GREENVILLE FIRST BANCSHARES INC
Form 10QSB
August 11, 2004

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

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

For the Quarterly Period Ended June 30, 2004

OR

**o 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 000-27719

Greenville First Bancshares, Inc.

(Exact name of registrant as specified in its charter)

South Carolina (State of Incorporation)	**58-2459561** (I.R.S. Employer Identification No.)
112 Haywood Road **Greenville, S.C.** (Address of principal executive offices)	**29607** (Zip Code)

864-679-9000

(Telephone Number)

Not Applicable

(Former name, former address

and former fiscal year,

if changed since last report)

Check whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 ý No o

APPLICABLE ONLY TO CORPORATE ISSUERS

State the number of shares outstanding of each of the issuer s classes of common equity, as of the latest practicable date:

1,727,994 shares of common stock, $.01 par value per share, issued and outstanding as of July 9, 2004.

Transitional Small Business Disclosure Format (check one): YES o NO ý

GREENVILLE FIRST BANCSHARES, INC.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

The financial statements of Greenville First Bancshares, Inc. and Subsidiary are set forth in the following pages.

GREENVILLE FIRST BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

	June 30, 2004 (Unaudited)	December 31, 2003 (Audited)
Assets		
Cash and due from banks	$ 2,613,413	$ 4,104,697
Federal funds sold	1,365,400	2,842,594
Investment securities available for sale	3,078,733	3,628,996
Investment securities held to maturity- (market value $13,658,094 and $9,761,305)	14,215,247	9,834,324
Other investments, at cost	3,591,373	2,296,150
Loans, net	244,407,022	206,076,833
Accrued interest	871,930	756,905
Property and equipment, net	1,557,915	824,259
Other real estate owned	305,485	
Other assets	1,386,183	476,463
Total assets	$ 273,392,701	$ 230,841,221
Liabilities		
Deposits	$ 177,987,321	$ 168,963,595
Official checks outstanding	1,104,261	1,575,357
Federal funds purchased and repurchase agreements	13,565,000	9,296,999
Federal Home Loan Bank advances	58,400,000	32,500,000
Note payable	3,000,000	
Junior subordinate debentures	6,186,000	6,186,000
Accrued interest payable	724,534	572,272
Accounts payable and accrued expenses	485,023	560,030
Total liabilities	261,452,139	219,654,253
Shareholders equity		
Preferred stock, par value $.01 per share, 10,000,000 shares authorized, no shares issued		
Common stock, par value $.00667 Authorized, 10,000,000 shares. Issued 1,727,994 and 1,724,994 at June 30, 2004 and December 31, 2003, respectively.	11,520	11,500
Additional paid-in capital	10,655,190	10,635,200
Accumulated other comprehensive income	28,780	96,997
Retained earnings	1,245,072	443,271
Total shareholders equity	11,940,562	11,186,968
Total liabilities and shareholders equity	$ 273,392,701	$ 230,841,221

See notes to consolidated financial statements that are an integral part of these consolidated statements.

GREENVILLE FIRST BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

	For the Three months ended June 30, 2004 (Unaudited)	2003 (Unaudited)
Interest income		
Loans	$ 2,950,548	$ 2,219,654
Investment securities	220,364	62,569
Federal funds sold	4,703	5,179
Total interest income	3,175,615	2,287,402
Interest expense		
Deposits	840,564	682,896
Borrowings	374,606	177,924
Total interest expense	1,215,170	860,820
Net interest income before provision for loan losses	1,960,445	1,426,582
Provision for loan losses	300,000	200,000
Net interest income after provision for loan losses	1,660,445	1,226,582
Noninterest income		
Loan fee income	40,789	59,312
Service fees on deposit accounts	72,978	63,567
Write-down on real estate owned		(100,000)
Other income	86,810	61,075
Total noninterest income	200,577	83,954
Noninterest expenses		
Compensation and benefits	600,877	488,564
Professional fees	50,882	40,958
Marketing	74,679	43,396
Insurance	31,146	26,580
Occupancy	149,129	137,965
Data processing and related costs	215,304	154,473
Telephone	6,836	5,717
Other	64,661	42,794
Total noninterest expenses	1,193,514	940,447
Income before income tax expense	667,508	370,089
Income tax expense	253,657	140,634
Net income	$ 413,851	$ 229,455
Earnings per common share:		
Basic	$ 0.24	$ 0.13
Diluted	$ 0.21	$ 0.12
Weighted average common shares outstanding		
Basic	1,725,494	1,724,994
Diluted	1,988,584	1,886,399

See notes to consolidated financial statements that are an integral part of these consolidated statements.

GREENVILLE FIRST BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

	For the Six months ended June 30, 2004 (Unaudited)		For the Six months ended June 30, 2003 (Unaudited)	
Interest income				
Loans	$	5,688,464	$	4,307,650
Investment securities		445,178		199,113
Federal funds sold		9,293		11,668
Total interest income		6,142,935		4,518,431
Interest expense				
Deposits		1,568,286		1,412,376
Borrowings		681,219		340,394
Total interest expense		2,249,505		1,752,770
Net interest income before provision for loan losses		3,893,430		2,765,661
Provision for loan losses		650,000		500,000
Net interest income after provision for loan losses		3,243,430		2,265,661
Noninterest income				
Loan fee income		66,824		103,666
Service fees on deposit accounts		139,728		123,296
Write-down on real estate owned				(100,000)
Other income		156,348		104,145
Total noninterest income		362,900		231,107
Noninterest expenses				
Compensation and benefits		1,199,522		967,842
Professional fees		99,815		74,559
Marketing		125,958		78,745
Insurance		61,662		53,265
Occupancy		289,899		299,362
Data processing and related costs		396,775		287,530
Telephone		13,306		11,187
Other		126,159		84,955
Total noninterest expenses		2,313,096		1,857,445
Income before income tax expense		1,293,234		639,323
Income tax expense		491,433		242,942
Net income	$	801,801	$	396,381
Earnings per common share:				
Basic	$	0.46	$	0.23
Diluted	$	0.40	$	0.21
Weighted average common shares outstanding				
Basic		1,725,294		1,724,994
Diluted		1,998,109		1,860,371

See notes to consolidated financial statements that are an integral part of these consolidated statements.

GREENVILLE FIRST BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

AND COMPREHENSIVE INCOME

FOR THE SIX MONTHS ENDED JUNE 30, 2004 AND 2003

(Unaudited)

	Common Stock				Additional		Accumulated other		Retained		Total
	Shares		**Amount**		**paid-in capital**		**comprehensive income**		**earnings (deficit)**		**shareholders equity**
December 31, 2002	1,150,000	$	11,500	$	10,635,200	$	147,733	$	(562,644)	$	10,231,789
Net income									396,381		396,381
Comprehensive loss, net of tax -											
Unrealized holding gain on securities available for sale							(27,614)				(27,614)
Comprehensive income											368,767
June 30, 2003	1,150,000	$	11,500	$	10,635,200	$	120,119	$	(166,263)	$	10,600,556
December 31, 2003	1,724,994	$	11,500	$	10,635,200	$	96,997	$	443,271	$	11,186,968
Net income									801,801		801,801
Comprehensive income, net of tax -											
Unrealized holding loss on securities available for sale							(68,217)				(68,217)
Comprehensive income											733,584
Exercise of warrants	3,000		20		19,990						20,010
June 30, 2004	1,727,994	$	11,520	$	10,655,190	$	28,780	$	1,245,072	$	11,940,562

See notes to consolidated financial statements that are an integral part of these consolidated statements.

GREENVILLE FIRST BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Six months ended June 30, 2004 (Unaudited)	2003 (Unaudited)
Operating activities		
Net income	$ 801,801	$ 396,381
Adjustments to reconcile net income to cash provided by operating activities:		
Provision for loan losses	650,000	500,000
Depreciation and other amortization	73,553	69,704
Accretion and amortization of securities discounts and premiums, net	50,756	50,869
Increase in other assets, net	(1,024,744)	(631,328)
Increase (decrease) in other liabilities, net	(358,699)	2,959,721
Net cash provided by operating activities	192,667	3,345,347
Investing activities		
Origination of loans, net	(39,285,674)	(26,005,362)
Purchase of property and equipment	(807,209)	(33,042)
Purchase of investment securities:		
Held to maturity	(5,585,942)	
Other investments	(2,510,000)	(800,000)
Payments and maturity of investment securities:		
Available for sale	429,286	9,889,791
Held to maturity	1,171,657	
Other investments	1,215,000	
Net cash used for investing activities	(45,372,882)	(16,948,613)
Financing activities		
Increase in deposits, net	9,023,726	10,983,054
Increase (decrease) in short-term borrowings	4,268,001	(9,107,000)
Increase (decrease) in other borrowings	3,000,000	(2,500,000)
Proceeds from junior subordinate debentures		6,186,000
Proceeds from exercise of stock warrants, net	20,010	
Increase in Federal Home Loan Bank advances	25,900,000	12,500,000
Net cash provided by financing activities	42,211,737	18,062,054
Net increase (decrease) in cash and cash equivalents	(2,968,478)	4,458,788
Cash and cash equivalents at beginning of the period	6,947,291	4,471,026
Cash and cash equivalents at end of the period	$ 3,978,813	$ 8,929,814
Supplemental information		
Cash paid for		
Interest	$ 2,097,244	$ 1,416,591
Income taxes	$ 1,266,585	$ 479,527

Schedule of non-cash transactions				
Foreclosure of real estate	$	305,485	$	
Unrealized loss on securities, net of income taxes	$	(68,217)	$	(27,614)

See notes to consolidated financial statements that are an integral part of these consolidated statements.

GREENVILLE FIRST BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Nature of Business and Basis of Presentation

Business activity

Greenville First Bancshares, Inc. (the company) is a South Carolina corporation that owns all of the capital stock of Greenville First Bank, N.A. (the bank) and all of the stock of Greenville First Statutory Trust I (the Trust). The bank is a national bank organized under the laws of the United States located in Greenville County, South Carolina. The bank is primarily engaged in the business of accepting demand deposits and savings deposits insured by the Federal Deposit Insurance Corporation, and providing commercial, consumer and mortgage loans to the general public. The Trust is a special purpose subsidiary for the sole purpose of issuing trust preferred securities.

Basis of Presentation

The accompanying financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-QSB. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the six-month period ended June 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004. For further information, refer to the consolidated financial statements and footnotes thereto included in the company s Form 10-KSB (Registration Number 000-27719) as filed with the Securities and Exchange Commission. The consolidated financial statements include the accounts of Greenville First Bancshares, Inc., and its wholly owned subsidiary Greenville First Bank, N.A. As discussed in Note 6, the financial statements related to the special purpose subsidiary, Greenville First Statutory Trust I, have not been consolidated in accordance with FASB Interpretation No. 46.

Cash and Cash Equivalents

For purposes of the Consolidated Statement of Cash Flows, cash and federal funds sold are included in cash and cash equivalents. These assets have contractual maturities of less than three months.

Note 2 Reclassifications

Certain amounts, previously reported, have been reclassified to state all periods on a comparable basis that had no effect on shareholder s equity or net income.

Note 3 Stock Split

On November 17, 2003, shareholders of record as of November 3, 2003, received one additional share of stock for every two shares of stock owned prior to the 3 for 2 stock split. All factional shares were paid in cash. The earnings per share amounts for all periods shown have been adjusted to reflect the 3 for 2 split.

Note 4 Note Payable

At June 30, 2004, the company had a $4.5 million revolving line of credit with another bank. At June 30, 2004, the outstanding balance was $3.0 million. This line of credit has a maturity of March 20, 2005. The line of credit bears interest at a rate of three-month libor plus 2.00%, which at June 30, 2004 was 3.11%. The company has pledged the stock of the bank as collateral for this line of credit. The line of credit agreement contains various covenants related to earnings and asset quality. As of June 30, 2004, the company believes it is in compliance with all covenants.

Note 5 Earnings per Share

The following schedule reconciles the numerators and denominators of the basic and diluted earnings per share computations for the three months and six months ended June 30, 2004 and 2003. Dilutive common shares arise from the potentially dilutive effect of Greenville First Bancshares, Inc. s stock options and warrants that are outstanding. The assumed conversion of stock options and warrants can create a difference between basic and dilutive net income per common share. The average dilutive shares have been computed utilizing the treasury stock method. The numbers of shares and the earnings per share have been adjusted for the 3 for 2 stock split.

	Three months ended June 30,			
		2004		**2003**
Basic Earnings Per Share				
Average common shares		1,725,494		1,724,994
Net income	$	413,851	$	229,455
Earnings per share	$	0.24	$	0.13
Diluted Earnings Per Share				
Average common shares outstanding		1,725,494		1,724,994
Average dilutive common shares		263,090		161,405
Adjusted average common shares		1,988,584		1,886,399
Net income	$	413,851	$	229,455
Earnings per share	$	0.21	$	0.12

	Six months ended June 30,			
		2004		**2003**
Basic Earnings Per Share				
Average common shares		1,725,294		1,724,994
Net income	$	801,801	$	396,381
Earnings per share	$	0.46	$	0.23
Diluted Earnings Per Share				
Average common shares outstanding		1,725,294		1,724,994
Average dilutive common shares		272,815		135,377
Adjusted average common shares		1,998,109		1,860,371
Net income	$	801,801	$	396,381
Earnings per share	$	0.40	$	0.21

Note 6 Accounting for Variable Interest Entities

Effective January 1, 2004, the Company adopted FASB Interpretation No. 46, (FIN 46), Consolidation of Variable Interest Entities. In accordance with FIN 46, the $186,000 investment by the parent company, Greenville First Bancshares, Inc, in the special purpose subsidiary, Greenville First Statutory Trust I, results in the special purpose subsidiary being treated as a variable interest entity as defined in FIN 46. Therefore, in accordance with the revised rules, the Company did not consolidate its special purpose trust subsidiary. Prior to the January 1, 2004, the effective date on the adoption of FIN 46, the company had consolidated the special purpose subsidiary. The 2003, consolidated financial statements have been restated, resulting in the deconsolidation of this wholly-owned subsidiary. The deconsolidation of this wholly-owned subsidiary, increased both the Company s other assets by $186,000, and the debt associated with the junior subordinate debentures. The company s maximum exposure to loss is the $186,000 invested in the special purpose subsidiary. In addition to the loss exposure related to the investment in the special purpose subsidiary, the Company has a full and unconditional guarantee for the $6,000,000 junior subordinate debentures that were issued. The special purpose subsidiary was formed for the sole purpose of issuing the junior subordinate debentures.

Note 7 Stock Based Compensation

The company has a stock-based employee compensation plan. The company accounts for the plan under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees,* and related Interpretations. No stock-based employee compensation cost is reflected in net income, as all stock options granted under these plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share if the company had applied the fair value recognition provisions of Financial Accounting Standards Board (FASB), Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation,* to stock-based employee compensation.

	For the Three months ended June 30,			
		2004		2003
Net income, as reported	$	413,851	$	229,455
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		(20,719)		(19,613)
Pro forma net income	$	393,132	$	209,842
Earnings per common share-adjusted for 3 for 2 stock split:				
Basic - as reported	$	0.24	$	0.13
Basic - pro forma	$	0.23	$	0.12
Diluted - as reported	$	0.21	$	0.12
Diluted - pro-forma	$	0.20	$	0.11

	For the Six months ended June 30,			
		2004		2003
Net income, as reported	$	801,801	$	396,381
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		(41,438)		(39,226)
Pro forma net income	$	760,363	$	357,155
Earnings per common share-adjusted for 3 for 2 stock split:				
Basic - as reported	$	0.46	$	0.23
Basic - pro forma	$	0.44	$	0. 21
Diluted - as reported	$	0.40	$	0.21
Diluted - pro-forma	$	0.38	$	0.19

The fair value of the option grant is estimated on the date of grant using the Black-Scholes option-pricing model. The following assumptions were used for grants: expected volatility of 10% for 2004 and 2003, risk-free interest rate of 3.00% for 2004 and 2003 respectively, expected lives of the options 10 years, and the assumed dividend rate was zero.

Item 2.

MANAGEMENT S DISCUSSION AND ANALYSIS

The following discussion reviews our results of operations and assesses our financial condition. You should read the following discussion and analysis in conjunction with the accompanying consolidated financial statements. The commentary should be read in conjunction with the discussion of forward-looking statements, the financial statements and the related notes and the other statistical information included in this report.

DISCUSSION OF FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements relating to, without limitation, future economic performance, plans and objectives of management for future operations, and projections of revenues and other financial items that are based on the beliefs of management, as well as assumptions made by and information currently available to management. The words may, will, anticipate, should, would, believe, con expect, estimate, continue, and intend, as well as other similar words and expressions of the future, are intended to identify forward-looking statements. Our actual results may differ materially from the results discussed in the forward-looking statements, and our operating performance each quarter is subject to various risks and uncertainties that are discussed in detail in our filings with the Securities and Exchange Commission, including, without limitation:

significant increases in competitive pressure in the banking and financial services industries;

changes in the interest rate environment which could reduce anticipated or actual margins;

changes in political conditions or the legislative or regulatory environment;

general economic conditions, either nationally or regionally and especially in primary service area, becoming less favorable than expected resulting in, among other things, a deterioration in credit quality;

changes occurring in business conditions and inflation;

changes in technology;

changes in monetary and tax policies;

the level of allowance for loan loss;

the rate of delinquencies and amounts of charge-offs;

the rates of loan growth;

adverse changes in asset quality and resulting credit risk-related losses and expenses;

loss of consumer confidence and economic disruptions resulting from terrorist activities;

changes in the securities markets; and

other risks and uncertainties detailed from time to time in our filings with the Securities and Exchange Commission.

Overview

We were incorporated in March 1999 to organize and serve as the holding company for Greenville First Bank, N.A. Since we opened our bank in January 2000, we have experienced consistent growth in total assets, loans, deposits, and shareholders equity, which has continued during the first six months of 2004.

Like most community banks, we derive the majority of our income from interest received on our loans and investments. Our primary source of funds for making these loans and investments is our deposits, on which we pay interest. Consequently, one of the key measures of our success is our amount of net interest income, or the difference between the income on our interest-earning assets, such as loans and investments, and the expense on our interest-bearing liabilities, such as deposits and borrowings. Another key measure is the spread between the yield we earn on these interest-earning assets and the rate we pay on our interest-bearing liabilities, which is called our net interest spread.

There are risks inherent in all loans, so we maintain an allowance for loan losses to absorb probable losses on existing loans that may become uncollectible. We maintain this allowance by charging a provision for loan losses against our operating earnings for each period. We have included a detailed discussion of this process, as well as several tables describing our allowance for loan losses.

In addition to earning interest on our loans and investments, we earn income through fees and other charges to our customers. We have also included a discussion of the various components of this noninterest income, as well as of our noninterest expense.

The following discussion and analysis also identifies significant factors that have affected our financial position and operating results during the periods included in the accompanying financial statements. We encourage you to read this discussion and analysis in conjunction with our financial statements and the other statistical information included in our filings with the Securities and Exchange Commission.

Critical Accounting Policies

We have adopted various accounting policies that govern the application of accounting principles generally accepted in the United States and with general practices within the banking industry in the preparation of our financial statements. Our significant accounting policies are described in the footnotes to our audited consolidated financial statements as of December 31, 2003, as filed in our annual report on Form 10-KSB.

Certain accounting policies involve significant judgments and assumptions by us that have a material impact on the carrying value of certain assets and liabilities. We consider these accounting policies to be critical accounting policies. The judgment and assumptions we use are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Because of the nature of the judgment and assumptions we make, actual results could differ from these judgments and estimates that could have a material impact on the carrying values of our assets and liabilities and our results of operations.

We believe the allowance for loan losses is the critical accounting policy that requires the most significant judgment and estimates used in preparation of our consolidated financial statements. Some of the more critical judgments supporting the amount of our allowance for loan losses include judgments about the credit worthiness of borrowers, the estimated value of the underlying collateral, the assumptions about cash flow, determination of loss factors for estimating credit losses, the impact of current events, and conditions, and other factors impacting the level of probable inherent losses. Under different conditions or using different assumptions, the actual amount of credit losses incurred by us may be different from management s estimates provided in our consolidated financial statements. Refer to the portion of this discussion that addresses our allowance for loan losses for a more complete discussion of our processes and methodology for determining our allowance for loan losses.

Effect of Economic Trends

During the three years ended December 31, 2003, and the six months ended June 30, 2004, our rates on both short-term or variable rate earning-assets and short-term or variable rate interest-bearing liabilities declined primarily as a result of the actions taken by the Federal Reserve.

During most of 2001 and during 2002, the United States experienced an economic decline. During this period, the economy was affected by lower returns of the stock markets. Economic data led the Federal Reserve to begin an aggressive program of reducing rates that moved the Federal Funds rate down 11 times during 2001 for a total reduction of 475 basis points. During the fourth quarter of 2002 and the first six months of 2003, the Federal Reserve reduced the Federal Funds rate down an additional 75 basis points, bringing the Federal Funds rate to its lowest level in 40 years.

Despite sharply lower short-term rates, stimulus to the economy during 2003 was muted and consumer demand and business investment activity remained weak. During all of 2003 and substantially all of the six months ended June 30, 2004, the financial markets operated under historically low interest rates. As a result of these unusual conditions, Congress passed an economic stimulus plan in 2003. During the first six months of 2004, many economists believed the economy began to show signs of strengthening and at the end of the second quarter the Federal Reserve increased the short-term interest rate by 25 basis points. Many economists believe that the Federal Reserve will continue to increase rates during the remainder of 2004 and during most of 2005. However, no assurance can be given that the Federal Reserve will take such action.

Results of Operations

Income Statement Review

Summary

Three months ended June 30, 2004 and 2003

Our net income was $413,851 and $229,455 for the three months ended June 30, 2004 and 2003, respectively, an increase of $184,396, or 80.4%. Our income was fully taxable in both three month periods. The $184,396 increase in net income resulted primarily from increases of $533,863 in net interest income and $116,623 in noninterest income. These increases were partly offset by $253,067 of additional noninterest expense, a $100,000 increase in provisions for loan losses, and a $113,023 increase in income tax expense. Our efficiency ratio continues to improve because we are earning more income without substantially increasing our overhead expenses. Our efficiency ratio was 55.23% and 62.26% for the three months ended June 30, 2004 and 2003, respectively.

S*ix months ended June 30, 2004 and 2003*

Our net income was $801,801 and $396,381 for the six months ended June 30, 2004 and 2003, respectively, an increase of $405,420, or 102.3%. Our income was fully taxable in both six month periods. The $405,420 increase in net income resulted primarily from increases of $1.1 million in net interest income and $131,793 in noninterest income. These increases were partly offset by $455,651 of additional noninterest expense, a $150,000 increase in provisions for loan losses, and a $248,491 increase in income tax expense. Our efficiency ratio continues to improve because we are earning more income without substantially increasing our overhead expenses. Our efficiency ratio was 54.35% and 61.96% for the six months ended June 30, 2004 and 2003, respectively.

Net Interest Income

Our level of net interest income is determined by the level of earning assets and the management of our net interest margin. The continuous growth in our loan portfolio is the primary driver of the increase in net interest income. During the three months ended June 30, 2004, our loan portfolio had increased an average of $17.2 million compared to first quarter of 2004. The growth in the first six months of 2004 was $38.3 million. We anticipate the growth in loans will continue to drive the growth in assets and the growth in net interest income. However, no assurance can be given that we will be able to continue to increase loans at the same levels we have experienced in the past.

Our decision to grow the loan portfolio at the current pace created the need for a higher level of capital and the need to increase deposits and borrowings. This loan growth strategy also resulted in a significant portion of our assets being in higher earning loans than in lower yielding investments. At June 30, 2004, loans represented 89.4% of total assets, while investments and federal funds sold represented 8.1% of total assets. While we plan to continue our focus on increasing the loan portfolio, as rates on investment securities begin to rise and additional capital and deposits are obtained, we also anticipate increasing the size of the investment portfolio.

The historically low interest rate environment in the last three years allowed us to obtain short-term borrowings and wholesale certificates of deposit at rates that were lower than certificate of deposit rates being offered in our local market. Therefore, we decided not to begin our retail deposit expansion program until the end of 2004. This funding strategy allowed us to continue to operate in one location, maintain a smaller staff, and not incur marketing costs to advertise deposit rates, which in turn allowed us to focus on the fast growing loan portfolio. At June 30, 2004, retail deposits represented $106.9 million, or 39.1% of total assets, borrowings represented $81.2 million, or 29.7% of total assets, and wholesale out-of-market deposits represented $71.1 million, or 26.0% of total assets.

In anticipation of rising interest rates, we are planning to open two retail deposit offices, one in the fourth quarter of 2004 and the other in the second quarter of 2005. We plan to focus our efforts in these two locations to obtain low cost transaction accounts that are less affected by rising rates. Also, in anticipation of rising rates, during the first six months of 2004, we offered aggressive promotional rates on new checking accounts and new money market accounts. The promotional rates offered are 2.00% on checking accounts and 2.25% on money market accounts and are guaranteed until January 31, 2005. Based on prior experience, we anticipate the majority of these funds to be retained at the end of the promotion. Our goal is to increase both the percentage of assets being funded by in market retail deposits and to increase the percentage of low-cost transaction accounts to total deposits. No assurance can be given that these objectives will be achieved; however, we anticipate that the two additional retail deposit offices will assist us in meeting these objectives. We also anticipate the current deposit promotion and the opening of the two new offices will have a negative impact on earnings in the years ending 2004 and 2005. However, we believe that these two strategies will provide additional clients in our local market and will provide a lower alternative cost of funding in a higher or rising interest rate environment, which we believe will increase earnings in future periods.

As more fully discussed in the Market Risk and Liquidity and Interest Rate Sensitivity sections below, at June 30, 2004, 68.0% of our loans had variable rates. Given our high percentage of rate-sensitive loans, our primary focus during the three years ended December 31, 2003 and for first six months of 2004 has been to obtain short-term liabilities to fund our asset growth. This strategy allows us to manage the impact on our earnings resulting from changes in market interest rates. At December 31, 2003, 83.4% of interest-bearing liabilities had a maturity of less than one year.

In anticipation of rising rates, in May 2004 we converted a total of $25.0 million of short-term deposits and borrowings with a term of less than three months into $25.0 million of deposits and borrowings with a weighted average life of five years. As of June 30, 2004, 80.2% of interest-bearing liabilities had a maturity of less than one year. We believe that we are positioned to benefit from future increases in short-term rates. At June 30, 2004, we had $23.5 million more assets than liabilities that reprice within the next three months.

We intend to maintain a capital level for the bank that exceeds the OCC requirements to be classified as a well capitalized bank. To provide the additional capital needed to support our bank s growth in assets, we issued $6.2 million in junior subordinated debentures in connection with our trust preferred securities offering, and we have borrowed $3.0 million under a short-term holding company line of credit.

In addition to the growth in both assets and liabilities, and the timing of repricing of our assets and liabilities, net interest income is also affected by the ratio of interest-earning assets to interest-bearing liabilities and the changes in interest rates earned on our assets and interest rates paid on our liabilities.

Our net interest income for the three months ended June 30, 2004 and the six months ended June 30, 2004 increased because we had more interest-earning assets than interest-bearing liabilities. For the three and six months ended June 30, 2004, interest-earning assets exceeded interest-bearing liabilities by $6.6 million and $7.0 million, respectively. The estimated $2.5 million cost of the two additional retail offices will reduce the amount by which interest-earning assets exceed interest-bearing liabilities.

During the three months and the six months ended June 30, 2004, our rates on both short-term or variable rate earning-assets and short-term or variable rate interest-bearing liabilities declined primarily as a result of the actions taken by the Federal Reserve to lower short-term rates.

The impact of the Federal Reserve s actions resulted in a decline in both the yields on our variable rate assets and the rates that we paid for our short-term deposits and borrowings. Our net interest spread and net interest margins also declined since more of our rate sensitive assets repriced sooner than our rate sensitive liabilities during the three month and six month periods ending June 30, 2004. Our net interest margin for the three month and six month periods were 3.07% and 3.15%, respectively.

We anticipate that the 25 basis point increase in short-term rates at the end of the second quarter of 2004 will result in an increase in loan yields, while our $25.0 million of longer-term, higher interest deposits and borrowings will result in a higher cost of funds to us. Accordingly, we believe that our net interest margin may continue to decline until further action is taken by the Federal Reserve to increase short-term rates.

We have included a number of tables to assist in our description of various measures of our financial performance. For example, the Average Balances tables show the average balance of each category of our assets and liabilities as well as the yield we earned or the rate we paid with respect to each category during both the three months ended June 30, 2004 and 2003 and the first six months of 2004 and 2003. A review of these tables shows that our loans typically provide higher interest yields than do other types of interest-earning assets, which is why we direct a substantial percentage of our earning assets into our loan portfolio. Similarly, the Rate/Volume Analysis tables help demonstrate the effect of changing interest rates and changing volume of assets and liabilities on our financial condition during the periods shown. We also track the sensitivity of our various categories of assets and liabilities to changes in interest rates, and we have included tables to illustrate our interest rate sensitivity with respect to interest-earning accounts and interest-bearing accounts. Finally, we have included various tables that provide detail about our investment securities, our loans, our deposits, and other borrowings.

The following tables set forth information related to our average balance sheets, average yields on assets, and average costs of liabilities. We derived these yields by dividing income or expense by the average balance of the corresponding assets or liabilities. We derived average balances from the daily balances throughout the periods indicated. During the six months ended June 30, 2004 and 2003, all investments were taxable. During the same period, we had no interest-bearing deposits in other banks or any securities purchased with agreements to resell. All investments were owned at an original maturity of over one year. Nonaccrual loans are included in the following tables. Loan yields have been reduced to reflect the negative impact on our earnings of loans on nonaccrual status. The net of capitalized loan costs and fees are amortized into interest income on loans.

Average Balances, Income and Expenses, and Rates
For the Three Months Ended June 30,

	2004			2003		
	Average Balance	**Income/ Expense**	**Yield/ Rate(1)**	**Average Balance**	**Income Expense**	**Yield/ Rate(1)**
			(In thousands)			
Earning assets:						
Federal funds sold	$ 1,914	$ 5	1.05%	$ 1,558	$ 5	1.29%
Investment securities	21,145	220	4.18%	6,815	63	3.71%
Loans	234,057	2,951	5.07%	165,143	2,219	5.39%
Total earning-assets	257,116	3,176	4.97%	173,516	2,287	5.29%
Non-earning assets	7,566			6,404		
Total assets	$ 264,682			$ 179,920		
Interest-bearing liabilities:						
NOW accounts	$ 38,631	$ 75	.78%	$ 28,902	$ 27	.37%
Savings & money market	39,543	143	1.45%	20,922	29	.56%
Time deposits	99,392	622	2.52%	87,040	627	2.89%
Total interest-bearing deposits	177,566	840	1.90%	136,864	683	2.00%
FHLB advances	50,131	257	2.06%	26,099	148	2.27%
Other borrowings	22,808	118	2.08%	3,807	30	3.16%
Total interest-bearing liabilities	250,505	1,215	1.95%	166,770	861	2.07%
Non-interest bearing liabilities	2,427			2,396		
Shareholders equity	11,750			10,754		
Total liabilities and shareholders equity	$ 264,682			$ 179,920		
Net interest spread			3.02%			3.22%
Net interest income / margin		$ 1,961	3.07%		$ 1,426	3.30%

(1) Annualized for the three month period.

Our net interest spread was 3.02% for the three months ended June 30, 2004, compared to 3.22% for the three months ended June 30, 2003.

Our net interest margin for the three months ended June 30, 2004 was 3.07%, compared to 3.30% for the three months ended June 30, 2003. During the three months ended June 30, 2004, earning assets averaged $257.1 million, compared to $173.5 million in the three months ended June 30, 2003.

The lower rate on loans for the three months ended June 30, 2004 compared to the three months ended June 30, 2003 resulted primarily from a reduction in the prime rate of 25 basis points in the second quarter of 2003. The deposit and borrowing cost did not decline as much as the reduction in the rates earned on interest-earning assets because of our decision to aggressively market interest-bearing transaction accounts by paying an above market rate. Also, we extended the maturity dates on various jumbo time deposits and FHLB advances. These decisions were intended to compensate for anticipated higher rates in the future.

Net interest income, the largest component of our income, was $2.0 million and $1.4 million for the three months ended June 30, 2004 and 2003, respectively. The significant increase in 2004 related to higher levels of both average earning assets and interest-bearing liabilities, offset by a slightly lower net interest margin. Average earning assets increased $83.6 million during the three months ended June 30, 2004 compared to the same period in 2003.

As previously discussed, our net interest margin for the three months ended June 30, 2004 and 2003, was 3.07% and 3.30%, respectively.

The $533,863 increase in net interest income for the three months ended June 30, 2004 compared to the same period in 2003 resulted primarily from a $570,000 increase in net income offset by a $66,000 decrease in net interest income. The increase in net income related to higher average earning assets and interest bearing liabilities. The decrease in net interest income was related to the lower net interest margin.

Interest income for the three months ended June 30, 2004 was $3.2 million, consisting of $3.0 million on loans, $220,364 on investments, and $4,703 on federal funds sold. Interest income for the three months ended June 30, 2003 was $2.3 million, consisting of $2.2 million on loans, $62,569 on investments, and $5,179 on federal funds sold. Interest on loans for the three months ended June 30, 2004 and 2003 represented 92.9% and 97.0%, respectively, of total interest income, while income from investments and federal funds sold represented only 7.1% and 2.7% of total interest income. The high percentage of interest income from loans was related to our strategy to maintain a significant portion of our assets in higher earning loans compared to lower yielding investments. Average loans represented 91.0% and 95.2% of average interest earning assets for the three months ended June 30, 2004 and 2003, respectively. Included in interest income on loans for the three months ended June 30, 2004 and 2003, was $131,810 and $95,258, respectively, related to the net amortization of loan fees and capitalized loan origination costs.

Interest expense for the three months ended June 30, 2004 was $1.2 million, consisting of $840,564 related to deposits and $374,606 related to borrowings. Interest expense for the three months ended June 30, 2003 was $860,820, consisting of $682,896 related to deposits and $177,924 related to borrowings. Interest expense on deposits for the three months ended June 30, 2004 and 2003 represented 69.2% and 79.3%, respectively, of total interest expense, while interest expense on borrowings represented 30.8% and 20.7%, respectively, of total interest expense for the three months ended June 30, 2004 and 2003. The lower percentage of interest expense on deposits and the higher percentage of interest on borrowings for the three months ended June 30, 2004 compared to the three months ended June 30, 2003 resulted from our decisions to delay our retail deposit office expansion program and instead utilize additional borrowings from the FHLB and from the sale of securities under agreements to repurchase with brokers. During the three months ended June 30, 2004, average interest bearing deposits increased by $40.7 million over the same period in 2003, while other borrowing during the three months ended June 30, 2004 increased $43.0 million over the same period in 2003. During the three months ended June 30, 2004, we were able to pledge additional collateral to the FHLB, allowing us the ability to increase our FHLB borrowings. Both the short term borrowings from the FHLB and the sale of securities under agreements to repurchase provide us with the opportunity to obtain low cost funding with various maturities similar to the maturities on our loans and investments.

Average Balances, Income and Expenses, and Rates
For the Six Months Ended June 30,

	2004						2003				
		Average Balance		Income/ Expense	Yield/ Rate(1)		Average Balance		Income Expense	Yield/ Rate(1)
	(In thousands)									
Earning assets:										
Federal funds sold	$	2,032	$	9	0.89%	$	1,953	$	12	1.24%
Investment securities		20,824		445	4.30%		10,274		199	3.91%
Loans		225,469		5,688	5.07%		159,722		4,308	5.44%
Total earning-assets		248,325		6,142	4.97%		171,949		4,519	5.30%
Non-earning assets		6,981					6,306			
Total assets	$	255,306				$	178,255			
Interest-bearing liabilities:										
NOW accounts	$	35,980	$	122	0.68%	$	28,248	$	59	0.42%
Savings & money market		33,486		202	1.21%		20,712		62	0.60%
Time deposits		103,489		1,244	2.42%		85,908		1,291	3.03%
Total interest-bearing deposits		172,955		1,568	1.82%		134,868		1,412	2.11%
FHLB advances		46,988		446	1.91%		23,646		266	2.27%
Other borrowings		21,430		235	2.21%		6,739		75	2.24%
Total interest-bearing liabilities		241,373		2,249	1.87%		165,253		1,753	2.17%
Non-interest bearing liabilities		2,369					2,375			
Shareholders equity		11,564					10,627			
Total liabilities and shareholders Equity	$	255,306				$	178,255			
Net interest spread					3.10%					3.13%
Net interest income / margin			$	3,893	3.15%			$	2,766	3.24%

(1) Annualized for the six-month period.

Our net interest spread was 3.10% for the six months ended June 30, 2004, compared to 3.13% for the six months ended June 30, 2003.

Our net interest margin for the period ended June 30, 2004 was 3.15%, compared to 3.24% for the six months ended June 30, 2003. During the first six months of 2004, earning assets averaged $248.3 million, compared to $171.9 million in the first six months of 2003.

The lower rate on loans for the six months ended June 30, 2004 compared to the six months ended June 30, 2003 resulted primarily from a of 25 basis points in the second quarter of 2003. The deposit and borrowing cost did not decline as much as the reduction in the rates earned on interest-earning assets because of our decision to aggressively market interest-bearing transaction accounts by paying an above market rate. Also, we extended the maturity dates on various jumbo time deposits and FHLB advances. These decisions were intended to compensate for anticipated higher rates in the future.

Net interest income, the largest component of our income, was $3.9 million and $2.8 million for the six months ended June 30, 2004 and 2003, respectively. The significant increase in 2004 related to higher levels of both average earning assets and interest-bearing liabilities, offset by a slightly lower net interest margin. Average earning assets increased $76.4 million during the six months ended June 30, 2004 compared to the same period in 2003.

As previously discussed, our net interest margin for the six months ended June 30, 2004 and 2003, was 3.15% and 3.24%, respectively.

The $1.1 million increase in net interest income for the six months ended June 30, 2004 compared to the same period in 2003 resulted from a $1.2 million increase in net income offset by a $37,000 decrease in net interest income. The increase in net income related to higher average earning assets and interest-bearing liabilities. The decrease in net interest income was related to the lower net interest margin.

Interest income for the six months ended June 30, 2004 was $6.1 million, consisting of $5.7 million on loans, $445,178 on investments, and $9,293 on federal funds sold. Interest income for the six months ended June 30, 2003 was $4.5 million, consisting of $4.3 million on loans, $199,113 on investments, and $11,668 on federal funds sold. Interest on loans for the six months ended June 30, 2004 and 2003 represented 92.6% and 95.3%, respectively, of total interest income, while income from investments and federal funds sold represented only 7.4% and 4.7% of total interest income. The high percentage of interest income from loans was related to our strategy to maintain a significant portion of our assets in higher earning loans compared to lower yielding investments. Average loans represented 90.8% and 92.9% of average interest-earning assets for the six months ended June 30, 2004 and 2003, respectively. Included in interest income on loans for the six months ended June 30, 2004 and 2003, was $232,319 and $179,933, respectively, related to the net amortization of loan fees and capitalized loan origination costs.

Interest expense for the six months ended June 30, 2004 was $2.2 million, consisting of $1.6 million related to deposits and $681,219 related to borrowings. Interest expense for the six months ended June 30, 2003 was $1.8 million, consisting of $1.4 million related to deposits and $340,394 related to borrowings. Interest expense on deposits for the six months ended June 30, 2004 and 2003 represented 69.7% and 80.6%, respectively, of total interest expense, while interest expense on borrowings represented 30.3% and 19.4%, respectively, of total interest expense for the six months ended June 30, 2004 and 2003. The lower percentage of interest expense on deposits and the higher percentage of interest on borrowings for the six months ended June 30, 2004 compared to the six months ended June 30, 2003 resulted from our decisions to delay our retail deposit office expansion program and instead utilize additional borrowings from the FHLB and from the sale of securities under agreements to repurchase with brokers. During the six months ended June 30, 2004, average deposits increased by $40.7 million over the same period in 2003, while other borrowing during the six months ended June 30, 2004 increased $43.0 million over the same period in 2003. During the six months ended June 30, 2004, we were able to pledge additional collateral to the FHLB, allowing us the ability to increase our FHLB borrowings. Both the short-term borrowings from the FHLB and the sale of securities under agreements to repurchase provide us with the opportunity to obtain low cost funding with various maturities similar to the maturities on our loans and investments.

Rate/Volume Analysis

Net interest income can be analyzed in terms of the impact of changing interest rates and changing volume. The following tables set forth the effect which the varying levels of interest-earning assets and interest-bearing liabilities and the applicable rates have had on changes in net interest income for the periods presented.

	Three Months Ended							
	June 30, 2004 vs. 2003 Increase (Decrease) Due to				June 30, 2003 vs. 2002 Increase (Decrease) Due to			
	Volume	Rate	Rate/ Volume	Total	Volume	Rate	Rate/ Volume	Total
	(In thousands)							
Interest income								
Loans	$ 926	(131)	(63)	732	763	(194)	(85)	484
Investment securities	132	8	16	156	(105)	(45)	25	(125)
Federal funds sold	1	(1)			(7)	(4)	2	(9)
Total interest income	1,059	(124)	(47)	888	651	(243)	(58)	350
Interest expense								
Deposits	203	(34)	(12)	157	97	(230)	(26)	(159)
FHLB advances	136	(14)	(14)	108	277	(19)	(146)	112
Other borrowings	150	(10)	(51)	89	12	4	7	23