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EAGLE BANCORP INC
Form 10-Q/A
August 20, 2004

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

FORM 10-Q/A

(MARK ONE)

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

For the Quarterly Period Ended March 31, 2004

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 0-25923

EAGLE BANCORP, INC
(Exact name of registrant as specified in its charter)

Maryland
(State or other jurisdiction of
incorporation or organization)

52-2061461
(I.R.S. Employer
Identification No.)

7815 Woodmont Avenue, Bethesda, Maryland
(Address of principal executive offices)

20814
(Zip Code)

(301) 986-1800
(Registrant's telephone number, including area code)

N/A
(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 No

Indicate by check mark whether the registrant is an accelerated filer
(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 practical date.

As of April 19, 2004, the registrant had 5,401,767 shares of Common
Stock outstanding.

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This amended report is filed solely for the purpose of reflecting, in Note 6 to the unaudited consolidated financial statements included in the report, certain options which were inadvertently omitted from the calculation in that Note of stock based compensation expense, pro forma net income and pro forma net income per share. The omission did not have any effect on reported net income or reported net income per share.

Item 1 - Financial Statements

EAGLE BANCORP, INC.
Consolidated Balance Sheets
March 31, 2004 and December 31, 2003
(dollars in thousands)

| | March 31, 2004 (unaudited) | |
|---|----------------------------------|-------|
| | ----- | ----- |
| ASSETS | | |
| Cash and cash equivalents | \$ 29,659 | \$ |
| Federal funds sold | 17,026 | |
| Interest bearing deposits with other banks | 4,981 | |
| Investment securities available for sale | 70,459 | |
| Loans held for sale | 4,341 | |
| Loans | 330,253 | |
| Less allowance for credit losses | (3,750) | |
| | ----- | ----- |
| Loans, net | 326,503 | |
| Premises and equipment, net | 4,863 | |
| Deferred income taxes | 863 | |
| Other assets | 10,767 | |
| | ----- | ----- |
| TOTAL ASSETS | \$ 469,462 | \$ |
| | ===== | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| LIABILITIES | | |
| Deposits: | | |
| Noninterest bearing demand | \$ 93,805 | \$ |
| Interest bearing transaction | 57,919 | |
| Savings and money market | 117,172 | |
| Time, \$100,000 or more | 64,946 | |
| Other time | 51,798 | |
| | ----- | ----- |
| Total deposits | 385,640 | |
| Federal funds purchased and securities sold under agreement to repurchase | 13,958 | |
| Other short-term borrowings | 4,000 | |
| Long-term borrowings | 9,551 | |
| Other liabilities | 1,657 | |
| | ----- | ----- |
| Total liabilities | 414,806 | |
| STOCKHOLDERS' EQUITY | | |
| Common stock, \$.01 par value; shares authorized 20,000,000, shares | | |

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| | | |
|--|------------|-----|
| Issued and outstanding 5,401,767 (2004) and 5,359,303 (2003) | 54 | |
| Additional paid in capital | 46,737 | |
| Retained earnings | 7,460 | |
| Accumulated other comprehensive income | 405 | |
| | ----- | --- |
| Total stockholders' equity | 54,656 | --- |
| | ----- | --- |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 469,462 | \$ |
| | ===== | == |

See notes to consolidated financial statements.

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EAGLE BANCORP, INC.
Consolidated Statements of Income
For the Three Months Ended March 31, 2004 and 2003
(dollars in thousands, except per share data - unaudited)

INTEREST INCOME

Interest and fees on loans
Taxable interest and dividends on investment securities
Interest on balances with other banks
Interest on federal funds sold and other cash equivalents

Total interest income

INTEREST EXPENSE

Interest on deposits
Interest on federal funds purchased and securities sold under agreement to repurchase
Interest on short-term borrowings
Interest on long-term borrowings

Total interest expense

NET INTEREST INCOME

PROVISION FOR CREDIT LOSSES

NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES

NONINTEREST INCOME

Service charges on deposits
Gain on sale of loans
Gain on sale of investment securities
Other income

Total noninterest income

Three

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NONINTEREST EXPENSE

Salaries and employee benefits
 Premises and equipment expenses
 Advertising
 Outside data processing
 Other expenses

Total noninterest expense

INCOME BEFORE INCOME TAX EXPENSE

INCOME TAX EXPENSE

NET INCOME

INCOME PER SHARE

Basic
 Diluted

See notes to consolidated financial statements.

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EAGLE BANCORP, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
 FOR THE THREE MONTHS ENDED MARCH 31, 2004 and 2003
 (dollars in thousands-unaudited)

| | Three Months Ended March 31, 2004 | Thre --- |
|---|--------------------------------------|-------------|
| | ----- | ----- |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 1,179 | |
| Adjustments to reconcile net income to net cash | | |
| Provided (used) by operating activities: | | |
| (Decrease) increase in deferred income taxes | (1) | |
| Provision for credit losses | 154 | |
| Depreciation and amortization | 209 | |
| Gain on sale of loans | (172) | |
| Origination of loans held for sale | (7,470) | |
| Proceeds from sale of loans held for sale | 6,950 | |
| Gain on sale of investment securities | (253) | |
| Increase in other assets | (409) | |
| Increase in other liabilities | 206 | |
| | ----- | |
| Net cash provided by operating activities | 393 | |
| | ----- | |

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| | |
|--|-----------|
| CASH FLOWS FROM INVESTING ACTIVITIES: | |
| (Increase) decrease in interest bearing deposits with other banks | (649) |
| Purchases of available for sale investment securities | (63,060) |
| Proceeds from maturities of available for sale securities | 45,251 |
| Proceeds from sale of available for sale securities | 30,340 |
| Increase in federal funds sold | (17,026) |
| Net increase in loans | (12,804) |
| Bank premises and equipment acquired | (813) |
| Increase in BOLI contracts | (2,000) |
| | ----- |
| Net cash used by investing activities | (20,761) |
| | ----- |
| CASH FLOWS FROM FINANCING ACTIVITIES: | |
| Increase in deposits | 50,126 |
| (Decrease) in federal funds purchased and securities sold under agreement to repurchase | (24,496) |
| Increase in other short term borrowings | -- |
| Decrease in long-term borrowings | (1,037) |
| Issuance of common stock | 331 |
| | ----- |
| Net cash provided by financing activities | 24,924 |
| | ----- |
| NET INCREASE IN CASH | 4,556 |
| CASH AND DUE FROM BANKS AT BEGINNING OF PERIOD | 25,103 |
| | ----- |
| CASH AND DUE FROM BANKS AT END OF PERIOD | \$ 29,659 |
| | ===== |
| Supplemental cash flow information: | |
| Interest paid | \$ 916 |
| Income taxes paid | \$ 400 |
| See notes to consolidated financial statements | |

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EAGLE BANCORP, INC
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
FOR THE THREE MONTHS ENDED MARCH 31, 2004 AND 2003
(dollars in thousands - unaudited)

| Common Stock | Additional Paid in Capital | Retained Earnings | Accumulated Other Comprehensive Income (loss) | Tota Stockhol Equit |
|-----------------|----------------------------------|----------------------|---|---------------------------|
| ----- | | | | |

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| | | | | | |
|--|-------|----------|----------|--------|--------|
| Balances at January 1, 2004 | \$ 54 | \$46,406 | \$ 6,281 | \$ 271 | \$53,0 |
| Net income | | | 1,179 | | 1,1 |
| Other comprehensive income- | | | | | |
| Unrealized gain on investment securities available for sale | | | | 134 | 1 |
| Total comprehensive income | | | | | 1,3 |
| Exercise of options for 42,464 shares of common stock | | 331 | | | 3 |
| Balances at March 31, 2004 | \$ 54 | \$46,737 | \$ 7,460 | \$ 405 | \$54,6 |
| Balances at January 1, 2003 | \$ 29 | \$16,541 | \$ 3,066 | \$ 392 | \$20,0 |
| Net income | | | 983 | | 9 |
| Other comprehensive income-unrealized loss on investment securities available for sale | | | | (173) | (1 |
| Total comprehensive income | | | | | 8 |
| Exercise of options for 2,770 shares of common stock | | 28 | | | |
| Balances at March 31, 2003 | \$ 29 | \$16,569 | \$ 4,049 | \$ 219 | \$20,8 |

See notes to consolidated financial statements.

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EAGLE BANCORP, INC.

NOTES TO FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

General - The financial statements of Eagle Bancorp, Inc. (the "Company") included herein are unaudited; however, they reflect all adjustments consisting only of normal recurring accruals that, in the opinion of Management, are necessary to present fairly the results for the periods presented. The amounts as of December 31, 2003 were derived from audited financial statements. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. There have been no significant changes to the Company's Accounting Policies as disclosed in the 2003 Annual Report. The Company believes that the disclosures are adequate to make the information presented not misleading. The results of operations for the three months ended March 31, 2004 are not necessarily indicative of the results of operations to be expected for the remainder of the year, or for

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any other period.

2. NATURE OF BUSINESS

The Company, through its bank subsidiary, provides domestic financial services primarily in Montgomery County, Maryland and Washington, DC. The primary financial services include real estate, commercial and consumer lending, as well as traditional demand deposits and savings products.

3. INVESTMENT SECURITIES

Amortized cost and estimated fair value of securities available - for - sale are summarized as follows: (in thousands)

| | March 31, 2004 | | | |
|--|-------------------|------------------------------|-------------------------------|----------------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| | ----- | ----- | ----- | ----- |
| U. S. Treasury securities | \$ 11,998 | -- | -- | 11,998 |
| U. S. Government Agency securities | 25,534 | 85 | -- | 25,619 |
| Mortgage backed securities | 24,513 | 223 | (94) | 24,642 |
| Federal Reserve Bank and Federal Home Loan Bank stock | 1,634 | -- | -- | 1,634 |
| Other equity investments | 6,166 | 418 | (18) | 6,566 |
| | ----- | ----- | ----- | ----- |
| | \$ 69,845 | \$ 726 | \$ (112) | \$ 70,459 |
| | ===== | ===== | ===== | ===== |

| | December 31, 2003 | | | |
|--|-------------------|------------------------------|-------------------------------|----------------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| | ----- | ----- | ----- | ----- |
| U. S. Treasury securities | \$ -- | \$ -- | \$ -- | \$ -- |
| U. S. Government Agency securities | 25,355 | 76 | (38) | 25,373 |
| Mortgage backed securities | 51,887 | 101 | (246) | 51,842 |
| Federal Reserve Bank and Federal Home Loan Bank stock | 1,670 | -- | -- | 1,670 |
| Other equity investments | 3,282 | 421 | (7) | 3,696 |
| | ----- | ----- | ----- | ----- |
| | \$ 82,174 | \$ 698 | \$ (291) | \$ 82,581 |
| | ===== | ===== | ===== | ===== |

Gross unrealized losses and fair value by length of time that the individual available securities have been in a continuous unrealized position as of March 31, 2004 are as follows:

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(in thousands)

| | Fair Value | Less than 12 Months | More than 12 Months | Total Unrealized Losses |
|----------------------------|------------|------------------------|------------------------|-------------------------------|
| Mortgage backed securities | \$ 10,445 | \$ (94) | \$ -- | \$ (94) |
| Other equity investments | 335 | (14) | (4) | (18) |
| | ----- | ----- | ----- | ----- |
| | \$ 10,780 | \$ (108) | \$ (4) | \$ (112) |
| | ===== | ===== | ===== | ===== |

4. INCOME TAXES

The Company uses the liability method of accounting for income taxes as required by SFAS No. 109, "Accounting for Income Taxes." Under the liability method, deferred-tax assets and liabilities are determined based on differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities (i.e., temporary differences) and are measured at the enacted rates that will be in effect when these differences reverse.

5. EARNINGS PER SHARE

Earnings per common share are computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period, including any potential dilutive common shares outstanding, such as options and warrants. As of March 31, 2004 there were no shares excluded from the diluted net income per share computation.

6. STOCK-BASED COMPENSATION

The Company has adopted the disclosure-only provisions of SFAS No. 123 "Accounting for Stock-Based Compensation" and SFAS No. 148 "Accounting for Stock-Based Compensation-Transition and Disclosure", but applies Accounting Principles Board Opinion No. 25 and related interpretations in accounting for its Plan. No compensation expense related to the Plan was recorded during the three months ended March 31, 2004 and 2003. If the Company had elected to recognize compensation cost based on fair value at the grant dates for awards under the Plan consistent with the method prescribed by SFAS No. 123, net income and earnings per share would have been changed to the pro forma amounts as follows for the three months ended March 31.

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| | 2004 | 2003 |
|---|---------|--------|
| | ---- | ---- |
| Net income, as reported | \$1,179 | \$ 983 |
| Less pro forma stock-based compensation | | |

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| | | |
|--|---------|---------|
| expense determined under the fair value method, net of related tax effects | (718) | (6) |
| | ----- | ----- |
| Pro forma net income | \$ 461 | \$ 977 |
| | ----- | ----- |
| Net income per share: | | |
| Basic - as reported | \$ 0.22 | \$ 0.34 |
| Basic - pro forma | \$ 0.09 | \$ 0.34 |
| Diluted - as reported | \$ 0.21 | \$ 0.32 |
| Diluted - pro forma | \$ 0.08 | \$ 0.31 |

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

The following discussion provides information about the results of operations, and financial condition, liquidity, and capital resources of the Company and its subsidiary the Bank. This discussion and analysis should be read in conjunction with the unaudited Consolidated Financial Statements and Notes thereto, appearing elsewhere in this report.

This report contains forward looking statements within the meaning of the Securities Exchange Act of 1934, as amended, including statements of goals, intentions, and expectations as to future trends, plans, events or results of Company operations and policies and regarding general economic conditions. In some cases, forward looking statements can be identified by use of such words as "may", "will", "anticipate", "believes", "expects", "plans", "estimates", "potential", "continue", "should", and similar words or phrases. These statements are based upon current and anticipated economic conditions, nationally and in the Company's market, interest rates and interest rate policy, competitive factors and other conditions which, by their nature, are not susceptible to accurate forecast, and are subject to significant uncertainty. Because of these uncertainties and the assumptions on which this discussion and the forward looking statements are based, actual future operations and results in the future may differ materially from those indicated herein. Readers are cautioned against placing undue reliance on any such forward looking statements.

GENERAL

Eagle Bancorp, Inc. is a growing, one-bank holding company headquartered in Bethesda, Maryland. We provide general commercial and consumer banking services through our wholly owned banking subsidiary EagleBank, a Maryland chartered bank which is a member of the Federal Reserve System. We were organized in October 1997 to be the holding company for the Bank. The Bank was organized as an independent, community oriented, full-service alternative to the super regional financial institutions, which dominate our primary market area. The cornerstone of our philosophy is to provide superior, personalized service to our customers. We focus on relationship banking, providing each customer with a number of services, becoming familiar with and addressing customer needs in a proactive, personalized fashion. The Bank has six offices serving the Montgomery County and two offices in the District of Columbia. On December 15, 2003, the Bank opened its sixth office in Montgomery County on Rockville Pike. However, the Bank has announced that it will close one Montgomery County office, the Sligo Office located at 850 Sligo Avenue, Silver Spring, MD, in June 2004. After thorough consideration, management and the board of directors decided to close the office rather than exercise an option to renew option in the lease available in June. The decision was made because the office had failed to reach initial

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growth and profit expectations and an analysis of the office's potential, in its existing location, did not provide indications that the office would improve its performance in the foreseeable future. Silver Spring will continue to be served by the original Silver Spring Office, which is located only a few blocks from the Sligo Office, and for this reason, the loss of business, in particular deposits, is expected to be minimal. No employees will be displaced by the closing but will be absorbed into the positions created by the new branch offices and other Company vacancies. On April 28, 2004 the Bank opened its second office in the District of Columbia at 1228 Connecticut Avenue. In February 2004, the Company executed a lease for a new office to be opened in 2006 in Friendship Heights, Montgomery County, Maryland, on the District of Columbia line. Lease negotiations are being undertaken for a third District of Columbia office in the vicinity of 14th and K Sts NW. There is no assurance that these negotiations will result in the Company acquiring space for a new branch in this area.

The Company offers full commercial banking services to our business and professional clients as well as complete consumer banking services to individuals living and/or working in the service area. We emphasize providing commercial banking services to sole proprietors, small and medium-sized businesses, partnerships, corporations, non-profit organizations and associations, and investors living and working in and near our primary service area. A full range of retail banking services are offered to accommodate the individual needs of both corporate customers as well as the community we serve. These services include the usual deposit functions of commercial banks, including business and personal checking accounts, "NOW" accounts and savings accounts, business, construction, and commercial loans, equipment leasing, residential mortgages and consumer loans and cash management services. We have developed significant expertise and commitment as an SBA lender, have been designated a Preferred Lender by the Small Business Administration (SBA), and are one of the largest SBA lenders, in dollar volume, in the Washington Metropolitan area.

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In June 2003, the Company formed a second wholly owned subsidiary, Bethesda Leasing, LLC ("Bethesda Leasing"). Bethesda Leasing was formed for the purpose of acquiring an impaired loan from the Bank in order to effect more efficient administration and collection procedures.

CRITICAL ACCOUNTING POLICIES

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") and follow general practices within the banking industry. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results

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in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available.

The allowance for credit losses is an estimate of the losses that may be sustained in our loan portfolio. The allowance is based on two principles of accounting: (a) Statement on Financial Accounting Standards ("SFAS") 5, "Accounting for Contingencies", which requires that losses be accrued when they are probable of occurring and are estimable and (b) SFAS No. 114, "Accounting by Creditors for Impairment of a Loan", which requires that losses be accrued when it is probable that the Company will not collect all principal and interest payments according to the contractual terms of the loan. The loss, if any, is determined by the difference between the loan balance and the value of collateral, the present value of expected future cash flows, or values observable in the secondary markets.

Three basic components comprise our allowance for credit losses: a specific allowance, a formula allowance and a nonspecific allowance. Each component is determined based on estimates that can and do change when the actual events occur. The specific allowance is used to individually allocate an allowance to loans identified as impaired. An impaired loan may show deficiencies in the borrower's overall financial condition, payment record, support available from financial guarantors and/or the fair market value of collateral. When a loan is identified as impaired a specific reserve is established based on the Company's assessment of the loss that may be associated with the individual loan. The formula allowance is used to estimate the loss on internally risk rated loans, exclusive of those identified as impaired. Loans identified as special mention, substandard, doubtful and loss, as well as impaired, are segregated from performing loans. Remaining loans are then grouped by type (commercial, commercial real estate, construction, home equity or consumer). Each loan type is assigned an allowance factor based on management's estimate of the risk, complexity and size of individual loans within a particular category. Classified loans are assigned higher allowance factors than non-rated loans due to management's concerns regarding collectibility or management's knowledge of particular elements regarding the borrower. Allowance factors grow with the worsening of the internal risk rating. The nonspecific formula is used to estimate the loss of non-classified loans stemming from more global factors such as delinquencies, loss history, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of management, national and local economic trends, concentrations of credit, quality of loan review system and the effect of external factors such as competition and regulatory requirements. The nonspecific allowance captures losses whose impact on the portfolio have occurred but have yet to be recognized in either the formula or specific allowance.

Management has significant discretion in making the judgments inherent in the determination of the provision and allowance for credit losses, including in connection with the valuation of collateral, a borrower's prospects of repayment, and in establishing allowance factors on the formula allowance and nonspecific allowance components of the allowance. The establishment of allowance factors is a continuing exercise, based on management's continuing assessment of the global factors discussed above and their impact on the portfolio, and allowance factors may change from period to period, resulting in an increase or decrease in the amount of the provision or allowance, based upon the same volume and classification of loans. Changes in allowance factors will

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have a direct impact on the amount of the provision, and a related, after tax effect on net income. Errors in management's perception and assessment of the global factors and their impact on the portfolio could result in the allowance not being adequate to cover losses in the portfolio, and may result in additional provisions or charge-offs. For additional information regarding the allowance for credit losses, refer to the discussion under the caption "Allowance for Credit Losses" below.

RESULTS OF OPERATIONS

The Company reported net income of \$1.18 million for the three months ended March 31, 2004, as compared to net income of \$983 thousand for the three months ended March 31, 2003. Income per basic share was \$0.22 for the three months ended March 31, 2004, as compared to \$0.34 for the same period in 2003. Income per diluted share was \$0.21 for the three months ended March 31, 2004, as compared to \$0.32 for the same period in 2003. The Company had a return on average assets of 1.08% and return on average equity of 8.80% for the first three months of 2004, as compared to returns on average assets and average equity of 1.16% and 19.14% respectively for the three months of 2003.

The increase in net income for the three months ended March 31, 2004 as compared to the same period in 2003 can be attributed to an increase of 30% in net interest income, reflecting an increase of 30% in average earning assets while net interest margin remained essentially constant declining, only 2 basis points. Net interest income increased from \$3.4 million to \$4.4 million and average earning assets increased from \$315 million to \$409 million. Net interest margin declined from 4.35% for the first quarter of 2003 to 4.33% for the same period in 2004 as market interest rates fell from the first quarter of 2003 through most of 2003, then stabilized, and longer term interest rates rose slightly in the first quarter of 2004. The percentage of loans, which generally have higher yields than securities and other earning assets, increased from 77% of average earning assets in the three month period of 2003 to 79% of earning assets in the same period of 2004. Noninterest income increased 24%, to \$1.1 million for the first quarter of 2004, from \$873 thousand in the same period of 2003.

For the three months ended March 31, 2004, the Company recorded a provision for credit losses in the amount of \$154 thousand. At March 31, 2004, the allowance for credit losses was \$3.78 million, as compared to \$3.68 million at December 31, 2003. The Company had net charge-offs of \$84 thousand during the first three months of 2004 representing 0.10% of average loans on an annualized basis. This compared to a provision for credit losses of \$224 thousand for the first three months of 2003, and net charge-offs of \$129 thousand for the same period, representing 0.2% of average loans on an annualized basis.

While the results of operations for the first quarter of 2004 compared to the first quarter of 2003 were up, \$1.18 million from \$983 thousand, earnings per share were down \$0.22 from \$0.34 and return on average equity was down to 8.80% from 19.14%. The reduction in both ratios is directly attributable to the 85% increase in the number of outstanding shares following the completion of the Company's offering of approximately 2.4 million shares in August 2003. The additional shares are expected to have an adverse impact on earnings per share for a number of quarters until the capital can be further leveraged and deployed in loans and other income producing assets other than low yielding, but highly liquid short term investment securities. Contributing to the first quarter results were gains on the sale of securities of \$253 thousand, on a pretax basis, in 2004 compared to \$192 thousand in 2003.

The following table sets out the annualized returns on average assets, returns on average equity and equity to assets (average) for the three months ending March 31, 2004 and 2003 and the year ending December 31, 2003:

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| | March 2004 ---- | March 2003 ---- | December 2003 ---- |
|----------------------------------|-----------------------|-----------------------|--------------------------|
| Return on average assets | 1.08% | 1.16% | 0.86% |
| Return on average equity | 8.80% | 19.14% | 9.45% |
| Average equity to average assets | 12.28% | 6.08% | 9.05% |

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NET INTEREST INCOME AND NET INTEREST MARGIN

Net interest income is the difference between interest income on earning assets and the cost of funds supporting those assets. Earning assets are composed primarily of loans and investment securities. The cost of funds represents interest expense on deposits, customer repurchase agreements and other borrowings. Noninterest bearing deposits and capital are other components representing funding sources. Changes in the volume and mix of assets and funding sources, along with the changes in yields earned and rates paid, determine changes in net interest income. Net interest income for the first three months of 2004 was \$4.4 million compared to \$3.4 million for the first three months of 2003.

The table labeled "Average Balances, Interest Yields and Rates and Net Interest Margin" presents the average balances and rates of the various categories of the Company's assets and liabilities. Included in the table is a measurement of interest rate spread and margin. Interest spread is the difference between the rate earned on assets less the cost of funds expressed as a percentage. While spread provides a quick comparison of earnings rates versus cost of funds, management believes that margin provides a better measurement of performance. Margin includes the effect of noninterest bearing liabilities in its calculation and is net interest income expressed as a percentage of total earning assets. Interest spread decreased in the three months of 2004 from the first three months of 2003 by 3 basis points, to 3.99% from 4.02%; and margin decreased 2 basis points, to 4.33% from 4.35%. The decrease in both spread and margin, from period to period, can be attributed to overall lower market interest rates and the resulting refinancing, repricing or renegotiation of existing earning assets and the acquisition of new earning assets at lower market rates. Management is particularly pleased that the Company was able to maintain a relatively stable spread and margin following a long period of interest rate declines. Management was able to maintain stability by reducing the cost of funds, from 1.72% during the first quarter of 2003 to 1.29% in 2004, as it faced lower yields on its earning assets, which declined from 5.74% during the first quarter of 2003 to 5.28% in 2004. At the same time, the mix of earning assets improved as higher yielding loans from increased from 77% of earning assets in 2003 to 79% in 2004.

The declines in both the yields on earning assets and interest bearing liabilities from the first three months of 2003 to the first three months of 2004 reflect the impact of the significant rate reductions effected by the Federal Reserve in 2001 and continued into 2002 with the last rate reduction occurring in June 2003. The investment portfolio yield declined by 32 basis points from the first quarter of 2003 to the same period in 2004 as the Bank maintained a portfolio of short term fixed rate securities and pass through mortgage backed securities. The Bank is pleased at the small decline in yield given the general interest rate climate and the effect on yield that mortgage refinancing activities had on the investment portfolio. The yield on mortgage backed securities declined as mortgage refinancing accelerated, resulting in earlier repayment of mortgage backed securities, and reinvestment of the

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proceeds at lower current market rates. In order to keep the investment portfolio short for liquidity with expectations that rates would start to move upward the Bank invested in interest bearing deposits with other banks, in amounts which made them eligible for FDIC insurance to obtain better short term yields. These CDs yielded 2.56% during the first quarter, a relatively attractive rate given their short term nature and low risk, as compared to the rates offered on federal funds and U. S. Treasury bills. At March 31, 2004, the Bank had \$4.9 million of such deposits.

The decline in the yield on the loan portfolio, while 55 basis points, was less than might be expected in the general interest rate environment of 2003 leading into the first quarter of 2004. Approximately 33% of the Bank's loan portfolio consists of loans which reprice in periods of three to five years and 8% reprice beyond five years. This repricing frequency minimizes the effects of rate reductions in reparable loans thereby slowing the decline in the overall yield of the portfolio. Over time, of course, market pressures and loan repayments and maturities will force the portfolio yield down even when there may be no further market rate reductions. In a rising rate environment, this repricing frequency may delay the Bank's ability to increase the yield on these loans. However, management is comfortable with 59% of the loan portfolio repricing within one year and expects to increase profitability in a rising interest rate environment. Interest rate shock results are included under the section Asset/Liability Management.

On the liability side, management aggressively reduced rates on deposit accounts. The reduction in the rate on total interest bearing liabilities from the first three months of 2003 to the first three months of 2004 was 43 basis points which compares to a reduction of 46 basis points in the yield on earning assets over the same period.

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It is anticipated that any further reductions in interest rates may have a significant adverse effect on earnings as rates paid on interest bearing liabilities, which are as low as 0.10% on NOW accounts, cannot continue to decline at the same rate as yields on loans and investments.

AVERAGE BALANCES, INTEREST YIELDS, AND RATES, AND NET INTEREST MARGIN THREE MONTHS ENDED MARCH 31,

| | 2004 | | | Average Balance |
|--|--------------------|----------|-----------------------|--------------------|
| | Average Balance | Interest | Average Yield/Rate | |
| ASSETS: | | | | |
| Interest earnings assets: | | | | |
| Interest bearing deposits with other banks | \$ 4,163 | \$ 26 | 2.56% | \$ 6,1 |
| Loans | 324,942 | 4,787 | 5.93% | 241,8 |
| Investment securities | 65,869 | 527 | 3.20% | 62,3 |
| Federal funds sold and cash equivalents | 14,094 | 36 | 1.03% | 4,5 |
| Total interest earning assets | 409,068 | 5,376 | 5.28% | 314,8 |
| Total noninterest earning assets | 33,330 | | | 25,7 |

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| | | | | |
|---|------------|----------|-------|----------|
| Less: allowance for credit losses | 3,764 | | | 2,8 |
| | ----- | | | ----- |
| Total nonearning assets | 29,566 | | | 22,8 |
| | ----- | | | ----- |
| TOTAL ASSETS | \$ 438,634 | | | \$ 337,7 |
| | ===== | | | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY: | | | | |
| Interest bearing liabilities: | | | | |
| NOW accounts | \$ 45,263 | 14 | 0.13% | \$ 36,0 |
| Savings and money market accounts | 111,523 | 261 | 0.94% | 95,3 |
| Certificates of deposit | 109,774 | 537 | 1.97% | 78,2 |
| Customer repurchase agreements | 21,263 | 30 | 0.56% | 20,5 |
| Short-term borrowing | 4,000 | 27 | 2.79% | 6,5 |
| Long-term borrowing | 10,170 | 101 | 4.00% | 16,9 |
| | ----- | ----- | | ----- |
| Total interest bearing liabilities | 301,993 | 969 | 1.29% | 253,5 |
| | ----- | ----- | | ----- |
| Noninterest bearing liabilities: | | | | |
| Noninterest bearing deposits | 81,438 | | | 62,0 |
| Other liabilities | 1,326 | | | 1,5 |
| | ----- | | | ----- |
| Total noninterest bearing liabilities | 82,764 | | | 63,5 |
| | ----- | | | ----- |
| Stockholders' equity | 53,877 | | | 20,5 |
| | ----- | | | ----- |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 438,634 | | | \$ 337,7 |
| | ===== | | | ===== |
| Net interest income | | | | |
| | | \$ 4,407 | | |
| | | ===== | | |
| Net interest spread | | | 3.99% | |
| Net interest margin | | | 4.33% | |

ALLOWANCE FOR CREDIT LOSSES

The provision for credit losses represents the expense recognized to fund the allowance for credit losses. The amount of the allowance for credit losses is based on many factors which reflect management's assessment of the risk in the loan portfolio. Those factors include economic conditions and trends, the value and adequacy of collateral, volume and mix of the portfolio, performance of the portfolio, and internal loan processes of the Company and Bank.

Management has developed a comprehensive review process to monitor the adequacy of the allowance for credit losses. The review process and guidelines were developed utilizing guidance from federal banking regulatory agencies. The results of this review process, in combination with conclusions of the Bank's outside loan review consultant, support management's view as to the adequacy of the allowance as of the balance sheet date. During the first three months of 2004, a provision for credit losses was made in the amount of \$154 thousand before net charge-offs of \$84 thousand. Please refer to the discussion under the caption, "Critical Accounting Policies" for an overview of the underlying

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methodology management employs on a quarterly basis to maintain the allowance.

At March 31, 2004, the Company had five loans classified as nonaccrual in the amount of \$561 thousand which it considered impaired under Statement of Financial Accounting Standards ("SFAS No. 114"). As part of its comprehensive loan review process, the Bank's Board of Director's Loan Committee and/or Board of Directors Credit Review Committee carefully evaluates loans over thirty days past due. The Committee(s) makes a thorough assessment of the conditions and circumstances surrounding each past due loan. The Bank's loan policy requires that loans be placed on nonaccrual if they are ninety days past due, unless they are well secured and in the process of collection.

The provision for credit losses of \$154 thousand in the first three months of 2004 compared to a provision for credit losses of \$224 thousand in the first three months of 2003. The higher level of the provision in 2003 is primarily attributable to a specific reserve set aside for a problem credit in 2003 which was not required when compared to 2004.

As the portfolio and allowance review process matures, there will be changes to different elements of the allowance and this may have an effect on the overall level of the allowance maintained. To date the Bank has enjoyed a very high quality portfolio with minimal net charge offs and very low delinquency. The maintenance of a high quality portfolio will continue to be management's prime objective as it relates to the lending process and to the allowance for credit losses.

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The following table sets forth activity in the allowance for credit losses for the periods indicated.

| (dollars in thousands) | Three Months Ended | | Year Ended | |
|------------------------------|--------------------|----------|--------------|----------|
| | March 31, | | December 31, | |
| | 2004 | 2003 | 2003 | 2002 |
| Balance at beginning of year | \$ 3,680 | \$ 2,766 | \$ 2,766 | \$ 2,111 |
| Charge-offs: | -- | -- | -- | -- |
| Commercial | (66) | (148) | (319) | (192) |
| Real estate - commercial | -- | -- | -- | -- |
| Construction | -- | -- | -- | -- |
| Home equity | -- | -- | -- | -- |
| Other consumer | (18) | -- | (14) | (40) |
| Total | (84) | (148) | (333) | (232) |
| Recoveries: | | | | |
| Commercial | -- | 19 | 68 | 26 |
| Real estate - commercial | -- | -- | -- | -- |
| Construction | -- | -- | -- | -- |
| Home equity | -- | -- | -- | -- |
| Other consumer | -- | -- | 4 | 18 |

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| | | | | |
|---|----------------------------|----------------------------|----------------------------|----------------------------|
| Total | ----- -- | ----- 19 | ----- 72 | ----- 44 |
| Net charge-offs | ----- (84) | ----- (129) | ----- (261) | ----- (188) |
| Additions charged to operations | ----- 154 | ----- 224 | ----- 1,175 | ----- 843 |
| Balance at end of period | ----- \$ 3,750 ===== | ----- \$ 2,861 ===== | ----- \$ 3,680 ===== | ----- \$ 2,766 ===== |
| Annualized ratio of net charge-offs during the during the period to average loans outstanding during the period | ----- 0.10% | ----- 0.20% | ----- 0.10% | ----- 0.09% |

The following table reflects the allocation of the allowance for credit losses at the dates indicated. The allocation of the allowance to each category is not necessarily indicative of future losses or charge-offs and does not restrict the use of the allowance to absorb losses in any category.

| (dollars in thousands) | As of March 31, | | As of December 31, | |
|-----------------------------------|---------------------------|------------------------|---------------------------|------------------------|
| | 2004 | | 2003 | |
| | Amount | Percent (1) | Amount | Percent (1) |
| Commercial | \$2,358 | 26.5% | \$1,689 | 29.3% |
| Real estate - commercial | 568 | 49.1 | 888 | 47.3 |
| Construction | 457 | 12.4 | 613 | 11.2 |
| Home equity | 90 | 10.9 | 171 | 10.7 |
| Other consumer | 82 | 1.1 | 72 | 1.5 |
| Unallocated | 195 | -- | 247 | -- |
| Total allowance for credit losses | ----- \$3,750 ===== | ----- 100% ===== | ----- \$3,680 ===== | ----- 100% ===== |

(1) Represents the percent of loans in category to gross loans

NON-PERFORMING ASSETS

The Company's non-performing assets, which are comprised of loans delinquent 90 days or more, non-accrual loans, and other real estate owned, totaled \$561 thousand at March 31, 2004 compared to \$759 thousand at March 31, 2003 and \$654 thousand at December 31, 2003. The percentage of non-performing assets to total assets was 0.17% at March 31, 2004, compared to 0.20% at March 31, 2003 and 0.20% at December 31, 2003.

Non-performing loans constituted all of the non-performing assets at March 31, 2004, March 31, 2003 and December 31, 2003. Non-performing loans at

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March 31, 2004 consist of five loans on nonaccrual of \$561 thousand compared to one nonaccrual loan in the amount of \$149 thousand and one impaired loan in the amount of \$610 thousand at March 31, 2003.

The Company had no other real estate owned at either March 31, 2004 or 2003.

The following table shows the amounts of non-performing assets at the dates indicated.

| | March 31, | | December 31, |
|--------------------------------|-----------|-------|--------------|
| (dollars in thousands) | 2004 | 2003 | 2003 |
| Nonaccrual Loans | | | |
| Commercial | \$470 | \$149 | \$554 |
| Consumer | 91 | -- | 100 |
| Real estate | -- | -- | -- |
| Accrual loans-past due 90 days | | | |
| Commercial | -- | 610 | -- |
| Consumer | -- | -- | -- |
| Real estate | -- | -- | -- |
| Restructured loans | -- | -- | -- |
| Real estate owned | | | |
| Total non-performing assets | \$561 | \$759 | \$654 |

At March 31, 2004, there were no performing loans considered potential problem loans, defined as loans which are not included in the past due, nonaccrual or restructured categories, but for which known information about possible credit problems causes management to be uncertain as to the ability of the borrowers to comply with the present loan repayment terms.

NONINTEREST INCOME

Noninterest income primarily represents deposit account service charges and fees, gains on the sale of loans, other noninterest loan fees, income from bank owned life insurance ("BOLI") and other service fees. For the three months ended March 31, 2004 noninterest income was \$1.08 million which included \$253 thousand in gains on the sale of investment securities. This compared to \$873 thousand of noninterest income for the three months ended March 31, 2003 which included \$192 thousand in gains on the sale of investment securities. The Company is an active originator of SBA loans and its current practice is to sell the insured portion of those loans at a premium. Income from this source was \$97 thousand for the three months ended March 31, 2004 compared to \$153 thousand for the three months ended March 31, 2003. The decreased March 31, 2003 to March 31, 2004 can be attributed to a slow down in SBA loan originations due to a reduction in the maximum loan eligible for an SBA guarantee. The Company believes that SBA activity will pick up with an improving economy and increased commercial loan activity. The Company also originates residential permanent mortgage loans on a pre-sold basis, servicing released. Sales of these mortgage loans yielded gains of \$75 thousand in 2004 compared to \$95 thousand in 2003. The decrease in the premiums realized on the sale of mortgage loans can be directly attributed to the rise in mortgage loan interest rates in the first quarter of 2004. The slow down in this area could continue as mortgage rates rise.

Other items in noninterest income increased 52% from \$433 thousand for the three months ended March 31, 2003 to \$657 thousand for the three months ended March 31, 2004. This category includes deposit account service charges

and noninterest income fees such as documentation preparation and prepayment penalties. Income for the three months ended March 31, 2004 was \$346 thousand from deposit account services charges, \$32 thousand from SBA loan service fees and \$83 thousand from BOLI, versus \$272 thousand from deposit account service charges, \$19 thousand from SBA service fees and \$55 thousand from BOLI for the three months ended March 31, 2003.

NONINTEREST EXPENSE

Noninterest expense was \$3.5 million for the three months ended March 31, 2004 compared to \$2.5 million for the three months ended March 31, 2003. This represented a period to period increase of 42%. Increases in noninterest expense primarily relate to increases in the expense category salaries and employee benefits which increased 45% from the first three months of 2003 to the first three months of 2004, from \$1.3 million to \$1.9 million. During the first quarter of 2004, to accommodate the growth in assets, customer accounts and offices experienced by the Bank in 2003 and to accommodate the growth anticipated in 2004, a number of additions to staff were made in the lending and operations (customer service) areas. Management felt that these additions and the associated expenses were necessary to assure a continued growth pattern and quality of service which characterized the Company since its inception. The increase of 41% in premises and equipment for the three months, from \$423 thousand to \$598 thousand can be attributed to the expenses for the Bank's Rockville Pike Office, new deposit and loan operations offices in Silver Spring acquired to house an expanded support staff.

Other expenses which increased 49% from \$499 thousand to \$743 thousand for the three months ending March 31, 2004 compared to the three months ended March 31, 2003, represent a number of expense categories ranging from business development, office supplies to charitable contributions. Management monitors these expenses closely and believes that the increase in them is consistent with the needs of an aggressively growing Company. In future periods, noninterest expenses to which the Company has not been subject to date, such as deposit insurance premiums which may be required as a result of declines in the reserve ratios of the deposit insurance funds, may have an adverse effect on the results of operations of the Company.

FINANCIAL CONDITION

As of March 31, 2004, assets were \$469 million and deposits were \$386 million. Assets grew by \$26 million from December 31, 2003, and deposits grew by approximately \$50 million.

Loans

Total loans, excluding loans held for sale, increased approximately \$12 million from December 31, 2003 to March 31, 2004, from \$318 million to \$330 million.

Loans, net of amortized deferred fees and costs, at March 31, 2004, March 31, 2003 and December 31, 2003 are summarized by type as follows:

| March 31, 2004 | Percent of Total | March 31, 2003 | Percent of Total |
|-------------------|---------------------|-------------------|---------------------|
| ----- | ----- | ----- | ----- |

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| | | | | |
|-----------------------------------|------------|-------|------------|-------|
| Commercial | \$ 87,471 | 26.5% | \$ 64,254 | 26.8% |
| Real estate - commercial | 162,188 | 49.1% | 118,239 | 49.4% |
| Construction | 40,842 | 12.4% | 23,268 | 9.7% |
| Home equity | 36,140 | 10.9% | 30,531 | 12.7% |
| Other consumer | 3,612 | 1.1% | 3,259 | 1.4% |
| | ----- | ----- | ----- | ----- |
| Total loans | 330,253 | 100% | 239,551 | 100% |
| Less: allowance for credit losses | (3,750) | | (2,861) | |
| | ----- | | ----- | |
| Loans, net | \$ 326,503 | | \$ 236,690 | |
| | ===== | | ===== | |

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Deposits And Other Borrowings

The principal sources of funds for the Bank are core deposits, consisting of demand deposits, NOW accounts, money market accounts, savings accounts and relationship certificates of deposits, from the local market areas surrounding the Bank's offices. The Bank's deposit base includes transaction accounts, time and savings accounts and accounts which customers use for cash management and which provide the Bank with a source of fee income and cross-marketing opportunities as well as a low-cost source of funds. Time and savings accounts, including money market deposit accounts, also provide a relatively stable and low-cost source of funding.

For the three months ending March 31, 2004 from December 31, 2003, deposits grew \$50 million, from \$336 million to \$386 million.

Approximately 30% of the Bank's deposits are made up of certificates of deposits, which are generally the most expensive form of deposit because of their fixed rate and term. Certificates of deposit in denominations of \$100 thousand or more can be more volatile and more expensive than certificates of less than \$100 thousand. However, because the Bank focuses on relationship banking and does not accept brokered certificates, its historical experience has been that large certificates of deposit have not been more volatile or significantly more expensive than smaller denomination certificates. It has been the practice of the Bank to pay posted rates on its certificates of deposit whether under or over \$100 thousand. The Bank has paid negotiated rates for deposits in excess of \$500 thousand but the rates paid have rarely been more than 25 to 50 basis points higher than posted rates and deposits also have been negotiated at below market rates. In late 2000, to fund strong loan demand, the Bank began accepting certificates of deposits, generally in denominations of less than \$100 thousand on a non brokered basis, from bank and credit union subscribers to a wholesale deposit rate line. The Bank has found rates on these deposits to be generally competitive with rates in our market given the speed and minimal noninterest cost at which deposits can be acquired, although it is possible for rates to significantly exceed local market rates it has not been the experience of the Bank. At March 31, 2004 the Bank held \$32.6 million of these deposits at an average rate of 2.57% as compared to \$12.1 million of these deposits, at an average rate of 4.08% at March 31, 2003. With the strong core deposit growth experienced by the Bank in 2002, these deposits were allowed to mature without renewal or replacement. However, during the first quarter of 2004 management felt that there was an opportunity to acquire longer maturities of these deposits at attractive interest rates and again began accepting these deposits with maturities greater than one year. During the first quarter of 2004, the Company introduced a new certificate of deposit program CDARS, which will provides its customers with access to greater FDIC insurance coverage.

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Using CDARS the Bank can distribute customer funds among other FDIC-insured banks and thrifts, allowing customer to manage all their CDs through one relationship.

At March 31, 2004, the Company had approximately \$94 million in noninterest bearing demand deposits, representing 24% of total deposits. This compared to \$90 million of these deposits at December 31, 2003. These are primarily business checking accounts on which the payment of interest is prohibited by regulations of the Federal Reserve. Proposed legislation has been introduced in each of the last several sessions of Congress which would permit banks to pay interest on checking and demand deposit accounts established by businesses. If legislation effectively permitting the payment of interest on business demand deposits is enacted, of which there can be no assurance, it is likely that we may be required to pay interest on some portion of our noninterest bearing deposits in order to compete with other banks. Payment of interest on these deposits could have a significant negative impact on our net income, net interest income, interest margin, return on assets and equity, and indices of financial performance.

As an enhancement to the basic noninterest bearing demand deposit account, the Company offers a sweep account, or "customer repurchase agreement", allowing qualifying businesses to earn interest on short term excess funds which are not suited for either a CD investment or a money market account. The balances in these accounts were \$14 million at March 31, 2004 compared to \$17 million at December 31, 2003. Customer repurchase agreements are not deposits and are not FDIC insured but are secured by US Treasury and/or US government agency securities. These accounts are particularly suitable to businesses with significant change in the levels of cash flow over a very short time frame often measured in days. Attorney and title company escrow accounts are an example of accounts which can benefit from this product, as are customers who may require collateral for deposits in excess of \$100 thousand but do not qualify for other pledging arrangements. This program requires the Company to maintain a

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sufficient investment securities level to accommodate the fluctuations in balances which may occur in these accounts.

At March 31, 2004, the Company had no outstanding balance under its line of credit provided by a correspondent bank. The Bank had \$13.3 million of FHLB short and long-term borrowings, as compared to \$14.3 million at December 31, 2003. These advances are secured 50% by US government agency securities and 50% by a blanket lien on qualifying loans in the Bank's commercial mortgage loan portfolio. Through another subsidiary of the Company, Bethesda Leasing LLC, there were outstanding long term borrowings of \$218 thousand. This loan was obtained to fund the purchase of an impaired loan from the Bank.

LIQUIDITY MANAGEMENT

Liquidity is the measure of the Bank's ability to meet the demands required for the funding of loans and to meet depositor requirements for use of their funds. The Bank's sources of liquidity consist of cash balances, due from banks, loan repayments, federal funds sold and short term investments. These sources of liquidity are supplemented by the ability of the Company and Bank to borrow funds. The Company maintains a \$10 million line of credit with a correspondent bank, against which it has guaranteed a \$218 thousand loan to its subsidiary Bethesda Leasing. The Bank can purchase up to \$12 million in federal funds on an unsecured basis and enter into reverse repurchase agreements up to \$10 million. At March 31, 2004, the Bank was also eligible to take FHLB advances of up to \$82

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million, of which it had advances outstanding of \$13.3 million.

The loss of deposits, through disintermediation, is one of the greater risks to liquidity. Disintermediation occurs most commonly when rates rise and depositors withdraw deposits seeking higher rates than the Bank may offer. The Bank was founded under a philosophy of relationship banking and, therefore, believes that it has less of an exposure to disintermediation and resultant liquidity concerns than do banks which build an asset base on non-core deposits and other borrowings. The history of the Bank includes a period of rising interest rates and significant competition for deposit dollars. During that period the Bank grew its core business without sacrificing its interest margin in higher deposit rates for non-core deposits. There is, however, a risk that some deposits would be lost if rates were to spike up and the Bank elected not to meet the market. Under those conditions the Bank believes that it is well positioned to use other liability management instruments such as FHLB borrowing, reverse repurchase agreements and Bank lines to offset a decline in deposits in the short run. Over the long term an adjustment in assets and change in business emphasis could compensate for a loss of deposits. Under these circumstances, further asset growth could be limited as the Bank utilizes its liquidity sources to replace, rather than supplement, core deposits.

Certificates of deposit acquired through the subscription service may be more sensitive to rate changes and pose a greater risk of disintermediation than deposits acquired in the local community. The Bank has limited the amount of such deposits to 25% of total assets, an amount which it believes it could replace with alternative liquidity sources, although there can be no assurance of this.

The mature earning pattern of the Bank is also a liquidity management resource for the Bank. The earnings of the Bank are now at a level that allows the Bank to pay higher rates to retain deposits over a short period, while it adjusts its asset base repricing to offset a higher cost of funds. The cost of retaining business in the short run and the associated reduction in earnings can be preferable to reducing deposit and asset levels and restricting growth.

At March 31, 2004, under the Bank's liquidity formula, it had \$123 million of liquidity representing 27.3% of total Bank assets.

ASSET/LIABILITY MANAGEMENT AND QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

A fundamental risk in banking, outside of credit risk, is exposure to market risk, or interest rate risk, since a bank's net income is largely dependent on net interest income. The Bank's Asset Liability Committee (ALCO) of the Board of Directors formulates and monitors the management of interest rate risk within policies established by it and the Board of Directors. In its consideration of establishing guidelines for levels and/or limits on market risk, the ALCO committee considers the impact on earnings and capital, the level and direction of interest rates, liquidity, local economic conditions, outside threats and other factors. Banking is generally a business of attempting to match asset and liability components to produce a spread sufficient to provide net income to the bank at nominal rate risk. The

Company, through ALCO, continually monitors the interest rate environment in which it operates and adjusts rates and maturities of its assets and liabilities to meet the market conditions. In the current low interest rate environment, the Company is keeping its assets either variably priced or with short term

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maturities or short average lives. At the same time it strives to attract longer term liabilities to lock in the lower cost of funds. In the current market, due to competitive factors and customer preferences, the effort to attract longer term fixed priced liabilities has not been as successful as the Company's best case asset liability mix would prefer. When interest rates begin to rise, the Company expects that it will seek to keep asset maturities and repricing periods short until rates appear to be nearing their peak and then extend maturities to extend the benefit of higher rates. There can be no assurance that the Company will be able to successfully carry out this intention, as a result of competitive pressures, customer preferences and the inability to perfectly forecast future interest rates.

One of the tools used by the Company to manage its interest rate risk is a static GAP analysis presented below. The Company also uses an earning simulation model on a quarterly basis to closely monitor interest sensitivity and to expose its balance sheet and income statement to different scenarios. The model is based on current Company data and adjusted by assumptions as to growth patterns, noninterest income and noninterest expense and interest rate sensitivity, based on historical data, for both assets and liabilities. The model is then subjected to a "shock test" assuming a sudden interest rate increase of 200 basis points or a decrease of 200 basis points, but not below zero. The results are measured by the effect on net income. The Company, in its latest model, shows a positive effect on income when interest rates immediately rise 200 basis points because of the short maturities of assets and a negative impact if rates were to decline further. With rates already at historic lows, a further reduction would reduce income on earning assets which could not be offset by a corresponding reduction in the cost of funds.

The following table reflects the result of a "shock test" simulation on the March 31, 2004, earning assets and interest bearing liabilities and the change in net interest income resulting from the simulated immediate increase and decrease in interest of 100 and 200 basis points. Also shown is the change in the Market Value Portfolio Equity resulting from the simulation. The model as presented is projected for one year.

| Change in interest rates (basis points) | Percentage change in net interest income | Percentage change in net income | Percentage change in Market Value of Portfolio Equity |
|--|---|------------------------------------|---|
| +200 | +16.4% | +40.4% | +19.1% |
| +100 | +8.6% | +21.1% | +10.3% |
| 0 | -- | -- | -- |
| -100 | -11.8% | -29.2% | -13.6% |
| -200 | -26.4% | -65.0% | -26.1% |

Certain shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities or repricing periods, they may react in different degrees to changes in market interest rates. Also, 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 may lag behind changes in market rates. Additionally, certain assets, such as adjustable-rate mortgage loans, have features that restrict changes in interest rates on a short-term basis and over the life of the loan. Further, in the event of a change in interest rates, prepayment and early withdrawal levels could deviate significantly from those assumed in calculating the tables. Finally, the ability of many borrowers to service their debt may decrease in the event of a significant interest rate

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increase.

GAP

Banks and other financial institutions are dependent upon net interest income, the difference between interest earned on interest earning assets and interest paid on interest bearing liabilities. In falling interest rate environments, net interest income is maximized with longer term, higher yielding assets being funded by lower yielding short-term funds; however, when interest rates trend upward this asset/liability structure can result in a significant adverse impact on net interest income. The current interest rate environment is signaling steady to possibly higher rates. Management has for a number of months shortened maturities in the Bank's investment portfolio and where possible also has shorten repricing opportunities for new loan requests. While management believes that this will help minimize interest rate risk in a rising rate environment, there can be no assurance as to actual results.

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GAP, a measure of the difference in volume between interest earning assets and interest bearing liabilities, is a means of monitoring the sensitivity of a financial institution to changes in interest rates. The chart below provides an indicator of the rate sensitivity of the Company. A negative GAP indicates the degree to which the volume of repriceable liabilities exceeds repriceable assets in particular time periods. At March 31, 2004, the Bank had a positive GAP of 35.4% out to three months and a cumulative positive GAP of 4.5% out to twelve months, as opposed to a three month positive gap of 11.02% and a cumulative twelve month negative gap of (10.06%) at December 31, 2003.

If interest rates were to continue to decline, the Bank's interest income and margin may be adversely effected. Because of the positive GAP measure in the 0 - 3 month period, continued decline in the prime lending rate will reduce income on repriceable assets within thirty to ninety days, while the repricing of liabilities may occur over future time periods and there may not be an ability to reduce the cost of interest bearing liabilities to fully offset the reduction in short term interest rates. This will result in a decline in net interest income and net income. Management has carefully considered its strategy to maximize interest income by reviewing interest rate levels, economic indicators and call features of some of its assets. These factors have been thoroughly discussed with the Board of Directors Asset Liability Committee and management believes that current strategies are appropriate to current economic and interest rate trends. The negative GAP is carefully monitored and will be adjusted as conditions change. The following GAP table is presented on the basis of the Bank only as inclusion of escrowed subscription assets and noninterest bearing escrowed subscription liabilities would create a distorted representation of the operating GAP.

GAP ANALYSIS

March 31, 2004

(dollars in thousands)

| Repriceable in: | 0-3 Months | 4-12 Months | 13-36 Months | 37-60 Months |
|-----------------|---------------|----------------|-----------------|-----------------|
|-----------------|---------------|----------------|-----------------|-----------------|

ASSETS:

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| | | | | |
|---|------------|--------------|-------------|-----------|
| Investment securities | \$ 14,899 | \$ 2,700 | \$ 13,409 | \$ 16,111 |
| Interest bearing deposits in other banks | 99 | 4,167 | 494 | - |
| Loans | 176,807 | 18,200 | 39,792 | 68,687 |
| Federal funds sold | 17,026 | -- | -- | - |
| | | | | |
| Total repriceable assets | 208,831 | 25,067 | 53,695 | 84,797 |
| | | | | |
| LIABILITIES: | | | | |
| NOW accounts | -- | 28,961 | 5,793 | 23,164 |
| Savings and Money Market accounts | 45,906 | 36,834 | 22,953 | 11,477 |
| Certificates of deposit | 10,662 | 78,895 | 25,826 | 1,367 |
| Customer repurchase agreements and Federal funds purchased | 4,187 | 5,584 | 1,395 | 2,791 |
| Other borrowing-short and long term | 1,000 | 3,000 | 9,333 | - |
| | | | | |
| Total repriceable liabilities | 61,755 | 153,274 | 65,300 | 38,791 |
| | | | | |
| GAP | \$ 147,076 | \$ (128,207) | \$ (11,605) | \$ 46,000 |
| Cumulative GAP | 147,076 | 18,869 | 7,264 | 53,264 |
| | | | | |
| Interval gap/earnings assets | 35.39% | (30.85)% | (2.79)% | 11.0% |
| Cumulative gap/earning assets | 35.39% | 4.54% | 1.75% | 12.8% |

Although, NOW and MMA accounts are subject to immediate repricing, the Bank's GAP model has incorporated a repricing schedule to account for the historical lag in effecting rate changes and the amount of those rate changes relative to the amount of rate change in assets.

CAPITAL RESOURCES AND ADEQUACY

The assessment of capital adequacy depends on a number of factors such as asset quality, liquidity, earnings performance, changing competitive conditions and economic forces, and the overall level of growth. The adequacy of the Company's current and future capital needs is monitored by management on an ongoing basis. Management

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seeks to maintain a capital structure that will assure an adequate level of capital to support anticipated asset growth and to absorb potential losses.

The capital position of the Company's wholly-owned subsidiary, the Bank, continues to meet regulatory requirements. The primary indicators relied on by bank regulators in measuring the capital position are the Tier 1 risk-based capital, total risk-based capital, and leverage ratios. Tier 1 capital consists of common and qualifying preferred stockholders' equity less goodwill. Total risk-based capital consists of Tier 1 capital, qualifying subordinated debt, and a portion of the allowance for credit losses. Risk-based capital ratios are calculated with reference to risk-weighted assets. The leverage ratio compares Tier 1 capital to total average assets. At March 31, 2003, the Company's and Bank's capital ratios were in excess of the mandated minimum requirements.

The ability of the Company to continue to grow is dependent on its earnings and the ability to obtain additional funds for contribution to the Bank's capital, through additional borrowing, the sale of additional common stock, the sale of preferred stock, or through the issuance of additional qualifying equity equivalents, such as subordinated debt or trust preferred securities. On August

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1, 2003 the Company completed its offering with the sale of 2,448,979 shares of common stock for gross proceeds of approximately \$30 million.

CAPITAL

The actual capital amounts and ratios for the Company and Bank as of March 31, 2004 and 2003 are presented in the table below:

| In thousands | Company Actual Amount ----- | Ratio ----- | Bank Actual Amount ----- | Ratio ----- | For Capital Adequacy Purposes Ratio ----- |
|--|--------------------------------------|----------------|-----------------------------------|----------------|---|
| As of March 31, 2004 | | | | | |
| Total capital (to risk-weighted assets) | \$58,431 | 16.4% | \$39,003 | 10.9% | 8.0% |
| Tier 1 capital (to risk-weighted assets) | \$54,656 | 15.3% | 35,243 | 9.9% | 4.0% |
| Tier 1 capital (to average Assets) | \$54,656 | 14.0% | 35,243 | 8.5% | 3.0% |
| As of March 31, 2003 | | | | | |
| Total capital (to risk-weighted assets) | \$23,727 | 9.2% | \$27,793 | 10.9% | 8.0% |
| Tier 1 capital (to risk weighted assets) | \$20,866 | 8.1% | 24,953 | 9.8% | 4.0% |
| Tier 1 capital (to average assets) | \$20,866 | 6.2% | 24,953 | 7.4% | 3.0% |

** Applies to Bank only

Bank and holding company regulations, as well as Maryland law, impose certain restrictions on dividend payments by the Bank, as well as restricting extension of credit and transfers of assets between the Bank and the Company. At March 31, 2004, the Bank could pay dividends to the parent to the extent of its earnings and so long as it maintained required capital ratios.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Please refer to Item 2 of this report, "Management's Discussion and Analysis of Financial Condition and Results of Operations", under the caption "Asset/Liability Management and Quantitative and Qualitative Disclosure About Market Risk".

ITEM 4. CONTROLS AND PROCEDURES

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The Company's management, under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer, evaluated as of the last day of the period covered by this report the effectiveness of the operation of the Company's disclosure controls and procedures, as defined in Rule 13a-14 under the Securities and Exchange Act of 1934. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were adequate. There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15 under the Securities Act of 1934) during the quarter ended March 31, 2004 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1 LEGAL PROCEEDINGS

From time to time the Company may become involved in legal proceedings. At the present time there are no proceedings which the Company believes will have an adverse impact on the financial condition or earnings of the Company.

ITEM 2. CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES

- (a) Modification of Rights of Registered Securities. None
- (b) Issuance or Modification of Other Securities Affecting Rights of Registered Securities. None
- (c) Sales of Unregistered Securities. None
- (d) Use of Proceeds. Not Applicable.
- (e) Issuer Purchases of Securities. None

ITEM 3 DEFAULTS UPON SENIOR SECURITIES None.

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS None

ITEM 5. OTHER INFORMATION None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

| Exhibit No. | Description of Exhibit |
|-------------|------------------------|
|-------------|------------------------|

| | |
|------|--|
| 3(a) | Certificate of Incorporation of the Company, as amended (1) |
| 3(b) | Bylaws of the Company (2) |
| 10.1 | 1998 Stock Option Plan (3) |
| 10.2 | Employment Agreement between Michael Flynn and the Company (4) |
| 10.3 | Employment Agreement between Thomas D. Murphy and the Bank (4) |
| 10.4 | Employment Agreement between Ronald D. Paul and the Company (4) |
| 10.5 | Director Fee Agreement between Leonard L. Abel and the Company (4) |
| 10.6 | Employment Agreement between Susan G. Riel and the Bank (4) |
| 10.7 | Employment Agreement between Martha F. Tonat and the Bank (4) |
| 10.8 | Employment Agreement between Wilmer L. Tinley and the Bank (4) |

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| | |
|------|---|
| 11 | Statement Regarding Computation of Per Share Income |
| 21 | Subsidiaries of the Registrant |
| 31.1 | Certification of Ronald D. Paul |
| 31.2 | Certification of Wilmer L. Tinley |
| 32.1 | Certification of Ronald D. Paul |
| 32.2 | Certification of Wilmer L. Tinley |

-
- (1) Incorporated by reference to the exhibit of the same number to the Company's Quarterly Report on Form 10-QSB for the period ended September 30, 2002.
 - (2) Incorporated by reference to Exhibit 3(b) to the Company's Registration Statement on Form SB-2, dated December 12, 1997.
 - (3) Incorporated by reference to Exhibit 10.1 to the Company's Annual Report on Form 10-KSB for the year ended December 31, 1998.
 - (4) Incorporated by reference to exhibits of the same number to the Company's Annual Report on Form 10-K for the year ended December 31, 2003.
- (b) Reports on Form 8-K

On January 16, 2004, the Company filed a Current Report on Form 8-K, under Items 7, 9 and 12 thereof, reporting earnings for the year ended December 31, 2003.

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.

EAGLE BANCORP, INC.

Date: August 20, 2004

By: /s/ Ronald D. Paul

Ronald D. Paul, President and CEO

Date: August 20, 2004

By: /s/ Wilmer L. Tinley

Wilmer L. Tinley, Senior Vice President and CFO