

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

(Mark One)

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

For the quarterly period ended June 30, 2024

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF 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 (State or other jurisdiction of incorporation or organization) | 41-1777397 (I.R.S. Employer Identification No.) |
| 1016 Civic Center Drive N.W., Rochester, MN (Address of principal executive offices) | 55901 (Zip Code) |
| Registrant's telephone number, including area code: | (507) 535-1200 |

Securities registered pursuant to Section 12(b) of the Act:

| Title of Each Class | Trading Symbol(s) | Name of Each Exchange on Which Registered |
|---------------------|-------------------|---|
| Common Stock | HMNF | The Nasdaq Stock Market LLC |

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer
Smaller reporting company Emerging growth company

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

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

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

| Class | Outstanding at July 29, 2024 |
|--------------------------------|------------------------------|
| Common stock, \$0.01 par value | 4,464,952 |

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PART I – FINANCIAL INFORMATION

Item 1 : Financial Statements

HMN FINANCIAL, INC. AND SUBSIDIARIES
Consolidated Balance Sheets

| <i>(Dollars in thousands, except share and per share data)</i> | June 30, 2024 | December 31, 2023 |
|--|---------------------|----------------------|
| | (unaudited) | |
| Assets | | |
| Cash and cash equivalents | \$ 13,663 | 11,151 |
| Securities available for sale: | | |
| Mortgage-backed and related securities (amortized cost \$ 161,951 and \$179,366) | 144,991 | 161,414 |
| Other marketable securities (amortized cost \$54,330 and \$54,112) | 54,031 | 53,680 |
| Total securities available for sale | <u>199,022</u> | <u>215,094</u> |
| Loans held for sale | 2,861 | 1,006 |
| Loans receivable, net | 864,698 | 845,692 |
| Accrued interest receivable | 3,982 | 3,553 |
| Mortgage servicing rights, net | 2,643 | 2,709 |
| Premises and equipment, net | 15,623 | 15,995 |
| Goodwill | 0 | 802 |
| Prepaid expenses and other assets | 3,967 | 3,962 |
| Deferred tax asset, net | 7,088 | 7,171 |
| Total assets | <u>\$ 1,113,547</u> | <u>1,107,135</u> |
| Liabilities and Stockholders' Equity | | |
| Deposits | \$ 983,244 | 976,793 |
| Federal Home Loan Bank advances and Federal Reserve borrowings | 10,800 | 13,200 |
| Accrued interest payable | 3,903 | 2,399 |
| Customer escrows | 1,993 | 2,246 |
| Accrued expenses and other liabilities | 3,264 | 4,790 |
| Total liabilities | <u>1,003,204</u> | <u>999,428</u> |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Serial-preferred stock (\$.01 par value): authorized 500,000 shares; issued 0 | 0 | 0 |
| Common stock (\$.01 par value): authorized 16,000,000 shares; issued 9,128,662 outstanding 4,464,952 and 4,457,905 | 91 | 91 |
| Additional paid-in capital | 41,280 | 41,235 |
| Retained earnings, subject to certain restrictions | 143,782 | 142,278 |
| Accumulated other comprehensive loss | (12,367) | (13,191) |
| Unearned employee stock ownership plan shares | (772) | (870) |
| Treasury stock, at cost 4,663,710 and 4,670,757 shares | (61,671) | (61,836) |
| Total stockholders' equity | <u>110,343</u> | <u>107,707</u> |
| Total liabilities and stockholders' equity | <u>\$ 1,113,547</u> | <u>1,107,135</u> |

See accompanying notes to consolidated financial statements (unaudited).

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

| <i>(Dollars in thousands, except per share data)</i> | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|--------|------------------------------|--------|
| | 2024 | 2023 | 2024 | 2023 |
| Interest income: | | | | |
| Loans receivable | \$ 11,104 | 9,619 | 21,790 | 18,622 |
| Securities available for sale: | | | | |
| Mortgage-backed and related | 473 | 600 | 987 | 1,252 |
| Other marketable | 558 | 200 | 967 | 343 |
| Other | 445 | 78 | 835 | 193 |
| Total interest income | 12,580 | 10,497 | 24,579 | 20,410 |
| Interest expense: | | | | |
| Deposits | 5,070 | 2,549 | 9,810 | 4,352 |
| Customer escrows | 0 | 23 | 0 | 55 |
| Advances and other borrowings | 18 | 197 | 21 | 212 |
| Total interest expense | 5,088 | 2,769 | 9,831 | 4,619 |
| Net interest income | 7,492 | 7,728 | 14,748 | 15,791 |
| Provision for credit losses | (306) | 256 | (515) | 248 |
| Net interest income after provision for credit losses | 7,798 | 7,472 | 15,263 | 15,543 |
| Non-interest income: | | | | |
| Fees and service charges | 764 | 831 | 1,496 | 1,638 |
| Loan servicing fees | 386 | 391 | 774 | 791 |
| Gain on sales of loans | 633 | 334 | 927 | 629 |
| Other | 427 | 418 | 920 | 844 |
| Total non-interest income | 2,210 | 1,974 | 4,117 | 3,902 |
| Non-interest expense: | | | | |
| Compensation and benefits | 4,420 | 4,459 | 9,117 | 9,264 |
| Occupancy and equipment | 880 | 914 | 1,732 | 1,864 |
| Data processing | 579 | 545 | 1,114 | 1,050 |
| Professional services | 750 | 292 | 1,071 | 529 |
| Goodwill impairment charge | 802 | 0 | 802 | 0 |
| Other | 1,234 | 1,247 | 2,380 | 2,443 |
| Total non-interest expense | 8,665 | 7,457 | 16,216 | 15,150 |
| Income before income tax expense | 1,343 | 1,989 | 3,164 | 4,295 |
| Income tax expense | 373 | 568 | 876 | 1,240 |
| Net income | 970 | 1,421 | 2,288 | 3,055 |
| Other comprehensive income, net of tax | 832 | 705 | 824 | 2,951 |
| Comprehensive income available to common stockholders | \$ 1,802 | 2,126 | 3,112 | 6,006 |
| Basic earnings per share | \$ 0.22 | 0.33 | 0.53 | 0.70 |
| Diluted earnings per share | \$ 0.22 | 0.32 | 0.52 | 0.70 |

See accompanying notes to consolidated financial statements (unaudited).

HMN FINANCIAL, INC. AND SUBSIDIARIES
Consolidated Statements of Stockholders' Equity
For the Three and Six Months Ended June 30, 2024 and 2023
(unaudited)

| (Dollars in thousands) | Common Stock | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Loss | Unearned Employee Stock Ownership Plan Shares | Treasury Stock | Total Stock- Holders' Equity |
|---|--------------|----------------------------|-------------------|--------------------------------------|---|-----------------|------------------------------|
| Balance, March 31, 2024 | \$ 91 | 41,232 | 143,248 | (13,199) | (821) | (61,727) | 108,824 |
| Net income | | | 970 | | | | 970 |
| Other comprehensive income | | | | | 832 | | 832 |
| Dividends paid to stockholders (\$0.10 per share) | | | | (436) | | | (436) |
| Restricted stock awards | | (56) | | | | 56 | 0 |
| Amortization of restricted stock awards | | 47 | | | | | 47 |
| Earned employee stock ownership plan shares | | 57 | | | 49 | | 106 |
| Balance, June 30, 2024 | <u>\$ 91</u> | <u>41,280</u> | <u>143,782</u> | <u>(12,367)</u> | <u>(772)</u> | <u>(61,671)</u> | <u>110,343</u> |
| Balance, December 31, 2023 | \$ 91 | 41,235 | 142,278 | (13,191) | (870) | (61,836) | 107,707 |
| Net income | | | 2,288 | | | | 2,288 |
| Other comprehensive income | | | | | 824 | | 824 |
| Dividends paid to stockholders (\$0.18 per share) | | | | (784) | | | (784) |
| Restricted stock awards | | (166) | | | | 166 | 0 |
| Stock awards withheld for tax withholding | | | | | | (1) | (1) |
| Amortization of restricted stock awards | | 96 | | | | | 96 |
| Earned employee stock ownership plan shares | | 115 | | | 98 | | 213 |
| Balance, June 30, 2024 | <u>\$ 91</u> | <u>41,280</u> | <u>143,782</u> | <u>(12,367)</u> | <u>(772)</u> | <u>(61,671)</u> | <u>110,343</u> |

| (Dollars in thousands) | Common Stock | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Loss | Unearned Employee Stock Ownership Plan Shares | Treasury Stock | Total Stock- Holders' Equity |
|---|--------------|----------------------------|-------------------|--------------------------------------|---|-----------------|------------------------------|
| Balance, March 31, 2023 | \$ 91 | 40,975 | 138,952 | (17,515) | (1,014) | (61,267) | 100,222 |
| Net income | | | 1,421 | | | | 1,421 |
| Other comprehensive income | | | | | 705 | | 705 |
| Dividends paid to stockholders (\$0.08 per share) | | | | (348) | | | (348) |
| Restricted stock awards | | (60) | | | | 60 | 0 |
| Amortization of restricted stock awards | | 57 | | | | | 57 |
| Earned employee stock ownership plan shares | | 47 | | | 48 | | 95 |
| Balance, June 30, 2023 | <u>\$ 91</u> | <u>41,019</u> | <u>140,025</u> | <u>(16,810)</u> | <u>(966)</u> | <u>(61,207)</u> | <u>102,152</u> |
| Balance, December 31, 2022 | \$ 91 | 41,013 | 138,409 | (19,761) | (1,063) | (61,353) | 97,336 |
| Net income | | | 3,055 | | | | 3,055 |
| Other comprehensive income | | | | | 2,951 | | 2,951 |
| Adoption of ASU 2016-13 (see Note 3) | | | (830) | | | | (830) |
| Dividends paid to stockholders (\$0.14 per share) | | | | (609) | | | (609) |
| Restricted stock awards | | (210) | | | | 210 | 0 |
| Stock awards withheld for tax withholding | | | 111 | | | (64) | (64) |
| Amortization of restricted stock awards | | | 105 | | | | 111 |
| Earned employee stock ownership plan shares | | | 97 | | | | 202 |
| Balance, June 30, 2023 | <u>\$ 91</u> | <u>41,019</u> | <u>140,025</u> | <u>(16,810)</u> | <u>(966)</u> | <u>(61,207)</u> | <u>102,152</u> |

See accompanying notes to consolidated financial statements (unaudited).

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

| <i>(Dollars in thousands)</i> | Six Months Ended June 30, | |
|---|------------------------------|-----------|
| | 2024 | 2023 |
| Cash flows from operating activities: | | |
| Net income | \$ 2,288 | 3,055 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Provision for credit losses | (515) | 248 |
| Depreciation | 540 | 563 |
| Amortization of premiums, net | 150 | 402 |
| Amortization of deferred loan fees | (74) | (90) |
| Amortization of mortgage servicing rights and servicing costs | 422 | 412 |
| Capitalized mortgage servicing rights | (356) | (215) |
| Deferred income tax expense | (219) | 0 |
| Losses (gains) recognized on equity securities, net | 21 | (62) |
| Gains on sale of premises and equipment | 0 | (9) |
| Gain on sales of loans | (927) | (629) |
| Proceeds from sales of loans held for sale | 40,841 | 25,550 |
| Disbursements on loans held for sale | (37,418) | (23,232) |
| Amortization of restricted stock awards | 96 | 111 |
| Amortization of unearned Employee Stock Ownership Plan shares | 98 | 97 |
| Earned Employee Stock Ownership Plan shares priced above original cost | 115 | 105 |
| Increase in accrued interest receivable | (429) | (392) |
| Increase in accrued interest payable | 1,504 | 817 |
| Goodwill impairment charge | 802 | 0 |
| Increase in other assets | (150) | (82) |
| Decrease in other liabilities | (1,509) | (1,858) |
| Other, net | (2) | (1) |
| Net cash provided by operating activities | 5,278 | 4,790 |
| Cash flows from investing activities: | | |
| Principal collected on securities available for sale | 17,047 | 18,554 |
| Proceeds collected on maturities of securities available for sale | 20,000 | 5,000 |
| Purchases of securities available for sale | (20,000) | (5,013) |
| Purchase of Federal Home Loan Bank stock | (817) | (5,318) |
| Redemption of Federal Home Loan Bank stock | 918 | 4,297 |
| Net increase in loans receivable | (22,759) | (53,543) |
| Proceeds from sale of premises | 0 | 42 |
| Purchases of premises and equipment | (168) | (386) |
| Net cash used by investing activities | (5,779) | (36,367) |
| Cash flows from financing activities: | | |
| Increase (decrease) in deposits | 6,451 | (11,214) |
| Stock awards withheld for tax withholding | (1) | (64) |
| Dividends to stockholders | (784) | (609) |
| Proceeds from borrowings | 18,000 | 128,120 |
| Repayment of borrowings | (20,400) | (103,420) |
| Decrease in customer escrows | (253) | (4,261) |
| Net cash provided by financing activities | 3,013 | 8,552 |
| Increase (decrease) in cash and cash equivalents | 2,512 | (23,025) |
| Cash and cash equivalents, beginning of period | 11,151 | 36,259 |
| Cash and cash equivalents, end of period | \$ 13,663 | 13,234 |
| Supplemental cash flow disclosures: | | |
| Cash paid for interest | \$ 8,327 | 3,803 |
| Cash paid for income taxes | 1,216 | 1,702 |
| Supplemental noncash flow disclosures: | | |
| Loans transferred to loans held for sale | 4,343 | 2,320 |
| Transfer of loans to real estate | 0 | 220 |

See accompanying notes to consolidated financial statements (unaudited).

HMN FINANCIAL, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(unaudited)

(1) Description of the Business and Summary of Significant Accounting Policies

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 facilities in Minnesota, Iowa and Wisconsin. The Bank has two wholly owned subsidiaries, Osterud Insurance Agency, Inc. (OIA), which does business as Home Federal Investment Services and offers financial planning products and services, and HFSB Property Holdings, LLC (HPH), which is currently inactive, but has acted in the past as an intermediary for the Bank in holding and operating certain foreclosed properties.

The consolidated financial statements included herein are for HMN, the Bank, OIA and HPH. 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 comprehensive income, consolidated statements of stockholders' equity 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 unaudited consolidated financial statements presented in this report should be read in conjunction with the audited consolidated financial statements and the accompanying notes for the year ended December 31, 2023, included in the Company's Form 10-K/A filed with the Securities and Exchange Commission (SEC) on March 19, 2024. The results of operations for the three- and six-month periods ended June 30, 2024 are not necessarily indicative of the results which may be expected for the entire year.

The Company has evaluated subsequent events for potential recognition and/or disclosure through the date the unaudited consolidated financial statements included in this Quarterly Report on Form 10-Q were issued.

(3) Proposed Merger with Alerus Financial Corporation (Nasdaq: ALRS)

On May 14, 2024, HMN entered into an Agreement and Plan of Merger (the merger agreement) with Alerus Financial Corporation, a Delaware corporation (Alerus), pursuant to which HMN will merge into Alerus, with Alerus as the surviving corporation (the merger). Subject to the terms and conditions of the merger Agreement, at the effective time of the merger, HMN stockholders will have the right to receive 1.25 (the exchange ratio) shares of common stock of Alerus for each share of common stock of HMN. The exchange ratio is subject to potential downward adjustment if HMN's stockholders' equity as of the closing date of the merger is less than a specified stockholders' equity threshold, as described in the merger agreement. Holders of options to purchase shares of HMN common stock and holders of restricted HMN common stock will have such options or restricted stock vest immediately prior to the merger. The shares of HMN common stock issued upon exercise of such stock options and the shares of HMN common stock that are vested will receive the same exchange ratio consideration as the HMN stockholders, as described in the merger agreement. It is anticipated that Home Federal Savings Bank will be merged with and into Alerus' banking subsidiary, Alerus Financial, National Association, immediately following the completion of the merger. The merger agreement was unanimously approved by the Board of Directors of each of HMN and Alerus.

The merger agreement contains customary representations and warranties of both parties and customary conditions to the parties' obligations to close the transaction, as well as agreements to cooperate in the process of consummating the transaction. The parties expect the merger to be completed in the fourth quarter of 2024, subject to the satisfaction of customary closing conditions in the merger agreement and the approval of the appropriate regulatory authorities and of the stockholders of each of HMN and Alerus.

The Company has incurred \$0.5 million of merger related expenses for the three months ended June 30, 2024, primarily related to legal, accounting, and other professional service costs, which are included in the Consolidated Statements of Comprehensive Income. The Company expects to incur additional merger related costs through the closing of the merger.

(4) New Accounting Standards

In December 2023, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2023-09, *Income Taxes (Topic 740): Improvements to Income Tax Disclosures*. The amendments in the ASU address investor requests for more transparency about income tax information through improvements to income tax disclosures primarily related to the rate reconciliation and income taxes paid information. The amendments in this ASU apply to all entities that are subject to *Topic 740, Income Taxes* with certain disclosures only required by public business entities. For public business entities, such as the Company, the amendments in this ASU are effective for annual periods beginning after December 15, 2024, with early adoption permitted. Management is currently in the process of reviewing how the Company's income tax disclosure will be impacted by the additional guidance when this ASU is required to be adopted on December 31, 2025.

In November 2023, the FASB issued ASU 2023-07, *Segment Reporting (Topic 280): Improvements to Reportable Segment Disclosures*. The amendments in the ASU address investor requests for additional, more detailed information about a reportable segment's expenses. The amendments in the ASU apply to all public entities, such as the Company, that are required to report segment information in accordance with *Topic 280, Segment Reporting*. The amendments in the ASU do not change the current disclosure requirements or how a public entity identifies its operating segments. The amendments in the ASU are effective for fiscal years beginning after December 15, 2023, and interim periods with fiscal years beginning after December 15, 2024, with early adoption permitted. Management is currently in the process of reviewing how the Company's segment reporting will be impacted by the additional guidance when this ASU is required to be adopted on December 31, 2024.

(5) Fair Value Measurements

Accounting Standards Codification (ASC) 820, *Fair Value Measurements*, establishes a framework for measuring 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:

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

Level 2 - 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.

Level 3 - Valuation is generated from model-based techniques that use significant assumptions not observable in the market and are used only to the extent that observable inputs are not available. These non-observable assumptions reflect the Company's 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.

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The following table summarizes the assets and off balance sheet financial instruments of the Company for which fair values are determined on a recurring basis as of June 30, 2024 and December 31, 2023.

| (Dollars in thousands) | Carrying Value at June 30, 2024 | | | |
|-------------------------------|---------------------------------|----------|----------------|----------|
| | Total | Level 1 | Level 2 | Level 3 |
| Securities available for sale | \$ 199,022 | 0 | 199,022 | 0 |
| Equity securities | 362 | 0 | 362 | 0 |
| Commitments to extend credit | (18) | 0 | (18) | 0 |
| Total | \$ 199,366 | 0 | 199,366 | 0 |

| (Dollars in thousands) | Carrying Value at December 31, 2023 | | | |
|-------------------------------|-------------------------------------|----------|----------------|----------|
| | Total | Level 1 | Level 2 | Level 3 |
| Securities available for sale | \$ 215,094 | 0 | 215,094 | 0 |
| Equity securities | 382 | 0 | 382 | 0 |
| Commitments to extend credit | 7 | 0 | 7 | 0 |
| Total | \$ 215,483 | 0 | 215,483 | 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 GAAP. These adjustments to fair value usually result from the application of the lower-of-cost-or-market accounting or write-downs of individual assets. 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 June 30, 2024 and December 31, 2023.

| (Dollars in thousands) | Carrying Value at June 30, 2024 | | | | Three Months Ended June 30, 2024 Total Gains | Six Months Ended June 30, 2024 Total Gains |
|--------------------------------|---------------------------------|----------|--------------|--------------|--|--|
| | Total | Level 1 | Level 2 | Level 3 | | |
| Loans held for sale | \$ 2,861 | 0 | 2,861 | 0 | 8 | 18 |
| Mortgage servicing rights, net | 2,643 | 0 | 0 | 2,643 | 0 | 0 |
| Collateral dependent loans | 3,172 | 0 | 3,172 | 0 | 4 | 12 |
| Total | \$ 8,676 | 0 | 6,033 | 2,643 | 12 | 30 |

| (Dollars in thousands) | Carrying Value at December 31, 2023 | | | | Year Ended December 31, 2023 | Total Losses |
|--------------------------------|-------------------------------------|----------|--------------|--------------|------------------------------------|--------------|
| | Total | Level 1 | Level 2 | Level 3 | | |
| Loans held for sale | \$ 1,006 | 0 | 1,006 | 0 | (26) | (26) |
| Mortgage servicing rights, net | 2,709 | 0 | 0 | 2,709 | 0 | 0 |
| Collateral dependent loans | 3,856 | 0 | 3,856 | 0 | (287) | (287) |
| Total | \$ 7,571 | 0 | 4,862 | 2,709 | (313) | (313) |

(6) Fair Value of Financial Instruments

ASC 825, *Disclosures about Fair Values of Financial Instruments* requires interim reporting period disclosure of the estimated fair values of the Company's financial instruments, including assets, liabilities and off-balance sheet items for which it is practicable to estimate fair value. The fair value estimates are made as of June 30, 2024 and December 31, 2023 based upon relevant market information, if available, and upon the characteristics of the financial instruments themselves. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based upon judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors.

The estimated fair value of the Company's financial instruments as of June 30, 2024 and December 31, 2023 are shown below. Following the table there is an explanation of the methods and assumptions used to estimate the fair value of each class of financial instruments.

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| (Dollars in thousands) | June 30, 2024 | | | | | | December 31, 2023 | | |
|---|-----------------|----------------------|----------------------|---------|---------|-----------------|-------------------|----------------------|-----------------|
| | Carrying Amount | Estimated Fair Value | Fair Value Hierarchy | | | Contract Amount | Carrying Amount | Estimated Fair Value | Contract Amount |
| | | | Level 1 | Level 2 | Level 3 | | | | |
| Financial assets: | | | | | | | | | |
| Cash and cash equivalents | \$ 13,663 | 13,663 | 13,663 | | | | 11,151 | 11,151 | |
| Securities available for sale | 199,022 | 199,022 | | 199,022 | | | 215,094 | 215,094 | |
| Equity securities | 362 | 362 | | 362 | | | 382 | 382 | |
| Loans held for sale | 2,861 | 2,861 | | 2,861 | | | 1,006 | 1,006 | |
| Loans receivable, net | 864,698 | 801,215 | | 801,215 | | | 845,692 | 778,952 | |
| Federal Home Loan Bank stock | 1,151 | 1,151 | | 1,151 | | | 1,252 | 1,252 | |
| Accrued interest receivable | 3,982 | 3,982 | | 3,982 | | | 3,553 | 3,553 | |
| Mortgage servicing assets | 2,643 | 6,692 | | | 6,692 | | 2,709 | 6,539 | |
| Financial liabilities: | | | | | | | | | |
| Deposits | 983,244 | 982,021 | | 982,021 | | | 976,793 | 975,963 | |
| FHLB advances and other borrowings | 10,800 | 10,800 | | 10,800 | | | 13,200 | 13,200 | |
| Accrued interest payable | 3,903 | 3,903 | | 3,903 | | | 2,399 | 2,399 | |
| Off-balance sheet financial instruments: | | | | | | | | | |
| Commitments to extend credit | (18) | (18) | | | | 149,438 | 7 | 7 | 167,447 |
| Commitments to sell loans | 1 | 1 | | | | 9,371 | (17) | (17) | 3,078 |

Cash and Cash Equivalents

The carrying amount of cash and cash equivalents approximates their fair value.

Securities Available for Sale

The fair values of securities were based upon quoted market prices for similar securities. The fair values measurements are subject to independent verification by another pricing source on a quarterly basis to review for reasonableness.

Equity Securities

The fair values of equity securities were based upon quoted market prices for similar securities.

Loans Held for Sale

The fair values of loans held for sale were based upon quoted market prices for loans with similar interest rates and terms to maturity.

Loans Receivable

The fair value of the loan portfolio, with the exception of the adjustable rate portfolio, was calculated by discounting the scheduled cash flows through the estimated maturity using anticipated prepayment speeds and using discount rates that reflect the credit and interest rate risk inherent in each loan portfolio. The fair value of the adjustable loan portfolio, with the exception of those loans that adjust on a daily basis, is estimated by grouping the loans with similar characteristics and comparing the characteristics of each group to the prices quoted for similar types of loans in the secondary market.

Federal Home Loan Bank (FHLB) Stock

The carrying amount of FHLB stock approximates its fair value.

Accrued Interest Receivable

The carrying amount of accrued interest receivable approximates its fair value since it is short-term in nature and does not present unanticipated credit concerns.

Mortgage Servicing Assets

The fair values of mortgage servicing assets were calculated by a third party using a discounted cash flow model-based technique that uses significant assumptions both observable and non-observable in the market. The non-observable assumptions reflect estimates of assumptions that market participants would use in pricing the mortgage servicing asset.

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Deposits

The fair value of demand deposits, savings accounts and certain money market account deposits is the amount payable on demand at the reporting date. The fair value of fixed maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities. The fair value disclosures for all of the deposits were adjusted to reflect the exit price amount anticipated to be received from the sale of the deposits in an open market transaction.

FHLB Advances and Other Borrowings

The fair values of advances and borrowings with fixed maturities are estimated based on a discounted cash flow analysis using as discount rates the interest rates charged by the FHLB for borrowing of similar remaining terms. The carrying amount of overnight advances approximates their fair value.

Accrued Interest Payable

The carrying amount of accrued interest payable approximates its fair value since it is short-term in nature.

Commitments to Extend Credit

The fair values of commitments to extend credit are estimated using the fees normally charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counter parties.

Commitments to Sell Loans

The fair values of commitments to sell loans are estimated using the quoted market prices for loans with similar interest rates and terms to maturity.

(7) Other Comprehensive Income

Other comprehensive income is defined as the change in equity during a period from transactions and other events from non-owner sources. Comprehensive income is the total of net income and other comprehensive income, which for the Company is comprised of unrealized gains or losses on securities available for sale. The components of other comprehensive income and the related tax effects were as follows:

| (Dollars in thousands) | For the Three Months Ended June 30, | | | | | |
|--|-------------------------------------|---------------|---------------|---------------|------------------|---------------|
| | 2024 | | 2023 | | | |
| | Before Tax | Tax Effect | Net of Tax | Before Tax | Tax Effect(1) | Net of Tax |
| Securities available for sale: | | | | | | |
| Unrealized gains arising during the period | \$ 1,137 | 305 | 832 | 106 | (599) | 705 |
| Other comprehensive income | <u>\$ 1,137</u> | <u>305</u> | <u>832</u> | <u>106</u> | <u>(599)</u> | <u>705</u> |
| For the Six Months Ended June 30, | | | | | | |
| (Dollars in thousands) | 2024 | | | | | |
| | Before Tax | Tax Effect | Net of Tax | Before Tax | Tax Effect(1) | Net of Tax |
| Securities available for sale: | | | | | | |
| Unrealized gains arising during the period | \$ 1,125 | 301 | 824 | 2,952 | 1 | 2,951 |
| Other comprehensive income | <u>\$ 1,125</u> | <u>301</u> | <u>824</u> | <u>2,952</u> | <u>1</u> | <u>2,951</u> |

(1) The tax effect on gross unrealized gains was impacted by a change in the effective tax rate used in the second quarter of 2023 to allocate the total unrealized gains on securities between the deferred tax asset and other comprehensive income.

(8) Securities Available For Sale

The following table shows the gross unrealized losses and fair values for the securities available for sale portfolio, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2024 and December 31, 2023.

| (Dollars in thousands) | Less Than Twelve Months | | | Twelve Months or More | | | Total | |
|--|-------------------------|------------------|-------------------|-----------------------|-------------------|-------------------|-------------------|-------------------|
| | # of Investments | Fair Value | Unrealized Losses | # of Investments | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| June 30, 2024 | | | | | | | | |
| Mortgage backed securities: | | | | | | | | |
| Federal National Mortgage Association (FNMA) | 0 | \$ 0 | 0 | 34 | \$ 78,291 | (8,882) | \$ 78,291 | (8,882) |
| Federal Home Loan Mortgage Corporation (FHLMC) | 0 | 0 | 0 | 24 | 66,672 | (8,076) | 66,672 | (8,076) |
| Collateralized mortgage obligations: | | | | | | | | |
| FNMA | 0 | 0 | 0 | 1 | 28 | (2) | 28 | (2) |
| Other marketable securities: | | | | | | | | |
| U.S. Government agency obligations | 6 | 29,587 | (82) | 4 | 19,783 | (222) | 49,370 | (304) |
| Total temporarily impaired securities | <u>6</u> | <u>\$ 29,587</u> | <u>(82)</u> | <u>63</u> | <u>\$ 164,774</u> | <u>(17,182)</u> | <u>\$ 194,361</u> | <u>(17,264)</u> |

| (Dollars in thousands) | Less Than Twelve Months | | | Twelve Months or More | | | Total | |
|---------------------------------------|-------------------------|-----------------|-------------------|-----------------------|-------------------|-------------------|-------------------|-------------------|
| | # of Investments | Fair Value | Unrealized Losses | # of Investments | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| December 31, 2023 | | | | | | | | |
| Mortgage backed securities: | | | | | | | | |
| FNMA | 0 | \$ 0 | 0 | 34 | \$ 87,133 | (9,704) | \$ 87,133 | (9,704) |
| FHLMC | 0 | 0 | 0 | 24 | 74,249 | (8,246) | 74,249 | (8,246) |
| Collateralized mortgage obligations: | | | | | | | | |
| FNMA | 0 | 0 | 0 | 1 | 32 | (2) | 32 | (2) |
| Other marketable securities: | | | | | | | | |
| U.S. government agency obligations | 1 | 5,000 | (9) | 7 | 34,456 | (543) | 39,456 | (552) |
| Total temporarily impaired securities | <u>1</u> | <u>\$ 5,000</u> | <u>(9)</u> | <u>66</u> | <u>\$ 195,870</u> | <u>(18,495)</u> | <u>\$ 200,870</u> | <u>(18,504)</u> |

The Company reviews its investment portfolio on a quarterly basis for indications of impairment due to credit-related factors or noncredit-related factors and the Company does not intend to sell the securities and has the intent and ability to hold them for a period of time sufficient for recovery in their amortized cost basis. This review includes analyzing the extent to which the fair value has been lower than the cost, the market liquidity for the investment, the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer, and the Company's intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in fair value.

As of June 30, 2024, the Company did not consider the unrealized losses on its securities available for sale to be attributable to credit-related factors. All of the Company's investments are issued by U.S. government agencies, are implicitly guaranteed by the U.S. government, and have a long history of no credit losses. The unrealized losses on impaired securities are the result of changes in interest rates. As a result, there was no allowance for credit losses required on available for sale debt securities in an unrealized loss position at June 30, 2024. During the three- and six-month periods ended June 30, 2024 and June 30, 2023, there were no sales of securities.

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A summary of securities available for sale at June 30, 2024 and December 31, 2023 is as follows:

| (Dollars in thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|--------------------------------------|--------------------------|------------------------|-------------------------|-----------------------|
| June 30, 2024 | | | | |
| Mortgage-backed securities: | | | | |
| FNMA | \$ 87,173 | 0 | (8,882) | 78,291 |
| FHLMC | 74,748 | 0 | (8,076) | 66,672 |
| Collateralized mortgage obligations: | | | | |
| FNMA | 30 | 0 | (2) | 28 |
| | <u>161,951</u> | <u>0</u> | <u>(16,960)</u> | <u>144,991</u> |
| Other marketable securities: | | | | |
| U.S. Government agency obligations | 54,330 | 5 | (304) | 54,031 |
| | <u>54,330</u> | <u>5</u> | <u>(304)</u> | <u>54,031</u> |
| | <u><u>\$ 216,281</u></u> | <u><u>5</u></u> | <u><u>(17,264)</u></u> | <u><u>199,022</u></u> |
| December 31, 2023 | | | | |
| Mortgage-backed securities: | | | | |
| FNMA | \$ 96,837 | 0 | (9,704) | 87,133 |
| FHLMC | 82,495 | 0 | (8,246) | 74,249 |
| Collateralized mortgage obligations: | | | | |
| FNMA | 34 | 0 | (2) | 32 |
| | <u>179,366</u> | <u>0</u> | <u>(17,952)</u> | <u>161,414</u> |
| Other marketable securities: | | | | |
| U.S. Government agency obligations | 54,112 | 120 | (552) | 53,680 |
| | <u>54,112</u> | <u>120</u> | <u>(552)</u> | <u>53,680</u> |
| | <u><u>\$ 233,478</u></u> | <u><u>120</u></u> | <u><u>(18,504)</u></u> | <u><u>215,094</u></u> |

The following table indicates amortized cost and estimated fair value of securities available for sale at June 30, 2024 based upon contractual maturity adjusted for scheduled repayments of principal and projected prepayments of principal based upon current economic conditions and interest rates.

| (Dollars in thousands) | Amortized Cost | Fair Value |
|--|-------------------|----------------|
| Due less than one year | \$ 58,325 | 54,654 |
| Due after one year through five years | 127,436 | 117,044 |
| Due after five years through fifteen years | 30,518 | 27,322 |
| Due after fifteen years | 2 | 2 |
| Total | \$ 216,281 | 199,022 |

The allocation of mortgage-backed securities in the table above is based upon the anticipated future cash flow of the securities using estimated mortgage prepayment speeds. The allocation of other marketable securities that have call features is based on the anticipated cash flows to the expected call date if it is anticipated that the security will be called, or to the maturity date if it is not anticipated to be called.

The Company made an accounting policy election to exclude accrued interest receivable from the amortized cost basis of securities available for sale. Accrued interest receivable on securities available for sale was reported as a component of accrued interest receivable on the consolidated balance sheet, totaled \$0.7 million at June 30, 2024 and \$0.5 million at December 31, 2023, and was excluded from the estimated credit losses.

The Company had available for sale securities pledged as collateral for customer deposits in excess of the \$250,000 insurance limit of the Federal Deposit Insurance Corporation. The securities pledged had a fair market value of \$39.5 million and \$41.6 million at June 30, 2024 and December 31, 2023, respectively.

(9) Loans Receivable, Net

A summary of loans receivable at June 30, 2024 and December 31, 2023 is as follows:

| (Dollars in thousands) | June 30, 2024 | December 31, 2023 |
|--------------------------------|-------------------|----------------------|
| Single family | \$ 265,077 | 264,303 |
| Commercial real estate: | | |
| Real estate rental and leasing | 279,734 | 271,531 |
| Other | 223,087 | 218,422 |
| | 502,821 | 489,953 |
| Consumer | 41,792 | 42,734 |
| Commercial business | 66,943 | 61,118 |
| Total loans | 876,633 | 858,108 |
| Less: | | |
| Unamortized discounts | 14 | 15 |
| Net deferred loan fees | 629 | 577 |
| Allowance for credit losses | 11,292 | 11,824 |
| Total loans receivable, net | <u>\$ 864,698</u> | <u>845,692</u> |

(10) Allowance for Credit Losses and Credit Quality Information

The allowance for credit losses is summarized as follows:

| (Dollars in thousands) | Single Family | Commercial Real Estate | Consumer | Commercial Business | Total |
|--|-------------------|---------------------------|---------------|------------------------|----------------|
| For the three months ended June 30, 2024: | | | | | |
| Balance, March 31, 2024 | \$ 1,215 | 7,420 | 496 | 2,455 | 11,586 |
| Provision for losses | (83) | (94) | (56) | (74) | (307) |
| Charge-offs | 0 | 0 | (8) | (9) | (17) |
| Recoveries | 30 | 0 | 0 | 0 | 30 |
| Balance, June 30, 2024 | <u>\$ 1,162</u> | <u>7,326</u> | <u>432</u> | <u>2,372</u> | <u>11,292</u> |
| For the six months ended June 30, 2024: | | | | | |
| Balance, December 31, 2023 | \$ 1,426 | 7,514 | 607 | 2,277 | 11,824 |
| Provision for losses | (264) | (188) | (167) | 104 | (515) |
| Charge-offs | (30) | 0 | (8) | (9) | (47) |
| Recoveries | 30 | 0 | 0 | 0 | 30 |
| Balance, June 30, 2024 | <u>\$ 1,162</u> | <u>7,326</u> | <u>432</u> | <u>2,372</u> | <u>11,292</u> |
| Allocated to: | | | | | |
| Individual allowance | \$ 28 | 0 | 103 | 297 | 428 |
| Collective allowance | 1,398 | 7,514 | 504 | 1,980 | 11,396 |
| Balance, December 31, 2023 | <u>\$ 1,426</u> | <u>7,514</u> | <u>607</u> | <u>2,277</u> | <u>11,824</u> |
| Allocated to: | | | | | |
| Individual allowance | \$ 26 | 2 | 88 | 292 | 408 |
| Collective allowance | 1,136 | 7,324 | 344 | 2,080 | 10,884 |
| Balance, June 30, 2024 | <u>\$ 1,162</u> | <u>7,326</u> | <u>432</u> | <u>2,372</u> | <u>11,292</u> |
| Loans receivable at December 31, 2023: | | | | | |
| Individually reviewed for impairment | \$ 979 | 668 | 425 | 2,212 | 4,284 |
| Collectively reviewed for impairment | 263,324 | 489,285 | 42,309 | 58,906 | 853,824 |
| Ending balance | <u>\$ 264,303</u> | <u>489,953</u> | <u>42,734</u> | <u>61,118</u> | <u>858,108</u> |
| Loans receivable at June 30, 2024: | | | | | |
| Individually reviewed for impairment | \$ 806 | 1,199 | 320 | 1,255 | 3,580 |
| Collectively reviewed for impairment | 264,271 | 501,622 | 41,472 | 65,688 | 873,053 |
| Ending balance | <u>\$ 265,077</u> | <u>502,821</u> | <u>41,792</u> | <u>66,943</u> | <u>876,633</u> |

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| <i>(Dollars in thousands)</i> | Single Family | Commercial Real Estate | Consumer | Commercial Business | Total |
|---|-----------------|------------------------|------------|---------------------|---------------|
| For the three months ended June 30, 2023: | | | | | |
| Balance, March 31, 2023 | | | | | |
| \$ 959 | 7,561 | 620 | 2,202 | 11,342 | |
| Provision for losses | 284 | 304 | (12) | (376) | 200 |
| Charge-offs | 0 | 0 | (27) | 0 | (27) |
| Recoveries | 0 | 0 | 1 | 1 | 2 |
| Balance, June 30, 2023 | <u>\$ 1,243</u> | <u>7,865</u> | <u>582</u> | <u>1,827</u> | <u>11,517</u> |
| For the six months ended June 30, 2023: | | | | | |
| Balance, December 31, 2022 | | | | | |
| \$ 1,261 | 7,026 | 1,058 | 932 | 10,277 | |
| January 1, 2023 adoption of ASU 2016-13 | | | | | |
| (259) | 512 | (485) | 1,302 | 1,070 | |
| Provision for losses | 240 | 327 | 35 | (434) | 168 |
| Charge-offs | 0 | 0 | (27) | 0 | (27) |
| Recoveries | 1 | 0 | 1 | 27 | 29 |
| Balance, June 30, 2023 | <u>\$ 1,243</u> | <u>7,865</u> | <u>582</u> | <u>1,827</u> | <u>11,517</u> |

The Company adopted ASU 2016-13, *Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* on January 1, 2023, and uses a standardized process to determine the appropriateness of the allowance for credit losses (ACL) for the commercial real estate, commercial business, single family, and consumer loan portfolios. The determination of the ACL for each of these portfolios is calculated on a pooled basis when similar risk characteristics exist and on an individual basis when loans do not share risk characteristics, such as all non-performing loans. Qualitative reserves are also established and reflect management's overall estimate of the extent to which current expected credit losses on collectively evaluated loans will differ from historical loss experience.

Collateral dependent loans are those for which the borrower is experiencing financial difficulty and repayment is expected to be provided substantially through the operation or sale of the collateral. These loans do not typically share similar risk characteristics with other loans and expected credit losses are evaluated on an individual basis. Loans evaluated individually are not included in the collective evaluation. Estimates of expected credit losses for collateral dependent loans, whether or not foreclosure is probable, are based on the fair value of the collateral, adjusted for selling costs when repayment depends on the sale of the collateral. The estimates are reviewed periodically, and any adjustments are recorded in the provision for credit losses in the periods in which the adjustments become known and loans are charged off to the extent they are deemed to be uncollectible.

The Company made an accounting policy election to exclude accrued interest receivable from the amortized cost basis of loans. Accrued interest receivable on loans is reported as a component of accrued interest receivable on the consolidated balance sheet and totaled \$3.3 million at June 30, 2024 and \$3.0 million at December 31, 2023 and is excluded from the estimated credit losses.

In addition to the ACL on loans, the Company has established an ACL on unfunded commitments that is included in other liabilities on the consolidated balance sheets. This reserve is maintained at a level that management believes is sufficient to absorb losses arising from unfunded loan commitments. This amount is determined quarterly based on an estimate of outstanding commitments that are anticipated to be funded and multiplying those amounts by the loss rate for their loan category. The allowance for unfunded commitments was not material at June 30, 2024 and was \$0.1 million at December 31, 2023.

The provision for credit losses is determined by the Company as the amount to be added to the ACL for various types of financial instruments including loans, investment securities, and off-balance sheet credit exposures after net charge-offs have been deducted to bring the ACL to a level that, in management's judgment, is necessary to absorb expected credit losses over the lives of the respective financial instruments. No provision for credit losses was recorded on available-for-sale investment securities in the three- or six-month periods ended June 30, 2024 and 2023.

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The following table presents the components of the provision for credit losses for the three- and six-month periods ended June 30, 2024 and 2023.

| (Dollars in thousands) | Three months ended June 30, 2024 | Six months ended June 30, 2024 |
|--|-------------------------------------|-----------------------------------|
| Provision for credit losses on: | | |
| Loans | \$ (307) | (515) |
| Unfunded commitments | 1 | 0 |
| Total | \$ (306) | (515) |
| | | |
| (Dollars in thousands) | Three months ended June 30, 2023 | Six month ended June 30, 2023 |
| Provision for credit losses on: | | |
| Loans | \$ 200 | 168 |
| Unfunded commitments | 56 | 80 |
| Total | \$ 256 | 248 |

The following table presents total loans by risk categories and year of origination as of June 30, 2024:

| (Dollars in thousands) | 2024 | 2023 | 2022 | 2021 | 2020 | Prior | Revolving | Total |
|---------------------------------|------------------|----------------|----------------|----------------|----------------|---------------|---------------|----------------|
| Single family | | | | | | | | |
| Unclassified | \$ 16,747 | 79,057 | 55,049 | 59,804 | 29,750 | 23,060 | 0 | 263,467 |
| Special Mention | 0 | 0 | 285 | 0 | 0 | 0 | 0 | 285 |
| Substandard | 0 | 0 | 519 | 0 | 76 | 696 | 0 | 1,291 |
| Doubtful | 0 | 0 | 0 | 0 | 0 | 34 | 0 | 34 |
| Loss | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| | 16,747 | 79,057 | 55,853 | 59,804 | 29,826 | 23,790 | 0 | 265,077 |
| | | | | | | | | |
| Current period gross write offs | 0 | 0 | 0 | 0 | 0 | 30 | 0 | 30 |
| | | | | | | | | |
| Commercial Real Estate | | | | | | | | |
| Unclassified | 31,221 | 66,869 | 178,156 | 98,204 | 62,177 | 21,131 | 0 | 457,758 |
| Special Mention | 691 | 1,930 | 14,871 | 2,162 | 6,934 | 997 | 0 | 27,585 |
| Substandard | 999 | 90 | 214 | 857 | 13,777 | 1,541 | 0 | 17,478 |
| Doubtful | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Loss | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| | 32,911 | 68,889 | 193,241 | 101,223 | 82,888 | 23,669 | 0 | 502,821 |
| | | | | | | | | |
| Consumer | | | | | | | | |
| Unclassified | 6,562 | 6,875 | 6,053 | 1,219 | 1,692 | 5,800 | 13,253 | 41,454 |
| Special Mention | 40 | 0 | 0 | 0 | 0 | 0 | 0 | 40 |
| Substandard | 0 | 7 | 0 | 106 | 0 | 87 | 17 | 217 |
| Doubtful | 0 | 13 | 0 | 0 | 0 | 0 | 19 | 32 |
| Loss | 0 | 3 | 0 | 12 | 0 | 0 | 34 | 49 |
| | 6,602 | 6,898 | 6,053 | 1,337 | 1,692 | 5,887 | 13,323 | 41,792 |
| Current period gross write offs | 0 | 6 | 2 | 0 | 0 | 0 | 0 | 8 |
| | | | | | | | | |
| Commercial Business | | | | | | | | |
| Unclassified | 2,716 | 11,118 | 5,970 | 2,702 | 2,317 | 339 | 35,910 | 61,072 |
| Special Mention | 202 | 876 | 0 | 0 | 393 | 0 | 1,800 | 3,271 |
| Substandard | 1,673 | 113 | 425 | 132 | 4 | 22 | 231 | 2,600 |
| Doubtful | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Loss | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| | 4,591 | 12,107 | 6,395 | 2,834 | 2,714 | 361 | 37,941 | 66,943 |
| Current period gross write offs | 0 | 0 | 0 | 0 | 0 | 9 | 0 | 9 |
| | | | | | | | | |
| Total Loans | \$ 60,851 | 166,951 | 261,542 | 165,198 | 117,120 | 53,707 | 51,264 | 876,633 |

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The following table presents total loans by risk categories and year of origination as of December 31, 2023:

| (Dollars in thousands) | 2023 | 2022 | 2021 | 2020 | 2019 | Prior | Revolving | Total |
|---------------------------------|-------------------|----------------|----------------|----------------|---------------|---------------|---------------|----------------|
| Single family | | | | | | | | |
| Unclassified | \$ 81,070 | 59,474 | 62,690 | 33,637 | 10,915 | 14,635 | 0 | 262,421 |
| Special Mention | 0 | 511 | 0 | 0 | 0 | 0 | 0 | 511 |
| Substandard | 64 | 546 | 0 | 79 | 182 | 462 | 0 | 1,333 |
| Doubtful | 0 | 0 | 0 | 0 | 24 | 14 | 0 | 38 |
| Loss | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| | 81,134 | 60,531 | 62,690 | 33,716 | 11,121 | 15,111 | 0 | 264,303 |
| Commercial Real Estate | | | | | | | | |
| Unclassified | 64,688 | 187,320 | 109,729 | 75,754 | 14,531 | 9,603 | 0 | 461,625 |
| Special Mention | 1,026 | 7,756 | 2,188 | 371 | 0 | 1,016 | 0 | 12,357 |
| Substandard | 2,225 | 388 | 292 | 10,867 | 637 | 1,562 | 0 | 15,971 |
| Doubtful | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Loss | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| | 67,939 | 195,464 | 112,209 | 86,992 | 15,168 | 12,181 | 0 | 489,953 |
| Consumer | | | | | | | | |
| Unclassified | 9,913 | 7,583 | 1,606 | 1,870 | 2,369 | 4,778 | 14,170 | 42,289 |
| Special Mention | 20 | 0 | 0 | 0 | 0 | 0 | 0 | 20 |
| Substandard | 8 | 26 | 52 | 0 | 3 | 113 | 30 | 232 |
| Doubtful | 15 | 0 | 0 | 0 | 0 | 0 | 19 | 34 |
| Loss | 3 | 0 | 116 | 0 | 0 | 0 | 40 | 159 |
| | 9,959 | 7,609 | 1,774 | 1,870 | 2,372 | 4,891 | 14,259 | 42,734 |
| Current period gross write offs | 0 | 1 | 0 | 0 | 0 | 49 | 0 | 50 |
| Commercial Business | | | | | | | | |
| Unclassified | 12,404 | 6,967 | 3,539 | 3,317 | 217 | 288 | 30,160 | 56,892 |
| Special Mention | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Substandard | 1,703 | 483 | 152 | 104 | 11 | 31 | 1,742 | 4,226 |
| Doubtful | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Loss | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| | 14,107 | 7,450 | 3,691 | 3,421 | 228 | 319 | 31,902 | 61,118 |
| Current period gross write offs | 174 | 0 | 0 | 0 | 0 | 0 | 160 | 334 |
| Total Loans | \$ 173,139 | 271,054 | 180,364 | 125,999 | 28,889 | 32,502 | 46,161 | 858,108 |

Credit Quality Indicators

The Company categorized loans into risk categories based on relevant information about the ability of borrowers to service their debt. The information considered includes information, such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company established a risk rating at origination for all commercial real estate and commercial business loans and management monitors the loans on an ongoing basis for any changes in the borrower's ability to service their debt. Management also affirms the risk ratings for these loans on an annual basis.

Classified loans are categorized as special mention, substandard, doubtful, and loss. Loans classified as substandard, doubtful, or loss require the Bank to perform an analysis of the individual loan and charge off any loans, or portion thereof, that are deemed uncollectible. Loans not meeting the criteria to require an individual analysis that are not classified as special mention are considered to be unclassified or pass-rated loans.

The Company uses the following definitions for classifying loans:

Special Mention - Loans classified as special mention are loans that have potential weaknesses that, if left uncorrected, may result in deterioration of the repayment prospects for the asset or in the Bank's credit position at some future date.

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Substandard - Loans classified as substandard are loans that are generally inadequately protected by the current net worth and paying capacity of the obligor, or by the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Substandard loans are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful - Loans classified as doubtful have the weaknesses of those classified as substandard, with additional characteristics that make collection in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss.

Loss - Loans classified as loss are essentially uncollateralized and/or considered uncollectible and of such little value that continuance as an asset on the balance sheet may not be warranted.

The aging of past due loans at June 30, 2024 and December 31, 2023 is summarized as follows:

| (Dollars in thousands) | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or More Past Due | Total Past Due | Current Loans | Total Loans | Loans 90 Days or More Past Due and Still Accruing |
|--------------------------------|---------------------|---------------------|--------------------------|----------------|----------------|----------------|---|
| June 30, 2024 | | | | | | | |
| Single family | \$ 2,689 | 571 | 189 | 3,449 | 261,628 | 265,077 | 0 |
| Commercial real estate: | | | | | | | |
| Real estate rental and leasing | 0 | 0 | 0 | 0 | 279,734 | 279,734 | 0 |
| Other | 0 | 0 | 0 | 0 | 223,087 | 223,087 | 0 |
| Consumer | 131 | 176 | 40 | 347 | 41,445 | 41,792 | 0 |
| Commercial business | 11 | 18 | 0 | 29 | 66,914 | 66,943 | 0 |
| Total | <u>\$ 2,831</u> | <u>765</u> | <u>229</u> | <u>3,825</u> | <u>872,808</u> | <u>876,633</u> | <u>0</u> |
| December 31, 2023 | | | | | | | |
| Single family | \$ 453 | 71 | 363 | 887 | 263,416 | 264,303 | 0 |
| Commercial real estate: | | | | | | | |
| Real estate rental and leasing | 0 | 0 | 0 | 0 | 271,531 | 271,531 | 0 |
| Other | 0 | 0 | 399 | 399 | 218,023 | 218,422 | 0 |
| Consumer | 361 | 92 | 57 | 510 | 42,224 | 42,734 | 0 |
| Commercial business | 0 | 309 | 812 | 1,121 | 59,997 | 61,118 | 0 |
| Total | <u>\$ 814</u> | <u>472</u> | <u>1,631</u> | <u>2,917</u> | <u>855,191</u> | <u>858,108</u> | <u>0</u> |

The Company considers a loan to have defaulted when it becomes 90 or more days past due and the loan is classified as non-accruing. When a loan is classified as non-accruing, any accrued interest on the loan is reversed from interest income and any subsequent interest on the loan is recognized using the cash basis method of income recognition. A non-accruing loan may be reclassified as an accruing loan after the loan becomes current.

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The following table presents the carrying value of and related allowances for collateral dependent individually analyzed loans as of June 30, 2024 and December 31, 2023:

| (Dollars in thousands) | June 30, 2024 | | | December 31, 2023 | | |
|--|------------------------|--------------------------|-------------------|---------------------|--------------------------|-------------------|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| Loans with no related allowance recorded: | | | | | | |
| Single family | \$ 623 | 623 | 0 | 758 | 758 | 0 |
| Commercial real estate: | | | | | | |
| Other | 634 | 634 | 0 | 668 | 668 | 0 |
| Consumer | 216 | 216 | 0 | 306 | 306 | 0 |
| Loans with an allowance recorded: | | | | | | |
| Single family | 183 | 183 | 26 | 221 | 221 | 28 |
| Commercial real estate: | | | | | | |
| Other | 565 | 565 | 2 | 0 | 0 | 0 |
| Consumer | 104 | 104 | 88 | 119 | 119 | 103 |
| Commercial business | 1,255 | 1,589 | 292 | 2,212 | 2,546 | 297 |
| Total: | | | | | | |
| Single family | 806 | 806 | 26 | 979 | 979 | 28 |
| Commercial real estate: | | | | | | |
| Other ⁽¹⁾ | 1,199 | 1,199 | 2 | 668 | 668 | 0 |
| Consumer ⁽²⁾ | 320 | 320 | 88 | 425 | 425 | 103 |
| Commercial business ⁽³⁾ | 1,255 | 1,589 | 292 | 2,212 | 2,546 | 297 |
| | <u>\$ 3,580</u> | <u>3,914</u> | <u>408</u> | <u>4,284</u> | <u>4,618</u> | <u>428</u> |

(1) Secured by commercial land.

(2) Secured by second mortgages on single family housing and autos.

(3) Secured by business equipment.

At June 30, 2024 and December 31, 2023, non-accruing loans totaled \$3.2 million and \$3.8 million, respectively, for which the related allowance for credit losses was \$0.4 million for both periods. All of the interest income recognized for non-accruing loans was recognized using the cash basis method of income recognition. Non-accruing loans for which no specific allowance has been recorded because management determined that the value of the collateral was sufficient to repay the loan totaled \$1.1 million and \$1.3 million at June 30, 2024 and December 31, 2023, respectively.

The non-accrual loans at June 30, 2024 and December 31, 2023 are summarized as follows:

| (Dollars in thousands) | June 30, 2024 | December 31, 2023 |
|--------------------------------|------------------------|------------------------|
| | \$ 590 | \$ 762 |
| Single family | \$ 590 | \$ 762 |
| Commercial real estate: | | |
| Other | 1,025 | 493 |
| Consumer | 320 | 376 |
| Commercial business | 1,255 | 2,187 |
| | <u>\$ 3,190</u> | <u>\$ 3,818</u> |

There were two loans totaling less than \$0.1 million in the process of foreclosure at June 30, 2024. There were no loans in the process of foreclosure at December 31, 2023.

The Company accounts for loan modifications in accordance with the guidance in *Accounting Standards Codification (ASC) Topic 326*. Based on the guidance, a loan modification or refinancing results in a new loan if the terms of the new loan are at least as favorable to the lender as the terms with customers with similar collection risks that are not refinancing or restructuring their loans and the modification to the terms of the loan are more than minor. If a loan modification or refinancing does not result in a new loan, it is classified as a loan modification.

The Company had no loan modifications to borrowers experiencing financial difficulties in the second quarter 2024 or 2023. At June 30, 2024, there were no commitments to lend additional funds to borrowers experiencing financial difficulty whose loan terms have been previously restructured. During the quarter ended June 30, 2024, there were no defaults on loans that had been modified during the 12 months ended June 30, 2024 for borrowers experiencing financial difficulty.

(11) Intangible Assets

The Company's intangible assets consist of goodwill and mortgage servicing rights. A summary of mortgage servicing rights activity is as follows:

| <i>(Dollars in thousands)</i> | Six Months Ended June 30, 2024 | Twelve Months Ended December 31, 2023 | Six Months Ended June 30, 2023 |
|---|-----------------------------------|--|-----------------------------------|
| Balance, beginning of period | \$ 2,709 | 2,986 | 2,986 |
| Originations | 356 | 555 | 215 |
| Amortization | (422) | (832) | (412) |
| Balance, end of period | \$ 2,643 | 2,709 | 2,789 |
| Fair value of mortgage servicing rights | \$ 6,692 | 6,539 | 6,388 |

All of the loans sold where the Company continues to service the loans are serviced for FNMA under the individual loan sale program. The following is a summary of the risk characteristics of the loans being serviced for FNMA at June 30, 2024:

| <i>(Dollars in thousands)</i> | Loan Principal Balance | Weighted Average Interest Rate | Weighted Average Remaining Term (months) | Number of Loans |
|----------------------------------|------------------------------|---|---|--------------------|
| Original term 15 year fixed rate | \$ 85,533 | 2.97% | 123 | 906 |
| Original term 30 year fixed rate | 455,200 | 4.05 | 301 | 2,700 |

Amortization expense for intangible assets was \$0.4 million for both the six-month periods ended June 30, 2024 and 2023. The gross carrying amount of intangible assets and the associated accumulated amortization at June 30, 2024 and December 31, 2023 is presented in the following table.

| <i>(Dollars in thousands)</i> | Gross Carrying Amount | Accumulated Amortization | Impairment Charge | Unamortized Intangible Assets |
|-------------------------------|-----------------------------|-----------------------------|----------------------|-------------------------------------|
| <u>June 30, 2024</u> | | | | |
| Mortgage servicing rights | \$ 6,445 | (3,802) | 0 | 2,643 |
| Goodwill | 802 | 0 | (802) | 0 |
| Total | \$ 7,247 | (3,802) | (802) | 2,643 |
| <u>December 31, 2023</u> | | | | |
| Mortgage servicing rights | \$ 6,226 | (3,517) | 0 | 2,709 |
| Goodwill | 802 | 0 | 0 | 802 |
| Total | \$ 7,028 | (3,517) | 0 | 3,511 |

The following table indicates the estimated future amortization expense for mortgage servicing rights:

| <i>(Dollars in thousands)</i> | Mortgage Servicing Rights |
|-------------------------------|---------------------------------|
| Year ending December 31, | |
| 2024 | \$ 378 |
| 2025 | 698 |
| 2026 | 608 |
| 2027 | 441 |
| 2028 | 265 |
| Thereafter | 253 |
| Total | \$ 2,643 |

The projection of amortization is based on existing asset balances and the existing interest rate environment as of June 30, 2024. The Company's actual experience may be significantly different depending upon changes in mortgage interest rates and other market conditions.

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No amortization expense relating to goodwill is recorded as GAAP does not allow goodwill to be amortized but requires that it be tested for impairment at least annually, or sooner, if there are indications that impairment may exist. Goodwill was evaluated for impairment at December 31, 2023, and it was determined that goodwill was not impaired. Due primarily to the exchange ratio in the merger agreement as well as our stock price being below book value during the second quarter of 2024 a triggering event was identified by management which required an interim goodwill impairment analysis. The Company assessed its goodwill utilizing a quantitative impairment test and determined it was more likely than not the fair value of the Company was less than the carrying amount as of June 30, 2024. Based on the results of the impairment test, the Company recorded a goodwill impairment charge of \$ 0.8 million effective June 30, 2024.

(12) Leases

The Company accounts for its leases in accordance with *ASC Topic 842*. Operating lease right-of-use assets represent the Company's right to use an underlying asset during the lease term and operating lease liabilities represent its obligation to make lease payments arising from the lease. Right-of-use assets and operating lease liabilities are recognized at lease commencement based on the present value of the remaining lease payments using a discount rate that represents the Company's incremental borrowing rate at the lease commencement date. Because the Company only has operating leases and the right-of-use asset is offset by a lease payment obligation liability, the straight line expense of lease payments over the terms of the leases are the only amounts that are recorded in occupancy expense in the consolidated statements of comprehensive income.

The Company's leases relate to office space and bank branches with remaining lease terms between two and forty-one months. Certain leases contain extension options which typically range from three to ten years. Because these extension options are not considered reasonably certain of exercise, they are not included in the lease term. As of June 30, 2024 a \$0.2 million right-of-use asset and an offsetting lease payment obligation liability were recorded on the consolidated balance sheet in other assets and other liabilities, respectively. Operating lease costs were \$0.1 million for the three- and six-month periods ended June 30, 2024 and 2023.

The table below summarizes other information related to the Company's operating leases:

| <i>(Dollars in thousands)</i> | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------|-------|---------------------------|-------|
| | 2024 | 2023 | 2024 | 2023 |
| Cash paid for amounts included in the measurement of lease liabilities: | | | | |
| Operating cash flows from operating leases | \$ 60 | 55 | 118 | 110 |
| Weighted-average remaining lease term – operating leases, in years | 1.9 | 2.4 | 1.9 | 2.4 |
| Weighted-average discount rate – operating leases | 2.80% | 2.67% | 2.80% | 2.67% |

The table below summarizes the maturity of remaining lease liabilities at June 30, 2024:

| <i>(Dollars in thousands)</i> | June 30, 2024 |
|---|---------------|
| 2024 | \$ 96 |
| 2025 | 58 |
| 2026 | 27 |
| 2027 | 25 |
| 2028 | 0 |
| Total lease payments | 206 |
| Less: Interest | \$ (6) |
| Present value of lease liabilities | 200 |

(13) Earnings per Common Share

The following table reconciles the weighted average shares outstanding and the earnings available to common stockholders used for basic and diluted earnings per common share:

| (Dollars in thousands, except per share data) | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------|-----------|---------------------------|-----------|
| | 2024 | 2023 | 2024 | 2023 |
| Weighted average number of common shares outstanding used in basic earnings per common share calculation | 4,352,016 | 4,346,778 | 4,347,868 | 4,342,872 |
| Net dilutive effect of: | | | | |
| Restricted stock awards and options | 26,800 | 27,650 | 26,562 | 28,385 |
| Weighted average number of shares outstanding adjusted for effect of dilutive securities | 4,378,816 | 4,374,428 | 4,374,430 | 4,371,257 |
| Income available to common stockholders | \$ 970 | 1,421 | 2,288 | 3,055 |
| Basic earnings per common share | \$ 0.22 | 0.33 | 0.53 | 0.70 |
| Diluted earnings per common share | \$ 0.22 | 0.32 | 0.52 | 0.70 |

(14) Regulatory Capital and Oversight

The Bank is subject to the Basel III regulatory capital requirements. The Basel III requirements, among other things, (i) apply a set of capital requirements to the Bank, including requirements relating to common equity as a component of core capital, (ii) implement a "capital conservation buffer" against risk and a higher minimum Tier 1 capital requirement, and (iii) set forth rules for calculating risk-weighted assets for purposes of such requirements. The rules also made corresponding revisions to the prompt corrective action framework and include capital ratios and buffer requirements. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of its assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

The Board of Governors of the Federal Reserve Bank in its Small Bank Holding Company Policy Statement (Policy Statement) has exempted small bank holding companies with assets less than \$3 billion from the above capital requirements. The Policy Statement also includes savings and loan holding companies that meet the Policy Statement's qualitative requirements for exemption. The Company currently meets the qualitative exemption requirements, and therefore, is exempt from the above capital requirements.

Quantitative measures established by regulations to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table and defined in the regulation) of common equity Tier 1 capital to risk-weighted assets, Tier 1 capital to adjusted total assets, Tier 1 capital to risk-weighted assets and total capital to risk-weighted assets.

The Bank's average total assets and adjusted total assets for the second quarter of 2024 were both \$1.2 billion and its risk-weighted assets were \$ 899.1 million. The following table presents the Bank's capital amounts and ratios at June 30, 2024 for actual capital, required capital and excess capital, including ratios in order to qualify as being well capitalized under the prompt corrective actions regulations.

| (Dollars in thousands) | Actual | | | | Required to be Adequately Capitalized | | | | Excess Capital | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|------------------------------|------------|----------------------|---------------------------------------|----------------------|---------------------------------------|----------------------|-----------|----------------------|----------------|----------------------|--|----------------------|
| | Amount | Percent of Assets(1) | Required to be Adequately Capitalized | | Amount | Percent of Assets(1) | Amount | Percent of Assets(1) | Amount | Percent of Assets(1) | Amount | Percent of Assets(1) |
| | | | Amount | Percent of Assets(1) | | | | | | | | |
| June 30, 2024 | | | | | | | | | | | | |
| Common equity Tier 1 capital | \$ 107,335 | 11.94% | \$ 40,460 | 4.50% | \$ 66,875 | 7.44% | \$ 58,442 | 6.50% | | | | |
| Tier 1 leverage | 107,335 | 9.28 | 46,276 | 4.00 | 61,059 | 5.28 | 57,844 | 5.00 | | | | |
| Tier 1 risk-based capital | 107,335 | 11.94 | 53,947 | 6.00 | 53,388 | 5.94 | 71,929 | 8.00 | | | | |
| Total risk-based capital | 118,575 | 13.19 | 71,929 | 8.00 | 46,646 | 5.19 | 89,911 | 10.00 | | | | |

(1) Based upon the Bank's adjusted total assets for the purpose of the Tier 1 leverage capital ratio and risk-weighted assets for the purpose of the risk-based capital ratios.

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The Bank must maintain a capital conservation buffer of 2.50% composed of common equity Tier 1 capital above its minimum risk-based capital requirements in order to avoid limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers. Management believes that, as of June 30, 2024, the Bank's capital ratios were in excess of those quantitative capital ratio standards set forth under the current prompt corrective action regulations, including the capital conservation buffer described above. However, there can be no assurance that the Bank will continue to maintain such status in the future. The Office of the Comptroller of the Currency has extensive discretion in its supervisory and enforcement activities and can adjust the requirement to be well-capitalized in the future.

(15) Stockholders' Equity

The Company did not repurchase any shares of its common stock in the open market during the first six-months of 2024. At June 30, 2024, the Company was authorized to repurchase \$5.4 million of its common stock under the existing share repurchase program. The merger agreement restricts the Company from purchasing any additional shares of common stock through the merger date. The Company declared a quarterly cash dividend of 10 cents per share of common stock outstanding that was paid to stockholders on June 7, 2024. The merger agreement allows for quarterly dividends to be paid to stockholders in the ordinary course of business, however, during the quarter in which the closing date occurs, the Company quarterly dividend can't be paid if the payment would result in the stockholders of the Company receiving more than one quarter dividend from the Company and the Acquiror during that fiscal quarter.

(16) Commitments and Contingencies

The Bank issues standby letters of credit which guarantee the performance of customers to third parties. The standby letters of credit issued and available at June 30, 2024 were approximately \$8.9 million, expire over the next nineteen months, and are collateralized primarily with commercial real estate mortgages. Since the conditions under which the Bank is required to fund the standby letters of credit may not materialize, the cash requirements are expected to be less than the total outstanding commitments.

From time to time, the Company is party to legal proceedings arising out of its lending and deposit operations. The Company is, and expects to become, engaged in foreclosure proceedings, collection actions, and other litigation as part of its normal banking activities. The Company examines each legal matter, and, in those situations where it determines that a particular legal matter presents loss contingencies that are both probable and reasonably estimable, establishes an appropriate accrual. In many situations, the Company is not able to estimate reasonably possible losses due to the preliminary nature of the legal matter, as well as a variety of other factors and uncertainties. Based on the Company's current understanding of all of the outstanding legal matters, management does not believe that judgments or settlements arising from any pending or threatened litigation, individually or in the aggregate, would have a material adverse effect on the consolidated financial condition or results of operations.

(17) Business Segments

The Bank has been identified as a reportable operating segment in accordance with the provisions of ASC 280. HMN, the holding company, did not meet the quantitative thresholds for a reportable segment and therefore is included in the "Other" category.

The Company evaluates performance and allocates resources based on the segment's net income, return on average assets and return on average equity. Each corporation is managed separately with its own officers and board of directors. The following table sets forth certain information about the reconciliations of reported profit and assets for each of the Company's reportable segments.

| (Dollars in thousands) | Home Federal Savings Bank | Other | Eliminations | Consolidated Total |
|--|------------------------------|---------|--------------|-----------------------|
| At or for the six months ended June 30, 2024: | | | | |
| Interest income – external customers | \$ 24,579 | 0 | 0 | 24,579 |
| Non-interest income – external customers | 4,117 | 0 | 0 | 4,117 |
| Intersegment interest income | 0 | 175 | (175) | 0 |
| Intersegment non-interest income | 143 | 2,645 | (2,788) | 0 |
| Interest expense | 10,006 | 0 | (175) | 9,831 |
| Provision for credit losses | (515) | 0 | 0 | (515) |
| Non-interest expense | 15,712 | 647 | (143) | 16,216 |
| Income tax expense (benefit) | 991 | (115) | 0 | 876 |
| Net income | 2,645 | 2,288 | (2,645) | 2,288 |
| Total assets | 1,113,440 | 110,610 | (110,503) | 1,113,547 |
| At or for the six months ended June 30, 2023: | | | | |
| Interest income – external customers | \$ 20,410 | 0 | 0 | 20,410 |
| Non-interest income – external customers | 3,902 | 0 | 0 | 3,902 |
| Intersegment interest income | 0 | 140 | (140) | 0 |
| Intersegment non-interest income | 130 | 3,287 | (3,417) | 0 |
| Interest expense | 4,759 | 0 | (140) | 4,619 |
| Provision for credit losses | 248 | 0 | 0 | 248 |
| Non-interest expense | 14,847 | 433 | (130) | 15,150 |
| Income tax expense (benefit) | 1,301 | (61) | 0 | 1,240 |
| Net income | 3,287 | 3,055 | (3,287) | 3,055 |
| Total assets | 1,109,224 | 102,234 | (102,091) | 1,109,367 |
| At or for the quarter ended June 30, 2024: | | | | |
| Interest income – external customers | \$ 12,580 | 0 | 0 | 12,580 |
| Non-interest income – external customers | 2,210 | 0 | 0 | 2,210 |
| Intersegment interest income | 0 | 87 | (87) | 0 |
| Intersegment non-interest income | 72 | 1,213 | (1,285) | 0 |
| Interest expense | 5,175 | 0 | (87) | 5,088 |
| Provision for credit losses | (306) | 0 | 0 | (306) |
| Non-interest expense | 8,323 | 414 | (72) | 8,665 |
| Income tax expense (benefit) | 457 | (84) | 0 | 373 |
| Net income | 1,213 | 970 | (1,213) | 970 |
| Total assets | 1,113,440 | 110,610 | (110,503) | 1,113,547 |
| At or for the quarter ended June 30, 2023: | | | | |
| Interest income – external customers | \$ 10,497 | 0 | 0 | 10,497 |
| Non-interest income – external customers | 1,974 | 0 | 0 | 1,974 |
| Intersegment interest income | 0 | 76 | (76) | 0 |
| Intersegment non-interest income | 72 | 1,539 | (1,611) | 0 |
| Interest expense | 2,845 | 0 | (76) | 2,769 |
| Provision for credit losses | 256 | 0 | 0 | 256 |
| Non-interest expense | 7,305 | 224 | (72) | 7,457 |
| Income tax expense (benefit) | 598 | (30) | 0 | 568 |
| Net income | 1,539 | 1,421 | (1,539) | 1,421 |
| Total assets | 1,109,224 | 102,234 | (102,091) | 1,109,367 |

(18) Subsequent Event

On July 23, 2024 the Company's Board of Directors approved a resolution to withdraw from the Pentegra Defined Benefit Plan for Financial Institutions (Pentegra DB Plan) effective September 30, 2024. The resolution also indicates that as of the effective date, the Company will no longer participate in the Pentegra DB Plan and will be required, among other things, to purchase single premium insured annuities from one or more qualified insurance companies under which the Company's liabilities with respect to the plan participants are satisfied as of the plan withdrawal date. The estimate of the liability to purchase the annuities for the plan participants is \$0.9 million. This estimated liability amount was accrued upon the board's approval of the withdrawal resolution and may be adjusted in the future to appropriately reflect any changes in the estimated cost of purchasing the participant annuities.

Item 2:

**HMN FINANCIAL, INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Forward-looking Information

Safe Harbor Statement

This quarterly report on Form 10-Q and other reports filed by HMN Financial, Inc (HMN or the Company) with the Securities and Exchange Commission (SEC), may contain forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements are often identified by such forward-looking terminology as "anticipate," "continue," "could," "expect," "future," "may," "optimistic," "project" and "will," or similar statements or variations of such terms and include, but are not limited to, those relating to: the possibility that any of the anticipated benefits of the proposed merger will not be realized or will not be realized within the expected time period; the risk that integration of HMN's operations with those of Alerus will be materially delayed or will be more costly or difficult than expected; the parties' inability to meet expectations regarding the timing of the proposed merger; changes to tax legislation and their potential effects on the accounting for the proposed merger; the inability to complete the proposed merger due to the failure of HMN's or Alerus' stockholders to adopt the merger agreement, or the failure of Alerus' stockholders to approve the issuance of Alerus common stock in connection with the merger; the failure to satisfy other conditions to completion of the proposed merger, including receipt of required regulatory and other approvals; the failure of the proposed merger to close for any other reason; diversion of management's attention from ongoing business operations and opportunities due to the proposed merger; the challenges of integrating and retaining key employees; the effect of the announcement of the proposed merger on HMN's, Alerus' or the combined company's respective customer and employee relationships and operating results; the possibility that the proposed merger may be more expensive to complete than anticipated, including as a result of unexpected factors or events; the amount HMN's stockholders' equity as of the closing date of the proposed merger and any potential downward adjustment in the exchange ratio; the dilution caused by Alerus' issuance of additional shares of Alerus common stock in connection with the proposed merger; enacted and expected changes to the federal funds rate and the resulting impacts on consumer deposits, loan originations, net interest margin, net interest income and related aspects of the Home Federal Savings Bank's (the Bank) business; the anticipated impacts of inflation and rising interest rates on the general economy, the Bank's clients, and the allowance for credit losses; anticipated future levels of the provision for credit losses; anticipated level of future asset growth; anticipated ability to maintain and grow core deposit relationships; anticipated call dates of callable investments owned; anticipated impact of tax law changes on future taxable state income; anticipated level of future core deposit growth; and the payment of dividends by HMN.

A number of factors, many of which may be amplified by deterioration in economic conditions, could cause actual results to differ materially from the Company's assumptions and expectations. These include but are not limited to the adequacy and marketability of real estate and other collateral securing loans to borrowers; federal and state regulation and enforcement; possible legislative and regulatory changes, including changes to regulatory capital rules; the ability of the Bank to comply with other applicable regulatory capital requirements; enforcement activity of the Office of the Comptroller of the Currency (OCC) and the Federal Reserve Bank of Minneapolis in the event of non-compliance with any applicable regulatory standard or requirement; adverse economic, business and competitive developments such as shrinking interest margins, reduced collateral values, deposit outflows, changes in credit or other risks posed by the Company's loan and investment portfolios; changes in costs associated with traditional and alternate funding sources, including changes in collateral advance rates and policies of the Federal Home Loan Bank (FHLB) and the Federal Reserve Bank; technological, computer-related or operational difficulties including those from any third party cyberattack; reduced demand for financial services and loan products; adverse developments affecting the financial services industry, such as recent bank failures or concerns involving liquidity; changes in accounting policies and guidelines, or monetary and fiscal policies of the federal government or tax laws; domestic and international economic developments; the Company's access to and adverse changes in securities markets; the market for credit related assets; the future operating results, financial condition, cash flow requirements and capital spending priorities of the Company and the Bank; the availability of internal and, as required, external sources of funding; the Company's ability to attract and retain employees; or other significant uncertainties. Additional factors that may cause actual results to differ from the Company's assumptions and expectations include those set forth in the "Risk Factors" section of the Company's Annual Report on Form 10-K/A for the year ended December 31, 2023, filed with the SEC, under "Part I, Item 1A and Part II, Item 1A of this quarterly report on Form 10-Q. All forward-looking statements are qualified by, and should be considered in conjunction with, such cautionary statements. All statements in this quarterly report on Form 10-Q, including forward-looking statements, speak only as of the date they are made, and the Company undertakes no duty to update any of the forward-looking statements after the date of this quarterly report on Form 10-Q.

Additional Information and Where to Find It

Alerus filed a registration statement on Form S-4 with the SEC on July 15, 2024 in connection with the proposed transaction. The registration statement includes a joint proxy statement of Alerus and HMN that also constitutes a prospectus of Alerus, which will be sent to the stockholders of Alerus and HMN after the SEC declares the registration statement effective. Before making any voting decision, the stockholders of Alerus and HMN are advised to read the joint proxy statement/prospectus when it becomes available because it will contain important information about Alerus, HMN and the proposed transaction. When filed, this document and other documents relating to the Merger filed by Alerus or HMN can be obtained free of charge from the SEC's website at www.sec.gov. These documents also can be obtained free of charge by accessing Alerus' website at www.alerus.com under the link "Investors Relations" and then under "SEC Filings" and HMN's website at www.justcallhome.com/HMNFinancial under "SEC Filings." Alternatively, these documents can be obtained free of charge from Alerus upon written request to Alerus Financial Corporation, Corporate Secretary, 401 Demers Avenue, Grand Forks, North Dakota 58201 or by calling (701) 795-3200, or from HMN upon written request to HMN Financial, Inc., Corporate Secretary, 1016 Civic Center Drive NW, Rochester, Minnesota 55901 or by calling (507) 535-1200. The contents of the websites referenced above are not deemed to be incorporated by reference into this quarterly report on Form 10-Q, the registration statement or the joint proxy statement/prospectus.

Participants in the Solicitation

This quarterly report on Form 10-Q does not constitute a solicitation of proxy, an offer to purchase or a solicitation of an offer to sell any securities. Alerus, HMN, and certain of their directors, executive officers and other members of management and employees may be deemed to be participants in the solicitation of proxies from the stockholders of Alerus and HMN in connection with the proposed merger under SEC rules. Information about the directors and executive officers of Alerus and HMN will be included in the joint proxy statement/prospectus for the proposed transaction filed with the SEC. These documents (when available) may be obtained free of charge in the manner described above under "Additional Information and Where to Find It."

Security holders may obtain information regarding the names, affiliations and interests of Alerus' directors and executive officers in the definitive proxy statement of Alerus relating to its 2024 Annual Meeting of Stockholders filed with the SEC on March 25, 2024 and on Alerus' Annual Report on Form 10-K for the year ended December 31, 2023 filed with the SEC on March 8, 2024. Security holders may also obtain information regarding the names, affiliations and interests of HMN's directors and executive officers in the definitive proxy statement of HMN relating to its 2024 Annual Meeting of Stockholders filed with the SEC on March 21, 2024 and HMN's Annual Report on Form 10-K/A for the year ended December 31, 2023 filed with the SEC on March 19, 2024. To the extent the holdings of Alerus' securities by Alerus' directors and executive officers or the holdings of HMN securities by HMN's directors and executive officers have changed since the amounts set forth in Alerus' or HMN's respective proxy statement for its 2024 Annual Meeting of Stockholders, such changes have been or will be reflected on Statements of Change in Ownership on Form 4 filed with the SEC. These documents can be obtained free of charge in the manner described above under "Additional Information and Where to Find It."

General

HMN is the stock savings bank holding company for the Bank, which operates community banking and loan production offices in Minnesota, Iowa and Wisconsin. The earnings of the Company are primarily dependent on the Bank's net interest income, which is the difference between interest earned on loans and investments, and the interest paid on interest-bearing liabilities such as deposits and other borrowings. The difference between the average rate of interest earned on assets and the average rate paid on liabilities is the interest rate spread. Net interest income is produced when interest-earning assets equal or exceed interest-bearing liabilities and there is a positive interest rate spread. Net interest income and net interest rate spread are affected by changes in interest rates, the volume and composition of interest-earning assets and interest-bearing liabilities, and the level of non-performing assets. The Company's net earnings are also affected by the generation of non-interest income, which consists primarily of gains from the sale of loans, fees for servicing loans, commissions on the sale of uninsured investment products, and service charges on deposit accounts. The Bank incurs expenses in addition to interest expense in the form of compensation and benefits, occupancy and equipment expenses, provisions for credit losses, data processing costs, professional services, deposit insurance, amortization expense on mortgage servicing assets, advertising expenses, and income taxes. The earnings of financial institutions, such as the Bank, are also significantly affected by prevailing economic and competitive conditions, particularly changes in interest rates, government monetary and fiscal policies, and regulations of various regulatory authorities. Lending activities are influenced by the demand for and supply of business credit, single family and commercial properties, competition among lenders, the level of interest rates and the availability of funds. Deposit flows and costs of deposits are influenced by prevailing market rates of interest on competing investments, account maturities and the levels of personal income and savings.

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Proposed Merger with Alerus Financial Corporation (Alerus) (Nasdaq: ALRS)

On May 14, 2024, HMN entered into an Agreement and Plan of Merger (the merger agreement) with Alerus Financial Corporation, a Delaware corporation (Alerus), pursuant to which HMN will merge into Alerus, with Alerus as the surviving corporation (the merger). Subject to the terms and conditions of the merger agreement, at the effective time of the merger, HMN stockholders will have the right to receive 1.25 (the exchange ratio) shares of common stock of Alerus for each share of common stock of HMN. The exchange ratio is subject to potential downward adjustment if HMN's stockholders' equity as of the closing date of the merger is less than a specified stockholders' equity threshold, as described in the merger agreement. Holders of options to purchase shares of HMN common stock and holders of restricted HMN common stock will have such options or restricted stock vest immediately prior to the merger. The shares of HMN common stock issued upon exercise of such stock options and the shares of HMN common stock that are vested will receive the same exchange ratio consideration as the HMN stockholders, as described in the merger agreement. It is anticipated that Home Federal Savings Bank will be merged with and into Alerus' banking subsidiary, Alerus Financial, National Association, immediately following the completion of the merger. The merger agreement was unanimously approved by the Board of Directors of each of HMN and Alerus.

The merger agreement contains customary representations and warranties of both parties and customary conditions to the parties' obligations to close the transaction, as well as agreements to cooperate in the process of consummating the transaction. The parties expect the Merger to be completed in the fourth quarter of 2024, subject to the satisfaction of customary closing conditions in the merger agreement and the approval of the appropriate regulatory authorities and of the stockholders of each of HMN and Alerus.

The Company has incurred \$0.5 million of merger related expenses for the three months ended June 30, 2024, primarily related to legal, accounting, and other professional service costs, which are included in the Consolidated Statements of Comprehensive Income. The Company expects to incur additional merger related costs through the closing of the merger.

Subsequent Event

On July 23, 2024, the Company's Board of Directors approved a resolution to withdraw from the Pentegra Defined Benefit Plan for Financial Institutions (Pentegra DB Plan) effective September 30, 2024. The resolution also indicates that as of the effective date, the Company shall no longer participate in the Pentegra DB Plan and will be required, among other things, to purchase single premium insured annuities from one or more qualified insurance companies under which the Company's liabilities with respect to the plan participants are satisfied as of the plan withdrawal date. The estimate of the liability to purchase the annuities for the plan participants is \$0.9 million. This estimated liability amount was accrued upon the board's approval of the withdrawal resolution and may be adjusted in the future to appropriately reflect any changes in the estimated cost of purchasing the participant annuities.

Critical Accounting Estimates

While our significant accounting policies are described in the notes to our consolidated financial statements, we believe the following discussion addresses our most critical accounting estimates, which are those estimates made in accordance with U.S. generally accepted accounting principles (GAAP) that involve a significant level of estimation uncertainty and have had or are reasonably likely to have a material impact on our financial condition or results of operations. The Company has identified the following critical accounting estimates that management believes involve the most difficult, subjective, and/or complex judgments that are inherently uncertain. Therefore, actual financial results could differ significantly depending upon the estimates, assumptions and other factors used.

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Allowance for Credit Losses and Related Provision

The Company accounts for its allowance for credit losses and the related provision in accordance with ASC 326 and the allowance for credit losses is measured on a collective (pool) basis when similar risk characteristics exist. Loans that do not share risk characteristics are evaluated on an individual basis. Loans evaluated individually are also not included in the collective evaluations. The collective reserve amount is assessed based on size and risk characteristics of the various portfolio segments, past loss history and other adjustments determined to have a potential impact on future credit losses.

The Company has a standardized process to determine the appropriateness of the credit loss allowance for the commercial real estate, commercial business, single family, and consumer loan portfolios. The determination of the allowance for each of these portfolios is calculated on a pooled basis with individual determination of the allowance for all non-performing loans. The determination of the quantitative pooled loan reserves for the commercial real estate and commercial business loan portfolios involves analyzing prior year losses by their assigned standardized risk ratings and applying these historic loss factors to the loans in the current portfolio with similar risk rating. This process is referred to as a Vintage Loss Analysis. The determination of the quantitative pooled loan reserves for the single family and consumer loan portfolios involves analyzing prior year losses based on certain loan and borrower risk characteristics when the loans were originated and applying these historic loss factors to the loans in the current portfolio with similar risk characteristics. Qualitative reserves are also established and reflect management's overall estimate of the extent to which current expected credit losses on collectively evaluated loans will differ from historical loss experience. The determination of the qualitative reserves for all of the loan categories involves an analysis and consideration of certain factors that are anticipated to have an impact on future credit losses including, but not limited to: actual and anticipated changes in the size, composition, and concentrations of the loan portfolios; national, regional, and local economic conditions including inflation and unemployment data; loan delinquencies; the scope and results of loan quality reviews; level of non-accrual loans, and risk rating trends; lending policies, procedures, and staffing; and the demand for single family homes, commercial real estate, and building lots.

The appropriateness of the allowance for credit losses on individually reviewed collateral dependent loans is dependent upon management's estimates of variables affecting valuation, appraisals of collateral, evaluations of performance and status and the amounts and timing of future cash flows expected to be received on collateral dependent loans. Such estimates, appraisals, evaluations, and cash flows may be subject to adjustments due to changing economic prospects of borrowers or properties. The fair market value of collateral dependent loans is typically based on the appraised value of the property less estimated selling costs. The estimates are reviewed periodically, and any adjustments are recorded in the provision for credit losses in the periods in which the adjustments become known and loans are charged off to the extent they are deemed to be uncollectible. Because of the size of some loans, changes in estimates can have a significant impact on the provision for credit losses. The Company increases its allowance for credit losses by charging the provision for credit losses against income and by receiving recoveries of previously charged off loans. The Company decreases its allowance by crediting the provision for credit losses and recording loan charge-offs. The methodology for establishing the allowance for credit losses takes into consideration probable losses that have been identified in connection with the loans individually reviewed as well as the expected losses in each identified pool of loans that have not been individually reviewed. Although management believes that based on current conditions the allowance for credit losses is maintained at an appropriate amount to provide for the expected loan losses in the portfolio as of the balance sheet dates, future conditions may differ substantially from those anticipated in determining the allowance for credit losses and adjustments may be required in the future.

Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. These calculations are based on many complex factors including estimates of the timing of reversals of temporary differences, the interpretation of federal and state income tax laws, and a determination of the differences between the tax and the financial reporting basis of assets and liabilities. Actual results could differ significantly from the estimates and interpretations used in determining the current and deferred income tax assets and liabilities.

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The Company maintains significant net deferred tax assets for deductible temporary differences, the two largest relating to the net unrealized loss on securities available for sale and the allowance for credit losses. For tax purposes, the net unrealized losses on securities available for sale are not recognized unless the securities are sold and the loss becomes realized. For book purposes, the unrealized losses, net of income taxes, are reported as a separate component of stockholders' equity until realized. For the allowance for credit losses, only the net charge-offs are deductible while the entire provision for credit losses is used to determine book income. A deferred tax asset for both of these items is created because of the timing difference of when the expense is recognized for book and tax purposes. Under GAAP, a valuation allowance is required to be recognized if it is "more likely than not" that the deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon management's judgment and evaluation of both positive and negative evidence, including the forecasts of future income, tax planning strategies, and assessments of the current and future economic and business conditions. The positive evidence considered includes the Company's cumulative net income in the prior three-year period, the ability to implement tax planning strategies to accelerate taxable income recognition, and the probability that taxable income will be generated in future periods. The only negative evidence that the Company identified was related to a change in Wisconsin state tax law that was enacted in 2023. The law change allows financial institutions to claim an exemption from state taxation loan income from loans of \$5 million or less where the borrower resides or is located in Wisconsin. The law change is anticipated to substantially reduce the Company's effective state income tax rate in Wisconsin, which is expected to reduce the Company's Wisconsin state income tax expense in future periods. A valuation allowance has been recorded to reflect the anticipated reduction in the Company's ability to recognize future Wisconsin state tax benefits when the timing differences reverse on the previously recorded deferred tax assets. It is possible that future conditions may differ substantially from those anticipated in determining that a valuation allowance is required on deferred tax assets and adjustments may be required in the future.

Determining the ultimate settlement of any tax position requires significant estimates and judgments in arriving at the amount of tax benefits to be recognized in the financial statements. It is possible that the tax benefits realized upon the ultimate resolution of a tax position may result in tax benefits that are significantly different from those estimated.

RESULTS OF OPERATIONS FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2024 COMPARED TO THE SAME PERIODS ENDED JUNE 30, 2023

Net Income

Net income was \$1.0 million for the second quarter of 2024, a decrease of \$0.4 million compared to net income of \$1.4 million for the second quarter of 2023. Diluted earnings per share for the second quarter of 2024 was \$0.22, a decrease of \$0.10 from diluted earnings per share of \$0.32 for the second quarter of 2023. The decrease in net income between the periods was primarily because of a \$0.8 million increase in other expenses due to a goodwill impairment that was recorded, a \$0.5 million increase in professionals services due to merger related expenses, and a \$0.2 million decrease in net interest income because of a decline in the net interest margin as a result of funding costs increasing faster than the yields on interest earning assets. These decreases in net income were partially offset by a \$0.6 million decrease in the provision for credit losses due primarily to perceived improvements in the forecasted economic environment, a \$0.3 million increase in the gain on sales of loans due to an increase in the amount of originated loans that were sold, and a \$0.2 million reduction in income tax expense between the periods as a result of the reduced pretax income.

Net income was \$2.3 million for the six-month period ended June 30, 2024, a decrease of \$0.8 million, or 25.1%, compared to net income of \$3.1 million for the six-month period ended June 30, 2023. Diluted earnings per share for the six-month period ended June 30, 2024 was \$0.52, a decrease of \$0.18 per share compared to diluted earnings per share of \$0.70 for the same period in 2023. The decrease in net income between the periods was primarily because of a \$0.8 million increase in other expenses due to an impairment of goodwill that was recorded, a \$0.5 million increase in professional services due to merger related expenses, and a \$1.1 million decrease in net interest income because of a decline in the net interest margin as a result of funding costs increasing faster than the yields on interest earning assets. These decreases in net income were partially offset by a \$0.7 million decrease in the provision for credit losses due primarily to perceived improvements in the forecasted economic environment, a \$0.3 million increase in the gain on sales of loans due to an increase in the amount of loans that were sold, and a \$0.3 million reduction in income tax expense between the periods as a result of the reduced pretax income.

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Net Interest Income

Net interest income was \$7.5 million for the second quarter of 2024, a decrease of \$0.2 million, or 3.1%, compared to \$7.7 million for the second quarter of 2023. Interest income was \$12.6 million for the second quarter of 2024, an increase of \$2.1 million, or 19.8%, from \$10.5 million for the second quarter of 2023. Interest income increased primarily because of the increase in the average yield earned on interest-earning assets between the periods and also because of the \$47.3 million increase in the average interest-earning assets. The average yield earned on interest-earning assets was 4.54% for the second quarter of 2024, an increase of 60 basis points from 3.94% for the second quarter of 2023. The increase in the average yield is primarily related to the increase in market interest rates as a result of the 3.75% increase in the prime interest rate over the past two years.

Interest expense was \$5.1 million for the second quarter of 2024, an increase of \$2.3 million, or 83.7%, compared to \$2.8 million for the second quarter of 2023. Interest expense increased primarily because of the increase in the average interest rate paid on interest-bearing liabilities between the periods. Interest expense also increased because of the \$40.8 million increase in the average interest-bearing liabilities and non-interest bearing deposits between the periods. The average interest rate paid on interest-bearing liabilities and non-interest bearing deposits was 2.01% for the second quarter of 2024, an increase of 88 basis points from 1.13% for the second quarter of 2023. The increase in the average rate paid is primarily related to the change in the types of funding sources as more brokered deposits and certificates of deposits were used as funding sources in the second quarter of 2024 than were used in the second quarter of 2023. These funding sources generally have higher interest rates than traditional checking and money market accounts. The increase in market interest rates as a result of the 3.75% increase in the federal funds rate over the past two years also contributed to the higher funding costs in the second quarter of 2024 when compared to the same period in 2023.

Net interest margin (net interest income divided by average interest-earning assets) for the second quarter of 2024 was 2.70%, a decrease of 20 basis points, compared to 2.90% for the second quarter of 2023. The decrease in the net interest margin is primarily because the increase in the average rate paid on interest-bearing liabilities and non-interest bearing deposits exceeded the increase in the average yield earned on interest-earning assets between the periods.

Net interest income was \$14.7 million for the first six months of 2024, a decrease of \$1.1 million, or 6.6%, compared to \$15.8 million for the same period of 2023. Interest income was \$24.6 million for the first six months of 2024, an increase of \$4.2 million, or 20.4%, from \$20.4 million for the first six months of 2023. Interest income increased primarily because of the increase in the average yield earned on interest-earning assets between the periods and also because of the \$48.8 million increase in the average interest-earning assets. The average yield earned on interest-earning assets was 4.45% for the first six months of 2024, an increase of 58 basis points from 3.87% for the same period of 2023. The increase in the average yield is primarily related to the increase in market interest rates as a result of the 3.75% increase in the prime interest rate over the past two years.

Interest expense was \$9.8 million for the first six months of 2024, an increase of \$5.2 million, or 112.8%, compared to \$4.6 million for the same period of 2023. Interest expense increased primarily because of the increase in the average interest rate paid on interest-bearing liabilities between the periods. Interest expense also increased because of the \$42.8 million increase in the average interest-bearing liabilities and non-interest bearing deposits between the periods. The average interest rate paid on interest-bearing liabilities and non-interest bearing deposits was 1.94% for the first six months of 2024, an increase of 98 basis points from 0.96% for the first six months of 2023. The increase in the average rate paid is primarily related to the change in the types of funding sources as more brokered deposits and certificates of deposits were used as funding sources in the first six months of 2024 than were used in the same period of 2023. These funding sources generally have higher interest rates than traditional checking and money market accounts. The increase in market interest rates as a result of the 3.75% increase in the federal funds rate over the past two years also contributed to the higher funding costs in the first six months of 2024 when compared to the same period in 2023.

Net interest margin (net interest income divided by average interest-earning assets) for the first six months of 2024 was 2.67%, a decrease of 33 basis points, compared to 3.00% for the first six months of 2023. The decrease in the net interest margin is primarily because the increase in the average rate paid on interest-bearing liabilities and non-interest bearing deposits exceeded the increase in the average yield earned on interest-earning assets between the periods.

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A summary of the Company's net interest margin for the three- and six-month periods ended June 30, 2024 and 2023 is as follows:

| (Dollars in thousands) | For the three-month period ended | | | June 30, 2023 | | |
|---|----------------------------------|-----------------------------|-----------------------|-----------------------------|-----------------------------|-----------------------|
| | June 30, 2024 | Average Outstanding Balance | Interest Earned/ Paid | Yield/ Rate | Average Outstanding Balance | Interest Earned/ Paid |
| Interest-earning assets: | | | | | | |
| Securities available for sale | \$ 221,664 | 1,031 | 1.87% | \$ 259,187 | 800 | 1.24% |
| Loans held for sale | 2,944 | 50 | 6.87 | 1,872 | 29 | 6.24 |
| Single family loans, net | 265,291 | 2,958 | 4.48 | 225,065 | 2,195 | 3.91 |
| Commercial loans, net | 551,691 | 7,379 | 5.38 | 527,900 | 6,663 | 5.06 |
| Consumer loans, net | 41,246 | 717 | 6.99 | 47,518 | 732 | 6.18 |
| Other | 32,668 | 445 | 5.47 | 6,661 | 78 | 4.70 |
| Total interest-earning assets | 1,115,504 | 12,580 | 4.54 | 1,068,203 | 10,497 | 3.94 |
| Interest-bearing liabilities: | | | | | | |
| Checking accounts | 143,572 | 300 | 0.84 | 169,870 | 253 | 0.60 |
| Savings accounts | 104,100 | 28 | 0.11 | 115,658 | 28 | 0.10 |
| Money market accounts | 279,382 | 1,707 | 2.46 | 267,075 | 1,049 | 1.58 |
| Retail certificate accounts | 153,871 | 1,626 | 4.25 | 89,436 | 474 | 2.13 |
| Wholesale certificate accounts | 111,061 | 1,409 | 5.10 | 62,978 | 745 | 4.74 |
| Customer escrows | 0 | 0 | 0.00 | 4,737 | 23 | 2.00 |
| Advances and other borrowings | 1,266 | 18 | 5.63 | 14,419 | 197 | 5.48 |
| Total interest-bearing liabilities | 793,252 | | | 724,173 | | |
| Non-interest checking | 224,385 | | | 252,008 | | |
| Other non-interest bearing liabilities | 2,397 | | | 3,043 | | |
| Total interest-bearing liabilities and non-interest bearing deposits | \$ 1,020,034 | 5,088 | 2.01 | \$ 979,224 | 2,769 | 1.13 |
| Net interest income | \$ 7,492 | | | \$ 7,728 | | |
| Net interest rate spread | | | 2.53% | | | 2.81% |
| Net interest margin | | | 2.70% | | | 2.90% |
| For the six-month period ended | | | | | | |
| (Dollars in thousands) | June 30, 2024 | Average Outstanding Balance | Interest Earned/ Paid | Yield/ Rate | June 30, 2023 | |
| | Average Outstanding Balance | Interest Earned/ Paid | Yield/ Rate | Average Outstanding Balance | Interest Earned/ Paid | Yield/ Rate |
| Interest-earning assets: | | | | | | |
| Securities available for sale | \$ 225,783 | 1,954 | 1.74% | \$ 263,909 | 1,595 | 1.22% |
| Loans held for sale | 2,398 | 79 | 6.62 | 1,546 | 47 | 6.16 |
| Single family loans, net | 265,041 | 5,835 | 4.43 | 216,643 | 4,146 | 3.86 |
| Commercial loans, net | 546,419 | 14,450 | 5.32 | 525,425 | 13,036 | 5.00 |
| Consumer loans, net | 41,374 | 1,426 | 6.93 | 46,655 | 1,393 | 6.02 |
| Other | 30,673 | 835 | 5.47 | 8,726 | 193 | 4.46 |
| Total interest-earning assets | 1,111,688 | 24,579 | 4.45 | 1,062,904 | 20,410 | 3.87 |
| Interest-bearing liabilities: | | | | | | |
| Checking accounts | 144,210 | 606 | 0.84 | 165,811 | 441 | 0.54 |
| Savings accounts | 105,206 | 56 | 0.11 | 118,185 | 54 | 0.09 |
| Money market accounts | 275,698 | 3,288 | 2.40 | 262,944 | 1,704 | 1.31 |
| Retail certificate accounts | 144,032 | 2,975 | 4.15 | 82,725 | 697 | 1.70 |
| Wholesale certificate accounts | 113,742 | 2,885 | 5.10 | 62,018 | 1,456 | 4.73 |
| Customer escrows | 0 | 0 | 0.00 | 5,560 | 55 | 2.00 |
| Advances and other borrowings | 748 | 21 | 5.64 | 7,856 | 212 | 5.44 |
| Total interest-bearing liabilities | 783,636 | | | 705,099 | | |
| Non-interest checking | 231,357 | | | 266,989 | | |
| Other non-interest bearing liabilities | 2,648 | | | 2,735 | | |
| Total interest-bearing liabilities and non-interest bearing deposits | \$ 1,017,641 | 9,831 | 1.94 | \$ 974,823 | 4,619 | 0.96 |
| Net interest income | \$ 14,748 | | | \$ 15,791 | | |
| Net interest rate spread | | | 2.51% | | | 2.91% |
| Net interest margin | | | 2.67% | | | 3.00% |

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Provision for Credit Losses

The provision for credit losses was (\$0.3) million for the second quarter of 2024, a decrease of \$0.6 million compared to \$0.3 million for the second quarter of 2023. The provision for credit losses was (\$0.5) million in the first six months of 2024, a decrease of \$0.7 million compared to \$0.2 million for the first six months of 2023. The provision for credit losses decreased as a result of the reduction in the required qualitative reserves due primarily to perceived improvements in the forecasted economic conditions. These reductions were partially offset by an increase in the provision as a result of an increase in the allowance for credit losses attributable to loan growth.

The following table presents the components of the provision for credit losses for the three- and six-month periods ended June 30, 2024 and 2023.

| (Dollars in thousands) | Three months ended June 30, | |
|---------------------------------|-----------------------------|------|
| | 2024 | 2023 |
| Provision for credit losses on: | | |
| Loans | \$ (307) | 200 |
| Unfunded commitments | 1 | 56 |
| Total | \$ (306) | 256 |

| (Dollars in thousands) | Six months ended June 30, | |
|---------------------------------|---------------------------|------|
| | 2024 | 2023 |
| Provision for credit losses on: | | |
| Loans | \$ (515) | 168 |
| Unfunded commitments | 0 | 80 |
| Total | \$ (515) | 248 |

The allowance for credit losses is measured on a collective (pool) basis when similar risk characteristics exist. Loans that do not share risk characteristics are evaluated on an individual basis. Loans evaluated individually are not included in the collective evaluations. The collective reserve amount is assessed based on the size and risk characteristics of the various portfolio segments, past loss history, and other adjustments determined to have a potential impact on future credit losses.

A reconciliation of the Company's allowance for credit losses for the three- and six-month periods ended June 30, 2024 and 2023 is summarized as follows:

| (Dollars in thousands) | Three months ended June 30, | |
|------------------------|-----------------------------|--------|
| | 2024 | 2023 |
| Balance at March 31, | \$ 11,586 | 11,342 |
| Provision | (307) | 200 |
| Charge offs: | | |
| Consumer | (8) | (27) |
| Commercial business | (9) | 0 |
| Recoveries | 30 | 2 |
| Balance at June 30, | \$ 11,292 | 11,517 |
| Allocated to: | | |
| Collective allowance | \$ 10,884 | 11,345 |
| Individual allowance | 408 | 172 |
| | \$ 11,292 | 11,517 |

| <i>(Dollars in thousands)</i> | Six months ended June 30, | |
|--|---------------------------|--------|
| | 2024 | 2023 |
| Balance at January 1, | \$ 11,824 | 10,277 |
| Adoption of Accounting Standard Update (ASU) 2016-13 | 0 | 1,070 |
| Provision | (515) | 168 |
| Charge offs: | | |
| Single family | (30) | 0 |
| Consumer | (8) | (27) |
| Commercial business | (9) | 0 |
| Recoveries | 30 | 29 |
| Balance at June 30, | \$ 11,292 | 11,517 |

On January 1, 2023, the Company adopted Accounting Standards Update (ASU) 2016-13, *Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The transition to this ASU resulted in a cumulative-effect adjustment to the allowance for credit losses of \$1.1 million, an increase in deferred tax assets of \$0.3 million, and a decrease to retained earnings of \$0.8 million as of the adoption date. In addition, a liability of \$0.1 million was established for projected future losses on unfunded commitments on outstanding lines of credit upon adoption. The projected liability for unfunded commitments did not change during the first six months of 2024 and increased \$0.1 million in the first six months of 2023. The respective provisions for credit losses reflects these changes.

Non-Interest Income

Non-interest income was \$2.2 million for the second quarter of 2024, an increase of \$0.2 million, or 12.0%, from \$2.0 million for the second quarter of 2023. Gain on sales of loans increased \$0.3 million between the periods because of an increase in single family loan sales due primarily to an increase in the amount of originated mortgage loans that were sold. Other non-interest income increased slightly due primarily to an increase in the revenue earned on the sales of uninsured investment products between the periods. Fees and service charges decreased \$0.1 million between the periods due primarily to a decrease in overdraft fees collected as a result of changes to the Company's overdraft policy that were implemented in the first quarter of 2024. Loan servicing fees decreased slightly between the periods due to a decrease in the aggregate balances of commercial loans that were being serviced for others as more serviced loans were paid off than were added to the servicing portfolio during the period.

Non-interest income was \$4.1 million for the first six months of 2024, an increase of \$0.2 million, or 5.5%, from \$3.9 million for the first six months of 2023. Gain on sales of loans increased \$0.3 million between the periods because of an increase in single family loan sales due primarily to an increase in the amount of originated mortgage loans that were sold. Other non-interest income increased \$0.1 million due primarily to an increase in the revenue earned on the sales of uninsured investment products between the periods. These increases in net income were partially offset by a \$0.1 million decrease in fees and service charges between the periods due primarily to a decrease in overdraft fees collected as a result of changes to the Company's overdraft policy that were implemented in the first quarter of 2024. Loan servicing fees decreased slightly between the periods due to a decrease in the aggregate balances of commercial loans that were being serviced for others as more serviced loans were paid off than were added to the servicing portfolio during the period.

Non-Interest Expense

Non-interest expense was \$8.7 million for the second quarter of 2024, an increase of \$1.2 million, or 16.2%, from \$7.5 million for the second quarter of 2023. Other non-interest expense increased \$0.8 million primarily because there was an impairment of goodwill that was recorded during the quarter. Professional services increased \$0.5 million between the periods primarily because of an increase in legal, accounting, and other professional services expenses related to the pending merger. The Company expects to incur additional merger related costs through the closing of the pending merger with Alerus. Data processing expense increased slightly due to an increase in debit card processing expenses between the periods. These increases were partially offset by a slight decrease in compensation and benefits expense primarily because of a decrease in the number of employees between the periods. Occupancy and equipment expense decreased slightly between the periods due primarily to a decrease in building expenses.

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Non-interest expense was \$16.2 million for the first six months of 2024, an increase of \$1.0 million, or 7.0%, from \$15.2 million for the first six months of 2023. Other non-interest expense increased \$0.7 million primarily because a goodwill impairment was recorded in the second quarter. Professional services increased \$0.5 million between the periods primarily because of an increase in legal, accounting, and other professional services expenses related to the pending merger. The Company expects to incur additional merger related costs through the closing of the pending merger with Alerus. Data processing expense increased \$0.1 million due to an increase in debit card processing expenses between the periods. These increases were partially offset by a \$0.1 million decrease in compensation and benefits expense primarily because of a decrease in the number of employees between the periods. Occupancy and equipment expense decreased \$0.1 million between the periods due primarily to a decrease in building expenses.

Income Taxes

Income tax expense was \$0.4 million for the second quarter of 2024, a decrease of \$0.2 million from \$0.6 million for the second quarter of 2023. Income tax expense was \$0.9 million for the first six months of 2024, a decrease of \$0.3 million from \$1.2 million for the first six months of 2023. The decrease in income tax expense between the periods is primarily the result of a decrease in pre-tax income.

FINANCIAL CONDITION

Non-Performing Assets

The following table summarizes the amounts and categories of non-performing assets in the Bank's portfolio and loan delinquency information as of the end of the most recently completed quarter and December 31, 2023.

| | June 30, 2024 | December 31, 2023 |
|---|------------------|----------------------|
| <i>(Dollars in thousands)</i> | | |
| Non-performing loans: | | |
| Single family | \$ 590 | \$ 762 |
| Commercial real estate | 1,025 | 493 |
| Consumer | 320 | 376 |
| Commercial business | 1,255 | 2,187 |
| Total non-performing assets | <u>\$ 3,190</u> | <u>\$ 3,818</u> |
| Total as a percentage of total assets | <u>0.29%</u> | <u>0.34%</u> |
| Total as a percentage of total loans receivable | <u>0.36%</u> | <u>0.44%</u> |
| Allowance for credit losses to non-performing loans | <u>353.92%</u> | <u>309.69%</u> |
| Delinquency data: | | |
| Delinquencies (1) | | |
| 30+ days | \$ 3,198 | \$ 715 |
| 90+ days | 0 | 0 |
| Delinquencies as a percentage of loan portfolio (1) | | |
| 30+ days | 0.36% | 0.08% |
| 90+ days | 0.00% | 0.00% |

(1) Excludes non-accrual loans.

Dividends

The Company declared a quarterly dividend of 10 cents per share of common stock that was paid on June 7, 2024. The declaration and amount of any future cash dividends remains subject to the sole discretion of the Board of Directors and will depend upon many factors, including the Company's results of operations, financial condition, capital requirements, regulatory and contractual restrictions, business strategy and other factors deemed relevant by the Board of Directors.

LIQUIDITY AND CAPITAL RESOURCES

For the six months ended June 30, 2024, the net cash provided by operating activities was \$5.3 million. The Company collected \$17.0 million in principal repayments on securities, collected \$20.0 million on securities that matured, purchased FHLB stock for \$0.8 million, purchased securities available for sale of \$20.0 million, and received redemptions on FHLB stock of \$0.9 million. The Company had a net increase in deposit balances of \$6.5 million and a decrease of customer escrows of \$0.3 million during the first six months of 2024. It paid dividends to stockholders of \$0.8 million, purchased \$0.2 million of premises and equipment, received proceeds from borrowings of \$18.0 million and repaid borrowings of \$20.4 million. Loans receivable also increased \$22.8 million during the first six months of 2024.

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The Company has certificates of deposit with outstanding balances of \$199.5 million that come due over the next 12 months. Based upon past experience, management anticipates that the majority of the deposits will renew for another term. The Company believes that cash outflows from deposits that do not renew will be replaced with a combination of other customers' deposits or FHLB advances. Federal Reserve Bank of Minneapolis borrowings could also be used to fund unanticipated outflows of certificates of deposit. Unpledged securities could also be pledged and used as collateral for additional borrowings with the FHLB or Federal Reserve Bank of Minneapolis.

The Company had five deposit customers each with aggregate deposits greater than \$5.0 million as of June 30, 2024. The \$51.7 million in funds held by these customers may be withdrawn at any time, but management anticipates that the majority of these deposits will not be withdrawn from the Bank over the next twelve months. If these deposits were withdrawn, it is anticipated that they would be replaced with deposits from other customers or brokers or with FHLB advances. Federal Reserve Bank of Minneapolis borrowings could also be used to replace unanticipated outflows of large checking and money market deposits.

The Company estimates that approximately 24.5% of total deposits exceeded the Federal Deposit Insurance limit of \$250,000 at June 30, 2024. While these funds may be withdrawn at any time, management anticipates that the majority of these deposits will not be withdrawn from the Bank over the next twelve months. If these deposits were withdrawn, it is anticipated that they would be replaced with deposits from other customers or brokers or with FHLB advances. Federal Reserve Bank borrowings could also be used to replace unanticipated outflows of large checking and money market deposits.

The Company had the ability to borrow an additional \$278.9 million from the FHLB at June 30, 2024 based on the collateral value of the loans pledged. The credit policy of the FHLB relating to the collateral value of the loans collateralizing the available line of credit with the FHLB may change such that the current collateral pledged to secure future advances is no longer acceptable or the formulas for determining the excess pledged collateral may change. The FHLB could also reduce the amount of funds it will lend to the Bank. It is not anticipated that the Bank will need to find alternative funding sources in the next twelve months to replace the available borrowings from the FHLB. However, if needed, the Bank could borrow an additional \$101.7 million from the FRB at June 30, 2024 based on the collateral value of the loans pledged. The Company also has the ability to pledge securities as collateral to increase the borrowing capacity of the Company by \$104.4 million.

The Company's primary source of cash is dividends from the Bank. At June 30, 2024, the Company had \$15.5 million in cash. The primary use of cash by the Company is the payment of operating expenses, the repurchase of Company stock, and the payment of dividends to stockholders. The merger agreement allows for quarterly dividends to be paid to stockholders in the ordinary course of business, however, during the quarter in which the closing date occurs, the Company quarterly dividend can't be paid if the payment would result in the stockholders of the Company receiving more than one quarter dividend from the Company and the Acquiror during that fiscal quarter.

Market Risk

Market risk is the risk of loss from adverse changes in market prices and rates. The Company's market risk arises primarily from interest rate risk inherent in its investing, lending and deposit taking activities. Management actively monitors and manages its interest rate risk exposure.

The Company's profitability is affected by fluctuations in interest rates. A sudden and substantial change in interest rates may adversely impact the Company's earnings to the extent that the interest rates borne by assets and liabilities do not change at the same speed, to the same extent, or on the same basis. The Company monitors the projected changes in net interest income that occur if interest rates were to suddenly change up or down. The *Rate Shock Table* located in the following Asset/Liability Management section of this Management's Discussion and Analysis discloses the Company's projected changes in net interest income based upon immediate interest rate changes called rate shocks. The Company utilizes a model that uses the discounted cash flows from its interest-earning assets and its interest-bearing liabilities to calculate the current market value of those assets and liabilities. The model also calculates the changes in market value of the interest-earning assets and interest-bearing liabilities under different interest rate changes.

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The following table discloses the projected changes in the market value of the Company's interest-earning assets and interest-bearing liabilities based upon incremental 100 basis-point changes in interest rates in effect on June 30, 2024.

| <i>(Dollars in thousands)</i> | Market Value | | | | |
|---|--------------|-----------|-----------|-----------|---------|
| Basis point change in interest rates | -200 | -100 | 0 | +100 | +200 |
| Total market-risk sensitive assets | \$ 1,081,495 | 1,055,925 | 1,031,437 | 1,008,457 | 984,469 |
| Total market-risk sensitive liabilities | 934,533 | 892,110 | 856,162 | 826,628 | 806,749 |
| Off-balance sheet financial instruments | 49 | 30 | 0 | 177 | 341 |
| Net market risk | \$ 146,913 | 163,785 | 175,275 | 181,652 | 177,379 |
| Percentage change from current market value | (16.18)% | (6.56)% | 0.00% | 3.64% | 1.20% |

The preceding table was prepared utilizing a model using the following assumptions (the Model Assumptions) regarding prepayment and decay ratios that were determined by management based upon their review of historical prepayment speeds and future prepayment projections. Fixed rate loans were assumed to prepay at annual rates of between 3% to 57%, depending on the note rate and the period to maturity. Adjustable rate mortgages (ARMs) were assumed to prepay at annual rates of between 7% and 54%, depending on the note rate and the period to maturity. Mortgage-backed securities were projected to have prepayments based upon the underlying collateral securing the instrument. Certificate accounts were assumed not to be withdrawn until maturity. Savings accounts were assumed to decay at an annual rate of 1%. Money market accounts were assumed to decay at an annual rate of between 5% and 27%. Retail checking accounts, commercial checking accounts and commercial money market accounts were assumed to decay at annual rates of 4%, 38% and 30%, respectively. Callable investments were projected to be called at the first call date where the projected interest rate on similar remaining term instruments was less than the interest rate on the callable investment.

Certain shortcomings are inherent in the method of analysis presented in the above table. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types of assets and liabilities may lag behind changes in market interest rates. The model assumes that the difference between the current interest rate being earned or paid compared to a treasury instrument or other interest index with a similar term to maturity (the Interest Spread) will remain constant over the interest changes disclosed in the table. Changes in Interest Spread could impact projected market value changes. Certain assets, such as ARMs, have features which restrict changes in interest rates on a short-term basis and over the life of the assets. The market value of the interest-bearing assets that are approaching their lifetime interest rate caps could be different from the values disclosed in the table. Certain liabilities, such as certificates of deposit, have fixed rates that restrict interest rate changes until maturity. In the event of a change in interest rates, prepayment and early withdrawal levels may deviate significantly from those assumed in calculating the foregoing table. The ability of many borrowers to service their debt may also decrease in the event of a substantial sustained increase in interest rates.

Asset/Liability Management

The Company's management reviews the impact that changing interest rates will have on the Company's net interest income projected for the next twelve months to determine if its current level of interest rate risk is acceptable. The following table projects the estimated impact on net interest income during the twelve-month period ending June 30, 2025 of immediate interest rate changes called rate shocks:

| <i>(Dollars in thousands)</i> | Projected Change in Net Interest Income | | | Percentage Change |
|-------------------------------|---|-------------------------------|--|-------------------|
| Rate Shock in Basis Points | \$ | Change in Net Interest Income | | |
| +200 | \$ | (831) | | (2.46)% |
| +100 | | (382) | | (1.13) |
| 0 | | 0 | | 0.00 |
| -100 | | 387 | | 1.14 |
| -200 | | 169 | | 0.50 |

The preceding table was prepared utilizing the Model Assumptions. Certain shortcomings are inherent in the method of analysis presented in the foregoing table. In the event of a change in interest rates, prepayment and early withdrawal levels would likely deviate significantly from those assumed in calculating the foregoing table. The ability of many borrowers to service their debt may decrease in the event of a substantial increase in interest rates and could impact net interest income. The decrease in interest income in a rising rate environment is primarily because there are more deposits that would reprice to higher interest rates than there are loans and investments that would be repriced higher in the next twelve months.

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In an attempt to manage its exposure to changes in interest rates, management closely monitors interest rate risk. The Bank has an Asset/Liability Committee that meets frequently to discuss changes in the interest rate risk position and projected profitability. This Committee makes adjustments to the asset-liability position of the Bank that are reviewed by the Board of Directors of the Bank. This Committee also reviews the Bank's portfolio, formulates investment strategies and oversees the timing and implementation of transactions as intended to assure attainment of the Bank's objectives in an effective manner. In addition, each quarter the Board reviews the Bank's asset/liability position, including simulations of the effect on the Bank's capital of various interest rate scenarios.

In managing its asset/liability composition, the Bank may, at times, depending on the relationship between long-term and short-term interest rates, market conditions and consumer preference, place more emphasis on managing net interest margin than on better matching the interest rate sensitivity of its assets and liabilities in an effort to enhance net interest income. Management believes that the increased net interest income resulting from a mismatch in the maturity of its asset and liability portfolios can, in certain situations, provide high enough returns to justify the increased exposure to sudden and unexpected changes in interest rates.

To the extent consistent with its interest rate spread objectives, the Bank attempts to manage its interest rate risk and has taken a number of steps to structure its balance sheet to better match the maturities of its assets and liabilities. The Bank sells almost all of its originated 30-year fixed rate single family residential loans that are saleable to third parties and generally places only adjustable rate or shorter-term fixed rate loans that meet certain risk characteristics into its loan portfolio. In addition, a significant portion of the Bank's commercial loans that are placed into the portfolio are adjustable rate loans or fixed rate loans that reprice in five years or less.

Off-Balance Sheet Arrangements

The Company has no off-balance sheet arrangements other than commitments to originate and sell loans in the ordinary course of business.

Item 3: Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

Item 4: Controls and Procedures

Evaluation of disclosure controls and procedures. As of the end of the period covered by this report, the Company conducted an evaluation, under the supervision and with the participation of the Company's management, including the principal executive officer and principal financial officer, of the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)). Based on this evaluation, the principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures were 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.

Changes in internal controls. There was no change in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) during the Company's most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

HMN FINANCIAL, INC.

PART II - OTHER INFORMATION

ITEM 1. Legal Proceedings.

From time to time, the Company is party to legal proceedings arising out of its lending and deposit operations. The Company is, and expects to become, engaged in a number of foreclosure proceedings and other collection actions as part of its normal operations. Based on our current understanding of these pending legal proceedings, management does not believe that judgments or settlements arising from any pending or threatened litigation matters, individually or in the aggregate, would have a material adverse effect on the Company's consolidated financial statements.

ITEM 1A. Risk Factors.

The risks described in our Annual Report on Form 10-K/A for the fiscal year ended December 31, 2023, filed with the SEC, under "Part 1, Item 1A. Risk Factors" could affect the Company's financial performance and could cause its actual results for future periods to differ materially from its anticipated results or other expectations, including those expressed in any forward-looking statements made in this Quarterly Report on Form 10-Q.

As previously announced, we entered into an Agreement and Plan of Merger (the "merger agreement") dated May 14, 2024, with Alerus Financial Corporation, a Delaware corporation ("Alerus"), pursuant to which HMN will merge into Alerus, with Alerus as the surviving corporation (the "merger"). Subject to the terms and conditions of the merger agreement, at the effective time of the merger, HMN stockholders will have the right to receive 1.25 (the "exchange ratio") shares of common stock of Alerus for each share of common stock of HMN, subject to potential downward adjustment. The merger agreement was unanimously approved by the Board of Directors of each of HMN and Alerus. The merger agreement contains customary representations and warranties of both parties and customary conditions to the parties' obligations to close the transaction, as well as agreements to cooperate in the process of consummating the transaction.

There have been no material changes in the risk factors that were disclosed in Item 1A, under the caption "Risk Factors" in our Form 10-K/A for the year ended December 31, 2023 except in connection with the merger agreement and the merger with Alerus as set forth below:

The Value of the Merger Consideration Will Fluctuate Based on the Trading Price of Alerus Common Stock.

The exchange ratio determining the number of shares of Alerus common stock to be issued in the merger in exchange for each share of HMN common stock will not automatically adjust based on the trading price of Alerus common stock, and the market value of those shares may vary from the closing price of Alerus common stock on the date the merger was announced, on the date that this document was mailed to Alerus and HMN stockholders, on the date of the Alerus special meeting and the HMN special meeting, on the date the merger is consummated and thereafter. Any change in the market price of Alerus common stock prior to consummation of the merger will affect the amount of and the market value of the merger consideration that HMN stockholders will receive upon consummation of the merger. Accordingly, at the time of the Alerus special meeting and at the time of the HMN special meeting, stockholders will not know or be able to calculate with certainty the market value of the Alerus common stock to be issued to HMN stockholders upon consummation of the merger. Stock price changes may result from a variety of factors, including general market and economic conditions, changes in business, operations and prospects, and regulatory considerations. Many of these factors are beyond Alerus' or HMN's control. HMN stockholders should obtain current market quotations of both Alerus common stock and HMN common stock before they vote.

The Exchange Ratio Will be Reduced if HMN's Stockholders' Equity is Less Than the Stockholders' Equity Threshold on the Closing Date.

The exchange ratio determines the number of shares of Alerus common stock that will be issued to HMN stockholders in the merger. The exchange ratio is initially 1.25, but is subject to downward adjustment to the extent that the stockholders' equity of HMN, calculated in the manner set forth in the merger agreement, is less than an amount equal to the sum of (i) \$124,163,656, (ii)(a) minus, in the event that the closing date is prior to September 30, 2024, \$590,000 per month for every calendar month by which the closing date is prior to September 30, 2024 or (b) plus, in the event that the closing date is after September 30, 2024, \$645,000 per month for every calendar month by which the closing date follows September 30, 2024, and (iii) plus the amount of stockholders' equity attributable to the exercise of stock options after March 31, 2024, then the exchange ratio will be adjusted downward to reflect the shortfall in the stockholders' equity of HMN in accordance with a formula set forth in the merger agreement. A sample calculation of the adjustment to the exchange ratio is attached as Appendix A to the merger agreement.

Shortfalls in the stockholders' equity of HMN may result from lower than expected HMN earnings as of the closing date or higher than expected expenses incurred by HMN associated with the merger and related transactions. The amount of HMN's total stockholders' equity as of the closing date of the merger will not be known at the time of the Alerus special meeting or at the time of the HMN special meeting, meaning stockholders will not know or be able to calculate with certainty the exchange ratio prior to the consummation of the merger. Additionally, HMN's financial advisor has not and will not express any opinion regarding any adjustments to the exchange ratio pursuant to the merger agreement. HMN currently believes that it will have stockholders' equity at closing above the threshold described above, and that the exchange ratio will not be adjusted downward.

Regulatory Approvals May Not be Received, May Take Longer than Expected or May Impose Conditions that are Not Presently Anticipated or Cannot be Met.

Before the transactions contemplated in the merger agreement can be consummated, various approvals must be obtained from the bank regulatory and other governmental authorities. In deciding whether to grant regulatory clearances, the relevant governmental entities will consider a variety of factors, including the regulatory standing of each of the parties. An adverse condition or development in either party's regulatory standing or other factors could result in an inability to obtain one or more of the required regulatory approvals, or delay their receipt. The terms and conditions of the approvals that are granted may impose requirements, limitations or costs, or may place restrictions on the conduct of the combined company's business.

HMN believes that the merger should not raise significant regulatory concerns, and that the parties will be able to obtain all requisite regulatory approvals in a timely manner. Despite the parties' commitments to use their reasonable best efforts to comply with conditions imposed by regulatory entities, under the terms of the merger agreement, Alerus and HMN will not be required to consummate the merger if any such approvals would reasonably be expected to materially restrict or burden Alerus following the merger. There can be no assurance that regulators will not impose conditions, terms, obligations or restrictions, or that such conditions, terms, obligations or restrictions will not have the effect of delaying the consummation of the merger, imposing additional material costs on or materially limiting the revenues of the combined company following the merger or otherwise reduce the anticipated benefits of the merger if the merger were consummated successfully within the expected timeframe. In addition, HMN cannot provide assurance that any such conditions, terms, obligations or restrictions will not result in the delay or abandonment of the merger. The consummation of the merger is further conditioned on the absence of certain orders, injunctions or decrees by any court or regulatory agency of competent jurisdiction that would prohibit or make illegal the consummation of the merger.

The Merger Agreement May be Terminated in Accordance with its Terms and the Merger May Not be Consummated.

The merger agreement is subject to a number of conditions which must be fulfilled in order to consummate the merger. Those conditions include, among other things: approval of the merger agreement and the transactions contemplated therein by Alerus and HMN stockholders, including, in the case of Alerus stockholders, approval of the issuance of Alerus common stock pursuant to the merger agreement; receipt of certain requisite regulatory approvals; absence of orders prohibiting consummation of the merger; effectiveness of the registration statement including the joint proxy statement/prospectus to solicit approval of the stockholders of each of Alerus and HMN; nonobjection of the issuance of Alerus common stock, as applicable, for listing on Nasdaq; the accuracy of the representations and warranties by both parties (subject to the materiality standards set forth in the merger agreement); the performance by both parties of their covenants and agreements as set forth in the merger agreement; and the receipt by both parties of legal opinions from their respective tax counsels. These conditions to the closing of the merger may not be fulfilled in a timely manner or at all, and, accordingly, the merger may not be consummated. In addition, the parties can mutually decide to terminate the merger agreement at any time, before or after receipt of Alerus or HMN stockholder approval, or Alerus or HMN may elect to terminate the merger agreement in certain other circumstances.

Termination of the Merger Agreement Could Negatively Impact HMN.

If the merger is not consummated for any reason, including as a result of Alerus stockholders or HMN stockholders declining to approve the merger agreement and the transactions contemplated therein, including, in the case of Alerus stockholders, the issuance of Alerus common stock pursuant to the merger agreement, the ongoing business of HMN may be adversely impacted and, without realizing any of the anticipated benefits of completing the merger, HMN would be subject to a number of risks, including the following:

- HMN may experience negative reactions from its customers, vendors and employees;
- HMN will have incurred substantial expenses and will be required to pay certain costs relating to the merger, whether or not the merger is consummated;
- the merger agreement places certain restrictions on the conduct of HMN's business prior to consummation of the merger. Such restrictions, the waiver of which is subject to the consent of the other party (not to be unreasonably withheld, conditioned or delayed), may prevent HMN from making certain acquisitions or taking certain other specified actions during the pendency of the merger; and
- matters relating to the merger (including integration planning) will require substantial commitments of time and resources by HMN's management team, which would otherwise have been devoted to other opportunities that may have been beneficial to HMN as an independent company.

If the merger agreement is terminated and the HMN Board seeks another merger or business combination, HMN stockholders cannot be certain that HMN will be able to find a party willing to offer equivalent or more attractive consideration than the consideration Alerus has agreed to provide in the merger, or that such other merger or business combination will be consummated. Additionally, if the merger agreement is terminated under certain circumstances, the terminating party may be required to pay a termination fee to the non-terminating party of \$4.6 million.

HMN Will be Subject to Business Uncertainties and Contractual Restrictions While the Merger is Pending.

Uncertainty about the effect of the merger on employees and customers may have an adverse effect on HMN. These uncertainties may impair HMN's ability to attract, retain and motivate key personnel until the merger is consummated, and could cause customers and others that deal with HMN to seek to change existing business relationships with HMN. Retention of certain employees may be challenging during the pendency of the merger, as certain employees may experience uncertainty about their future roles. If key employees depart because of issues relating to the uncertainty and difficulty of integration or a desire not to remain with the business, Alerus' business following the merger could be negatively impacted. In addition, the merger agreement restricts HMN from making certain transactions and taking other specified actions without the consent of Alerus until the merger occurs. These restrictions may prevent HMN from pursuing attractive business opportunities that may arise prior to the consummation of the merger.

The Merger Agreement Contains Provisions that May Discourage Other Companies from Trying to Acquire HMN for Greater Merger Consideration.

The merger agreement contains provisions that may discourage a third party from submitting a business combination proposal to HMN that might result in greater value to HMN's stockholders than the proposed merger with Alerus, or that may result in a potential competing acquiror proposing to pay a lower per share price to acquire HMN than it might otherwise have proposed to pay absent such provisions. These provisions include a general prohibition on HMN from soliciting, or, subject to certain exceptions relating to the exercise of fiduciary duties by the HMN Board, entering into discussions with any third party regarding any acquisition proposal or offers for competing transactions. In addition, HMN may be required to pay Alerus a termination fee of \$4.6 million upon termination of the merger agreement in certain circumstances involving acquisition proposals for competing transactions.

HMN Will Incur Transaction Costs in Connection with the Merger.

HMN has incurred and expects that it will incur significant, non-recurring costs in connection with consummating the merger. HMN may also incur additional costs to maintain employee morale and to retain key employees. HMN will also incur significant legal, financial advisor, accounting, banking and consulting fees, fees relating to regulatory filings and notices, regulatory filing fees, printing and mailing fees and other costs associated with the merger.

There are many factors beyond our control that could affect the total amount of expenses relating to the merger. Moreover, many of the expenses that will be incurred are, by their nature, difficult to estimate accurately. Our future operating results and financial condition may be materially adversely affected by transaction expenses. Additionally, many of these expenses will be payable by HMN regardless of whether the merger is completed. The future operating results and financial condition of HMN and the combined company may be materially adversely affected by transaction expenses.

Litigation may be Filed Against HMN (or their Respective Boards of Directors) that Could Prevent or Delay the Consummation of the Merger or Result in the Payment of Damages Following Consummation of the Merger.

It is possible that, in connection with the merger, stockholders may file demands or putative class action lawsuits against Alerus or HMN (or their respective boards of directors). Among other remedies, these stockholders could seek financial damages or to enjoin the merger. The outcome of any such litigation is uncertain. Additionally, one of the conditions to the closing of the merger is that there must be no order, injunction, decree, statute, rule, regulation or other legal restraint or prohibition preventing or making illegal the consummation of the merger or any of the other transactions contemplated by the merger agreement. If a dismissal is not granted or a settlement is not reached and any plaintiff were successful in obtaining an injunction prohibiting Alerus or HMN from completing the merger or any of the other transactions contemplated by the merger agreement, then such injunction may delay or prevent the effectiveness of the merger and could result in significant costs to Alerus or HMN, including any cost associated with the indemnification of directors and officers of each company. The defense or settlement of any lawsuit or claim that remains unresolved at the time the merger is consummated may adversely affect the combined company's business, financial condition, results of operations and cash flows and the market price of the combined company.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds.

The Company did not purchase any of its own stock during the first six months of 2024. The Company announced on March 1, 2023 that the Board of Directors had authorized the repurchase of up to \$6.0 million of shares and \$5.4 million remained available for repurchase at June 30, 2024. Share repurchases may be executed through various means, including through open market transactions, privately negotiated transactions or otherwise. The repurchase program does not obligate the Company to purchase any shares and has no set expiration date, however, the merger agreement restricts the Company from purchasing any additional shares of common stock through the merger date.

ITEM 3. Defaults Upon Senior Securities.

None.

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ITEM 4. Mine Safety Disclosures.

Not applicable.

ITEM 5. Other Information.

None of our directors or officers (as defined in Rule 16a-1(f) of the Exchange Act) adopted, modified, or terminated any contract, instruction, or written plan for the purchase or sale of our securities that was intended to satisfy the affirmative defense conditions of Rule 10b5-1(c) of the Exchange Act or any non-Rule 10b5-1 trading arrangement (as defined in Item 408(c) of Regulation S-K) during the quarter ended June 30, 2024.

ITEM 6. Exhibits.

| Exhibit Number | INDEX TO EXHIBITS | Filing Status |
|----------------|--|---|
| Exhibit | | |
| 2.1 | Agreement and Plan of Merger, by and between Alerus Financial Corporation and HMN Financial, Inc., dated May 14, 2024* | Incorporated by reference to Exhibit 2.1 to the Company's Current Report on Form 8-K, filed May 15, 2024 |
| 10.1 | Voting and Support Agreement, by and among Alerus Financial Corporation and the directors and officers of HMN Financial, Inc. identified therein, dated May 14, 2024 | Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed May 15, 2024 |
| 10.2 | Voting and Support Agreement, by and among HMN Financial, Inc. and the directors and officers of Alerus Financial Corporation identified therein, dated May 14, 2024 | Incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K, filed May 15, 2024 |
| 10.3 | Agreement entered into May 14, 2024 to Amend the Executive Severance Agreement dated June 6, 2023 by and among HMN Financial, Inc., Home Federal Savings Bank and Jon Eberle | Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed May 17, 2024 |
| 10.4 | Agreement entered into May 14, 2024 to Amend the Executive Severance Agreement dated June 6, 2023 by and among HMN Financial, Inc., Home Federal Savings Bank and Lawrence McGraw | Incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K, filed May 17, 2024 |
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification of CEO | Filed Electronically |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification of CFO | Filed Electronically |
| 32 | Section 1350 Certifications of CEO and CFO | Filed Electronically |
| 101 | Financial statements from the Quarterly Report on Form 10-Q of the Company for the period ended June 30, 2024, filed with the Securities and Exchange Commission on August 6, 2024, formatted in Inline Extensible Business Reporting Language (iXBRL); (i) the Consolidated Balance Sheets at June 30, 2024 and December 31, 2023, (ii) the Consolidated Statements of Comprehensive Income for the Three and Six Months Ended June 30, 2024 and 2023, (iii) the Consolidated Statements of Stockholders' Equity for the Three and Six Months Ended June 30, 2024 and 2023, (iv) the Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2024 and 2023, and (v) Notes to Consolidated Financial Statements. | Filed Electronically |
| 104 | Cover Page Interactive Data File from the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2024 (formatted as Inline XBRL and contained in Exhibit 101). | Filed Electronically |

* The Company has omitted schedules and similar attachments to the subject agreement pursuant to Item 601(b) of Regulation S-K. The Company will furnish a copy of any omitted schedule or similar attachment to the SEC upon request.

SIGNATURES

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

HMN FINANCIAL, INC.

Registrant

Date: August 6, 2024

/s/ Bradley Krehbiel
Bradley Krehbiel, President and Chief Executive Officer
(Duly Authorized Officer)

Date: August 6, 2024

/s/ Jon Eberle
Jon Eberle, Senior Vice President and
Chief Financial Officer
(Principal Financial and Accounting Officer)

CERTIFICATIONS

I, Bradley Krehbiel, certify that:

1. I have reviewed this quarterly report on Form 10-Q of HMN Financial, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 6, 2024

By: /s/ Bradley Krehbiel
 Bradley Krehbiel
 President and Chief Executive Officer
 (Duly Authorized Officer)

CERTIFICATIONS

I, Jon J. Eberle, certify that:

1. I have reviewed this quarterly report on Form 10-Q of HMN Financial, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 6, 2024

By: /s/*Jon J. Eberle*
 Jon J. Eberle
 Senior Vice President, Chief Financial Officer and
 Treasurer
 (Principal Financial and Accounting Officer)

HMN FINANCIAL, INC.

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of HMN Financial, Inc. (the "Company") on Form 10-Q for the period ended June 30, 2024 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), we, Bradley Krehbiel, President and Chief Executive Officer of Company (Principal Executive Officer of the Company), and Jon Eberle, Senior Vice President, Chief Financial Officer and Treasurer of the Company (Principal Financial Officer of the Company), certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 6, 2024

/s/ Bradley Krehbiel

Bradley Krehbiel
President and Chief Executive Officer
(Duly Authorized Officer)

/s/ Jon Eberle

Jon Eberle
Senior Vice President/Chief Financial Officer
and Treasurer
(Principal Financial and Accounting Officer)