HMN FINANCIAL INC
Form 10-Q
November 03, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the quarterly period ended September 30, 2009

OR

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

For the transition period from __________ to __________

Commission File Number 0-24100

HMN FINANCIAL, INC.

(Exact name of Registrant as specified in its Charter)

Delaware	41-1777397
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
1016 Civic Center Drive N.W., Rochester, MN	55901
(Address of principal executive offices)	(ZIP Code)

Registrant s telephone number, including area code: (507) 535-1200

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes o No 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 þ Non-accelerated filer o Smaller reporting company o
(Do not check if a smaller reporting company)

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock as of the latest practicable date.

Class	Outstanding at October 19, 2009

Common stock, $0.01 par value	4,245,284

HMN FINANCIAL, INC.
CONTENTS

PART I FINANCIAL STATEMENTS

Item 1: Financial Statements

HMN FINANCIAL, INC. AND SUBSIDIARIES
Consolidated Balance Sheets

(Dollars in thousands)		September 30, 2009 (unaudited)	December 31, 2008
Assets			
Cash and cash equivalents	$	20,469	15,729
Securities available for sale:			
Mortgage-backed and related securities (amortized cost $56,776 and $76,166)		58,737	77,327
Other marketable securities (amortized cost $75,976 and $95,445)		76,847	97,818
		135,584	175,145
Loans held for sale		3,279	2,548
Loans receivable, net		818,897	900,889
Accrued interest receivable		3,952	5,568
Real estate, net		15,494	10,558
Federal Home Loan Bank stock, at cost		7,286	7,286
Mortgage servicing rights, net		1,266	728
Premises and equipment, net		13,097	13,972
Prepaid expenses and other assets		4,634	4,408
Deferred tax asset, net		8,759	8,649
Total assets	$	1,032,717	1,145,480
Liabilities and Stockholders Equity			
Deposits	$	781,574	880,505
Federal Home Loan Bank advances and Federal Reserve borrowings		142,500	142,500
Accrued interest payable		1,700	6,307
Customer escrows		1,605	639
Accrued expenses and other liabilities		4,892	3,316
Total liabilities		932,271	1,033,267
Commitments and contingencies			
Stockholders equity:			
Serial preferred stock: ($.01 par value)			
authorized 500,000 shares; issued shares 26,000		23,670	23,384
Common stock ($.01 par value):			
authorized 11,000,000; issued shares 9,128,662		91	91
Additional paid-in capital		58,593	60,687
Retained earnings, subject to certain restrictions		86,291	98,067
Accumulated other comprehensive income		1,709	2,091

Unearned employee stock ownership plan shares		(3,626)	(3,771)
Treasury stock, at cost 4,883,378 and 4,961,032 shares		(66,282)	(68,336)
Total stockholders equity		100,446	112,213
Total liabilities and stockholders equity	$	1,032,717	1,145,480

See accompanying notes to consolidated financial statements.

HMN FINANCIAL, INC. AND SUBSIDIARIES
Consolidated Statements of Income (Loss)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands, except per share data)	2009	2008	2009	2008
Interest income:				
Loans receivable	$ 12,928	14,634	39,764	44,573
Securities available for sale:				
Mortgage-backed and related	649	360	2,177	797
Other marketable	693	1,224	2,475	4,641
Cash equivalents	0	78	1	196
Other	55	78	50	211
Total interest income	14,325	16,374	44,467	50,418
Interest expense:				
Deposits	4,172	6,235	13,876	20,944
Federal Home Loan Bank advances and Federal Reserve borrowings	1,563	1,571	4,732	4,047
Total interest expense	5,735	7,806	18,608	24,991
Net interest income	8,590	8,568	25,859	25,427
Provision for loan losses	3,381	15,790	23,254	18,480
Net interest income (loss) after provision for loan losses	5,209	(7,222)	2,605	6,947
Non-interest income:				
Fees and service charges	1,034	1,163	3,071	3,114
Mortgage servicing fees	262	240	770	722
Securities gains, net	0	479	5	479
Gain on sales of loans	493	58	1,858	442
Other	94	99	298	716
Total non-interest income	1,883	2,039	6,002	5,473
Non-interest expense:				
Compensation and benefits	3,180	3,010	10,313	9,406
Occupancy	970	1,131	3,071	3,424
Advertising	101	95	311	311
Data processing	298	485	888	1,323
Amortization of mortgage servicing rights, net	121	142	431	456
Goodwill impairment charge	0	0	0	3,801

Loss (gain) on real estate owned	(357)	0	3,812	0
Other	1,723	1,784	6,241	4,139
Total non-interest expense	6,036	6,647	25,067	22,860
Income (loss) before income tax expense (benefit)	1,056	(11,830)	(16,460)	(10,440)
Income tax expense (benefit)	175	(4,779)	(5,515)	(2,851)
Net income (loss)	$ 881	(7,051)	(10,945)	(7,589)
Preferred stock dividends and discount	438	0	1,306	0
Net income (loss) available to common shareholders	443	(7,051)	(12,251)	(7,589)
Basic earnings (loss) per common share	$ 0.12	(1.93)	(3.32)	(2.08)
Diluted earnings (loss) per common share	$ 0.12	(1.93)	(3.32)	(2.08)

See accompanying notes to consolidated financial statements.

HMN FINANCIAL, INC. AND SUBSIDIARIES
Consolidated Statement of Stockholders Equity and Comprehensive Loss
For the Nine-Month Period Ended September 30, 2009
(unaudited)

(Dollars in thousands)	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Unearned Employee Stock Ownership Plan Shares	Treasury Stock	Total Stock-Holders Equity
Balance, December 31, 2008	$23,384	91	60,687	98,067	2,091	(3,771)	(68,336)	112,213
Net loss				(10,945)				(10,945)
Other comprehensive loss, net of tax:								
Net unrealized losses on securities available for sale					(382)			(382)
Total comprehensive loss								(11,327)
Preferred stock discount amortization	286		(286)					0
Restricted stock awards forfeited			127				(127)	0
Restricted stock awards dividend forfeited				7				7
Stock compensation tax benefits			20					20
Unearned compensation restricted stock awards			(2,181)				2,181	0
Amortization of restricted stock awards			269					269
Dividends paid				(838)				(838)
Earned employee stock ownership plan shares			(43)			145		102
Balance, September 30, 2009	$23,670	91	58,593	86,291	1,709	(3,626)	(66,282)	100,446

See accompanying notes to consolidated financial statements.

HMN FINANCIAL, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(unaudited)

(Dollars in thousands)	Nine Months Ended September 30, 2009	2008
Cash flows from operating activities:		
Net loss	$ (10,945)	(7,589)
Adjustments to reconcile net loss to cash provided by operating activities:		
Provision for loan losses	23,254	18,480
Provision for real estate losses	5,216	0
Depreciation	1,404	1,288
Amortization of premiums, net	320	101
Amortization of deferred loan fees	(878)	(616)
Amortization of mortgage servicing rights and servicing costs	431	456
Capitalized mortgage servicing rights	(969)	(9)
Securities gains, net	(5)	(479)
Gain on sales of real estate	(1,404)	(160)
Gain on sales of loans	(1,858)	(442)
Proceeds from sales of loans held for sale	103,293	47,640
Disbursements on loans held for sale	(100,904)	(45,914)
Amortization of restricted stock awards	269	310
Amortization of unearned ESOP shares	145	146
Earned employee stock ownership shares priced above original cost	(43)	122
Stock option compensation	20	25
Decrease in accrued interest receivable	1,616	1,682
Decrease in accrued interest payable	(4,607)	(3,531)
Goodwill impairment charge	0	3,801
Decrease (increase) in other assets	63	(5,371)
Increase (decrease) in other liabilities	1,469	(3,091)
Other, net	96	26
Net cash provided by operating activities	15,983	6,875
Cash flows from investing activities:		
Proceeds from sales of securities available for sale	2,141	10,442
Principal collected on securities available for sale	17,272	2,872
Proceeds collected on maturities of securities available for sale	60,000	85,000
Purchases of securities available for sale	(40,352)	(99,442)
Purchase of Federal Home Loan Bank stock	0	(5,959)
Redemption of Federal Home Loan Bank stock	0	4,696
Proceeds from sales of real estate	7,281	6,046
Net decrease (increase) in loans receivable	42,316	(40,579)
Purchases of premises and equipment	(582)	(2,725)
Net cash provided (used) by investing activities	88,076	(39,649)

Cash flows from financing activities:			
Increase (decrease) in deposits		(99,447)	518
Purchase of treasury stock		0	(723)
Dividends to stockholders		(838)	(2,750)
Proceeds from borrowings		1,094,000	347,700
Repayment of borrowings		(1,094,000)	(318,700)
Increase in customer escrows		966	233
Net cash provided (used) by financing activities		(99,319)	26,278
Increase (decrease) in cash and cash equivalents		4,740	(6,496)
Cash and cash equivalents, beginning of period		15,729	23,718
Cash and cash equivalents, end of period	$	20,469	17,222
Supplemental cash flow disclosures:			
Cash paid for interest	$	23,215	28,522
Cash paid for income taxes		33	5,247
Supplemental noncash flow disclosures:			
Transfer of loans to real estate		16,066	12,476
Loans transferred to loans held for sale		1,234	2,170

See accompanying notes to consolidated financial statements.

HMN FINANCIAL, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(unaudited)
September 30, 2009 and 2008

(1) HMN Financial, Inc.

HMN Financial, Inc. (HMN or the Company) is a stock savings bank holding company that owns 100 percent of Home Federal Savings Bank (the Bank). The Bank has a community banking philosophy and operates retail banking and loan production offices in Minnesota and Iowa. The Bank has one wholly owned subsidiary, Osterud Insurance Agency, Inc. (OIA), which offers financial planning products and services. HMN has another wholly owned subsidiary, Security Finance Corporation (SFC), which acts as an intermediary for the Bank in completing certain real estate transactions.

The consolidated financial statements included herein are for HMN, SFC, the Bank and the Bank s wholly owned subsidiary, OIA. All significant intercompany accounts and transactions have been eliminated in consolidation.

(2) Basis of Preparation

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-Q and therefore, do not include all disclosures necessary for a complete presentation of the consolidated balance sheets, consolidated statements of income (loss), consolidated statement of stockholders equity and comprehensive loss and consolidated statements of cash flows in conformity with U.S. generally accepted accounting principles (GAAP). However, all normal recurring adjustments which are, in the opinion of management, necessary for the fair presentation of the interim financial statements have been included. The consolidated statement of income (loss) for the three and nine-month periods ended September 30, 2009 is not necessarily indicative of the results which may be expected for the entire year.

Certain amounts in the consolidated financial statements for prior periods have been reclassified to conform with the current period presentation.

Subsequent events were evaluated through the filing date of the quarterly 10-Q with the Securities and Exchange Commission on November 3, 2009.

(3) New Accounting Standards

In June 2009, the FASB issued SFAS No. 168 (ASU 105.10), *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162, The Hierarchy of Generally Accepted Accounting Principles*. This Statement establishes the Codification as the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the SEC under federal securities laws are also sources of authoritative GAAP for SEC registrants. All guidance contained in the Codification carries an equal level of authority. Following this Statement, the FASB will not issue new standards in the form of Statements, FASB Staff Positions, or Emerging Issues Task Force Abstracts. Instead, it will issue Accounting Standard Updates (ASUs) that will serve only to update the Codification. This Statement is effective for financial statements issued for interim and annual periods ending after September 15, 2009 and did not have any impact on the Company s consolidated financial statements except for disclosure changes to the authoritative pronouncement references.

In June 2009, the FASB issued SFAS No. 167 (ASU 810.10), *Amendments to FASB Interpretation No. 46(R).* This Statement amends FASB 46(R) to require an enterprise to perform an analysis and ongoing reassessments to determine whether the enterprise s variable interest or interests give it a controlling financial interest in a variable interest entity and amends certain guidance for determining whether an entity is a variable interest entity. It also requires enhanced disclosures that will provide users of financial statements with more transparent information about an enterprise s involvement in a variable interest entity. This Statement is effective as of the beginning of each reporting entity s first annual reporting period that begins after November 15, 2009 and for all interim reporting periods after that and is not anticipated to have any impact on the Company s consolidated financial statements as the Company has no interests in any variable interest entities.

In June 2009, the FASB issued SFAS No. 166 (ASU 860.10), *Accounting for Transfers of Financial Assets an amendment of FASB Statement No. 140.* This Statement amends SFAS 140 and removes the concept of a qualifying special-purpose entity from SFAS 140 and eliminates the exception from applying FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities,* on qualifying special-purpose entities. This Statement is effective as of the beginning of each reporting entity s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter and is not anticipated to have any impact on the Company s consolidated financial statements.

(4) Derivative Instruments and Hedging Activities

The Company has commitments outstanding to extend credit to future borrowers that had not closed prior to the end of the quarter. The Company intends to sell these commitments, which are referred to as its mortgage pipeline. As commitments to originate or purchase loans enter the mortgage pipeline, the Company generally enters into commitments to sell the mortgage pipeline into the secondary market on a firm commitment or best efforts basis. The commitments to originate, purchase or sell loans on a firm commitment basis are derivatives. As a result of marking to market the mortgage pipeline and the related firm commitments to sell for the period ended September 30, 2009, the Company recorded an increase in other assets of $78,562, an increase in other liabilities of $66,890 and a gain on sales of loans of $11,672.

The current commitments to sell loans held for sale are derivatives that do not qualify for hedge accounting. As a result, these derivatives are marked to market and the related loans held for sale are recorded at the lower of cost or market. The Company recorded an increase in other liabilities of $40,100 and a loss included in the gain on sales of loans of $40,100 due to the mark-to-market adjustment on the commitments to sell loans held for sale.

(5) Fair Value Measurements

The Company measures the fair value of assets and liabilities using a hierarchy system consisting of three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

<u>Level 1</u> Valuation is based upon quoted prices for identical instruments traded in active markets that the Company has the ability to access.

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

<u>Level 3</u> Valuation is generated from model-based techniques that use significant assumptions not observable in the market and that are used only to the extent observable inputs are not available. These unobservable assumptions reflect our own estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

The following table summarizes the assets of the Company for which fair values are determined on a recurring basis as of September 30, 2009.

	Carrying value at September 30, 2009			
(Dollars in thousands)	Total	Level 1	Level 2	Level 3
Securities available for sale	$ 135,584	7,260	128,324	0
Mortgage loan commitments	79	0	79	0
Total	$ 135,663	7,260	128,403	0

The Company may also be required, from time to time, to measure certain other financial assets at fair value on a nonrecurring basis in accordance with generally accepted accounting principles. These adjustments to fair value usually result from the application of the lower-of-cost or market accounting or the write-down of individual assets. For assets measured at fair value on a nonrecurring basis in the third quarter of 2009, that were still held at September 30, 2009, the following table provides the level of valuation assumptions used to determine each adjustment and the carrying value of the related individual assets or portfolios at September 30, 2009.