FIRST BANCORP /NC/
Form 10-Q
August 09, 2006

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

# FORM 10-Q

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

For the quarterly period ended
June 30, 2006

Commission File Number 0-15572

FIRST BANCORP
(Exact Name of Registrant as Specified in its Charter)

| | |
|---|---|
| North Carolina | 56-1421916 |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification Number) |
| 341 North Main Street, Troy, North Carolina | 27371-0508 |
| (Address of Principal Executive Offices) | (Zip Code) |
| (Registrant's telephone number, including area code) | (910) 576-6171 |

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 twelve 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. [X] YES [ ] NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.
[ ] Large Accelerated Filer [X] Accelerated Filer [ ] Non-Accelerated Filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). [ ] YES [X] NO

The number of shares of the registrant's Common Stock outstanding on July 31, 2006 was 14,294,946.

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FIRST BANCORP AND SUBSIDIARIES


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Part I. Financial Information
Item 1 - Financial Statements

First Bancorp and Subsidiaries

Consolidated Balance Sheets

| ($ in thousands-unaudited) | June 30, 2006 | December 31, 2005 (audited) | June 30, 2005 |
|---|---|---|---|
| **ASSETS** | | | |
| Cash & due from banks, noninterest-bearing | $ 31,295 | 32,985 | 35,642 |
| Due from banks, interest-bearing | 83,894 | 41,655 | 41,741 |
| Federal funds sold | 22,029 | 28,883 | 20,700 |
| Total cash and cash equivalents | 137,218 | 103,523 | 98,083 |
| Securities available for sale (costs of $118,549, $114,662, and $118,958) | 115,579 | 113,613 | 119,716 |
| Securities held to maturity (fair values of $14,310, $14,321, and $13,076) | 14,333 | 14,172 | 12,820 |
| Presold mortgages in process of settlement | 2,586 | 3,347 | 2,063 |
| Loans | 1,635,899 | 1,482,611 | 1,425,856 |
| Less: Allowance for loan losses | (17,642) | (15,716) | (15,622) |
| Net loans | 1,618,257 | 1,466,895 | 1,410,234 |
| Premises and equipment | 37,152 | 34,840 | 31,758 |
| Accrued interest receivable | 9,887 | 8,947 | 7,553 |
| Intangible assets | 49,070 | 49,227 | 49,373 |
| Other | 8,627 | 6,486 | 6,997 |
| Total assets | $ 1,992,709 | 1,801,050 | 1,738,597 |
| **LIABILITIES** | | | |
| Deposits: Demand - noninterest-bearing | $ 209,062 | 194,051 | 184,605 |
| Savings, NOW, and money market | 480,522 | 458,221 | 476,642 |
| Time deposits of $100,000 or more | 390,589 | 356,281 | 349,972 |
| Other time deposits | 510,495 | 486,024 | 459,661 |
| Total deposits | 1,590,668 | 1,494,577 | 1,470,880 |
| Securities sold under agreements to repurchase | 30,602 | 33,530 | 1,850 |
| Borrowings | 195,013 | 100,239 | 101,239 |
| Accrued interest payable | 4,856 | 3,835 | 3,267 |
| Other liabilities | 11,655 | 13,141 | 7,159 |
| Total liabilities | 1,832,794 | 1,645,322 | 1,584,395 |
| **SHAREHOLDERS' EQUITY** | | | |
| Common stock, No par value per share Issued and outstanding: 14,279,847, 14,229,148, and 14,170,722 shares | 54,827 | 54,121 | 53,098 |
| Retained earnings | 107,151 | 102,507 | 100,902 |
| Accumulated other comprehensive income (loss) | (2,063) | (900) | 202 |
| Total shareholders' equity | 159,915 | 155,728 | 154,202 |
| Total liabilities and shareholders' equity | $ 1,992,709 | 1,801,050 | 1,738,597 |

See notes to consolidated financial statements.



First Bancorp and Subsidiaries
Consolidated Statements of Income

| ($ in thousands, except share data-unaudited) | Three Months Ended June 30, 2006 | 2005 | 2 |
|---|---|---|---|
| INTEREST INCOME | | | |
| Interest and fees on loans | $ 29,215 | 22,732 | |
| Interest on investment securities: | | | |
| Taxable interest income | 1,402 | 1,411 | |
| Tax-exempt interest income | 127 | 117 | |
| Other, principally overnight investments | 571 | 447 | |
| Total interest income | 31,315 | 24,707 | |
| INTEREST EXPENSE | | | |
| Savings, NOW and money market | 1,635 | 958 | |
| Time deposits of $100,000 or more | 4,174 | 2,725 | |
| Other time deposits | 5,004 | 3,007 | |
| Other, primarily borrowings | 2,058 | 1,010 | |
| Total interest expense | 12,871 | 7,700 | |
| Net interest income | 18,444 | 17,007 | |
| Provision for loan losses | 1,400 | 845 | |
| Net interest income after provision for loan losses | 17,044 | 16,162 | |
| NONINTEREST INCOME | | | |
| Service charges on deposit accounts | 2,225 | 2,145 | |
| Other service charges, commissions and fees | 1,119 | 935 | |
| Fees from presold mortgages | 244 | 285 | |
| Commissions from sales of insurance and financial products | 325 | 314 | |
| Data processing fees | 37 | 58 | |
| Securities gains | 205 | 2 | |
| Other gains (losses) | (311) | (27) | |
| Total noninterest income | 3,844 | 3,712 | |
| NONINTEREST EXPENSES | | | |
| Salaries | 5,734 | 5,393 | |
| Employee benefits | 1,786 | 1,791 | |
| Total personnel expense | 7,520 | 7,184 | |
| Net occupancy expense | 858 | 723 | |

| | | | |
|---|---|---|---|
| Equipment related expenses | 818 | 768 | |
| Intangibles amortization | 60 | 73 | |
| Other operating expenses | 3,808 | 3,512 | |
| Total noninterest expenses | 13,064 | 12,260 | |
| Income before income taxes | 7,824 | 7,614 | |
| Income taxes | 3,029 | 2,962 | |
| NET INCOME | $ 4,795 | 4,652 | |
| Earnings per share: | | | |
| Basic | $ 0.34 | 0.33 | |
| Diluted | 0.33 | 0.32 | |
| Weighted average common shares outstanding: | | | |
| Basic | 14,296,159 | 14,159,117 | 14 |
| Diluted | 14,433,830 | 14,345,013 | 14 |

See notes to consolidated financial statements.

First Bancorp and Subsidiaries
Consolidated Statements of Comprehensive Income

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| ($ in thousands-unaudited) | 2006 | 2005 | 2006 | 2005 |
| Net income | $ 4,795 | 4,652 | 9,786 | 9,368 |
| Other comprehensive income (loss): | | | | |
| Unrealized gains (losses) on securities available for sale: | | | | |
| Unrealized holding gains (losses) arising during the period, pretax | (1,621) | 886 | (1,717) | (428) |
| Tax benefit (expense) | 632 | (343) | 669 | 169 |
| Reclassification to realized gains | (205) | (2) | (205) | (2) |
| Tax expense | 80 | 1 | 80 | 1 |
| Adjustment to minimum pension liability: | | | | |
| Additional pension charge related to unfunded pension liability | -- | -- | 16 | (90) |
| Tax benefit (expense) | -- | -- | (6) | 35 |
| Other comprehensive income (loss) | (1,114) | 542 | (1,163) | (315) |
| Comprehensive income | $ 3,681 | 5,194 | 8,623 | 9,053 |

See notes to consolidated financial statements.

First Bancorp and Subsidiaries
Consolidated Statements of Shareholders' Equity

| (In thousands, except per share - unaudited) | Common Stock Shares | Common Stock Amount | Retained Earnings | Accumu Oth Compreh Income |
|---|---|---|---|---|
| Balances, January 1, 2005 | 14,084 | $ 51,614 | 96,347 | |
| Net income | | | 9,368 | |
| Cash dividends declared ($0.34 per share) | | | (4,813) | |
| Common stock issued under stock option plan | 51 | 585 | | |
| Common stock issued into dividend reinvestment plan | 36 | 799 | | |
| Tax benefit realized from exercise of nonqualified stock options | -- | 100 | | |
| Other comprehensive loss | | | | |
| Balances, June 30, 2005 | 14,171 | $ 53,098 | 100,902 | |
| Balances, January 1, 2006 | 14,229 | $ 54,121 | 102,507 | |
| Net income | | | 9,786 | |
| Cash dividends declared ($0.36 per share) | | | (5,142) | |
| Common stock issued under stock option plan | 66 | 618 | | |
| Common stock issued into dividend reinvestment plan | 37 | 815 | | |
| Purchases and retirement of common stock | (53) | (1,112) | | |
| Tax benefit realized from exercise of nonqualified stock options | -- | 94 | | |
| Stock-based compensation | -- | 291 | | |
| Other comprehensive loss | | | | |
| Balances, June 30, 2006 | 14,279 | $ 54,827 | 107,151 | |

See notes to consolidated financial statements.

First Bancorp and Subsidiaries
Consolidated Statements of Cash Flows

Six Months Ende

| ($ in thousands-unaudited) | June 30, 2006 | 200 |
|---|---|---|
| Cash Flows From Operating Activities | | |
| Net income | $ 9,786 | 9, |
| Reconciliation of net income to net cash provided by operating activities: | | |
| Provision for loan losses | 2,415 | 1, |
| Net security premium amortization | 45 | |
| Gain on sale of securities available for sale | (205) | |
| Other losses | 378 | |
| Net loan origination fees (costs) deferred | 247 | ( |
| Depreciation of premises and equipment | 1,382 | 1, |
| Tax benefit from exercise of nonqualified stock options | -- | |
| Stock-based compensation expense | 291 | |
| Amortization of intangible assets | 121 | |
| Deferred income tax benefit | (1,849) | ( |
| Origination of presold mortgages in process of settlement | (31,781) | (32, |
| Proceeds from sales of presold mortgages in process of settlement | 32,542 | 32, |
| Increase in accrued interest receivable | (940) | ( |
| Decrease in other assets | 213 | 2, |
| Increase in accrued interest payable | 1,021 | |
| Increase (decrease) in other liabilities | (1,479) | |
| Net cash provided by operating activities | 12,187 | 13, |
| Cash Flows From Investing Activities | | |
| Purchases of securities available for sale | (23,565) | (44, |
| Purchases of securities held to maturity | (2,682) | |
| Proceeds from maturities/issuer calls of securities available for sale | 18,248 | 13, |
| Proceeds from maturities/issuer calls of securities held to maturity | 3,186 | 1, |
| Proceeds from sales of securities available for sale | 1,575 | |
| Net increase in loans | (154,743) | (61, |
| Purchases of premises and equipment | (3,730) | (2, |
| Net cash used by investing activities | (161,711) | (94, |
| Cash Flows From Financing Activities | | |
| Net increase in deposits and repurchase agreements | 93,163 | 83, |
| Proceeds from borrowings, net | 94,774 | 9, |
| Cash dividends paid | (5,133) | (4, |
| Proceeds from issuance of common stock | 1,433 | 1, |
| Purchases and retirement of common stock | (1,112) | |
| Tax benefit from exercise of nonqualified stock options | 94 | |
| Net cash provided by financing activities | 183,219 | 89, |
| Increase in Cash and Cash Equivalents | 33,695 | 8, |
| Cash and Cash Equivalents, Beginning of Period | 103,523 | 89, |
| Cash and Cash Equivalents, End of Period | $ 137,218 | 98, |
| Supplemental Disclosures of Cash Flow Information: | | |
| Cash paid during the period for: | | |
| Interest | $ 22,712 | 13, |
| Income taxes | 7,571 | 5, |
| Non-cash transactions: | | |

| | | |
|---|---|---|
| Unrealized loss on securities available for sale, net of taxes | (1,173) | ( |
| Foreclosed loans transferred to other real estate | 774 | 2, |

See notes to consolidated financial statements.



First Bancorp and Subsidiaries
Notes to Consolidated Financial Statements

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(unaudited) For the Periods Ended June 30, 2006 and 2005

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Note 1 - Basis of Presentation

In the opinion of the Company, the accompanying unaudited consolidated financial statements contain all adjustments necessary to present fairly the consolidated financial position of the Company as of June 30, 2006 and 2005 and the consolidated results of operations and consolidated cash flows for the periods ended June 30, 2006 and 2005. All such adjustments were of a normal, recurring nature. Reference is made to the 2005 Annual Report on Form 10-K filed with the SEC for a discussion of accounting policies and other relevant information with respect to the financial statements. The results of operations for the periods ended June 30, 2006 and 2005 are not necessarily indicative of the results to be expected for the full year.

Note 2 - Accounting Policies

Note 1 to the 2005 Annual Report on Form 10-K filed with the SEC contains a description of the accounting policies followed by the Company and discussion of recent accounting pronouncements. The following paragraph updates that information as necessary.

In July 2006, the Financial Accounting Standards Board (FASB) released FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109" (FIN 48). FIN 48 clarifies the accounting and reporting for uncertainties in income tax law. FIN 48 prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. The Company will adopt FIN 48 in the first quarter of 2007. The cumulative effect of applying the provisions of this interpretation is required to be reported separately as an adjustment to the opening balance of retained earnings in the year of adoption. The Company is in the process of reviewing and evaluating FIN 48, and therefore the ultimate impact of its adoption is not yet known.

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004) (Statement 123(R)), "Share-Based Payment." Statement 123(R) replaces FASB Statement No. 123 (Statement 123), "Accounting for Stock-Based Compensation," and supersedes Accounting Principles Board Opinion No. 25 (Opinion 25), "Accounting for Stock Issued to Employees." Statement 123(R) requires that the compensation cost relating to share-based payment transactions be recognized in the financial statements. Statement 123(R) permits public companies to adopt its requirements using one of two methods. The "modified prospective" method recognizes compensation for all stock options granted after the date of adoption and for all previously granted stock options that become vested after the date of adoption. The "modified retrospective" method includes the requirements of the "modified prospective" method described above, but also permits entities to restate prior period results based on the amounts previously presented under Statement 123 for purposes of pro-forma disclosures. The Company has elected to adopt Statement 123(R) under the "modified prospective" method and accordingly will not restate prior period results. See Note 4 for a more detailed description the Company's adoption of Statement 123(R).

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154 (Statement 154), "Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3." Statement 154 applies to all voluntary changes in accounting principle as well as to changes required by an accounting pronouncement that does not include specific transition provisions. Statement 154 eliminates the previous requirement that the cumulative effect of changes in accounting principle be reflected in the income statement in the period of change. Instead, to enhance the comparability of prior period financial statements, Statement 154 requires that changes in accounting principle be retrospectively applied. Under retrospective application, the new accounting principle is applied as of the beginning of the first period presented, as if that



principle had always been used. Statement 154 carries forward the requirement that an error be reported by restating prior period financial statement as of the beginning of the first period. Statement 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The initial adoption of Statement 154 did not have a material impact on the Company's financial statements; however the adoption of this statement could result in a material change to the way the Company reflects future changes in accounting principles, depending on the nature of future changes in accounting principles and whether specific transition provisions are included.

Note 3 - Reclassifications

Certain amounts reported in the period ended June 30, 2005 have been reclassified to conform with the presentation for June 30, 2006. These reclassifications had no effect on net income or shareholders' equity for the periods presented, nor did they materially impact trends in financial information.

Note 4 - Equity-Based Compensation Plans

At June 30, 2006, the Company had the following equity-based compensation plans, all of which are stock option plans: the First Bancorp 2004 Stock Option Plan, the First Bancorp 1994 Stock Option Plan, and four plans that were assumed from acquired entities, which are all described below. The Company's shareholders approved all equity-based compensation plans, except for those assumed from acquired companies. As of June 30, 2006, the First Bancorp 2004 Stock Option Plan was the only plan that had shares available for future grants.

The First Bancorp 2004 Stock Option Plan and its predecessor plan, the First Bancorp 1994 Stock Option Plan, were intended to serve as a means of attracting, retaining and motivating key employees and directors and to associate the interests of the plans' participants with those of the Company and its shareholders. Stock option grants to non-employee directors have historically had no vesting requirements, whereas, except as discussed below, stock option grants to employees have generally had five-year vesting schedules (20% vesting each year). In April 2004, the Company granted 128,000 options to employees with no vesting requirements. These options were granted without any vesting requirements for two reasons - 1) the options were granted primarily as a reward for past performance and therefore had already been "earned" in the view of the Committee, and 2) to potentially minimize the impact that any change in accounting standards for stock options could have on future years' reported net income. Employee stock option grants since the April 2004 grant have reverted to having five year vesting periods. The Company's options provide for immediate vesting if there is a change in control (as defined in the plans). Under the terms of these two plans, options can have a term of no longer than ten years, and all options granted thus far under these plans have had a term of ten years. Except for grants to directors (see below), the Company cannot estimate the amount of future stock option grants at this time. In the past, stock option grants to employees have been irregular, generally falling into three categories - 1) to attract and retain new employees, 2) to recognize changes in responsibilities of existing employees, and 3) to periodically reward exemplary performance. As it relates to directors, the Company has historically granted 2,250 stock options to each of the Company's non-employee directors in June of each year, and expects to continue doing so for the foreseeable future. At June 30, 2006, there were 658,883 options outstanding related to these two plans with exercise prices ranging from $4.45 to $22.12. At June 30, 2006, there were 1,186,840 shares remaining available for grant under the First Bancorp 2004 Stock Option Plan.



The Company also has four stock option plans as a result of assuming plans of acquired companies. At June 30, 2006, there were 44,686 stock options outstanding in connection with these plans, with option prices ranging from $10.22 to $11.49.

The Company issues new shares when options are exercised.

Prior to January 1, 2006, the Company accounted for all of these plans using the intrinsic value method prescribed by Opinion 25 and related interpretations. Because all of the Company's stock options had an exercise price equal to the market value of the underlying common stock on the date of grant, no compensation cost had ever been recognized. On January 1, 2006, the Company adopted Statement 123(R). Statement 123(R) supersedes Opinion 25 (and related interpretations) and requires that the compensation cost relating to share-based payment transactions be recognized in the financial statements. Statement 123(R) permits public companies to adopt its requirements using one of two methods. The "modified prospective" method recognizes compensation for all stock options granted after the date of adoption and for all previously granted stock options that become vested after the date of adoption. The "modified retrospective" method includes the requirements of the "modified prospective" method described above, but also permits entities to restate prior period results based on the amounts previously presented under Statement 123 for purposes of pro-forma disclosures. The Company has elected to adopt Statement 123(R) under the "modified prospective" method and accordingly will not restate prior period results.

The Company measures the fair value of each option award on the date of grant using the Black-Scholes option-pricing model. The Company determines the assumptions used in the Black-Scholes option pricing model as follows: the risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of the grant; the dividend yield is based on the Company's dividend yield at the time of the grant (subject to adjustment if the dividend yield on the grant date is not expected to approximate the dividend yield over the expected life of the option); the volatility factor is based on the historical volatility of the Company's stock (subject to adjustment if historical volatility is reasonably expected to differ from the past); the weighted-average expected life is based on the historical behavior of employees related to exercises, forfeitures and cancellations.

As noted above, prior to the adoption of Statement 123(R), the Company applied Opinion 25 to account for its stock options. The following table illustrates the effect on net income and earnings per share had the Company accounted for share-based compensation in accordance with Statement 123(R) for the periods indicated:

| (In thousands except per share data) | | Three Months Ended June 30, 2005 | Six Months Ended June 30, 2005 |
|---|---|---|---|
| Net income, as reported | | $ 4,652 | 9,368 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | | (180) | (232) |
| Pro forma net income | | $ 4,472 | 9,136 |
| Earnings per share: | Basic - As reported | $ 0.33 | 0.66 |
| | Basic - Pro forma | 0.32 | 0.65 |
| | Diluted - As reported | 0.32 | 0.65 |
| | Diluted - Pro forma | 0.31 | 0.64 |

For the three and six month periods ended June 30, 2006, the Company recorded stock-based compensation expense in the income statement of $244,000 and $291,000, respectively. The Company recognized income tax benefits in the income statement related to stock-based compensation of $78,000 for each of the three and six month periods ended June 30, 2006, respectively. This stock-based compensation expense related to the vesting of several stock option grants made prior to January 1, 2006, as well as a grant of 29,250 options (2,250 options to



each non-employee director of the Company) on June 1, 2006 with no vesting requirements. This compensation expense was reflected as an adjustment to cash flows from operating activities on the Company's Consolidated Statement of Cash Flows. At June 30, 2006, the Company had $90,000 of unrecognized compensation costs related to unvested stock options. The cost is expected to be amortized over a weighted-average life of 1.8 years, with $22,000 being expensed in the third quarter of 2006, $12,000 being expensed in the fourth quarter of 2006, $47,000 being expensed in 2007 equally distributed among each of the four quarters, and $3,000 being expensed in each of 2008, 2009 and 2010, equally distributed among each of the four quarters of each year. In addition, as discussed above, the Company granted 2,250 options, without vesting requirements, to each of its non-employee directors on June 1, 2006 and expects to continue this grant on June 1 of each year thereafter.

As noted above, certain of the Company's stock option grants contain terms that provide for a graded vesting schedule whereby portions of the award vest in increments over the requisite service period. As provided for under Statement 123(R), the Company has elected to recognize compensation expense for awards with graded vesting schedules on a straight-line basis over the requisite service period for the entire award. Statement 123(R) requires companies to recognize compensation expense based on the estimated number of stock options and awards for which service is to be rendered. Over the past five years, there have only been four forfeitures or expirations, totaling 9,600 options, and therefore the Company assumes that all options granted will become vested.

The Company's only option grants for the first six months of 2006 and 2005 were grants of 29,250 and 31,500 options to non-employee directors on June 1, 2006 and 2005, respectively (2,250 option per director). The per share weighted-average fair value of options granted during the six months ended June 30, 2006 and June 30, 2005, was $6.79, and $6.68, respectively, on the date of the grant using the following weighted-average assumptions:

| | Six months ended June 30, 2006 | Six months ended June 30, 2005 |
|---|---|---|
| Expected dividend yield | 3.30% | 3.07% |
| Risk-free interest rate | 5.05% | 3.84% |
| Expected life | 7 years | 7 years |
| Expected volatility | 32.56% | 32.99% |

The following table presents information regarding the activity during the first six months of 2006 related to all of the Company's stock options outstanding:

| | All Options Outstanding | | | |
|---|---|---|---|---|
| Six months ended June 30, 2006 | Number of Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | Aggr Intrins ($ |
| Outstanding at the beginning of the period | 746,882 | $ 15.75 | | |
| Granted during the period | 29,250 | 21.83 | | |
| Exercised during the period | 68,063 | 9.69 | | |
| Forfeited or expired during the period | 4,500 | 6.55 | | |
| Outstanding at end of period | 703,569 | $ 16.65 | 5.7 | $ |
| Exercisable at June 30, 2006 | 651,944 | $ 16.72 | 5.7 | $ |

The Company received $618,000 and $585,000 as a result of stock option exercises during the six



months ended June 30, 2006 and 2005, respectively. The intrinsic value of the stock options exercised during the six months ended June 30, 2006 and 2005 was $787,000 and $585,000, respectively. The Company recorded $94,000 and $100,000 in associated tax benefits from the exercise of nonqualified stock options during the six months ended June 30, 2006 and 2005, respectively. In accordance with Statement 123(R), this benefit is included as a financing activity in the accompanying Statement of Cash Flows for periods subsequent to the adoption of Statement 123(R), but continues to be reported as an operating activity in periods prior to its adoption.

The following table presents information regarding the activity during the first six months of 2006 related to the Company's stock options outstanding that are nonvested:

| Six months ended June 30, 2006 | Nonvested Options: Number of Shares | Nonvested Options: Weighted-Average Grant-Date Fair Value |
|---|---|---|
| Nonvested options outstanding at the beginning of the period | 67,999 | $4.75 |
| Granted during the period | -- | -- |
| Vested during the period | (16,374) | 4.83 |
| Forfeited or expired during the period | -- | -- |
| Nonvested options outstanding at end of period | 51,625 | $4.74 |

Note 5 - Earnings Per Share

Basic earnings per share were computed by dividing net income by the weighted average common shares outstanding. Diluted earnings per share includes the potentially dilutive effects of the Company's stock option plan. The following is a reconciliation of the numerators and denominators used in computing basic and diluted earnings per share:

| | For the Three Months Ended June 30, | | | | |
|---|---|---|---|---|---|
| | 2006 | | | 2005 | |
| ($ in thousands except per share amounts) | Income (Numerator) | Shares (Denominator) | Per Share Amount | Income (Numerator) | Shares (Denominator) |
| Basic EPS | | | | | |
| Net income | $ 4,795 | 14,296,159 | $ 0.34 | $ 4,652 | 14,159,117 |
| Effect of Dilutive Securities | -- | 137,671 | | -- | 185,896 |
| Diluted EPS | $ 4,795 | 14,433,830 | $ 0.33 | $ 4,652 | 14,345,013 |

| | For the Six Months Ended June 30, | | | | |
|---|---|---|---|---|---|
| | 2006 | | | 2005 | |
| ($ in thousands except per share amounts) | Income (Numerator) | Shares (Denominator) | Per Share Amount | Income (Numerator) | Shares (Denominator) |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Basic EPS | | | | | | | | | |
| Net income | $ | 9,786 | 14,275,472 | $ | 0.69 | $ | 9,368 | 14,132,347 |
| Effect of Dilutive Securities | | -- | 150,028 | | | | -- | 222,505 |
| Diluted EPS | $ | 9,786 | 14,425,500 | $ | 0.68 | $ | 9,368 | 14,354,852 |

For the three months ended June 30, 2006 and 2005, there were options of 220,980, and 189,230, respectively, that were antidilutive because the exercise price exceeded the average market price for the period. For the six months ended June 30, 2006, there were 220,980 antidilutive options, while there were no antidilutive options for the six months ended June 30, 2005. Antidilutive options have been omitted from the calculation of diluted



earnings per share for the respective periods.

Note 6 - Asset Quality Information

Nonperforming assets are defined as nonaccrual loans, loans past due 90 or more days and still accruing interest, restructured loans and other real estate. Nonperforming assets are summarized as follows:

| ($ in thousands) | June 30, 2006 | December 31, 2005 | June 30, 2005 |
|---|---|---|---|
| Nonperforming loans: | | | |
| Nonaccrual loans | $ 3,973 | 1,640 | 3,806 |
| Restructured loans | 12 | 13 | 15 |
| Accruing loans > 90 days past due | -- | -- | -- |
| Total nonperforming loans | 3,985 | 1,653 | 3,821 |
| Other assets - primarily other real estate | 2,024 | 1,421 | 2,520 |
| Total nonperforming assets | $ 6,009 | 3,074 | 6,341 |
| Nonperforming loans to total loans | 0.24% | 0.11% | 0.27% |
| Nonperforming assets as a percentage of loans and other real estate | 0.37% | 0.21% | 0.44% |
| Nonperforming assets to total assets | 0.30% | 0.17% | 0.36% |
| Allowance for loan losses to total loans | 1.08% | 1.06% | 1.10% |

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Note 7 - Deferred Loan Fees

Loans are shown on the Consolidated Balance Sheets net of net deferred loan costs (fees) of ($64,000), $184,000, and $11,000 at June 30, 2006, December 31, 2005, and June 30, 2005, respectively.

Note 8 - Goodwill and Other Intangible Assets

The following is a summary of the gross carrying amount and accumulated amortization of amortizable intangible assets as of June 30, 2006, December 31, 2005, and June 30, 2005 and the carrying amount of unamortized intangible assets as of those same dates.

| | June 30, 2006 | | December 31, 2005 | | Jun |
|---|---|---|---|---|---|
| ($ in thousands) | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization | Gross Carry Amount |
| Amortizable intangible assets: | | | | | |
| Customer lists | $ 394 | 131 | 394 | 115 | 3 |
| Noncompete agreements | 50 | 50 | 50 | 50 | |
| Core deposit premiums | 2,441 | 1,116 | 2,441 | 1,011 | 2,4 |
| Total | $ 2,885 | 1,297 | 2,885 | 1,176 | 2,8 |
| Unamortizable intangible assets: | | | | | |
| Goodwill | $ 47,247 | | 47,247 | | 47,2 |
| Pension | $ 237 | | 273 | | 2 |

Amortization expense totaled $60,000 and $73,000 for the three months ended June 30, 2006 and 2005, respectively. Amortization expense totaled $121,000 and $146,000 for the six months ended June 30, 2006 and 2005, respectively.



The following table presents the estimated amortization expense for each of the five calendar years ending December 31, 2010 and the estimated amount amortizable thereafter. These estimates are subject to change in future periods to the extent management determines it is necessary to make adjustments to the carrying value or estimated useful lives of amortized intangible assets.

| (Dollars in thousands) | Estimated Amortization Expense |
|---|---|
| 2006 | $ 242 |
| 2007 | 220 |
| 2008 | 219 |
| 2009 | 218 |
| 2010 | 218 |
| Thereafter | 592 |
| Total | $ 1,709 |

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Note 9 - Pension Plans

The Company sponsors two defined benefit pension plans - a qualified retirement plan (the "Pension Plan") which is generally available to all employees, and a Supplemental Executive Retirement Plan (the "SERP Plan"), which is for the benefit of certain senior management executives of the Company.

The Company recorded pension expense totaling $581,000 and $447,000 for the three months ended June 30, 2006 and 2005, respectively, related to the Pension Plan and the SERP Plan. The following table contains the components of the pension expense for the three months ended June 30, 2006 and 2005.

| | For the Three Months Ende | | | |
|---|---|---|---|---|
| (in thousands) | 2006 Pension Plan | 2005 Pension Plan | 2006 SERP Plan | 20 SERP |
| Service cost - benefits earned during the period | $ 341 | 284 | 79 | |
| Interest cost on projected benefit obligation | 227 | 192 | 52 | |
| Expected return on plan assets | (268) | (237) | -- | |
| Net amortization and deferral | 119 | 86 | 31 | |
| Net periodic pension cost | $ 419 | 325 | 162 | |

The Company recorded pension expense totaling $1,162,000 and $894,000 for the six months ended June 30, 2006 and 2005, respectively, related to the Pension Plan and the SERP Plan. The following table contains the components of the pension expense for the six months ended June 30, 2006 and 2005.

| | For the Six Months Ende | | | |
|---|---|---|---|---|
| (in thousands) | 2006 Pension Plan | 2005 Pension Plan | 2006 SERP Plan | 20 SERP |
| Service cost - benefits earned during the period | $ 682 | $ 568 | 158 | |
| Interest cost on projected benefit obligation | 454 | 384 | 104 | |
| Expected return on plan assets | (536) | (474) | -- | |
| Net amortization and deferral | 238 | 172 | 62 | |
| Net periodic pension cost | $ 838 | $ 650 | 324 | |

The Company's contributions to the Pension Plan are based on computations by independent actuarial consultants and are intended to provide the Company with the maximum deduction for income tax purposes. The contributions are invested to provide for benefits under the Pension Plan. The Company estimates that its contribution to the Pension Plan will be $945,000 during 2006.

The Company's funding policy with respect to the SERP Plan is to fund the related benefits through investments in life insurance policies, which are not considered plan assets for the purpose of determining the SERP Plan's funded status. The cash surrender values of the life insurance policies are included in the line item "other assets." The Company estimates that its payments to participants in the SERP Plan will be $25,000 in 2006.

Note 10 - Contingency

The Company recorded a loss amount of $6,320,000, or $0.44 per diluted share, in the third quarter of 2005 to accrue for contingent tax loss exposure involving the North Carolina Department of Revenue. In February 2006, the North Carolina Department of Revenue announced a "Settlement Initiative" that offered companies with certain transactions that had been challenged by the North Carolina Department of Revenue the opportunity to resolve such matters with reduced penalties by agreeing to participate in the initiative by June 15, 2006. Although the Company believed that its tax returns complied with the relevant statutes, the Board of Directors of the Company decided that it was in the best interests of the Company to settle this matter by participating in the initiative. Based on the terms of the initiative, the Company estimated that its total liability to settle the matter will be approximately $4.3 million, net of the federal tax benefit, or $2.0 million less than the amount that was originally accrued. Accordingly, in March 2006, the Company adjusted its originally reported 2005 earnings to reflect the impact of this subsequent event by reducing originally reported tax expense for the three and twelve months ended December 31, 2005 by $1,982,000, or $0.14 per diluted share. The Company believes it has fully reserved for this liability and does not have any additional state income tax exposure other than the ongoing interest that will continue to accrue ($65,000 per quarter on an after-tax basis) until the Settlement Initiative is completed and the Company pays the amounts due in accordance with the settlement, which is expected to occur in the fourth quarter of this year.

Note 11 - Pending Acquisitions

On January 20, 2006, the Company reported that it had agreed to purchase a bank branch in Dublin, Virginia with approximately $20 million in deposits from another financial institution. This transaction was completed in July 2006.

On April 26, 2006, the Company reported that it had agreed to purchase a bank branch with approximately $25 million in deposits located in Carthage, North Carolina from another financial institution. This transaction is expected to close in September 2006.



Item 2 - Management's Discussion and Analysis of Consolidated Results of Operations and Financial Condition

CRITICAL ACCOUNTING POLICIES

The accounting principles followed by the Company and the methods of applying these principles conform with accounting principles generally accepted in the United States of America and with general practices followed by the banking industry. Certain of these principles involve a significant amount of judgment and/or use of estimates based on the Company's best assumptions at the time of the estimation. The Company has identified three policies as being more sensitive in terms of judgments and estimates, taking into account their overall potential impact to the Company's consolidated financial statements - 1) the allowance for loan losses, 2) tax uncertainties, and 3) intangible assets.

Allowance for Loan Losses

Due to the estimation process and the potential materiality of the amounts involved, the Company has identified the accounting for the allowance for loan losses and the related provision for loan losses as an accounting policy critical to the Company's consolidated financial statements. The provision for loan losses charged to operations is an amount sufficient to bring the allowance for loan losses to an estimated balance considered adequate to absorb losses inherent in the portfolio.

Management's determination of the adequacy of the allowance is based primarily on a mathematical model that estimates the appropriate allowance for loan losses. This model has two components. The first component involves the estimation of losses on loans defined as "impaired loans." A loan is considered to be impaired when, based on current information and events, it is probable the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. The estimated valuation allowance is the difference, if any, between the loan balance outstanding and the value of the impaired loan as determined by either 1) an estimate of the cash flows that the Company expects to receive from the borrower discounted at the loan's effective rate, or 2) in the case of a collateral-dependent loan, the fair value of the collateral.

The second component of the allowance model is to estimate losses for all loans not considered to be impaired loans. First, loans that have been risk graded by the Company as having more than "standard" risk but are not considered to be impaired are assigned estimated loss percentages generally accepted in the banking industry. Loans that are classified by the Company as having normal credit risk are segregated by loan type, and estimated loss percentages are assigned to each loan type, based on the historical losses, current economic conditions, and operational conditions specific to each loan type.

The reserve estimated for impaired loans is then added to the reserve estimated for all other loans. This becomes the Company's "allocated allowance." In addition to the allocated allowance derived from the model, management also evaluates other data such as the ratio of the allowance for loan losses to total loans, net loan growth information, nonperforming asset levels and trends in such data. Based on this additional analysis, the Company may determine that an additional amount of allowance for loan losses is necessary to reserve for probable losses. This additional amount, if any, is the Company's "unallocated allowance." The sum of the allocated allowance and the unallocated allowance is compared to the actual allowance for loan losses recorded on the books of the Company and any adjustment necessary for the recorded allowance to equal the computed allowance is recorded as a provision for loan losses. The provision for loan losses is a direct charge to earnings in the period recorded.

Although management uses the best information available to make evaluations, future adjustments may be necessary if economic, operational, or other conditions change. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize additions to the allowance based on the examiners' judgment about information available to them at the time of their examinations.



For further discussion, see "Nonperforming Assets" and "Summary of Loan Loss Experience" below.

Tax Uncertainties

The Company reserves for tax uncertainties in instances when it has taken a position on a tax return that may differ from the opinion of the applicable taxing authority. In accounting for tax contingencies, the Company assesses the relative merits and risks of certain tax transactions, taking into account statutory, judicial and regulatory guidance in the context of the Company's tax position. For those matters where it is probable that the Company will have to pay additional taxes, interest or penalties and a loss or range of losses can be reasonably estimated, the Company records reserves in the consolidated financial statements. For those matters where it is reasonably possible but not probable that the Company will have to pay additional taxes, interest or penalties and the loss or range of losses can be reasonably estimated, the Company only makes disclosures in the notes and does not record reserves in the consolidated financial statements. The process of concluding that a loss is reasonably possible or probable and estimating the amount of loss or range of losses and related tax reserves is inherently subjective and future changes to the reserve may be necessary based on changes in management's intent, tax law or related interpretations, or other functions.

See Note 10 to the Consolidated Financial Statements above for information related to a tax loss contingency accrual that was recorded in 2005.

Intangible Assets

Due to the estimation process and the potential materiality of the amounts involved, the Company has also identified the accounting for intangible assets as an accounting policy critical to the Company's consolidated financial statements.

When the Company completes an acquisition transaction, the excess of the purchase price over the amount by which the fair market value of assets acquired exceeds the fair market value of liabilities assumed represents an intangible asset. The Company must then determine the identifiable portions of the intangible asset, with any remaining amount classified as goodwill. Identifiable intangible assets associated with these acquisitions are generally amortized over the estimated life of the related asset, whereas goodwill is tested annually for impairment, but not systematically amortized. Assuming no goodwill impairment, it is beneficial to the Company's future earnings to have a lower amount assigned to identifiable intangible assets and higher amount of goodwill as opposed to having a higher amount considered to be identifiable intangible assets and a lower amount classified as goodwill.

For the Company, the primary identifiable intangible asset typically recorded in connection with a whole-bank or bank branch acquisition is the value of the core deposit intangible, whereas when the Company acquires an insurance agency, the primary identifiable intangible asset is the value of the acquired customer list. Determining the amount of identifiable intangible assets and their average lives involves multiple assumptions and estimates and is typically determined by performing a discounted cash flow analysis, which involves a combination of any or all of the following assumptions: customer attrition/runoff, alternative funding costs, deposit servicing costs, and discount rates. The Company typically engages a third party consultant to assist in each analysis. For the whole-bank and bank branch transactions recorded to date, the core deposit intangible in each case has been estimated to have a ten year life, with an accelerated rate of amortization. For insurance agency acquisitions, the identifiable intangible assets related to the customer lists were determined to have a life of ten to fifteen years, with amortization occurring on a straight-line basis.

Subsequent to the initial recording of the identifiable intangible assets and goodwill, the Company amortizes the identifiable intangible assets over their estimated average lives, as discussed above. In addition, on at least an annual basis, goodwill is evaluated for impairment by comparing the fair value of the Company's reporting units to their related carrying value, including goodwill (the Company's community banking operation is its only material reporting unit). At its last evaluation, the fair value of the Company's community banking operation exceeded its



carrying value, including goodwill. If the carrying value of a reporting unit were ever to exceed its fair value, the Company would determine whether the implied fair value of the goodwill, using a discounted cash flow analysis, exceeded the carrying value of the goodwill. If the carrying value of the goodwill exceeded the implied fair value of the goodwill, an impairment loss would be recorded in an amount equal to that excess. Performing such a discounted cash flow analysis would involve the significant use of estimates and assumptions.

The Company reviews identifiable intangible assets for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. The Company's policy is that an impairment loss is recognized, equal to the difference between the asset's carrying amount and its fair value, if the sum of the expected undiscounted future cash flows is less than the carrying amount of the asset. Estimating future cash flows involves the use of multiple estimates and assumptions, such as those listed above.

Current Accounting Matters

See Note 2 to the Consolidated Financial Statements above as it relates to accounting standards that have been recently adopted by the Company.

RESULTS OF OPERATIONS

Overview

Net income for the three months ended June 30, 2006 was $4,795,000, or $0.33 per diluted share, a 3.1% increase in diluted earnings per share compared to earnings of $4,652,000, or $0.32 per diluted share, recorded in the second quarter of 2005. Net income for the six months ended June 30, 2006 was $9,786,000, or $0.68 per diluted share, a 4.6% increase in diluted earnings per share from the net income of $9,368,000, or $0.65 per diluted share, reported for the six months ended June 30, 2005.

The increase in loans and deposits over the past twelve months resulted in an increase in the Company's net interest income when comparing the three and six month periods of 2006 to comparable periods in 2005. Net interest income for the second quarter of 2006 amounted to $18.4 million, an 8.4% increase over the $17.0 million recorded in the second quarter of 2005. Net interest income for the six months ended June 30, 2006 amounted to $36.3 million, a 9.0% increase over the $33.3 million recorded in the same six month period in 2005.

The impact of the growth in loans and deposits on the Company's net interest income was partially offset by declines in the Company's net interest margin (tax-equivalent net interest income divided by average earning assets). The Company's net interest margin for the second quarter of 2006 was 4.22% compared to 4.31% for the second quarter of 2005. The Company's net interest margin for the first six months of 2006 was 4.28% compared to 4.32% for the same six months of 2005. The 4.22% net interest margin realized in the second quarter of 2006 was an 11 basis point decrease from the first quarter of 2006 net interest margin of 4.33%. The compressing margin is primarily due to deposit rates paid by the Company rising by more than loan and investment yields. The Company has also been negatively impacted by customers shifting their funds from low cost deposits to higher cost deposits as rates have risen.

The Company's provision for loan losses amounted to $1,400,000 in the second quarter of 2006, an increase of 65.7% over the $845,000 recorded in the second quarter of 2005. The provision for loan losses for the first six months of 2006 was $2,415,000, an increase of 69.5% over the $1,425,000 recorded in first half of 2005. The higher provisions are a result of the strong loan growth realized in 2006, as asset quality ratios have remained stable and compare favorably to peers. Loan growth was $83 million in the second quarter of 2006 compared to $31 million in the second quarter of 2005, while loan growth was $153 million for the first half of 2006 compared to $59 million for the first half of 2005. The Company's ratios of annualized net charge-offs to average loans were 9 basis points and 6 basis points for the three and six month periods in 2006, respectively, compared to 8 basis



points for each of the three and six month periods in 2005. The Company's level of nonperforming assets to total assets was 0.30% at June 30, 2006 compared to 0.36% a year earlier.

Noninterest income amounted to $3.8 million in the second quarter of 2006, a 3.6% increase from the $3.7 million recorded in the second quarter of 2005. Noninterest income for the six months ended June 30, 2006 amounted to $7.8 million, an increase of 5.1% from the $7.4 million recorded in the first half of 2005.

Noninterest expenses amounted to $13.1 million in the second quarter of 2006, a 6.6% increase over the $12.3 million recorded in the comparable period of 2005. Noninterest expenses for the six months ended June 30, 2006 amounted to $25.8 million, a 7.6% increase from the $24.0 million recorded in the first six months of 2005. The increase in noninterest expenses is primarily attributable to costs associated with the Company's overall growth in loans, deposits and branch network.

The Company's effective tax rate was 38%-39% for each of the three and six month periods in 2005 and 2006.

The Company's annualized return on average assets for the second quarter of 2006 was 1.02% compared to 1.09% for the second quarter of 2005. The Company's annualized return on average assets for the six months ended June 30, 2006 was 1.07% compared to 1.13% for the first half of 2005.

The Company's annualized return on average equity for the second quarter of 2006 was 11.83% compared to 12.07% for the second quarter of 2005. The Company's annualized return on average equity for the six months ended June 30, 2006 was 12.30% compared to 12.32% for the first half of 2005.

Components of Earnings

Net interest income is the largest component of earnings, representing the difference between interest and fees generated from earning assets and the interest costs of deposits and other funds needed to support those assets.

Net interest income for the three month period ended June 30, 2006 amounted to $18,444,000, an increase of $1,437,000, or 8.4%, from the $17,007,000 recorded in the second quarter of 2005. Net interest income on a taxable equivalent basis for the three months ended June 30, 2006, amounted to $18,569,000, an increase of $1,451,000, or 8.5%, from the $17,118,000 recorded in the second quarter of 2005. Management believes that analysis of net interest income on a tax-equivalent basis is useful and appropriate because it allows a comparison of net interest income amounts in different periods without taking into account the different mix of taxable versus non-taxable investments that may have existed during those periods.

Net interest income for the six months ended June 30, 2006 amounted to $36,297,000, an increase of $3,005,000, or 9.0%, from the $33,292,000 recorded in the first six months of 2005. Net interest income on a taxable equivalent basis for the six months ended June 30, 2006 amounted to $36,548,000, an increase of $3,032,000, or 9.0%, from the $33,516,000 recorded in the first six months of 2005.

There are two primary factors that cause changes in the amount of net interest income recorded by the Company - 1) growth in loans and deposits, and 2) the Company's net interest margin. For the three and six month periods ended June 30, 2006, growth in loans and deposits were the primary cause for the increases in net interest income, as the Company's net interest margins in 2006 were slightly lower than those realized in 2005.

For internal purposes and in the discussion that follows, the Company evaluates its net interest income on a tax-equivalent basis by adding the tax benefit realized from tax-exempt securities to reported interest income. The following tables present net interest income analysis on a taxable-equivalent basis.



| | For the Three Months Ended June 30, | | | | |
|---|---|---|---|---|---|
| | 2006 | | | 2 | |
| ($ in thousands) | Average Volume | Average Rate | Interest Earned or Paid | Average Volume | Ave R |
| Assets | | | | | |
| Loans (1) | $1,593,070 | 7.36% | $ 29,215 | $1,409,118 | |
| Taxable securities | 118,172 | 4.76% | 1,402 | 119,180 | |
| Non-taxable securities (2) | 12,058 | 8.38% | 252 | 10,712 | |
| Short-term investments | 40,927 | 5.60% | 571 | 53,835 | |
| Total interest-earning assets | 1,764,227 | 7.15% | 31,440 | 1,592,845 | |
| Liabilities | | | | | |
| Savings, NOW and money market deposits | $ 475,558 | 1.38% | $ 1,635 | $ 477,311 | |
| Time deposits >$100,000 | 380,229 | 4.40% | 4,174 | 359,487 | |
| Other time deposits | 507,359 | 3.96% | 5,004 | 447,634 | |
| Total interest-bearing deposits | 1,363,146 | 3.18% | 10,813 | 1,284,432 | |
| Securities sold under agreements to repurchase | 29,102 | 3.76% | 273 | 420 | |
| Borrowings | 109,422 | 6.54% | 1,785 | 76,513 | |
| Total interest-bearing liabilities | 1,501,670 | 3.44% | 12,871 | 1,361,365 | |
| Non-interest-bearing deposits | 206,635 | | | 182,461 | |
| Net yield on interest-earning assets and net interest income | | 4.22% | $ 18,569 | | |

| | | |
|---|---|---|
| Interest rate spread | 3.71% | |
| Average prime rate | 7.90% | |

(1) Average loans include nonaccruing loans, the effect of which is to lower the average rate shown.

(2) Includes tax-equivalent adjustments of $125,000 and $111,000 in 2006 and 2005, respectively, to reflect the tax benefit that the Company receives related to its tax-exempt securities, which carry interest rates lower than similar taxable investments due to their tax exempt status. This amount has been computed assuming a 39% tax rate and is reduced by the related nondeductible portion of interest expense.



| | For the Six Months Ended June 30, | | | | |
|---|---|---|---|---|---|
| | 2006 | | | 2 | |
| ($ in thousands) | Average Volume | Average Rate | Interest Earned or Paid | Average Volume | Ave R |
| Assets | | | | | |
| Loans (1) | $1,554,763 | 7.26% | $ 55,977 | $1,396,167 | |
| Taxable securities | 116,541 | 4.73% | 2,731 | 111,214 | |
| Non-taxable securities (2) | 11,940 | 8.53% | 505 | 11,026 | |
| Short-term investments | 40,137 | 5.37% | 1,068 | 46,598 | |
| Total interest-earning assets | 1,723,381 | 7.05% | 60,281 | 1,565,005 | |
| Liabilities | | | | | |
| Savings, NOW and money market deposits | $ 471,659 | 1.27% | $ 2,968 | $ 475,997 | |
| Time deposits >$100,000 | 372,847 | 4.25% | 7,851 | 350,987 | |
| Other time deposits | 501,103 | 3.80% | 9,436 | 436,256 | |
| Total interest-bearing deposits | 1,345,609 | 3.04% | 20,255 | 1,263,240 | |
| Securities sold under agreements to repurchase | 29,708 | 3.63% | 535 | 210 | |
| Borrowings | 91,486 | 6.49% | 2,943 | 76,598 | |
| Total interest-bearing liabilities | 1,466,803 | 3.26% | 23,733 | 1,340,048 | |
| Non-interest-bearing deposits | 201,865 | | | 177,567 | |
| Net yield on interest-earning assets and net interest income | | 4.28% | $ 36,548 | | |
| Interest rate spread | | 3.79% | | | |

Average prime rate 7.66%

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(1) Average loans include nonaccruing loans, the effect of which is to lower the average rate shown.

(2) Includes tax-equivalent adjustments of $251,000 and $224,000 in 2006 and 2005, respectively, to reflect the tax benefit that the Company receives related to its tax-exempt securities, which carry interest rates lower than similar taxable investments due to their tax exempt status. This amount has been computed assuming a 39% tax rate and is reduced by the related nondeductible portion of interest expense.

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Average loans outstanding for the second quarter of 2006 were $1.593 billion, which was 13.1% higher than the average loans outstanding for the second quarter of 2005 ($1.409 billion). Average loans outstanding for the six months ended June 30, 2006 were $1.555 billion, which was 11.4% higher than the average loans outstanding for the six months ended June 30, 2005 ($1.396 billion).

The mix of the Company's loan portfolio remained substantially the same at June 30, 2006 compared to December 31, 2005 with approximately 86% of the Company's loans being real estate loans, 9% being commercial, financial, and agricultural loans, and the remaining 5% being consumer installment loans.

Average total deposits outstanding for the second quarter of 2006 were $1.570 billion, which was 7.0% higher than the average deposits outstanding for the second quarter of 2005 ($1.467 billion). Average deposits outstanding for the six months ended June 30, 2006 were $1.547 billion, which was 7.4% higher than the average deposits outstanding for the six months ended June 30, 2005 ($1.441 billion). Generally, the Company can reinvest funds from deposits at higher yields than the interest rate being paid on those deposits, and therefore increases in deposits typically result in higher amounts of net interest income for the Company.

See additional discussion regarding reasons for and the nature of the growth in loans and deposits in the section entitled "Financial Condition" below. The effect of the higher amounts of average loans and deposits was to increase net interest income in 2006.

As derived from the tables above, yields on interest earning assets and liabilities are higher for the periods presented in 2006 compared to 2005, which is a result of the rising rate environment that began in the third quarter



of 2004. From July 1, 2004 to June 30, 2006, the Federal Reserve raised short-term interest rates 17 times totaling 425 basis points. The tables also indicate that the interest-bearing liability rates paid by the Company have risen by more than yields realized on interest-earning assets. For each of the three and six month periods ended June 30, 2006, interest-earning asset yields have increased by approximately 90 basis points, whereas the average rate paid on interest-bearing liabilities has risen by 110-117 basis points. This narrowing spread was caused by rates paid on most of the Company's categories of interest-bearing liabilities increasing by more than the increases in yields realized on most of the Company's earning assets, as well as a higher concentration of the Company's funding sources being comprised of time deposits and borrowings, the highest cost funding sources for the Company. As a result of the narrowed interest rate spread, the Company's net interest margin (tax-equivalent net interest income divided by average earning assets) has declined in 2006, with the Company's net interest margin amounting to 4.22% in the second quarter of 2006 compared to 4.31% in the second quarter of 2005, and the Company's net interest margin amounting to 4.28% for the six months ended June 30, 2006 compared to 4.32% for the same six months of 2005.

See additional information regarding net interest income in the section entitled "Interest Rate Risk."

The provision for loan losses amounted to $1,400,000 in the second quarter of 2006 compared to $845,000 in the second quarter of 2005, and the provision for loan losses for the first six months of 2006 was $2,415,000 compared to $1,425,000 for the first six months of 2005. The higher provisions for loan losses in 2006 compared to 2005 are a result of the strong loan growth realized in 2006, as asset quality ratios have remained stable and compare favorably to peers. Loan growth was $83 million in the second quarter of 2006 compared to $31 million in the second quarter of 2005, while loan growth was $153 million for the first half of 2006 compared to $59 million for the first half of 2005. The Company's ratios of annualized net charge-offs to average loans were 9 basis points and 6 basis points for the three and six month periods in 2006, respectively, compared to 8 basis points for each of the three and six month periods in 2005. The Company's level of nonperforming assets to total assets was 0.30% at June 30, 2006 compared to 0.36% a year earlier.

Noninterest income amounted to $3,844,000 for the second quarter of 2006, a 3.6% increase from $3,712,000 recorded in the second quarter of 2005. Noninterest income for the six months ended June 30, 2006 amounted to $7,798,000, an increase of 5.1% from the $7,422,000 recorded in the first half of 2005. The increases were primarily a result of general growth in the Company's customer base and increased usage of credit cards and debit cards by the Company's customers (which impacted the line item "other service charges, commissions and fees").

These increases were partially offset by a $132,000 decrease in data processing income in the first six months of 2006 compared to 2005. The Company's data processing subsidiary makes its excess data processing capabilities available to area financial institutions for a fee. At January 1, 2005, the Company had five community bank customers using this service. Three of these customers terminated their contracts with the Company in the latter half of 2005, which resulted in the decrease in data processing fee income. The Company intends to continue to market this service to area banks, but does not currently have any near-term prospects for additional business.

Also negatively impacting noninterest income for each of the three and six month periods ended June 30, 2006 were higher amounts of "other losses," which were only partially offset by higher amounts of securities gains in 2006. Gains from sales of securities and "other losses" amounted to a net loss of $106,000 in the second quarter of 2006 compared to a net loss of $25,000 in the second quarter of 2005. For the six months ended June 30, 2006, gains from sales of securities and "other losses" amounted to a net loss of $173,000 compared to a net loss of $57,000 in the first half of 2005. During the second quarter of 2006, the Company recorded an "other loss" of $230,000 related to a merchant card customer of the Company that sells furniture over the internet. The furniture store did not deliver furniture that its customers had ordered and paid for, and was unable to refund their credit card purchases. As the furniture store's credit card processor, the Company became liable for the amounts that were required to be refunded. Through June 30, 2006, the Company had funded $240,000 in customer refunds, while the total exposure is believed to be approximately $1.9 million. The Company is vigorously pursuing repayment of these advances from the furniture store. The furniture store is under new management and intends to repay the Company for all funds advanced. Although the furniture store has begun repaying the Company, the Company determined that recording a $230,000 loss was prudent to reserve for this situation. The Company reports outstanding advances related to this situation as an "other asset," and within the line item - "Other assets - primarily other real estate" in asset quality tables, while the corresponding reserve is classified as a valuation allowance within other assets. The Company sold securities for a gain of $205,000 during the second quarter of 2006 partially in response to this loss situation.

Noninterest expenses amounted to $13,064,000 in the second quarter of 2006, a 6.6% increase over the $12,260,000 in 2005. Noninterest expenses for the six months ended June 30, 2006 amounted to $25,793,000, a 7.6% increase from the $23,975,000 recorded in the first six months of 2005. The increase in noninterest expenses occurred in all categories and is associated with the overall growth of the Company in terms of branch network, employees and customer base. In accordance with the new accounting requirements regarding stock-based compensation that were effective on January 1, 2006, the Company recorded stock option expense of $244,000 ($166,000 after-tax effect) and $291,000 ($212,000 after-tax effect) for the three and six month periods ended June 30, 2006, respectively - see Note 4 to the Consolidated Financial Statements above for additional discussion. Noninterest expenses for the second quarter of 2005 were impacted by several expenses that did not recur in 2006 totaling approximately $500,000, including; immediately vested post-retirement benefits granted to the Company's CEO totaling $196,000, external Sarbanes-Oxley costs related to the prior year SOX certification of $181,000, and public relation expenses of $123,000 associated with the Company's sponsorship of the 2005 U.S. Open Golf Tournament that was held in the Company's largest market - Moore County, North Carolina.

The provision for income taxes was $3,029,000 in the second quarter of 2006, an effective tax rate of 38.7%, compared to $2,962,000 in the second quarter of 2005, an effective tax rate of 38.9%. The provision for income taxes was $6,101,000 for the six months ended June 30, 2006, an effective tax rate of 38.4%, compared to $5,946,000 for the six months ended June 30, 2005, an effective tax rate of 38.8%. The Company expects its effective tax rate to remain at approximately 38-39% for the foreseeable future.

The Consolidated Statements of Comprehensive Income reflect "Other Comprehensive Loss" of $1,114,000 during the second quarter of 2006 and "Other Comprehensive Loss" of $1,163,000 for the six months ended June 30, 2006, compared to "Other Comprehensive Income" of $542,000 for the second quarter of 2005 and "Other Comprehensive Loss" of $315,000 for the six months ended June 30, 2005. The primary component of other comprehensive loss for the periods presented relates to changes in unrealized holding gains/losses of the Company's available for sale securities. The Company's available for sale securities portfolio is predominantly comprised of fixed rate bonds that increase in value when market yields for fixed rate bonds decrease and decline in value when market yields for fixed rate bonds increase. Except for a brief decrease in bond yields in the second quarter of 2005, generally rising short-term and long-term bond yields in the marketplace have resulted in significant declines in value of the Company's available for sale securities portfolio.



FINANCIAL CONDITION

Total assets at June 30, 2006 amounted to $1.99 billion, 14.6% higher than a year earlier. Total loans at June 30, 2006 amounted to $1.64 billion, a 14.7% increase from a year earlier, and total deposits amounted to $1.59 billion at June 30, 2006, an 8.1% increase from a year earlier.

The following tables present information regarding the nature of the Company's growth since June 30, 2005.

| July 1, 2005 to June 30, 2006 | Balance at beginning of period | Internal Growth | Growth from Acquisitions | Balance at end of period | Total percentage growth | P |
|---|---|---|---|---|---|---|
| | | | ($ in thousands) | | | |
| Loans | $1,425,856 | 210,043 | -- | 1,635,899 | 14.7% | |
| Deposits - Noninterest bearing | $ 184,605 | 24,457 | -- | 209,062 | 13.2% | |
| Deposits - Savings, NOW, and Money Market | 476,642 | 3,880 | -- | 480,522 | 0.8% | |
| Deposits - Time>$100,000 | 349,972 | 40,617 | -- | 390,589 | 11.6% | |
| Deposits - Time | | | | | | |