these risks, uncertainties, and assumptions, you should refer to the sections entitled "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" in this report and in our 2017 10-K, as well as our subsequent filings made with the Securities and Exchange Commission ("SEC"). However, these risks and uncertainties are not exhaustive. Other sections of this report describe additional factors that could adversely impact our business and financial performance.

CRITICAL ACCOUNTING ESTIMATES

Our consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles ("GAAP") and are consistent with general practices within the banking industry. Application of GAAP requires management to make estimates, assumptions, and judgments based on information available as of the date of the financial statements that affect the amounts reported in the financial statements and accompanying notes. Critical accounting estimates are those estimates that management believes are the most important to our financial position and results of operations. Future changes in information may impact these estimates, assumptions, and judgments, which may have a material effect on the amounts reported in the financial statements.

For additional information regarding critical accounting estimates, see the "Summary of Significant Accounting Policies," presented in Note 1 to the Consolidated Financial Statements and the section titled "Critical Accounting Estimates" in Management's Discussion and Analysis of Financial Condition and Results of Operations included in the Company's 2017 10-K. There have been no material changes in the Company's application of critical accounting estimates related to the allowance for credit losses, valuation of securities, income taxes, and goodwill and other intangible assets since December 31, 2017.

SIGNIFICANT RECENT EVENTS

Delivering Excellence Initiative

During the second quarter of 2018, the Company initiated certain actions in connection with its previously announced Delivering Excellence initiative. This initiative further demonstrates the Company's ongoing commitment to providing service excellence to its clients, as well as maximizing both the efficiency and scalability of its operating platform. Components of Delivering Excellence include improved delivery of services to clients through streamlined processes, the consolidation or closing of 19 locations, organizational realignments, and several revenue growth opportunities. The Company expects to incur total pre-tax implementation costs associated with Delivering Excellence of $25 million, the majority of which will be recognized in 2018. The Company began implementing this initiative in the second quarter of 2018, which resulted in pre-tax implementation costs of $15 million associated with property valuation adjustments on locations identified for closure, employee severance, and general restructuring and advisory services.

Pending Acquisition

Northern States Financial Corporation

On June 6, 2018, the Company entered into a definitive agreement to acquire Northern States, the holding company for NorStates Bank, based in Waukegan, Illinois. As of June 30, 2018, Northern States had approximately $530 million in total assets, $450 million in deposits, and $310 million in loans. The merger agreement provides for an exchange ratio of 0.0369 shares of Company common stock for each share of Northern States common stock, subject to adjustment as set forth in the merger agreement. As of the date of the public announcement, the overall transaction was valued at approximately $91 million. The acquisition is expected to close in the fourth quarter of 2018, subject to customary regulatory approvals and closing conditions, as well as the approval of Northern States' stockholders.

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PERFORMANCE OVERVIEW
Table 1
Selected Financial Data
(Amounts in thousands, except per share data)

	Quarters Ended June 30, 2018	Quarters Ended June 30, 2017	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017
Operating Results				
Interest income	$142,088	$126,516	$273,433	$250,215
Interest expense	14,685	8,933	27,467	17,435
Net interest income	127,403	117,583	245,966	232,780
Provision for loan losses	11,614	8,239	26,795	13,157
Noninterest income	36,947	44,945	72,464	84,896
Noninterest expense	113,416	99,751	208,998	216,393
Income before income tax expense	39,320	54,538	82,637	88,126
Income tax expense	9,720	19,588	19,527	30,321
Net income	$29,600	$34,950	$63,110	$57,805
Weighted-average diluted common shares outstanding	102,159	101,763	102,049	101,101
Diluted earnings per common share	$0.29	$0.34	$0.61	$0.57
Diluted earnings per common share, adjusted(1)	$0.40	$0.35	$0.72	$0.68
Performance Ratios				
Return on average common equity(2)	6.23 %	7.58 %	6.70 %	6.42 %
Return on average common equity, adjusted(1)(2)	8.62 %	7.74 %	7.91 %	7.75 %
Return on average tangible common equity(2)	10.83 %	13.37 %	11.65 %	11.52 %
Return on average tangible common equity, adjusted(1)(2)	14.81 %	13.64 %	13.67 %	13.81 %
Return on average assets(2)(3)	0.81 %	1.00 %	0.88 %	0.84 %
Return on average assets, adjusted(1)(2)	1.12 %	1.02 %	1.04 %	1.02 %
Tax-equivalent net interest margin(1)(2)(3)	3.91 %	3.88 %	3.85 %	3.88 %
Efficiency ratio(1)	59.65 %	59.01 %	60.28 %	60.13 %
Efficiency ratio (prior presentation)(1)(4)	N/A	58.67 %	N/A	59.80 %

(1) This item is a non-GAAP financial measure. For a discussion of non-GAAP financial measures, see the section of this Item 2 titled "Non-GAAP Financial Information and Reconciliations."

(2) These ratios are presented on an annualized basis.

(3) See the section of this Item 2 titled "Earnings Performance" below for additional discussion and calculation of this financial measure.

(4) Presented as calculated prior to March 31, 2018, which included a tax-equivalent adjustment for BOLI. Management believes that removing this adjustment from the current calculation of this metric enhances comparability for peer comparison purposes.

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	As of			June 30, 2018 Change From	
	June 30, 2018	December 31, 2017	June 30, 2017	December 31, 2017	June 30, 2017
Balance Sheet Highlights					
Total assets	$14,818,076	$14,077,052	$13,969,140	$741,024	$848,936
Total loans	10,891,565	10,437,812	10,232,159	453,753	659,406
Total deposits	11,492,263	11,053,325	10,999,720	438,938	492,543
Core deposits	9,567,902	9,406,542	9,461,176	161,360	106,726
Loans to deposits	94.8 %	94.4 %	93.0 %		
Core deposits to total deposits	83.3 %	85.1 %	86.0 %		
Asset Quality Highlights					
Non-accrual loans	$53,475	$66,924	$79,196	$(13,449)	$(25,721)
90 days or more past due loans, still accruing interest[1]	7,954	3,555	2,059	4,399	5,895
Total non-performing loans	61,429	70,479	81,255	(9,050)	(19,826)
Accruing troubled debt restructurings ("TDRs")	1,760	1,796	2,029	(36)	(269)
Other real estate owned ("OREO")	12,892	20,851	26,493	(7,959)	(13,601)
Total non-performing assets	$76,081	$93,126	$109,777	$(17,045)	$(33,696)
30-89 days past due loans[1]	$39,171	$39,725	$19,081	$(554)	$20,090
Non-performing assets to total loans plus OREO	0.70 %	0.89 %	1.07 %		
Allowance for Credit Losses					
Allowance for credit losses	$97,691	$96,729	$93,371	$962	$4,320
Allowance for credit losses to total loans[2]	0.90 %	0.93 %	0.91 %		
Allowance for credit losses to total loans, excluding acquired loans[3]	1.00 %	1.07 %	1.10 %		
Allowance for credit losses to non-accrual loans[2]	182.69 %	144.54 %	117.90 %		

(1) Purchased credit impaired ("PCI") loans with an accretable yield are considered current and are not included in past due loan totals.

(2) This ratio includes acquired loans that are recorded at fair value through an acquisition adjustment, which incorporates credit risk as of the acquisition date with no allowance for credit losses being established at that time. As the acquisition adjustment is accreted into income over future periods, an allowance for credit losses is established as necessary to reflect credit deterioration. A discussion of the allowance for acquired loan losses and the related acquisition adjustment is presented in the section titled "Loan Portfolio and Credit Quality."

(3) This item is a non-GAAP financial measure. For a discussion of non-GAAP financial measures, see the section of this Item 2 titled "Non-GAAP Financial Information and Reconciliations."

Net income for the second quarter and first six months of 2018 was $29.6 million, or $0.29 per share, and $63.1 million, or $0.61 per share, respectively. Performance for the second quarter and first six months of 2018 was impacted by $15.0 million of pre-tax costs related to the implementation of the Delivering Excellence initiative. Performance for the second quarter and first six months of 2017 was impacted by acquisition and integration related pre-tax expenses of $1.2 million and $19.7 million, respectively. Excluding these expenses, net income for the second quarter and first six months of 2018 increased to $40.9 million, or $0.40 per share, and $74.4 million, or $0.72 per share, respectively, compared to $35.7 million, or $0.35 per share, and $69.6 million, or $0.68 per share, for the same periods in 2017. The increase in net income, adjusted, and earnings per share, adjusted, compared to the second quarter and first six months of 2017 reflects higher net interest income, controlled noninterest expense, consistent noninterest income, and a lower effective income tax rate, partially offset by higher provision for loan losses. A discussion of net interest income, noninterest income, noninterest expense, and income tax expense is presented in the following section titled "Earnings Performance."

Total loans of $10.9 billion grew by $453.8 million, or 8.7% annualized, from December 31, 2017.

Non-performing assets to total loans plus OREO was 0.70% at June 30, 2018, down from 0.89% and 1.07% at December 31, 2017 and June 30, 2017, respectively. See the following "Loan Portfolio and Credit Quality" section for further discussion of our loan portfolio, non-accrual loans, 90 days or more past due loans, TDRs, and OREO.

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EARNINGS PERFORMANCE

Net Interest Income

Net interest income is our primary source of revenue and is impacted by interest rates and the volume and mix of interest-earning assets and interest-bearing liabilities. The accounting policies for the recognition of interest income on loans, securities, and other interest-earning assets are presented in Note 1 to the Consolidated Financial Statements included in our 2017 10-K.

Our accounting and reporting policies conform to GAAP and general practices within the banking industry. For purposes of this discussion, both net interest income and net interest margin have been adjusted to a fully tax-equivalent basis to more appropriately compare the returns on certain tax-exempt loans and securities to those on taxable interest-earning assets. The effect of this adjustment is shown at the bottom of Tables 2 and 3. Although we believe that these non-GAAP financial measures enhance investors' understanding of our business and performance, they should not be considered an alternative to GAAP. For a discussion of non-GAAP financial measures, see the section of this Item 2 titled "Non-GAAP Financial Information and Reconciliations."

Table 2 summarizes our average interest-earning assets and interest-bearing liabilities for the quarters ended June 30, 2018 and 2017, the related interest income and interest expense for each earning asset category and funding source, and the average interest rates earned and paid. Table 2 also details differences in interest income and expense from the prior quarter and the extent to which any changes are attributable to volume and rate fluctuations. Table 3 presents this same information for the six months ended June 30, 2018 and 2017.

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Table 2
Net Interest Income and Margin Analysis
(Dollar amounts in thousands)

	Quarters Ended June 30, 2018			2017			Attribution of Change in Net Interest Income		
	Average Balance	Interest	Yield/ Rate (%)	Average Balance	Interest	Yield/ Rate (%)	Volume	Yield/ Rate	Total
Assets									
Other interest-earning assets	$147,996	$519	1.41	$262,206	$686	1.05	$(764)	$597	$(167)
Securities[1]	2,165,091	13,322	2.46	1,983,341	11,482	2.32	957	883	1,840
Federal Home Loan Bank ("FHLB") and Federal Reserve Bank ("FRB") stock	80,038	864	4.32	57,073	441	3.09	213	210	423
Loans[1][2]	10,788,285	128,422	4.77	10,064,119	115,949	4.62	8,532	3,941	12,473
Total interest-earning assets[1][2]	13,181,410	143,127	4.35	12,366,739	128,558	4.17	8,938	5,631	14,569
Cash and due from banks	197,025			188,886					
Allowance for loan losses	(99,469)			(92,152)					
Other assets	1,326,749			1,497,370					
Total assets	$14,605,715			$13,960,843					
Liabilities and Stockholders' Equity									
Savings deposits	$2,060,066	373	0.07	$2,072,343	394	0.08	(2)	(19)	(21)
NOW accounts	2,065,530	1,472	0.29	2,010,152	663	0.13	18	791	809
Money market deposits	1,759,313	1,073	0.24	1,942,672	648	0.13	(54)	479	425
Time deposits	1,871,666	5,114	1.10	1,538,845	2,024	0.53	517	2,573	3,090
Borrowed funds	913,902	3,513	1.54	553,046	2,099	1.52	1,387	27	1,414
Senior and subordinated debt	195,385	3,140	6.45	194,819	3,105	6.39	21	14	35
Total interest-bearing liabilities	8,865,862	14,685	0.66	8,311,877	8,933	0.43	1,887	3,865	5,752
Demand deposits	3,621,645			3,538,049					
Total funding sources	12,487,507		0.47	11,849,926		0.30			
Other liabilities	227,481			280,381					
Stockholders' equity – common	1,890,727			1,830,536					
Total liabilities and stockholders' equity	$14,605,715			$13,960,843					
Tax-equivalent net interest		128,442	3.91		119,625	3.88	$7,051	$1,766	$8,817

income/margin(1)				
Tax-equivalent adjustment	(1,039)		(2,042)	
Net interest income (GAAP)	$127,403		$117,583	
Impact of acquired loan accretion(1)	$4,445	0.14	$8,757	0.28
Tax-equivalent net interest income/ margin, adjusted(1)	$123,997	3.77	$110,868	3.60

(1) Interest income and yields on tax-exempt securities and loans are presented on a tax-equivalent basis, assuming the applicable federal income tax rate for each period presented. As a result, interest income and yields on tax-exempt securities and loans subsequent to December 31, 2017 are presented at the current federal income tax rate of 21% and the prior period is presented using the federal income tax rate applicable at that time of 35%. The corresponding income tax impact related to tax-exempt items is recorded in income tax expense. These adjustments have no impact on net income. For a discussion of non-GAAP financial measures, see the section of this Item 2 titled "Non-GAAP Financial Information and Reconciliations."

(2) Non-accrual loans, which totaled $53.5 million as of June 30, 2018 and $79.2 million as of June 30, 2017, are included in loans for purposes of this analysis. Additional detail regarding non-accrual loans is presented in the following section of this Item 2 titled "Non-performing Assets and Corporate Performing Potential Problem Loans."

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Table 3
Net Interest Income and Margin Analysis
(Dollar amounts in thousands)

	Six Months Ended June 30, 2018			2017			Attribution of Change in Net Interest Income		
	Average Balance	Interest	Yield/ Rate (%)	Average Balance	Interest	Yield/ Rate (%)	Volume	Yield/ Rate	Total
Assets									
Other interest-earning assets	$130,166	$942	1.46	$239,189	$1,128	0.95	$(789)	$603	$(186)
Securities[1]	2,114,439	25,464	2.41	2,002,144	23,016	2.30	1,128	1,320	2,448
FHLB and FRB stock	78,469	1,302	3.32	55,654	809	2.91	367	126	493
Loans[1][2]	10,644,581	247,739	4.69	9,992,713	229,358	4.63	15,134	3,247	18,381
Total interest-earning assets[1][2]	12,967,655	275,447	4.28	12,289,700	254,311	4.17	15,840	5,296	21,136
Cash and due from banks	189,452			182,952					
Allowance for loan losses	(99,352)			(90,617)					
Other assets	1,339,785			1,435,744					
Total assets	$14,397,540			$13,817,779					
Liabilities and Stockholders' Equity									
Savings deposits	$2,037,995	742	0.07	$2,051,105	794	0.08	(5)	(47)	(52)
NOW accounts	2,029,303	2,520	0.25	1,963,742	1,141	0.12	39	1,340	1,379
Money market deposits	1,786,534	1,897	0.21	1,916,831	1,267	0.13	(80)	710	630
Time deposits	1,803,787	9,052	1.01	1,527,285	3,736	0.49	781	4,535	5,316
Borrowed funds	886,253	6,992	1.59	643,068	4,293	1.35	1,823	876	2,699
Senior and subordinated debt	195,314	6,264	6.47	194,749	6,204	6.43	18	42	60
Total interest-bearing liabilities	8,739,186	27,467	0.63	8,296,780	17,435	0.42	2,576	7,456	10,032
Demand deposits	3,544,666			3,447,365					
Total funding sources	12,283,852		0.45	11,744,145		0.30			
Other liabilities	231,567			276,412					
Stockholders' equity – common	1,882,121			1,797,222					
Total liabilities and stockholders' equity	$14,397,540			$13,817,779					
Tax-equivalent net interest income/margin[1]		247,980	3.85		236,876	3.88	$13,264	$(2,160)	$11,104
		(2,014)			(4,096)				

Tax-equivalent adjustment				
Net interest income (GAAP)	$245,966		$232,780	
Impact of acquired loan accretion[1]	$9,557	0.15	$20,102	0.33
Tax-equivalent net interest income/ margin, adjusted[1]	$238,423	3.70	$216,774	3.55

(1) Interest income and yields on tax-exempt securities and loans are presented on a tax-equivalent basis, assuming the applicable federal income tax rate for each period presented. As a result, interest income and yields on tax-exempt securities and loans subsequent to December 31, 2017 are presented at the current federal income tax rate of 21% and the prior period is presented using the federal income tax rate applicable at that time of 35%. The corresponding income tax impact related to tax-exempt items is recorded in income tax expense. These adjustments have no impact on net income. For a discussion of non-GAAP financial measures, see the section of this Item 2 titled "Non-GAAP Financial Information and Reconciliations."

(2) Non-accrual loans, which totaled $53.5 million as of June 30, 2018 and $79.2 million as of June 30, 2017, are included in loans for purposes of this analysis. Additional detail regarding non-accrual loans is presented in the following section of this Item 2 titled "Non-performing Assets and Corporate Performing Potential Problem Loans."

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Net interest income increased by 8.4% and 5.7% compared to the second quarter and first six months of 2017, respectively. The rise in net interest income compared to both prior periods resulted primarily from the impact of higher interest rates and growth in loans and securities, partially offset by lower acquired loan accretion and higher cost of funds.
Acquired loan accretion contributed $4.4 million and $9.6 million to net interest income for the second quarter and first six months of 2018, respectively, lower than $8.8 million and $20.1 million for the same periods in 2017.
Tax-equivalent net interest margin for the second quarter and first six months of 2018 was 3.91% and 3.85%, respectively, compared to 3.88% for both the second quarter and first six months of 2017. Compared to the same periods in 2017, the benefit of higher interest rates and growth in interest-earning assets more than offset the 14 and 18 basis point decrease in acquired loan accretion. In addition, tax-equivalent net interest margin for the second quarter and first six months of 2018 was negatively impacted by a 3 basis point reduction in the tax-equivalent adjustment as a result of lower federal income tax rates compared to the same periods in 2017.
Total average interest-earning assets rose by $814.7 million and $678.0 million from the second quarter and first six months of 2017, respectively. The increase resulted primarily from loan growth and security purchases.
Compared to the second quarter and first six months of 2017, total average funding sources increased by $637.6 million and $539.7 million, respectively. The increase compared to both prior periods resulted primarily from an increase in core and time deposits and FHLB advances.

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Noninterest Income

A summary of noninterest income for the quarters and six months ended June 30, 2018 and 2017 is presented in the following table.

Table 4

Noninterest Income Analysis

(Dollar amounts in thousands)

	Quarters Ended June 30,			Six Months Ended June 30,		
	2018	2017	% Change	2018	2017	% Change
Service charges on deposit accounts	$12,058	$12,153	(0.8)	$23,710	$23,518	0.8
Wealth management fees	10,981	10,525	4.3	21,939	20,185	8.7
Card-based fees, net[(1)(2)]:						
Card-based fees	6,270	8,832	(29.0)	11,962	16,948	(29.4)
Cardholder expenses	(1,876)	—	—	(3,635)	—	—
Card-based fees, net	4,394	8,832	(50.2)	8,327	16,948	(50.9)
Capital market products income	2,819	2,217	27.2	4,377	3,593	21.8
Mortgage banking income	1,736	1,645	5.5	4,133	3,533	17.0
Merchant servicing fees, net[(1)(3)]:						
Merchant servicing fees	2,553	3,197	(20.1)	4,790	6,332	(24.4)
Merchant card expenses	(2,170)	—	—	(4,077)	—	—
Merchant servicing fees, net	383	3,197	(88.0)	713	6,332	(88.7)
Other service charges, commissions, and fees	2,455	2,659	(7.7)	4,673	4,966	(5.9)
Total fee-based revenues	34,826	41,228	(15.5)	67,872	79,075	(14.2)
Other income[(4)]	2,121	3,433	(38.2)	4,592	5,537	(17.1)
Net securities gains	—	284	(100.0)	—	284	(100.0)
Total noninterest income	$36,947	$44,945	(17.8)	$72,464	$84,896	(14.6)

Noninterest Income, Adjusted[(5)]

(Dollar amounts in thousands)

	Quarters Ended June 30,			Six Months Ended June 30,		
	2018	2017	% Change	2018	2017	% Change
Total noninterest income	$36,947	$44,945	(17.8)	$72,464	$84,896	(14.6)
Accounting reclassification[(1)]	4,046	—	—	7,712	—	—
Durbin Amendment[(6)]	—	(3,100)	(100.0)	—	(6,000)	(100.0)
Net securities gains	—	(284)	(100.0)	—	(284)	(100.0)
Total noninterest income, adjusted[(5)]	$40,993	$41,561	(1.4)	$80,176	$78,612	2.0

(1) As a result of accounting guidance adopted in the first quarter of 2018 (the "accounting reclassification"), certain noninterest income line items and the related noninterest expense line items that are presented on a gross basis for prior year periods are presented on a net basis in noninterest income for current year periods. For further discussion of this guidance, see Note 2 of "Notes to the Condensed Consolidated Financial Statements" in Part I, Item 1 of this Form 10-Q.

(2) Card-based fees, net consists of debit and credit card interchange fees for processing transactions, various fees on both consumer and non-customer automated teller machine ("ATM") and point-of-sale transactions processed through the ATM and point-of-sale networks, as well as the related cardholder expense.

(3) Merchant servicing fees, net are included in other service charges, commissions, and fees in the Condensed Consolidated Statements of Income.

(4) Other income consists of various items, including BOLI income, safe deposit box rentals, miscellaneous recoveries, and gains on the sales of various assets.

(5) See the "Non-GAAP Financial Information" section presented later in this release for a discussion of this non-GAAP financial measure.

(6) Amount represents the impact of the Durbin Amendment, which became effective for the Company in the third quarter of 2017.

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Total noninterest income of $36.9 million and $72.5 million for the second quarter and first six months of 2018, respectively, was down by 17.8% and 14.6%, respectively, compared to the same periods in 2017. In the first quarter of 2018, the Company adopted accounting guidance which impacted how cardholder and merchant card expenses are presented within noninterest income on a prospective basis. As a result, these expenses are presented on a net basis against the related noninterest income for the second quarter and first six months of 2018 versus a gross basis within noninterest expense for the same periods in 2017. In addition, the Durbin Amendment became effective for the Company in the third quarter of 2017. Excluding these items and net securities gains, noninterest income, adjusted was $41.0 million and $80.2 million for the second quarter and first six months of 2018, respectively, down modestly from the second quarter of 2017 and up 2.0% from the first six months of 2017.

The increase in wealth management fees compared to both prior periods was driven primarily by continued sales of fiduciary and investment advisory services. Net card-based fees, excluding the accounting reclassification and the Durbin Amendment, were up by 8.5% and 11.0% compared to the second quarter and first six months of 2017, respectively, due to higher transaction volumes.

Mortgage banking income for the second quarter and first six months of 2018 resulted from sales of $64.3 million and $128.1 million, respectively, of 1-4 family mortgage loans in the secondary market, compared to $59.5 million and $114.1 million in the same periods of 2017. Compared to both prior periods, mortgage banking income was positively impacted by fair value adjustments on mortgage servicing rights, which fluctuate from quarter to quarter, partially offset by decreases in market pricing on sales of 1-4 family mortgage loans.

Capital market products income increased compared to both prior periods, which fluctuates from quarter to quarter based on the size and frequency of sales to corporate clients. Other income in the second quarter and first six months of 2017 was elevated due to net gains from the disposition of branch properties and other miscellaneous items.

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Noninterest Expense

A summary of noninterest expense for the quarters and six months ended June 30, 2018 and 2017 is presented in the following table.

Table 5

Noninterest Expense Analysis

(Dollar amounts in thousands)

	Quarters Ended June 30,			Six Months Ended June 30,		
	2018	2017	% Change	2018	2017	% Change
Salaries and employee benefits:						
Salaries and wages	$46,256	$44,194	4.7	$92,086	$89,084	3.4
Retirement and other employee benefits	11,676	10,381	12.5	22,633	21,263	6.4
Total salaries and employee benefits	57,932	54,575	6.2	114,719	110,347	4.0
Net occupancy and equipment expense	13,651	12,485	9.3	27,424	24,810	10.5
Professional services	8,298	9,112	(8.9)	15,878	17,575	(9.7)
Technology and related costs	4,837	4,485	7.8	9,608	8,918	7.7
Advertising and promotions	2,061	1,693	21.7	3,711	2,759	34.5
Net OREO expense	(256)	1,631	(115.7)	812	3,331	(75.6)
Other expenses	11,878	10,282	15.5	21,831	20,251	7.8
Delivering Excellence implementation costs	15,015	—	—	15,015	—	—
Acquisition and integration related expenses	—	1,174	(100.0)	—	19,739	(100.0)
Merchant card expenses[(1)]	—	2,632	(100.0)	—	5,217	(100.0)
Cardholder expenses[(1)]	—	1,682	(100.0)	—	3,446	(100.0)
Total noninterest expense[(1)]	$113,416	$99,751	13.7	$208,998	$216,393	(3.4)

Noninterest Expense, Adjusted[(2)]

(Dollar amounts in thousands)

	Quarters Ended June 30,			Six Months Ended June 30,		
	2018	2017	% Change	2018	2017	% Change
Total noninterest expense	$113,416	$99,751	13.7	$208,998	$216,393	(3.4)
Delivering Excellence implementation costs	(15,015)	—	—	(15,015)	—	—
Accounting reclassification[(1)]	4,046	—	—	7,712	—	—
Acquisition and integration related expenses	—	(1,174)	(100.0)	—	(19,739)	(100.0)
Total noninterest expense, adjusted[(2)]	$102,447	$98,577	3.9	$201,695	$196,654	2.6

(1) As a result of accounting guidance adopted in the first quarter of 2018, certain noninterest income line items and the related noninterest expense line items that are presented on a gross basis for prior year periods are presented on a net basis in noninterest income for current year periods. For further discussion of this guidance, see Note 2 of "Notes to the Condensed Consolidated Financial Statements" in Part I, Item 1 of this Form 10-Q.

(2) See the "Non-GAAP Financial Information" section presented later in this release for a discussion of this non-GAAP financial measure.

Total noninterest expense increased by 13.7% and decreased by 3.4% compared to the second quarter and first six months of 2017, respectively. During the second quarter and first six months of 2018, noninterest expense was impacted by costs related to the implementation of the Delivering Excellence initiative, which include property valuation adjustments on locations identified for closure, employee severance, and general restructuring and advisory services. In the first quarter of 2018, the Company adopted accounting guidance which impacted how cardholder and merchant card expenses are presented within noninterest income on a prospective basis. As a result, these expenses are presented on a net basis against the related noninterest income for the second quarter and first six months of 2018 versus a gross basis within noninterest expense for the prior periods. Expenses for the quarter and first six months of 2017 were impacted by acquisition and integration related expenses related to the acquisition of Standard

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Bancshares, Inc ("Standard"). Excluding these items, noninterest expense for the second quarter and first six months of 2018 was $102.4 million and $201.7 million, up by 3.9% and 2.6% from the same periods in 2017.

The increase in salaries and employee benefits compared to the second quarter and first six months of 2017 was driven primarily by merit increases, the distribution of higher pension plan lump-sum payments to retired employees, and organizational growth. Professional services expenses decreased compared to the second quarter and first six months of 2017 as the prior year was impacted by certain costs associated with organizational growth and higher loan remediation expenses. Compared to the second quarter and first six months of 2017, the rise in advertising and promotions expense resulted from the timing of certain advertising costs. The decrease in net OREO expense compared to both prior periods resulted primarily from higher levels of operating income and lower valuation adjustments. Other expenses increased compared to both prior periods as a result of property valuation adjustments related to the Company's corporate headquarters relocation and higher other miscellaneous expenses.

Compared to both prior periods, net occupancy and equipment expenses increased due largely to higher costs related to the Company's corporate headquarters relocation. In addition, net occupancy and equipment expenses compared to the first six months of 2017 increased as a result of higher costs related to winter weather conditions.

Income Taxes

Our provision for income taxes includes both federal and state income tax expense. An analysis of the provision for income taxes for the quarters and six months ended June 30, 2018 and 2017 is detailed in the following table.

Table 6

Income Tax Expense Analysis

(Dollar amounts in thousands)

	Quarters Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Income before income tax expense	$39,320	$54,538	$82,637	$88,126
Income tax expense:				
Federal income tax expense	$7,623	$16,159	$14,769	$25,053
State income tax expense	2,097	3,429	4,758	5,268
Total income tax expense	$9,720	$19,588	$19,527	$30,321
Effective income tax rate	24.7 %	35.9 %	23.6 %	34.4 %

Federal income tax expense and the related effective income tax rate are influenced by the amount of tax-exempt income derived from investment securities and BOLI in relation to pre-tax income and state income taxes. State income tax expense and the related effective tax rate are driven by the amount of state tax-exempt income in relation to pre-tax income and state tax rules related to consolidated/combined reporting and sourcing of income and expense.

The decrease in the effective tax rate for the quarter and six months ended June 30, 2018 compared to the same periods in 2017 was driven primarily by the reduction in the federal income tax rate from 35% to 21%, which became effective in the first quarter of 2018 as a result of federal income tax reform. In addition, the first six months of 2018 and 2017 were impacted by income tax benefits of $1.0 million and $638,000, respectively, related to employee share-based payments.

Total income tax expense for the quarter and six months ended June 30, 2018 was down by 50.4% and 35.6%, respectively, compared to the same periods in the prior year. These decreases were driven primarily by the decrease in the federal income tax rate and lower levels of income subject to tax at statutory rates, partially offset by a decrease in tax-exempt income.

Our accounting policies regarding the recognition of income taxes in the Consolidated Statements of Financial Condition and Income are described in Notes 1 and 15 to the Consolidated Financial Statements of our 2017 10-K.

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FINANCIAL CONDITION

Investment Portfolio Management

Securities that we have the intent and ability to hold until maturity are classified as securities held-to-maturity and are accounted for using historical cost, adjusted for amortization of premiums and accretion of discounts. Equity securities are carried at fair value and consist primarily of community development investments and certain diversified investment securities held in a grantor trust for participants in the Company's nonqualified deferred compensation plan that are invested in money market and mutual funds. All other securities are classified as securities available-for-sale and are carried at fair value with unrealized gains and losses, net of related deferred income taxes, recorded in stockholders' equity as a separate component of accumulated other comprehensive loss.

We manage our investment portfolio to maximize the return on invested funds within acceptable risk guidelines, to meet pledging and liquidity requirements, and to adjust balance sheet interest rate sensitivity to mitigate the impact of changes in interest rates on net interest income.

From time to time, we adjust the size and composition of our securities portfolio based on a number of factors, including expected loan growth, anticipated changes in collateralized public funds on account, the interest rate environment, and the related value of various segments of the securities markets. The following table provides a valuation summary of our investment portfolio.

Table 7

Investment Portfolio

(Dollar amounts in thousands)

	As of June 30, 2018				As of December 31, 2017			
	Amortized Cost	Net Unrealized Gains (Losses)	Fair Value	% of Total	Amortized Cost	Net Unrealized Gains (Losses)	Fair Value	% of Total
Securities Available-for-Sale								
U.S. treasury securities	$49,455	$(297)	$49,158	2.3	$46,529	$(184)	$46,345	2.5
U.S. agency securities	150,443	(2,159)	148,284	6.9	157,636	(789)	156,847	8.3
Collateralized mortgage obligations ("CMOs")	1,270,304	(37,874)	1,232,430	57.5	1,113,019	(17,833)	1,095,186	58.1
Other mortgage-backed securities ("MBSs")	450,512	(12,876)	437,636	20.4	373,676	(4,133)	369,543	19.6
Municipal securities	222,034	(3,689)	218,345	10.2	209,558	(567)	208,991	11.1
Corporate debt securities	57,867	(855)	57,012	2.7	—	—	—	—
Equity securities[1]	—	—	—	—	7,408	(111)	7,297	0.4
Total securities available-for-sale	$2,200,615	$(57,750)	$2,142,865	100.0	$1,907,826	$(23,617)	$1,884,209	100.0
Securities Held-to-Maturity								
Municipal securities	$13,042	$(2,124)	$10,918		$13,760	$(1,747)	$12,013	
Equity Securities[1]			$28,441				$—	
Trading Securities[1]			$—				$20,447	

[1] As a result of accounting guidance adopted in the first quarter of 2018, equity securities are no longer presented within trading securities or securities available-for-sale and are now presented within equity securities in the Consolidated Statements of Financial Condition for the current period. For further discussion of this guidance, see

Note 2 of "Notes to the Condensed Consolidated Financial Statements" in Part I, Item 1 of this Form 10-Q.

Portfolio Composition

As of June 30, 2018, our securities available-for-sale portfolio totaled $2.1 billion, increasing by $258.7 million, or 13.7%, from December 31, 2017. The increase from December 31, 2017 was driven primarily by purchases of CMOs, MBSs, and corporate debt securities in light of current market conditions.

Investments in municipal securities consist of general obligations of local municipalities in various states. Our municipal securities portfolio has historically experienced very low default rates and provides a predictable cash flow.

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Table 8
Securities Effective Duration Analysis

	As of June 30, 2018			As of December 31, 2017		
	Effective Duration[1]	Average Life[2]	Yield to Maturity[3]	Effective Duration[1]	Average Life[2]	Yield to Maturity[3]
Securities Available-for-Sale						
U.S. treasury securities	1.04%	1.07	1.74 %	1.01 %	1.03	1.30 %
U.S. agency securities	1.81%	3.34	2.09 %	1.80 %	3.22	1.74 %
CMOs	3.91%	4.86	2.57 %	3.36 %	4.51	2.35 %
MBSs	4.31%	5.68	2.56 %	3.77 %	5.29	2.30 %
Municipal securities	4.78%	5.15	2.59 %	4.47 %	4.87	3.04 %
Corporate debt securities	0.03%	7.59	3.36 %	N/M	N/M	N/M
Total securities available-for-sale	3.77%	4.94	2.54 %	3.38 %	4.51	2.34 %
Securities Held-to-Maturity						
Municipal securities	5.09%	6.98	3.61 %	5.33 %	7.15	4.55 %

N/M – Not meaningful.

(1) The effective duration represents the estimated percentage change in the fair value of the securities portfolio given a 100 basis point increase or decrease in interest rates. This measure is used to evaluate the portfolio's price volatility at a single point in time and is not intended to be a precise predictor of future fair values since those values will be influenced by a number of factors.

(2) Average life is presented in years and represents the weighted-average time to receive half of all future cash flows using the dollar amount of principal paydowns, including estimated principal prepayments, as the weighting factor.

(3) Yields on municipal securities are reflected on a tax-equivalent basis, assuming the applicable federal income tax rate for each period presented.

Effective Duration

The average life and effective duration of our securities available-for-sale portfolio was 4.94 years and 3.77%, respectively, as of June 30, 2018, up from 4.51 years and 3.38% as of December 31, 2017. The increase resulted primarily from purchases of CMOs, MBSs, and corporate debt securities, as well as higher rates.

Realized Gains and Losses

There were no net securities gains or impairment charges recognized during the second quarter and first six months of 2018. For both the second quarter and first six months of 2017, there were $284,000 of net securities gains recognized on securities with carrying values of $30.7 million. In addition, during the first quarter of 2017, $210.2 million of securities acquired in the Standard transaction were sold shortly after the acquisition date and resulted in no gains or losses as they were recorded at fair value upon acquisition.

Unrealized Gains and Losses

Unrealized gains and losses on securities available-for-sale represent the difference between the aggregate cost and fair value of the portfolio. These amounts are presented in the Consolidated Statements of Comprehensive Income and reported as a separate component of stockholders' equity in accumulated other comprehensive loss, net of deferred income taxes. This balance sheet component will fluctuate as current market interest rates and conditions change and affect the aggregate fair value of the portfolio. Higher market rates drove the rise in net unrealized losses to $57.8 million as of June 30, 2018 from $23.6 million as of December 31, 2017.

Net unrealized losses in the CMO and MBS portfolio totaled $37.9 million and $12.9 million, respectively, as of June 30, 2018, compared to $17.8 million and $4.1 million for the same portfolios as of December 31, 2017. CMOs and MBSs are either backed by U.S. government-owned agencies or issued by U.S. government-sponsored enterprises. We do not believe any individual unrealized loss on these securities as of June 30, 2018 represents other-than-temporary securities impairment ("OTTI") related to credit deterioration. In addition, we do not intend to sell the CMOs or MBSs with unrealized losses and we do not believe it is more likely than not that we will be required to sell them before recovery of their amortized cost basis, which may be at maturity.

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LOAN PORTFOLIO AND CREDIT QUALITY

Portfolio Composition

Our loan portfolio is comprised of both corporate and consumer loans, with corporate loans representing 80.7% of total loans as of June 30, 2018. Consistent with our emphasis on relationship banking, the majority of our corporate loans are made to our core, multi-relationship customers. The customers usually maintain deposit relationships and utilize our other banking services, such as treasury or wealth management services.

To maximize loan income within an acceptable level of risk, we have certain lending policies and procedures that management reviews on a regular basis. In addition, management receives periodic reporting related to loan production, loan quality, credit concentrations, loan delinquencies, and non-performing and corporate performing potential problem loans to monitor and mitigate potential and current risks in the portfolio.

Table 9

Loan Portfolio

(Dollar amounts in thousands)

	As of June 30, 2018	% of Total Loans	As of December 31, 2017	% of Total Loans	% Change
Commercial and industrial	$3,844,067	35.3	$3,529,914	33.8	8.9
Agricultural	433,175	4.0	430,886	4.1	0.5
Commercial real estate:					
Office, retail, and industrial	1,834,918	16.8	1,979,820	19.0	(7.3)
Multi-family	703,091	6.5	675,463	6.5	4.1
Construction	633,601	5.8	539,820	5.2	17.4
Other commercial real estate	1,337,396	12.3	1,358,515	13.0	(1.6)
Total commercial real estate	4,509,006	41.4	4,553,618	43.7	(1.0)
Total corporate loans	8,786,248	80.7	8,514,418	81.6	3.2
Home equity	847,903	7.8	827,055	7.9	2.5
1-4 family mortgages	880,181	8.1	774,357	7.4	13.7
Installment	377,233	3.4	321,982	3.1	17.2
Total consumer loans	2,105,317	19.3	1,923,394	18.4	9.5
Total loans	$10,891,565	100.0	$10,437,812	100.0	4.3

Total loans of $10.9 billion increased by 8.8%, annualized, from December 31, 2017. Growth in commercial and industrial loans, primarily within our sector-based lending businesses, multi-family, and construction loans drove the rise in total corporate loans. The rise in construction loans was due to line draws on existing credits. The overall decline in office, retail, and industrial and other commercial real estate loans resulted primarily from the decision of certain customers to opportunistically sell their commercial businesses and investment real estate properties, as well as expected payoffs. Growth in consumer loans compared to December 31, 2017 benefited from the impact of purchases of shorter-duration home equity loans, 1-4 family mortgages, and installment loans, as well as organic production.

Commercial, Industrial, and Agricultural Loans

Commercial, industrial, and agricultural loans represent 39.3% of total loans, and totaled $4.3 billion at June 30, 2018, an increase of $316.4 million, or 8.0%, from December 31, 2017. Our commercial and industrial loans are a diverse group of loans generally located in the Chicago metropolitan area with purposes that include supporting seasonal working capital needs, accounts receivable financing, inventory and equipment financing, and select sector-based lending, such as healthcare, asset-based lending, structured finance, and syndications. Our commercial and industrial portfolio does not have significant direct exposure to the oil and gas industry. Most commercial and industrial loans are secured by the assets being financed or other business assets, such as accounts receivable or inventory. The underlying collateral securing commercial and industrial loans may fluctuate in value due to the success of the business or economic conditions. For loans secured by accounts receivable, the availability of funds for repayment and economic conditions may impact the cash flow of the borrower. Accordingly, the underwriting for these loans is based primarily on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower and may incorporate a personal guarantee.

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Agricultural loans are generally provided to meet seasonal production, equipment, and farm real estate borrowing needs of individual and corporate crop and livestock producers. Seasonal crop production loans are repaid by the liquidation of the financed crop that is typically covered by crop insurance. Equipment and real estate term loans are repaid through cash flows of the farming operation. Risks uniquely inherent in agricultural loans relate to weather conditions, agricultural product pricing, and loss of crops or livestock due to disease or other factors. Therefore, as part of the underwriting process, the Company examines projected future cash flows, financial statement stability, and the value of the underlying collateral.

Commercial Real Estate Loans

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans. The repayment of commercial real estate loans depends on the successful operation of the property securing the loan or the business conducted on the property securing the loan. This category of loans may be more adversely affected by conditions in the real estate market. In addition, many commercial real estate loans do not fully amortize over the term of the loan, but have balloon payments due at maturity. The borrower's ability to make a balloon payment may depend on the availability of long-term financing or their ability to complete a timely sale of the underlying property. Management monitors and evaluates commercial real estate loans based on cash flow, collateral, geography, and risk rating criteria.

Construction loans are generally based on estimates of costs and values associated with the completed projects and are underwritten utilizing feasibility studies, independent appraisal reviews, sensitivity analyses of absorption and lease rates, and financial analyses of the developers and property owners. Sources of repayment may be permanent long-term financing, sales of developed property, or an interim loan commitment until permanent financing is obtained. Generally, construction loans have a higher risk profile than other real estate loans since repayment is impacted by real estate values, interest rate changes, governmental regulation of real property, demand and supply of alternative real estate, the availability of long-term financing, and changes in general economic conditions.

The following table presents commercial real estate loan detail as of June 30, 2018 and December 31, 2017.

Table 10

Commercial Real Estate Loans

(Dollar amounts in thousands)

	As of June 30, 2018	% of Total	As of December 31, 2017	% of Total
Office, retail, and industrial:				
Office	$747,986	16.6	$ 844,413	18.5
Retail	466,480	10.3	471,781	10.4
Industrial	620,452	13.8	663,626	14.6
Total office, retail, and industrial	1,834,918	40.7	1,979,820	43.5
Multi-family	703,091	15.6	675,463	14.8
Construction	633,601	14.0	539,820	11.8
Other commercial real estate:				
Multi-use properties	327,210	7.3	330,926	7.3
Rental properties	181,478	4.0	197,579	4.3
Warehouses and storage	163,252	3.6	172,505	3.8
Hotels	128,673	2.8	97,016	2.1
Restaurants	115,908	2.6	112,547	2.5
Service stations and truck stops	102,520	2.3	107,834	2.4
Recreational	81,090	1.8	87,986	1.9
Automobile dealers	35,737	0.8	39,020	0.9

Other	201,528	4.5	213,102	4.7
Total other commercial real estate	1,337,396	29.7	1,358,515	29.9
Total commercial real estate	$4,509,006	100.0	$ 4,553,618	100.0

Commercial real estate loans represent 41.4% of total loans, and totaled $4.5 billion at June 30, 2018, decreasing by $44.6 million, or 1.0%, from December 31, 2017.

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The mix of properties securing the loans in our commercial real estate portfolio is balanced between owner-occupied and investor categories and is diverse in terms of type and geographic location, generally within the Company's markets. Approximately 43% of the commercial real estate portfolio, excluding multi-family and construction loans, is owner-occupied as of June 30, 2018. Using outstanding loan balances, non-owner-occupied commercial real estate loans to total capital was 210% and construction loans to total capital was 35% as of June 30, 2018. Non-owner-occupied (investor) commercial real estate is calculated in accordance with federal banking agency guidelines and includes construction, multi-family, non-farm non-residential property, and commercial real estate loans that are not secured by real estate collateral.

Consumer Loans

Consumer loans represent 19.3% of total loans, and totaled $2.1 billion at June 30, 2018, an increase of $181.9 million, or 9.5%, from December 31, 2017. Consumer loans are centrally underwritten using a credit scoring model developed by the Fair Isaac Corporation ("FICO"), which employs a risk-based system to determine the probability a borrower may default. Underwriting standards for home equity loans are heavily influenced by statutory requirements, which include loan-to-value and affordability ratios, risk-based pricing strategies, and documentation requirements. The home equity category consists mainly of revolving lines of credit secured by junior liens on owner-occupied real estate. Loan-to-value ratios on home equity loans and 1-4 family mortgages are based on the current appraised value of the collateral. Repayment for these loans is dependent on the borrower's continued financial stability, and is more likely to be impacted by adverse personal circumstances.

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Non-performing Assets and Corporate Performing Potential Problem Loans

The following table presents our loan portfolio by performing and non-performing status. A discussion of our accounting policies for non-accrual loans, TDRs, and loans 90 days or more past due can be found in Note 1 of "Notes to the Condensed Consolidated Financial Statements" in Part 1, Item 1 of this Form 10-Q.

Table 11

Loan Portfolio by Performing/Non-Performing Status

(Dollar amounts in thousands)

	Accruing					
	PCI[1]	Current	30-89 Days Past Due	90 Days Past Due	Non-accrual[2]	Total Loans
As of June 30, 2018						
Commercial and industrial	$2,234	$3,799,454	$18,163	$1,544	$ 22,672	$3,844,067
Agricultural	2,481	424,807	1,477	1,418	2,992	433,175
Commercial real estate:						
Office, retail, and industrial	11,947	1,807,196	5,366	1,402	9,007	1,834,918
Multi-family	13,014	683,906	351	2,269	3,551	703,091
Construction	4,888	628,155	107	243	208	633,601
Other commercial real estate	56,805	1,268,396	6,316	591	5,288	1,337,396
Total commercial real estate	86,654	4,387,653	12,140	4,505	18,054	4,509,006
Total corporate loans	91,369	8,611,914	31,780	7,467	43,718	8,786,248
Home equity	1,947	837,412	3,145	—	5,399	847,903
1-4 family mortgages	17,296	857,016	1,470	41	4,358	880,181
Installment	996	373,015	2,776	446	—	377,233
Total consumer loans	20,239	2,067,443	7,391	487	9,757	2,105,317
Total loans	$111,608	$10,679,357	$39,171	$7,954	$ 53,475	$10,891,565
As of December 31, 2017						
Commercial and industrial	$5,450	$3,458,049	$24,005	$1,830	$ 40,580	$3,529,914
Agricultural	7,203	423,007	280	177	219	430,886
Commercial real estate:						
Office, retail, and industrial	14,575	1,950,564	2,776	345	11,560	1,979,820
Multi-family	14,071	657,878	3,117	20	377	675,463
Construction	8,778	530,264	198	371	209	539,820
Other commercial real estate	64,675	1,287,522	2,380	317	3,621	1,358,515
Total commercial real estate	102,099	4,426,228	8,471	1,053	15,767	4,553,618
Total corporate loans	114,752	8,307,284	32,756	3,060	56,566	8,514,418
Home equity	2,745	815,014	3,252	98	5,946	827,055
1-4 family mortgages	18,080	750,555	1,310	—	4,412	774,357
Installment	1,113	318,065	2,407	397	—	321,982
Total consumer loans	21,938	1,883,634	6,969	495	10,358	1,923,394
Total loans	$136,690	$10,190,918	$39,725	$3,555	$ 66,924	$10,437,812

(1) PCI loans with an accretable yield are considered current.

(2) Includes PCI loans of $748,000 and $763,000 as of June 30, 2018 and December 31, 2017, respectively, which no longer have an accretable yield as estimates of expected future cash flows have decreased since the acquisition date due to credit deterioration.

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The following table provides a comparison of our non-performing assets and past due loans to prior periods.
Table 12
Non-Performing Assets and Past Due Loans
(Dollar amounts in thousands)

	As of June 30, 2018	March 31, 2018	December 31, 2017	September 30, 2017	June 30, 2017
Non-accrual loans	$53,475	$75,015	$ 66,924	$ 65,176	$79,196
90 days or more past due loans, still accruing interest[(1)]	7,954	4,633	3,555	2,839	2,059
Total non-performing loans	61,429	79,648	70,479	68,015	81,255
Accruing TDRs	1,760	1,778	1,796	1,813	2,029
OREO	12,892	17,472	20,851	19,873	26,493
Total non-performing assets	$76,081	$98,898	$ 93,126	$ 89,701	$109,777
30-89 days past due loans[(1)]	$39,171	$42,573	$ 39,725	$ 28,868	$19,081
Non-accrual loans to total loans	0.49 %	0.70 %	0.64 %	0.63 %	0.77 %
Non-performing loans to total loans	0.56 %	0.75 %	0.68 %	0.65 %	0.79 %
Non-performing assets to total loans plus OREO	0.70 %	0.92 %	0.89 %	0.86 %	1.07 %

(1) PCI loans with an accretable yield are considered current and are not included in past due loan totals.

Total non-performing assets represented 0.70% of total loans and OREO at June 30, 2018, down from 0.89% and 1.07% at December 31, 2017 and June 30, 2017, respectively. The decline in OREO compared to prior periods resulted from sales of OREO properties. Non-accrual loans decreased by $13.4 million from December 31, 2017 due primarily to the final resolution of two corporate relationships.

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TDRs

Loan modifications may be performed at the request of an individual borrower and may include reductions in interest rates, changes in payments, and extensions of maturity dates. We occasionally restructure loans at other than market rates or terms to enable the borrower to work through financial difficulties for a period of time, and these restructured loans remain classified as TDRs for the remaining term of these loans.

Table 13
TDRs by Type
(Dollar amounts in thousands)

	As of June 30, 2018		December 31, 2017		June 30, 2017	
	Number of Loans	Amount	Number of Loans	Amount	Number of Loans	Amount
Commercial and industrial	6	$ 7,100	11	$ 19,223	4	$ 1,164
Commercial real estate:						
Office, retail, and industrial	2	501	4	4,236	2	860
Multi-family	2	566	3	723	3	737
Other commercial real estate	1	187	1	192	1	197
Total commercial real estate	5	1,254	8	5,151	6	1,794
Total corporate loans	11	8,354	19	24,374	10	2,958
Home equity	13	554	15	824	16	939
1-4 family mortgages	11	1,090	11	1,131	11	1,168
Total consumer loans	24	1,644	26	1,955	27	2,107
Total TDRs	35	$ 9,998	45	$ 26,329	37	$ 5,065
Accruing TDRs	13	$ 1,760	14	$ 1,796	16	$ 2,029
Non-accrual TDRs	22	8,238	31	24,533	21	3,036
Total TDRs	35	$ 9,998	45	$ 26,329	37	$ 5,065
Year-to-date charge-offs on TDRs		$ 3,672		$ 6,345		$ 113
Specific reserves related to TDRs		625		1,977		—

As of June 30, 2018, TDRs totaled $10.0 million, decreasing by $16.3 million from December 31, 2017. The decrease from December 31, 2017 was driven primarily by paydowns and the final resolution of one non-accrual corporate relationship during the first six months of 2018.

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Corporate Performing Potential Problem Loans

Corporate performing potential problem loans consist of special mention loans and substandard loans, excluding accruing TDRs. These loans are performing in accordance with their contractual terms, but we have concerns about the ability of the borrower to continue to comply with loan terms due to the borrower's operating or financial difficulties.

Table 14

Corporate Performing Potential Problem Loans

(Dollar amounts in thousands)

	As of June 30, 2018			As of December 31, 2017		
	Special Mention(1)	Substandard(2)	Total(3)	Special Mention(1)	Substandard(2)	Total(3)
Commercial and industrial	$122,881	$ 49,633	$172,514	$70,863	$ 30,074	$100,937
Agricultural	8,474	6,666	15,140	10,989	5,732	16,721
Commercial real estate	85,114	58,463	143,577	72,749	69,228	141,977
Total corporate performing potential problem loans(4)	$216,469	$ 114,762	$331,231	$154,601	$ 105,034	$259,635
Corporate performing potential problem loans to corporate loans	2.46 %	1.31 %	3.77 %	1.82 %	1.23 %	3.05 %
Corporate PCI performing potential problem loans included in the totals above	$14,546	$ 22,022	$36,568	$17,685	$ 26,635	$44,320

(1) Loans categorized as special mention exhibit potential weaknesses that require the close attention of management since these potential weaknesses may result in the deterioration of repayment prospects in the future.

(2) Loans categorized as substandard exhibit well-defined weaknesses that may jeopardize the liquidation of the debt. These loans continue to accrue interest because they are well-secured and collection of principal and interest is expected within a reasonable time.

(3) Total corporate performing potential problem loans excludes accruing TDRs of $645,000 as of June 30, 2018 and $657,000 as of December 31, 2017.

(4) Includes corporate PCI performing potential problem loans.

Corporate performing potential problem loans to corporate loans was 3.77% at June 30, 2018, increasing from 3.05% at December 31, 2017, which resulted primarily from higher levels of commercial and industrial loans classified as special mention. Management has specific monitoring and remediation plans associated with these loans.

OREO

OREO consists of properties acquired as the result of borrower defaults on loans.

Table 15

OREO by Type

(Dollar amounts in thousands)

	As of		
	June 30, 2018	December 31, 2017	June 30, 2017
Single-family homes	$633	$ 837	$1,243
Land parcels:			
Raw land	148	850	868
Commercial lots	5,006	8,698	9,852
Single-family lots	1,962	2,150	2,150

Total land parcels	7,116	11,698	12,870
Multi-family units	225	48	48
Commercial properties	4,918	8,268	12,332
Total OREO	$12,892	$ 20,851	$26,493

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OREO Activity
A rollforward of OREO balances for the quarters and six months ended June 30, 2018 and 2017 is presented in the following table.
Table 16
OREO Rollforward
(Dollar amounts in thousands)

	Quarters Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Beginning balance	$17,472	$29,140	$20,851	$26,083
Transfers from loans	235	1,299	1,172	1,982
Acquisitions	—	(3)	—	8,424
Proceeds from sales	(4,762)	(3,112)	(8,638)	(8,476)
Gains on sales of OREO	35	215	15	59
OREO valuation adjustments	(88)	(1,046)	(508)	(1,579)
Ending balance	$12,892	$26,493	$12,892	$26,493

Allowance for Credit Losses
Methodology for the Allowance for Credit Losses
The allowance for credit losses is comprised of the allowance for loan losses and the reserve for unfunded commitments and is maintained by management at a level believed adequate to absorb estimated losses inherent in the existing loan portfolio. Determination of the allowance for credit losses is inherently subjective since it requires significant estimates and management judgment, including the amounts and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans, and consideration of current economic trends.
Acquired loans are recorded at fair value, which incorporates credit risk, at the date of acquisition. No allowance for credit losses is recorded on the acquisition date for such loans. As the acquisition adjustment is accreted into income over future periods, an allowance for credit losses is established as necessary to reflect credit deterioration. In addition, certain acquired loans that have renewed subsequent to their respective acquisition dates are no longer classified as acquired loans. Instead, they are included with our loan population that is allocated an allowance in accordance with our allowance for loan losses methodology.
While management utilizes its best judgment and information available, the ultimate adequacy of the allowance for credit losses depends on a variety of factors beyond the Company's control, including the performance of its loan portfolio, the economy, changes in interest rates and property values, and the interpretation of loan risk ratings by regulatory authorities. Management believes that the allowance for credit losses is an appropriate estimate of credit losses inherent in the loan portfolio as of June 30, 2018.
The accounting policy for the allowance for credit losses is discussed in Note 1 of "Notes to the Condensed Consolidated Financial Statements" in Part I, Item 1 of this Form 10-Q.

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An allowance for credit losses is established on loans originated by the Bank, acquired loans, and covered loans. Additional discussion regarding acquired and covered loans can be found in Notes 1 and 6 of "Notes to the Condensed Consolidated Financial Statements" in Part I, Item 1 of this Form 10-Q. The following table provides additional details related to acquired loans, the allowance for credit losses related to acquired loans, and the remaining acquisition adjustment associated with acquired loans as of June 30, 2018 and December 31, 2017.

Table 17
Allowance for Credit Losses and Acquisition Adjustment
(Dollar amounts in thousands)

	Loans, Excluding Acquired Loans	Acquired Loans[1]	Total
Six months ended June 30, 2018			
Beginning balance	$94,123	$2,606	$96,729
Net charge-offs	(25,178)	(655)	(25,833)
Provision for loan losses and other expense	26,795	—	26,795
Ending balance	$95,740	$1,951	$97,691
As of June 30, 2018			
Total loans	$9,568,000	$1,323,565	$10,891,565
Remaining acquisition adjustment[2]	N/A	66,083	66,083
Allowance for credit losses to total loans[3]	1.00 %	0.15 %	0.90 %
Remaining acquisition adjustment to acquired loans	N/A	4.99 %	N/A
As of December 31, 2017			
Total loans	$8,822,560	$1,615,252	$10,437,812
Remaining acquisition adjustment[2]	N/A	74,677	74,677
Allowance for credit losses to total loans[3]	1.07 %	0.16 %	0.93 %
Remaining acquisition adjustment to acquired loans	N/A	4.62 %	N/A

N/A – Not applicable.

(1) These amounts and ratios relate to the loans acquired in completed acquisitions.

(2) The remaining acquisition adjustment consists of $38.4 million and $27.7 million relating to PCI and non-purchased credit impaired ("Non-PCI") loans, respectively, as of June 30, 2018, and $43.5 million and $31.2 million relating to PCI and Non-PCI loans, respectively, as of December 31, 2017.

(3) The allowance for credit losses to total loans, excluding acquired loans is a non-GAAP financial measure. For a discussion of non-GAAP financial measures, see the section of this Item 2 titled "Non-GAAP Financial Information and Reconciliations."

Excluding acquired loans, the allowance for credit losses to total loans was 1.00% as of June 30, 2018. The acquisition adjustment decreased by $8.6 million during the first six months of 2018, driven primarily by acquired loan accretion, resulting in a remaining acquisition adjustment as a percent of acquired loans of 4.99%. Acquired loans that are renewed are no longer classified as acquired loans. These loans totaled $419.8 million and $366.0 million as of June 30, 2018 and December 31, 2017, respectively, and are included in loans, excluding acquired loans, and allocated an allowance in accordance with our allowance for loan losses methodology. In addition, there is an allowance for credit losses of $2.0 million on acquired loans.

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Table 18
Allowance for Credit Losses and
Summary of Credit Loss Experience
(Dollar amounts in thousands)

	Quarters Ended June 30, 2018	March 31, 2018	December 31, 2017	September 30, 2017	June 30, 2017
Change in allowance for credit losses					
Beginning balance	$95,854	$96,729	$95,814	$93,371	$89,163
Loan charge-offs:					
Commercial, industrial, and agricultural	8,662	14,670	6,919	8,935	2,957
Office, retail, and industrial	305	461	49	14	—
Multi-family	4	—	—	—	—
Construction	—	—	—	(6)	39
Other commercial real estate	1	69	34	6	307
Consumer	2,337	1,885	2,118	1,617	1,556
Total loan charge-offs	11,309	17,085	9,120	10,566	4,859
Recoveries of loan charge-offs:					
Commercial, industrial, and agricultural	753	538	1,386	698	400
Office, retail, and industrial	26	97	127	1,825	8
Multi-family	—	—	3	2	6
Construction	8	13	12	19	12
Other commercial real estate	359	39	39	25	79
Consumer	386	342	444	331	323
Total recoveries of loan charge-offs	1,532	1,029	2,011	2,900	828
Net loan charge-offs	9,777	16,056	7,109	7,666	4,031
Provision for loan losses	11,614	15,181	8,024	10,109	8,239
Ending balance	$97,691	$95,854	$96,729	$95,814	$93,371
Allowance for credit losses					
Allowance for loan losses	$96,691	$94,854	$95,729	$94,814	$92,371
Reserve for unfunded commitments	1,000	1,000	1,000	1,000	1,000
Total allowance for credit losses	$97,691	$95,854	$96,729	$95,814	$93,371
Allowance for credit losses to loans(1)	0.90 %	0.90 %	0.93 %	0.92 %	0.91 %
Allowance for credit losses to loans, excluding acquired loans(2)	1.00 %	1.01 %	1.07 %	1.09 %	1.10 %
Allowance for credit losses to non-accrual loans	182.69 %	127.78 %	144.54 %	147.01 %	117.90 %
Allowance for credit losses to non-performing loans	159.03 %	120.35 %	137.25 %	140.87 %	114.91 %
Average loans	$10,785,341	$10,496,089	$10,380,689	$10,273,630	$10,059,968
Net loan charge-offs to average loans, annualized	0.36 %	0.62 %	0.27 %	0.30 %	0.16 %

(1)

This ratio includes acquired loans that are recorded at fair value through an acquisition adjustment, which incorporates credit risk as of the acquisition date with no allowance for credit losses being established at that time. As the acquisition adjustment is accreted into income over future periods, an allowance for credit losses is established as necessary to reflect credit deterioration. See the Allowance for Credit Losses and Acquisition Adjustment table above for further discussion of the allowance for acquired loan losses and the related acquisition adjustment.

(2) This item is a non-GAAP financial measure. For a discussion of non-GAAP financial measures, see the section of this Item 2 titled "Non-GAAP Financial Information and Reconciliations."

Activity in the Allowance for Credit Losses

The allowance for credit losses was $97.7 million as of June 30, 2018 and represents 0.90% of total loans compared to 0.93% at December 31, 2017.

The provision for loan losses was $11.6 million for the quarter ended June 30, 2018, up from $8.0 million and $8.2 million for the quarters ended December 31, 2017 and June 30, 2017, respectively. The increase compared to the quarter ended December 31, 2017 resulted primarily from higher levels of net charge-offs and loan growth.

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Net loan charge-offs to average loans, annualized, were 0.36%, or $9.8 million, for the second quarter of 2018, up from 0.27% and 0.16% for the fourth quarter of 2017 and second quarter of 2017, respectively. Charge-offs for the second quarter of 2018 include the final resolution of certain commercial and industrial relationships.

FUNDING AND LIQUIDITY MANAGEMENT

The following table provides a comparison of average funding sources. We believe that average balances, rather than period-end balances, are more meaningful in analyzing funding sources because of the normal fluctuations that may occur on a daily or monthly basis within funding categories.

Table 19
Funding Sources – Average Balances
(Dollar amounts in thousands)

	Quarters Ended			June 30, 2018 % Change From	
	June 30, 2018	December 31, 2017	June 30, 2017	December 31, 2017	June 30, 2017
Demand deposits	$3,621,645	$3,611,811	$3,538,049	0.3	2.4
Savings deposits	2,060,066	2,017,489	2,072,343	2.1	(0.6)
NOW accounts	2,065,530	1,992,150	2,010,152	3.7	2.8
Money market accounts	1,759,313	1,938,195	1,942,672	(9.2)	(9.4)
Core deposits	9,506,554	9,559,645	9,563,216	(0.6)	(0.6)
Time deposits	1,860,561	1,613,681	1,516,531	15.3	22.7
Brokered deposits	11,105	6,077	22,314	82.7	(50.2)
Total time deposits	1,871,666	1,619,758	1,538,845	15.6	21.6
Total deposits	11,378,220	11,179,403	11,102,061	1.8	2.5
Securities sold under agreements to repurchase	114,726	119,797	122,961	(4.2)	(6.7)
Federal funds purchased	714	—	—	N/M	N/M
FHLB advances	798,462	434,837	430,085	83.6	85.7
Total borrowed funds	913,902	554,634	553,046	64.8	65.2
Senior and subordinated debt	195,385	195,102	194,819	0.1	0.3
Total funding sources	$12,487,507	$11,929,139	$11,849,926	4.7	5.4
Average interest rate paid on borrowed funds	1.54%	1.62%	1.52%		
Weighted-average maturity of FHLB advances	1.1 months	1.0 months	1.1 months		
Weighted-average interest rate of FHLB advances	2.05%	1.26%	1.08%		

N/M – Not meaningful.

Total average funding sources for the second quarter of 2018 increased by $558.4 million, or 4.7%, compared to the first quarter of 2018 and $637.6 million, or 5.4%, compared to the second quarter of 2017. The increase compared to both prior periods resulted from an increase in FHLB advances as related interest rate swaps became effective and a rise in time deposits due to the continued success of promotions which started in 2017.

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Table 20
Borrowed Funds
(Dollar amounts in thousands)

	As of June 30, 2018		As of June 30, 2017	
	Amount	Weighted-Average Rate (%)	Amount	Weighted-Average Rate (%)
At period-end:				
Securities sold under agreements to repurchase	$111,044	0.08	$124,333	0.08
FHLB advances	870,000	2.05	515,000	1.08
Total borrowed funds	$981,044	1.83	$639,333	0.89
Average for the year-to-date period:				
Securities sold under agreements to repurchase	$117,275	0.07	$124,572	0.06
Federal funds purchased	6,022	1.64	—	—
FHLB advances	762,956	1.82	518,496	1.66
Total borrowed funds	$886,253	1.59	$643,068	1.35
Maximum amount outstanding at the end of any day during the period:				
Securities sold under agreements to repurchase	$128,553		$140,764	
Federal funds purchased	65,000		—	
FHLB advances	945,000		940,000	

Average borrowed funds totaled $886.3 million for the second quarter of 2018, increasing by $243.2 million compared to the same period in 2017. This increase was due primarily to higher levels of FHLB advances. The weighted-average rate on FHLB advances for both periods presented was impacted by the hedging of $710.0 million and $415.0 million in FHLB advances as of June 30, 2018 and 2017, respectively, using interest rate swaps through which the Company receives variable amounts and pays fixed amounts. The weighted-average interest rate paid on these interest rate swaps was 1.91% and 2.17% as of June 30, 2018 and 2017, respectively. For a detailed discussion of interest rate swaps, see Note 9 of "Notes to the Condensed Consolidated Financial Statements" in Part I, Item 1 of this Form 10-Q.

Securities sold under agreements to repurchase generally mature within 1 to 90 days from the transaction date.

MANAGEMENT OF CAPITAL

Capital Measurements

A strong capital structure is required under applicable banking regulations and is crucial in maintaining investor confidence, accessing capital markets, and enabling us to take advantage of future growth opportunities. Our capital policy requires that the Company and the Bank maintain capital ratios in excess of the minimum regulatory guidelines. It serves as an internal discipline in analyzing business risks and internal growth opportunities and sets targeted levels of return on equity. Under regulatory capital adequacy guidelines, the Company and the Bank are subject to various capital requirements set and administered by the federal banking agencies. On January 1, 2015, the Company and the Bank became subject to the Basel III Capital rules, a new comprehensive capital framework for U.S. banking organizations published by the Federal Reserve. These rules are discussed in the "Supervision and Regulation" section in Item 1, "Business" in the Company's 2017 10-K. In addition, financial institutions, such as the Company and the Bank, with average total consolidated assets greater than $10 billion were previously required by the Dodd-Frank Act to conduct an annual company-run stress test of capital, report results to the Federal Reserve, and publicly disclose a summary of the results. As a result of regulatory reform signed into law during the second quarter of 2018, the Company and the Bank are no longer required to perform these actions.

The following table presents our consolidated measures of capital as of the dates presented and the capital guidelines established by the Federal Reserve for the Bank to be categorized as "well-capitalized." We manage our capital levels for both the Company and the Bank to consistently maintain these measurements in excess of the Federal Reserve's minimum levels to be considered "well-capitalized," which is the highest capital category established. All regulatory mandated ratios for characterization as "well-capitalized" were exceeded as of June 30, 2018 and December 31, 2017.

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The tangible common equity ratios presented in the table below are capital adequacy metrics used and relied on by investors and industry analysts; however, they are non-GAAP financial measures. For a discussion of non-GAAP financial measures, see the section of this Item 2 titled "Non-GAAP Financial Information and Reconciliations."

Table 21
Capital Measurements
(Dollar amounts in thousands)

	As of June 30, 2018	December 31, 2017	As of June 30, 2018 Regulatory Minimum For Well-Capitalized	Excess Over Required Minimums	
Bank regulatory capital ratios					
Total capital to risk-weighted assets	10.77 %	10.95 %	10.00 %	8 %	$95,369
Tier 1 capital to risk-weighted assets	9.98 %	10.13 %	8.00 %	25 %	$243,907
CET1 to risk-weighted assets	9.98 %	10.13 %	6.50 %	54 %	$428,578
Tier 1 capital to average assets	8.86 %	9.10 %	5.00 %	77 %	$534,989
Company regulatory capital ratios					
Total capital to risk-weighted assets	12.07 %	12.15 %	N/A	N/A	N/A
Tier 1 capital to risk-weighted assets	10.09 %	10.10 %	N/A	N/A	N/A
CET1 to risk-weighted assets	9.68 %	9.68 %	N/A	N/A	N/A
Tier 1 capital to average assets	8.95 %	8.99 %	N/A	N/A	N/A
Company tangible common equity ratios(1)(2)					
Tangible common equity to tangible assets	8.04 %	8.33 %	N/A	N/A	N/A
Tangible common equity, excluding accumulated other comprehensive loss, to tangible assets	8.50 %	8.58 %	N/A	N/A	N/A
Tangible common equity to risk-weighted assets	9.16 %	9.31 %	N/A	N/A	N/A

N/A – Not applicable.

(1) Ratios are not subject to formal Federal Reserve regulatory guidance.

(2) Tangible common equity ratios are non-GAAP financial measures. For a discussion of non-GAAP financial measures, see the section of this Item 2 titled "Non-GAAP Financial Information and Reconciliations."

Overall, the Company's regulatory capital ratios decreased compared to December 31, 2017, due primarily to the impact of loan growth on risk-weighted assets and the nearly 10 basis point impact of the phase-in of certain provisions related to regulatory capital ratio calculations, substantially offset by an increase in retained earnings. The Board of Directors reviews the Company's capital plan each quarter, considering the current and expected operating environment as well as evaluating various capital alternatives.

Dividends

The Board of Directors approved a quarterly cash dividend of $0.11 per common share during the second quarter of 2018, which follows a dividend increase from $0.10 to $0.11 per common share during the first quarter of 2018 and represents the 142nd consecutive quarterly cash dividend paid by the Company since its inception in 1983.

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NON-GAAP FINANCIAL INFORMATION AND RECONCILIATIONS

The Company's accounting and reporting policies conform to GAAP and general practices within the banking industry. As a supplement to GAAP, the Company provides non-GAAP performance results, which the Company believes are useful because they assist investors in assessing the Company's operating performance. These non-GAAP financial measures include earnings per share ("EPS"), adjusted, the efficiency ratio, return on average assets, adjusted, tax-equivalent net interest income (including its individual components), tax-equivalent net interest margin, tax-equivalent net interest margin, adjusted, noninterest income, adjusted, noninterest expense, adjusted, tangible common equity to tangible assets, tangible common equity, excluding accumulated other comprehensive loss, to tangible assets, tangible common equity to risk-weighted assets, return on average common equity, adjusted, return on average tangible common equity, return on average tangible common equity, adjusted, and allowance for credit losses to loans, excluding acquired loans.

The Company presents EPS, the efficiency ratio, return on average assets, return on average common equity, and return on average tangible common equity, all adjusted for certain significant transactions. These transactions include Delivering Excellence implementation costs (second quarter and first six months of 2018) and acquisition and integration related expenses (second quarter and first six months of 2017). Management believes excluding these transactions from EPS, the efficiency ratio, return on average assets, return on average common equity, and return on average tangible common equity are useful in assessing the Company's underlying operational performance since these transactions do not pertain to its core business operations and their exclusion facilitates better comparability between periods. Management believes that excluding acquisition and integration related expenses from these metrics is useful to the Company, as well as analysts and investors, since these expenses can vary significantly based on the size, type, and structure of each acquisition. Additionally, management believes excluding these transactions from these metrics enhances comparability for peer comparison purposes.

The Company presents noninterest income, adjusted, which excludes the accounting reclassification, the Durbin Amendment, and net securities gains, and noninterest expense, adjusted, which excludes the accounting reclassification, Delivering Excellence implementation costs, and acquisition and integration related expenses. Management believes that excluding these items from noninterest income and noninterest expense is useful in assessing the Company's underlying operational performance as these items either do not pertain to its core business operations or their exclusion facilitates better comparability between periods and for peer comparison purposes.

The tax-equivalent adjustment to net interest income and net interest margin recognizes the income tax savings when comparing taxable and tax-exempt assets. Interest income and yields on tax-exempt securities and loans subsequent to December 31, 2017 are presented using the current federal income tax rate of 21% and prior periods are computed using the federal income tax rate applicable at that time of 35%. Management believes that it is standard practice in the banking industry to present net interest income and net interest margin on a fully tax-equivalent basis and that it enhances comparability for peer comparison purposes. In addition, management believes that presenting the tax-equivalent net interest margin, adjusted, enhances comparability for peer comparison purposes and is useful to the Company, as well as analysts and investors, since acquired loan accretion income may fluctuate based on the size of each acquisition, as well as from period to period.

In management's view, tangible common equity measures are capital adequacy metrics meaningful to the Company, as well as analysts and investors, in assessing the Company's use of equity and in facilitating comparisons with peers. These non-GAAP measures are valuable indicators of a financial institution's capital strength since they eliminate intangible assets from stockholders' equity and retain the effect of accumulated other comprehensive loss in stockholders' equity.

The Company presents the allowance for credit losses to total loans, excluding acquired loans. Management believes excluding acquired loans is useful as it facilitates better comparability between periods as these loans are recorded at fair value, which incorporates credit risk, at the date of acquisition. No allowance for credit losses is recorded on the acquisition date. As the acquisition adjustment is accreted into income over future periods, an allowance for credit losses is established as necessary to reflect credit deterioration. Additionally, management believes excluding these transactions from these metrics enhances comparability for peer comparison purposes. See Table 17 in the section of this Item 2 titled "Loan Portfolio and Credit Quality" for details on the calculation of this measure.

Although intended to enhance investors' understanding of the Company's business and performance, these non-GAAP financial measures should not be considered an alternative to GAAP. In addition, these non-GAAP financial measures may differ from those used by other financial institutions to assess their business and performance. See the previously provided tables and the following reconciliations for details on the calculation of these measures to the extent presented herein.

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Non-GAAP Reconciliations
(Amounts in thousands, except per share data)

	Quarters Ended June 30, 2018	2017	Six Months Ended June 30, 2018	2017
Earnings Per Share				
Net income	$29,600	$34,950	$63,110	$57,805
Net income applicable to non-vested restricted shares	(240)	(336)	(551)	(570)
Net income applicable to common shares	29,360	34,614	62,559	57,235
Adjustments to net income:				
Delivering Excellence implementation costs	15,015	—	15,015	—
Tax effect of Delivering Excellence implementation costs	(3,754)	—	(3,754)	—
Acquisition and integration related expenses	—	1,174	—	19,739
Tax effect of acquisition and integration related expenses	—	(470)	—	(7,896)
Total adjustments to net income, net of tax	11,261	704	11,261	11,843
Net income applicable to common shares, adjusted[1]	$40,621	$35,318	$73,820	$69,078
Weighted-average common shares outstanding:				
Weighted-average common shares outstanding (basic)	102,159	101,743	102,041	101,081
Dilutive effect of common stock equivalents	—	20	8	20
Weighted-average diluted common shares outstanding	102,159	101,763	102,049	101,101
Basic EPS	$0.29	$0.34	$0.61	$0.57
Diluted EPS	$0.29	$0.34	$0.61	$0.57
Diluted EPS, adjusted[1]	$0.40	$0.35	$0.72	$0.68
Return on Average Assets				
Net income	$29,600	$34,950	$63,110	$57,805
Total adjustments to net income, net of tax	11,261	704	11,261	11,843
Net income, adjusted[1]	$40,861	$35,654	$74,371	$69,648
Average assets	$14,605,715	$13,960,843	$14,397,540	$13,817,779
Return on average assets[3]	0.81%	1.00%	0.88%	0.84%
Return on average assets, adjusted[1][3]	1.12%	1.02%	1.04%	1.02%
Return on Average Common and Tangible Common Equity				
Net income applicable to common shares	$29,360	$34,614	$62,559	$57,235
Intangibles amortization	1,794	2,163	3,596	4,128
Tax effect of intangibles amortization	(449)	(865)	(957)	(1,651)
Net income applicable to common shares, excluding intangibles amortization	30,705	35,912	65,198	59,712
Total adjustments to net income, net of tax	11,261	704	11,261	11,843
Net income applicable to common shares, excluding intangibles amortization, adjusted[1]	$41,966	$36,616	$76,459	$71,555
Average stockholders' common equity	$1,890,727	$1,830,536	1,882,121	$1,797,222
Less: average intangible assets	(753,887)	(753,521)	(753,879)	(752,063)
Average tangible common equity	$1,136,840	$1,077,015	$1,128,242	$1,045,159
Return on average common equity[3]	6.23%	7.58%	6.70%	6.42%

Return on average common equity, adjusted(1)(3)	8.62	%	7.74	%	7.91	%	7.75	%
Return on average tangible common equity(3)	10.83	%	13.37	%	11.65	%	11.52	%
Return on average tangible common equity, adjusted(1)(3)	14.81	%	13.64	%	13.67	%	13.81	%

Note: Non-GAAP Reconciliations footnotes are located at the end of this section.

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	As of June 30, 2018	As of December 31, 2017
Tangible Common Equity		
Stockholders' equity	$1,883,563	$1,864,874
Less: goodwill and other intangible assets	(753,020)	(754,757)
Tangible common equity	1,130,543	1,110,117
Less: accumulated other comprehensive income ("AOCI")	64,400	33,036
Tangible common equity, excluding AOCI	$1,194,943	$1,143,153
Total assets	$14,818,076	$14,077,052
Less: goodwill and other intangible assets	(753,020)	(754,757)
Tangible assets	$14,065,056	$13,322,295
Risk-weighted assets	$12,345,200	$11,920,372
Tangible common equity to tangible assets	8.04 %	8.33 %
Tangible common equity, excluding AOCI, to tangible assets	8.50 %	8.58 %
Tangible common equity to risk-weighted assets	9.16 %	9.31 %

	Quarters Ended June 30, 2018	Quarters Ended June 30, 2017	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017
Efficiency Ratio Calculation				
Noninterest expense	$113,416	$99,751	$208,998	$216,393
Less:				
Net OREO expense	256	(1,631)	(812)	(3,331)
Delivering Excellence implementation costs	(15,015)	—	(15,015)	—
Acquisition and integration related expenses	—	(1,174)	—	(19,739)
Total	$98,657	$96,946	$193,171	$193,323
Tax-equivalent net interest income[2]	$128,442	$119,625	$247,980	$236,876
Noninterest income	36,947	44,945	72,464	84,896
Less: net securities gains	—	(284)	—	(284)
Total	$165,389	$164,286	$320,444	$321,488
Efficiency ratio	59.65 %	59.01 %	60.28 %	60.13 %
Efficiency ratio (prior presentation)[4]	N/A	58.67 %	N/A	59.80 %

Note: Non-GAAP Reconciliations footnotes are located at the end of this section.

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Efficiency Ratio Calculation
(Dollar amounts in thousands)

	For the Years Ended December 31,				
	2017	2016	2015	2014	2013
Efficiency Ratio					
Noninterest expense	$415,909	$339,500	$307,216	$283,826	$256,737
Less:					
Net OREO expense	(4,683)	(3,024)	(5,281)	(7,075)	(8,547)
Special bonus	(1,915)	—	—	—	—
Charitable contribution	(1,600)	—	—	—	—
Acquisition and integration related expenses	(20,123)	(14,352)	(1,389)	(13,872)	—
Lease cancellation fee	—	(950)	—	—	—
Property valuation adjustments	—	—	(8,581)	—	—
Total	$387,588	$321,174	$291,965	$262,879	$248,190
Tax-equivalent net interest income[2]	$479,965	$358,334	$322,277	$288,589	$272,429
Noninterest income	163,149	159,312	136,581	126,618	140,883
Less:					
Net securities gains (losses)	1,876	(1,420)	(2,373)	(8,097)	(34,164)
Net gain on sale-leaseback transaction	—	(5,509)	—	—	—
Gains on sales of properties	—	—	—	(3,954)	
Loss on early extinguishment of debt	—	—	—	2,059	—
Gain on termination of FHLB forward commitments	—	—	—	—	(7,829)
Total	$644,990	$510,717	$456,485	$405,215	$371,319
Efficiency ratio	60.09%	62.89%	63.96%	64.87%	66.84%
Efficiency ratio (prior presentation)[4]	59.73%	62.59%	63.57%	64.57%	64.19%

Footnotes for non-GAAP reconciliations

(1) Adjustments to net income for each period presented are detailed in the EPS non-GAAP reconciliation above.

(2) Presented on a tax-equivalent basis, assuming the applicable federal income tax rate for each period presented. As a result, interest income and yields on tax-exempt securities and loans subsequent to December 31, 2017 are presented using the current federal income tax rate of 21% and prior periods are computed using the federal income tax rate applicable at that time of 35%.

(3) Annualized based on the actual number of days for each period presented.

(4) Presented as calculated prior to March 31, 2018, which included a tax-equivalent adjustment for BOLI. Management believes that removing this adjustment from the current calculation of this metric enhances comparability for peer comparison purposes.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the risk of loss arising from adverse changes in the fair value of financial instruments due to changes in interest rates, exchange rates, and equity prices. Interest rate risk is our primary market risk and is the result of repricing, basis, and option risk. A description and analysis of our interest rate risk management policies is included in Part II, Item 7A, "Quantitative and Qualitative Disclosures about Market Risk," in our 2017 10-K.

We seek to achieve consistent growth in net interest income and net income while managing volatility that arises from shifts in interest rates. The Bank's Asset Liability Committee ("ALCO") oversees financial risk management by developing programs to measure and manage interest rate risks within authorized limits set by the Bank's Board of Directors. ALCO also approves the Bank's asset and liability management policies, oversees the formulation and implementation of strategies to improve balance sheet positioning and earnings, and reviews the Bank's interest rate sensitivity position. Management uses net interest income simulation modeling to analyze and capture exposure of earnings to changes in interest rates.

Net Interest Income Sensitivity

The analysis of net interest income sensitivity assesses the magnitude of changes in net interest income over a twelve-month measurement period resulting from immediate changes in interest rates using multiple rate scenarios. These scenarios include, but are not limited to, a flat or unchanged rate environment, immediate increases of 100, 200, and 300 basis points, and an immediate decrease of 100 basis points. Due to the low interest rate environment as of June 30, 2018 and December 31, 2017, management determined that an immediate decrease in interest rates greater than 100 basis points was not meaningful for this analysis.

This simulation analysis is based on expected future cash flows and repricing characteristics for balance sheet and off-balance sheet instruments and incorporates market-based assumptions regarding the effect of changing interest rates on the prepayment rates of certain assets and liabilities. In addition, this sensitivity analysis examines assets and liabilities at the beginning of the measurement period and does not assume any changes from growth or business plans over the next twelve months. Interest-earning assets and interest-bearing liabilities are assumed to re-price based on contractual terms over the twelve-month measurement period assuming an instantaneous parallel shift in interest rates in effect at the beginning of the measurement period. The simulation analysis also incorporates assumptions based on the historical behavior of deposit rates in relation to interest rates. Because these assumptions are inherently uncertain, the simulation analysis cannot definitively measure net interest income or predict the impact of the fluctuation in interest rates on net interest income, but does provide an indication of the Company's sensitivity to changes in interest rates. Actual results may differ from simulated results due to the timing, magnitude, and frequency of interest rate changes as well as changes in market conditions and management strategies.

The Company's current simulation analysis indicates we would benefit from rising interest rates. Interest-earning assets consist of short and long-term products. Excluding non-accrual loans, and including the impact of hedging certain corporate variable rate loans using interest rate swaps through which the Company receives fixed amounts and pays variable amounts, 49% of the loan portfolio consisted of fixed rate loans and 51% were floating rate loans as of June 30, 2018, consistent with December 31, 2017. See Note 9 of "Notes to the Condensed Consolidated Financial Statements" in Part I, Item 1 of this Form 10-Q for additional detail regarding interest rate swaps.

As of June 30, 2018, investments, consisting of securities and interest-bearing deposits in other banks, are more heavily weighted toward fixed rate securities at 92% of the total compared to 8% for floating rate interest-bearing deposits in other banks. This compares to investments comprising 93% of fixed rate securities and 7% of floating rate interest-bearing deposits in other banks as of December 31, 2017. Fixed rate loans are most sensitive to the 3-5 year portion of the yield curve and the Bank limits its loans with maturities that extend beyond 5 years. The majority of floating rate loans are indexed to the short-term LIBOR or Prime rates. The amount of floating rate loans with active interest rate floors was $9.0 million, less than 1% of the floating rate loan portfolio, as of June 30, 2018, compared to $60.0 million, or 1% of the floating rate loan portfolio, as of December 31, 2017. On the liability side of the balance sheet, 83% of deposits as of both June 30, 2018 and December 31, 2017 are demand deposits or interest-bearing core deposits, which either do not pay interest or the interest rates are expected to rise at a slower pace than short-term interest rates.

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Analysis of Net Interest Income Sensitivity
(Dollar amounts in thousands)

	Immediate Change in Rates			
	+300	+200	+100	-100
As of June 30, 2018				
Dollar change	$74,655	$45,758	$23,435	$(50,182)
Percent change	14.1 %	8.7 %	4.4 %	(9.5)%
As of December 31, 2017				
Dollar change	$70,999	$44,733	$33,099	$(44,579)
Percent change	14.8 %	9.3 %	6.9 %	(9.3)%

The sensitivity of estimated net interest income to an instantaneous parallel shift in interest rates is reflected as both dollar and percentage changes. This table illustrates that an instantaneous 200 basis point rise in interest rates as of June 30, 2018 would increase net interest income by $45.8 million, or 8.7%, over the next twelve months compared to no change in interest rates. This same measure was $44.7 million, or 9.3%, as of December 31, 2017.

Overall, positive interest rate risk volatility as of June 30, 2018 decreased modestly compared to December 31, 2017. This decrease was driven primarily by higher interest rates, partially offset by continued growth in floating rate loans funded with time deposits and fixed rate FHLB advances.

ITEM 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, (the "Evaluation Date"), the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chairman of the Board, President and Chief Executive Officer and its Executive Vice President and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rules 13a-15(e) and 15d-15 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based on that evaluation, the Chairman of the Board, President and Chief Executive Officer and Executive Vice President and Chief Financial Officer concluded that as of the Evaluation Date, the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms. There were no changes in the Company's internal control over financial reporting during the most recent fiscal quarter 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

In the ordinary course of business, there were certain legal proceedings pending against the Company and its subsidiaries at June 30, 2018. While the outcome of any legal proceeding is inherently uncertain, based on information currently available, the Company's management does not expect that any liabilities arising from pending legal matters will have a material adverse effect on the Company's business, financial condition, results of operations, or cash flows.

ITEM 1A. RISK FACTORS

The Company provided a discussion of certain risks and uncertainties faced by the Company in the section entitled "Risk Factors" in its 2017 10-K. These risks and uncertainties are not exhaustive. Additional risks and uncertainties are discussed in the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" in this report, our 2017 10-K, and our other filings made with the SEC, as well as in other sections of such reports.

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

The following table summarizes the Company's monthly common stock purchases during the second quarter of 2018. The Board approved a stock repurchase program on November 27, 2007. Up to 2.5 million shares of the Company's common stock may be repurchased, and the total remaining authorization under the program was 2,487,947 shares as of June 30, 2018. The repurchase program has no set expiration or termination date.

Issuer Purchases of Equity Securities

	Total Number of Shares Purchased[1]	Average Price Paid per Share	Total Number of Shares Purchased as Part of a Publicly Announced Plan or Program	Maximum Number of Shares that May Yet Be Purchased Under the Plan or Program
April 1 - April 30, 2018	2,562	$ 24.81	—	2,487,947
May 1 - May 31, 2018	592	25.72	—	2,487,947
June 1 - June 30, 2018	279	26.58	—	2,487,947
Total	3,433	$ 25.11	—	

(1) Consists of shares acquired pursuant to the Company's share-based compensation plans and not the Company's Board-approved stock repurchase program. Under the terms of the Company's share-based compensation plans, the Company accepts previously owned shares of common stock surrendered to satisfy tax withholding obligations associated with the vesting of restricted stock.

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ITEM 6. EXHIBITS

Exhibit Number	Description of Documents
10.1[(1)]	Employment Agreement, dated as of June 18, 2018, between the Company and its Chief Executive Officer.
10.2	Confidentiality and Restrictive Covenants Agreement, dated as of June 18, 2018, between the Company and its Chief Executive Officer.
10.3[(1)]	First Midwest Bancorp, Inc. 2018 Stock and Incentive Plan is incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on May 17, 2018.
11	Statement re: Computation of Per Share Earnings – The computation of basic and diluted earnings per common share is included in Note 8 of the Company's Notes to the Condensed Consolidated Financial Statements included in "ITEM 1. FINANCIAL STATEMENTS" of this document.
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1[(2)]	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2[(2)]	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	Interactive Data File.

(1) Management contract or compensatory plan or arrangement.

(2) Furnished, not filed.

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SIGNATURES

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

First Midwest Bancorp, Inc.

/s/ PATRICK S. BARRETT

Patrick S. Barrett

Executive Vice President and Chief Financial Officer*

Date: August 7, 2018

* Duly authorized to sign on behalf of the registrant.