SIERRA BANCORP
Form 10-Q
May 08, 2009
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2009

Commission file number: 000-33063

SIERRA BANCORP

(Exact name of Registrant as specified in its charter)

California	**33-0937517**
(State of Incorporation)	**(IRS Employer Identification No)**
86 North Main Street, Porterville, California	**93257**
(Address of principal executive offices)	**(Zip Code)**

(559) 782-4900

(Registrant s telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ¨ No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

Large accelerated filer ¨ Accelerated filer þ Non-accelerated filer ¨ Smaller Reporting Company ¨

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No þ

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

Common stock, no par value, 9,678,791 shares outstanding as of April 30, 2009

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PART I FINANCIAL INFORMATION

Item 1

SIERRA BANCORP

CONSOLIDATED BALANCE SHEETS

(dollars in thousands)

	March 31, 2009 (unaudited)	December 31, 2008 (audited)
ASSETS		
Cash and due from banks	$ 24,211	$ 40,960
Interest-bearing deposits in other banks	5,050	5,050
Federal funds sold	8,300	5,500
Total Cash & Cash Equivalents	37,561	51,510
Investment securities available for sale	239,679	243,413
Loans and leases:		
Gross loans and leases	947,098	946,640
Allowance for loan and lease losses	(15,181)	(15,094)
Deferred loan and lease fees, net	(1,151)	(1,365)
Net Loans and Leases	930,766	930,181
Premises and equipment, net	18,993	19,280
Other assets	80,873	81,908
TOTAL ASSETS	$ 1,307,872	$ 1,326,292
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES		
Deposits:		
Non-interest bearing	$ 221,150	$ 232,168
Interest bearing	873,859	829,330
Total Deposits	1,095,009	1,061,498
Federal funds purchased and repurchase agreements	24,799	24,419
Short-term borrowings	15,000	59,500
Long-term borrowings	20,000	30,000
Other liabilities	12,847	13,147
Junior subordinated debentures	30,928	30,928
TOTAL LIABILITIES	1,198,583	1,219,492
SHAREHOLDERS' EQUITY		
Common stock, no par value; 24,000,000 shares authorized; 9,678,791 and 9,673,291 shares issued and outstanding at March 31, 2009 and December 31, 2008, respectively	13,466	13,429
Additional paid in capital	8,501	8,460
Retained earnings	85,659	83,932
Accumulated other comprehensive income (loss)	1,663	979

TOTAL SHAREHOLDERS' EQUITY	109,289	106,800
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 1,307,872	$ 1,326,292

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

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SIERRA BANCORP

CONSOLIDATED STATEMENTS OF INCOME

(dollars in thousands, except per share data, unaudited)

	For the Quarter Ended March 31, 2009	For the Quarter Ended March 31, 2008
Interest income:		
Interest and fees on loans	$ 14,979	$ 18,303
Interest on investment securities:		
Taxable	2,098	1,592
Tax-exempt	588	578
Interest on Federal funds sold and interest-bearing deposits	36	6
Total interest income	17,701	20,479
Interest expense:		
Interest on deposits	3,243	4,426
Interest on short-term borrowings	134	1,504
Interest on long-term borrowings	241	91
Interest on mandatorily redeemable trust preferred securities	282	515
Total interest expense	3,900	6,536
Net Interest Income	13,801	13,943
Provision for loan losses	3,601	2,270
Net Interest Income after Provision for Loan Losses	10,200	11,673
Non-interest revenue:		
Service charges on deposit accounts	2,629	2,468
Gains on investment securities available-for-sale	66	45
Other	745	1,654
Total other operating income	3,440	4,167
Other operating expense:		
Salaries and employee benefits	5,060	4,498
Occupancy expense	1,655	1,486
Other	3,498	2,559
Total other operating expenses	10,213	8,543
Income before income taxes	3,427	7,297
Provision for income taxes	732	2,338
Net Income	$ 2,695	$ 4,959
PER SHARE DATA		
Book value	$ 11.29	$ 10.65
Cash dividends	$ 0.10	$ 0.17
Earnings per share basic	$ 0.28	$ 0.52
Earnings per share diluted	$ 0.28	$ 0.51
Average shares outstanding, basic	9,675,846	9,558,161
Average shares outstanding, diluted	9,752,425	9,801,531

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

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SIERRA BANCORP

CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands, unaudited)

	Three Months Ended March 31, 2009	2008
Cash Flows from Operating Activities		
Net income	$ 2,695	$ 4,959
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on investment securities		(45)
Gain on sales of loans	(6)	(1)
Gain on disposal of fixed assets	5	(82)
Loss on sale on foreclosed assets	28	32
Writedown on foreclosed assets	(518)	
Share-based compensation expense	40	86
Provision for loan losses	3,601	2,270
Depreciation and amortization	792	722
Net amortization on securities premiums and discounts	7	29
Increase in unearned net loan fees	(214)	(226)
Increase in cash surrender value of life insurance policies	(106)	(160)
Proceeds from sales of loans held for sale	(651)	
Decrease in interest receivable and other assets	849	811
Increase (Decrease) in other liabilities	(300)	172
Excess tax benefit from share-based payment arrangements		(113)
Net cash provided by operating activities	6,222	8,454
Cash Flows from Investing Activities		
Maturities of securities available for sale	537	1,200
Proceeds from sales/calls of securities available for sale	498	6,000
Purchases of securities available for sale	(5,873)	(61,205)
Principal paydowns on securities available for sale	9,745	5,438
Decrease in loans receivable, net	(3,138)	(1,094)
Purchases of premises and equipment, net	(401)	(844)
Proceeds from sales of foreclosed assets		1,264
Net cash provided by (used in) investing activities	1,368	(49,241)
Cash Flows from Financing Activities		
Increase in deposits	33,511	73,401
Decrease in federal funds purchased		(7,000)
Decrease in borrowed funds	(54,500)	(26,000)
Increase in repurchase agreements	380	3,812
Cash dividends paid	(968)	(1,630)
Stock repurchased		(2,080)
Stock options exercised	38	299
Excess tax benefit from share-based payment arrangements		113
Net cash (used in) provided by financing activities	(21,539)	40,915
Increase (Decrease) in cash and cash equivalents	(13,949)	128

Cash and Cash Equivalents		
Beginning of period	51,510	44,022
End of period	$ 37,561	$ 44,150

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

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SIERRA BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2009

Note 1 The Business of Sierra Bancorp

Sierra Bancorp (the Company), headquartered in Porterville, California, is a California corporation registered as a bank holding company under the Bank Holding Company Act of 1956, as amended. The Company was incorporated in November 2000 and acquired all of the outstanding shares of Bank of the Sierra (the Bank) in August 2001. The Company s principal subsidiary is the Bank, and the Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. The Company s main source of income is dividends from the Bank, but we intend to explore supplemental sources of income in the future. The expenditures of the Company, including (but not limited to) the payment of dividends to shareholders, if and when declared by our Board of Directors, the cost of servicing debt, audit costs, and shareholder expenses, will generally be paid from accumulated cash or from dividends remitted to the Company by the Bank.

At the present time, the Company s only other direct subsidiaries are Sierra Statutory Trust II and Sierra Capital Trust III, which were formed in March 2004 and June 2006, respectively, solely to facilitate the issuance of capital trust pass-through securities. Pursuant to Financial Accounting Standards Board (FASB) Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46), these trusts are not reflected on a consolidated basis in the financial statements of the Company. References herein to the Company include Sierra Bancorp and its consolidated subsidiary, the Bank, unless the context indicates otherwise.

The Bank is a California state-chartered bank headquartered in Porterville, California, that offers a full range of retail and commercial banking services to communities in the central and southern sections of the San Joaquin Valley. On the southern end, our footprint extends east through the Tehachapi plateau and into the northwestern tip of the Mojave Desert. The Bank was incorporated in September 1977 and opened for business in January 1978, and in the ensuing years has grown to be the largest independent bank head-quartered in the South San Joaquin Valley. Our growth has primarily been organic, but includes the acquisition of Sierra National Bank in 2000. We currently operate 23 full service branch offices throughout our geographic footprint, as well as an internet branch which provides the ability to open deposit accounts online. The Bank s two newest brick and mortar branches commenced operations in the Sunnyside area of South Fresno in November 2008 and in East Bakersfield in July 2008. Our next office is expected to be a second branch in the City of Tulare, with an anticipated opening in the third quarter of 2009, and we have also executed a ground lease for a location in Selma. In addition to these full-service branches, the Bank has an agricultural credit unit and an SBA lending unit with staff located at our corporate headquarters, offsite ATM s at seven different non-branch locations, and a virtual branch through which customers can open deposit accounts and submit certain loan applications online. The Bank s deposit accounts are insured by the Federal Deposit Insurance Corporation (FDIC) up to maximum insurable amounts.

Note 2 Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in a condensed format, and therefore do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The information furnished in these interim statements reflects all adjustments that are, in the opinion of management, necessary for a fair statement of the results for such period. Such adjustments are of a normal recurring nature, unless otherwise disclosed in this Form 10-Q. The results of operations in the interim statements are not necessarily indicative of the results that may be expected for any other quarter, or for the full year. Certain amounts reported for 2008 have been reclassified to be consistent with the reporting for 2009. The interim financial information should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2008 as filed with the Securities and Exchange Commission.

Note 3 Current Accounting Developments

In April 2009, the FASB issued three FASB Staff Positions (FSP s) related to fair value and impairment charges (see Note 9 Fair Value Option and Fair Value Measurements, below), for interim and annual periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. FSP No. FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, amends Statement of Financial Accounting Standards No. 157, Fair Value Measurements (FAS 157), to better determine fair value when there is no active market or where the price inputs being used represent distressed sales, and requires disclosures if application of the FSP results in any changes in valuation techniques or related inputs. FSP No. FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments, relates to FAS 115 and EITF 99-20. It affirms the requirement that the entire impairment of an impaired debt security be recognized as an other-than-temporary impairment (OTTI) in earnings if it is likely that the security will be sold prior to recovery of the security s cost basis, but allows an entity to recognize the non-credit related portion of the security s OTTI as part of other comprehensive income rather than earnings if it is more likely that an impaired security will held until its cost basis can be recovered. FSP No. FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments, requires additional qualitative disclosures under FAS 107 for interim periods for public companies, in addition to the existing annual requirement.

Note 4 Supplemental Disclosure of Cash Flow Information

During the three months ended March 31, 2009 and 2008, cash paid for interest due on interest-bearing liabilities was $4.3 million and $5.8 million, respectively. There was no cash paid for income taxes during the three months ended March 31, 2009, and $410,000 in cash paid for income taxes during the three months ended March 31, 2008. Assets totaling $1.3 million and $2.6 million were acquired in the settlement of loans for the three months ended March 31, 2009 and March 31, 2008, respectively, while $471,000 in foreclosed assets were sold during the first three months of 2009 relative to $1.3 million sold during the first three months of 2008. There were no loans extended to finance the sale of other real estate during the three months ended March 31, 2009, and only one loan in the amount of $825,000 for the three months ended March 31, 2008.

Note 5 Share Based Compensation

The 2007 Stock Incentive Plan (the 2007 Plan) was adopted by the Company in 2007 and our 1998 Stock Option Plan (the 1998 Plan) was concurrently terminated, although 424,278 options granted prior to the termination of the 1998 Plan were still outstanding as of March 31, 2009 and were not affected by the termination. The 2007 Plan provides for the issuance of both incentive and nonqualified stock options to officers and employees, and of nonqualified stock options to non-employee directors, of the Company. The 2007 Plan also provides for the issuance of restricted stock awards to these same classes of eligible participants, which awards may be granted on such terms and conditions as are established at the discretion of the Board of Directors or the Compensation Committee. The total number of shares of the Company s authorized but unissued stock reserved and available for issuance pursuant to Awards under the 2007 Plan was initially 1,500,000 shares, although options were granted in the fourth quarters of 2007 and 2008 and the number available for grant as of March 31, 2009 was 1,346,900.

Pursuant to FASB Statement 123(R), share-based employee compensation expense is reflected in our income statement for each option granted, over the vesting period of such option. The Company is utilizing the Black-Scholes model to value stock options, and the multiple option approach is used to allocate the resulting valuation to actual expense. Under the multiple option approach, an employee s options for each vesting period are separately valued and amortized. This appears to be the FASB-preferred method for option grants with multiple vesting periods, which is the case for most options granted by the Company. A pre-tax charge of $40,000 was reflected in the Company s income statement during the first quarter of 2009 and $86,000 was reflected during the first quarter of 2008, as compensation expense related to outstanding and unvested stock options.

Note 6 Earnings Per Share

Basic earnings per share for all periods presented in the Consolidated Statements of Income are computed based on the weighted average number of shares outstanding during each period. There were 9,675,846 weighted average shares outstanding during the first quarter of 2009, and 9,558,161 during the first quarter of 2008.

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Diluted earnings per share include the effect of the potential issuance of common shares, which for the Company is limited to in-the-money shares that would be issued on the exercise of outstanding stock options. The dilutive effect of all options outstanding was calculated using the treasury stock method, excluding anti-dilutive shares and adjusting for unamortized expense and windfall tax benefits. For the first quarter of 2009, the dilutive effect of options outstanding calculated under the treasury stock method totaled 76,579, which was added to basic weighted average shares outstanding for purposes of calculating diluted earnings per share. Likewise, for the first quarter of 2008, shares totaling 243,370 were added to basic weighted average shares outstanding in order to calculate diluted earnings per share.

Note 7 Comprehensive Income

Comprehensive income includes net income and other comprehensive income. The Company s only source of other comprehensive income is derived from unrealized gains and losses on investment securities available-for-sale. Reclassification adjustments, resulting from gains or losses on investment securities that were realized and included in net income of the current period that also had been included in other comprehensive income as unrealized holding gains or losses in the period in which they arose, are excluded from comprehensive income of the current period. The Company s comprehensive income was as follows (dollars in thousands):

	For the Three-month Period Ended March 31, 2009	2008
Net income	$ 2,695	$ 4,959
Other comprehensive income:		
Unrealized holding gain	1,178	2,209
Less: reclassification adjustment		45
Pre-tax other comprehensive income	1,178	2,164
Less: tax impact of above	495	910
Net other comprehensive income	683	1,254
Comprehensive income	$ 3,378	$ 6,213

Note 8 Financial Instruments with Off-Balance-Sheet Risk

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business, in order to meet the financing needs of its customers. These financial instruments consist of commitments to extend credit and standby letters of credit. They involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The Company s exposure to credit loss in the event of nonperformance by the other party for commitments to extend credit and letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and issuing letters of credit as it does for making loans included on the balance sheet. The following financial instruments represent off-balance-sheet credit risk (dollars in thousands):

	March 31, 2009	December 31, 2008
Commitments to extend credit	$ 186,103	$ 177,230
Standby letters of credit	$ 10,444	$ 11,138
Commercial letters of credit	$ 10,082	$ 10,098

Commitments to extend credit consist primarily of unfunded single-family residential construction loans and home equity lines of credit, and commercial real estate construction loans and commercial revolving lines of credit. Construction loans are established under standard underwriting guidelines and policies and are secured by deeds of trust, with disbursements made over the course of construction. Commercial revolving lines of credit have a high degree of industry diversification. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Standby letters of credit are generally unsecured and are issued by the

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Company to guarantee the performance of a customer to a third party, while commercial letters of credit represent the Company s commitment to pay a third party on behalf of a customer upon fulfillment of contractual requirements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

Note 9 Fair Value Option and Fair Value Measurements

FAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (FAS 159), provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities.

In FAS 157, fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. FAS 157 establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a company s own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Company used the following methods and significant assumptions to estimate fair values for each category of financial assets noted below:

Securities: The fair values of trading securities and securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges or matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities relationship to other benchmark quoted securities.

Loans held for sale: Since loans designated by the Company as available-for-sale are typically sold shortly after making the decision to sell them, realized gains or losses are usually recognized within the same period and fluctuations in fair values are thus not relevant for reporting purposes. If available for sale loans exist on our books as of a reporting date, the fair value of those loans is determined using quoted secondary-market prices.

Impaired loans: A specific loss allowance is created for impaired loans, representing the difference between the face value of the loan and either its current appraised value less estimated disposition costs, or its net present value as determined by a discounted cash flow analysis. An impaired real estate loan might be carried on our books at its face value with an associated specific loss reserve included as part of the Company s allowance for loan and lease losses, or it might be written down to its estimated impaired value with an offsetting entry to the allowance, depending on the likelihood of the ultimate realization of the impaired amount.

Foreclosed assets: Repossessed real estate (OREO) and other assets are acquired at fair value, which is appraised value less expected selling costs for OREO and some other assets such as mobile homes, and estimated sales proceeds as determined by using reasonably available sources for all other assets. Foreclosed assets for which appraisals can be feasibly obtained are periodically measured for impairment using updated appraisals. Other foreclosed assets are periodically re-evaluated by adjusting expected cash flows and timing of resolution, again using reasonably available sources. If impairment is determined to exist, the book value of a foreclosed asset is

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immediately written down to its estimated impaired value through the income statement, thus the carrying amount is equal to the fair value and there is no valuation allowance.

Assets and liabilities measured at fair value on a recurring basis, including financial liabilities for which the Company has elected the fair value option, are summarized below:

	Fair Value Measurements at March 31, 2009, Using			
	Level 1	Level 2	Level 3	Total
Available for Sale Securities	$ 1,423,294	$ 238,255,423	$	$ 239,678,717
Loans Held for Sale	$ 650,746	$	$	$ 650,746

Assets and liabilities measured at the lower of cost or fair value on a non-recurring basis are summarized below:

	Lower of Cost or Fair Value at March 31, 2009, Using			
	Level 1	Level 2	Level 3	Total
Impaired Loans	$	$ 38,476,891	$ 3,940,208	$ 42,417,099
Foreclosed Assets	$	$ 7,440,362	$	$ 7,440,362

Impaired loans had a carrying amount of $44,690,738 at March 31, 2009, with a valuation allowance of $2,273,639.

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PART I FINANCIAL INFORMATION

ITEM 2

MANAGEMENT S DISCUSSION AND

ANALYSIS OF FINANCIAL CONDITION

AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

This Form 10-Q includes forward-looking statements that involve inherent risks and uncertainties. Words such as expects , anticipates , believes , projects , and estimates or variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed, forecast in, or implied by such forward-looking statements.

A variety of factors could have a material adverse impact on the Company s financial condition or results of operations, and should be considered when evaluating the potential future financial performance of the Company. These include, but are not limited to, the possibility of deterioration in economic conditions in the Company s service areas; risks associated with fluctuations in interest rates; liquidity risks; increases in nonperforming assets and net credit losses that could occur, particularly in times of weak economic conditions or rising interest rates; the loss in market value of available-for-sale securities that could result if interest rates change substantially or an issuer has real or perceived financial difficulties; and risks associated with the multitude of current and future laws and regulations to which the Company is and will be subject.

CRITICAL ACCOUNTING POLICIES

The Company s financial statements are prepared in accordance with accounting principles generally accepted in the United States. The financial information and disclosures contained within those statements are significantly impacted by Management s estimates and judgments, which are based on historical experience and various other assumptions that are believed to be reasonable under current circumstances. Actual results may differ from those estimates under divergent conditions.

Critical accounting policies are those that involve the most complex and subjective decisions and assessments, and have the greatest potential impact on the Company s stated results of operations. In Management s opinion, the Company s critical accounting policies deal with the following areas: the establishment of the Company s allowance for loan and lease losses, as explained in detail in the Provision for Loan and Lease Losses and Allowance for Loan and Lease Losses sections of this discussion and analysis; deferred loan origination costs, as discussed below in Non-Interest Revenue and Operating Expense, which are estimated based on an annual evaluation of expenses (primarily salaries) associated with successful loan originations and are allocated to individual loans as they are booked, but can actually vary significantly for individual loans depending on the characteristics of such loans; income taxes, especially with regard to the ability of the Company to recover deferred tax assets, as discussed in the Provision for Income Taxes and Other Assets sections of this discussion and analysis; goodwill, which is evaluated annually based on changes in the market capitalization of the Company and for which management has determined that no impairment exists; and equity-based compensation, which is discussed in greater detail in Note 5 to the consolidated financial statements. Critical accounting areas are evaluated on an ongoing basis to ensure that the Company s financial statements incorporate the most recent expectations with regard to these areas.

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OVERVIEW OF THE RESULTS OF OPERATIONS

AND FINANCIAL CONDITION

RESULTS OF OPERATIONS SUMMARY

First Quarter 2009 compared to First Quarter 2008

Net income for the quarter ended March 31, 2009 was $2.7 million compared with $5.0 million for the quarter ended March 31, 2008, a drop of 46%. Basic and diluted earnings per share for the first quarter of 2009 were $0.28, compared to $0.52 basic earnings per share and $0.51 diluted earnings per share for the first quarter of 2008. The Company s annualized return on average equity was 10.03% and annualized return on average assets was 0.83% for the quarter ended March 31, 2009, compared to a return on equity of 19.82% and return on assets of 1.62% for the quarter ended March 31, 2008. The primary drivers behind the variance in net income are as follows:

Because of a lower net interest margin, net interest income declined 1% despite an increase of $80 million, or 7%, in average interest-earning assets. Our net interest margin declined to 4.80% from 5.15% due to net interest reversals on loans placed on non-accrual in the first quarter of 2009, stronger growth in investments than in higher-yielding loans, a significant increase in the average balance of non-accruing loans and OREO, the impact of declining interest rates, and an increase in the percentage of interest-earning assets funded by interest-bearing liabilities.

The provision for loan losses was $3.6 million in the first quarter of 2009, which represents an increase of $1.3 million, or 59%, relative to the first quarter of 2008, due to an increase in specific reserves for potential losses on certain loans migrating to non-accrual status, and higher general reserves for certain performing loan categories as dictated by evolving historical loss rates and forward-looking risk factors.

Despite a $161,000, or 7%, increase in service charges on deposit accounts, total non-interest income declined by $727,000, or 17%, due in part to non-recurring events that added $459,000 to income in 2008. The drop also reflects the elimination of dividends on our FHLB equity investment, and includes a significant increase in pass-through operating costs associated with our investment in low-income housing tax credit funds. Tax credit investment costs are netted against non-interest income.

Total non-interest expense increased by $1.7 million, or 20%. In addition to increases in personnel and occupancy costs, related in part to our newest branches, other non-interest expenses were up by $939,000, or 37%. The increase in Other is due mainly to a $242,000 non-recurring offset against deposit services costs in the first quarter of 2008, an increase in FDIC insurance assessments, costs related to credit issues, and an increase in telecommunications expense.

The Company s tax accrual rate dropped to 21% in the first quarter of 2009 from 32% in the first quarter of 2008, mainly because tax credits and tax-exempt municipal income stayed about the same and thus had a relatively greater impact on a lower level of pre-tax income.

FINANCIAL CONDITION SUMMARY

March 31, 2009 relative to December 31, 2008

The Company s total assets were $1.308 billion at March 31, 2009, an $18 million decline relative to total assets of $1.326 billion at December 31, 2008. The most significant characteristics of and changes in the Company s balance sheet during the first three months of 2009 are outlined below:

Total assets dropped due to a $17 million decline in cash and due from banks, caused mainly by timing differences on cash items in process of collection. Interest-earning assets were about the same, since a $3 million increase in fed funds sold and an increase of $585,000 in net loans and leases were roughly offset by a $4 million drop in investment securities.

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Total deposits increased by $34 million, or 3%, although after a $24 million drop in wholesale-sourced brokered deposits is factored out, the growth in branch deposits is calculated at $58 million, or 6%. Most of the increase in branch deposits was in time deposits, including a $17 million increase in CDARS deposits and a $39 million increase in other time deposits over $100,000.

We were able to let $55 million in Federal Home Loan Bank (FHLB) borrowings roll off due to the aggregate deposit influx and the drop in total assets, thus improving our liquidity position.

Total nonperforming assets increased by $15 million, or 41%, ending the quarter at $52 million. An $11 million real estate loan that was classified as nonperforming, but is well-secured based on a current appraisal, represents a major portion of the increase. Nonperforming assets were 3.98% of total assets at March 31, 2009 and 2.79% at December 31, 2008.

The Company had net charge-offs against the allowance for loan and lease losses totaling $3.5 million during the first quarter of 2009, relative to $2.1 million during the first quarter of 2008. Losses on unsecured consumer loans were much lower, but losses on commercial loans and real estate loans increased substantially. As of March 31, 2009 our allowance for loan and lease losses was 1.60% of total loans, relative to 1.59% at December 31, 2008 and 1.35% at March 31, 2008. Because of the large increase in nonperforming loans, however, the allowance fell to 34% of nonperforming loans at March 31, 2009, from 51% at December 31, 2008.

EARNINGS PERFORMANCE

The Company earns income from two primary sources. The first is net interest income, which is interest income generated by earning assets less interest expense on interest-bearing liabilities. The second is non-interest income, which primarily consists of customer service charges and fees but also comes from non-customer sources such as bank-owned life insurance. The majority of the Company s non-interest expenses are operating costs that relate to providing a full range of banking services to our customers.

NET INTEREST INCOME AND NET INTEREST MARGIN

For the first quarter, net interest income declined by $142,000, or 1%, to $13.8 million in 2009 from $13.9 million in 2008. The level of net interest income depends on several factors in combination, including growth in earning assets, yields on earning assets, the cost of interest-bearing liabilities, the relative volumes of earning assets and interest-bearing liabilities, and the mix of products which comprise the Company s earning assets, deposits, and other interest-bearing liabilities. Net interest income can also be impacted by the reversal of interest for loans placed on non-accrual, and by the recovery of interest on loans that have been on non-accrual and are either sold or returned to accrual status.

The following Average Balances and Rates table shows, for the quarters noted, the average balance of each principal balance sheet category and the amount of interest income or interest expense associated with that category. This table also shows the calculated yields on each major component of the Company s investment and loan portfolio, the average rates paid on each key segment of the Company s interest bearing liabilities, and the net interest margin.

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Average Balances and Rates

(dollars in thousands, except per share data)	For the Quarter Ended March 31, 2009 (a) (b) (f) Average Balance	Income/ Expense	Average Rate/Yield	For the Quarter Ended March 31, 2008 (a) (b) (f) Average Balance	Income/ Expense	Average Rate/Yield
Assets						
Investments:						
Federal funds sold/Due from time	$ 12,022	$ 36	1.21%	$ 705	$ 6	3.42%
Taxable	181,687	2,098	4.68%	138,235	1,592	4.63%
Non-taxable	58,650	588	4.07%	58,425	578	3.98%
Equity	1,601		0.00%	335		0.00%
Total Investments	253,960	2,722	4.35%	197,700	2,176	4.43%
Loans and Leases:[(c) (e)]						
Agricultural	12,809	174	5.51%	11,659	233	8.04%
Commercial	138,718	2,024	5.92%	133,703	2,663	8.01%
Real Estate	667,750	11,173	6.79%	689,088	13,732	8.01%
Consumer	65,493	1,351	8.37%	55,212	1,372	9.99%
Direct Financing Leases	16,980	257	6.14%	19,832	303	6.14%
Other	38,184		0.00%	6,533		0.00%
Total Loans and Leases	939,934	14,979	6.46%	916,027	18,303	8.04%
Total Interest Earning Assets [(e)]	1,193,894	17,701	6.01%	1,113,727	20,479	7.40%
Other Earning Assets	9,361			10,567		
Non-Earning Assets	109,167			108,504		
Total Assets	$ 1,312,422			$ 1,232,798		
Liabilities and Shareholders' Equity						
Interest Bearing Deposits:						
NOW	$ 102,275	$ 90	0.36%	$ 88,801	$ 102	0.46%
Savings Accounts	57,497	41	0.29%	52,670	69	0.53%
Money Market	145,861	558	1.55%	126,029	715	2.28%
CDAR s	116,099	659	2.30%	15,493	151	3.92%
Certificates of Deposit < $100,000	115,348	588	2.07%	129,110	1,203	3.75%
Certificates of Deposit ≥ $100,000	198,983	648	1.32%	155,150	1,415	3.67%
Brokered Deposits	119,477	659	2.24%	66,767	771	4.64%
Total Interest Bearing Deposits	855,540	3,243	1.54%	634,020	4,426	2.81%
Borrowed Funds:						
Federal Funds Purchased	648		0.00%	7,734	66	3.43%
Repurchase Agreements	24,328	17	0.28%	23,463	29	0.50%
Short-Term Borrowings	22,458	117	2.11%	174,325	1,409	3.25%
Long-Term Borrowings	28,111	241	3.48%	10,824	91	3.38%
TRUPS	30,928	282	3.70%	30,928	515	6.70%
Total Borrowed Funds	106,473	657	2.50%	247,274	2,110	3.43%
Total Interest Bearing Liabilities	962,013	3,900	1.64%	881,294	6,536	2.98%

Demand Deposits	226,351			232,399		
Other Liabilities	15,050			18,461		
Shareholders' Equity	109,008			100,644		
Total Liabilities and Shareholders' Equity	$ 1,312,422			$ 1,232,798		
Interest Income/Interest Earning Assets			6.12%			7.51%
Interest Expense/Interest Earning Assets			1.32%			2.36%
Net Interest Income and Margin[(d)]		$ 13,801	4.80%		$ 13,943	5.15%

(a) Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.

(b) Yields and net interest margi