Aldeyra Therapeutics, Inc.
Form 10-Q
November 12, 2014
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2014

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: 001-36332

ALDEYRA THERAPEUTICS, INC.

(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of** **incorporation or organization)**	**20-1968197** **(I.R.S. Employer** **Identification No.)**
131 Hartwell Avenue, Suite 320 **Lexington, MA** **(Address of principal executive offices)**	**02421** **(Zip Code)**

(781) 761-4904

(Registrant s telephone number, including area code)

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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company x

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

As of November 11, 2014, there were 5,565,415 shares of the registrant s common stock issued and outstanding.

Table of Contents

Aldeyra Therapeutics, Inc.

Quarterly Report on Form 10-Q

For the Quarter Ended September 30, 2014

INDEX

		Page
PART I FINANCIAL INFORMATION		
ITEM 1.	Financial Statements (Unaudited):	3
	Balance Sheets at September 30, 2014 and December 31, 2013	3
	Statements of Operations and Comprehensive Income (Loss) for the three and nine months ended September 30, 2014 and 2013	4
	Statements of Redeemable Convertible Preferred Stock and Stockholders Equity (Deficit) for the Period from December 31, 2013 to September 30, 2014	5
	Statements of Cash Flows for the nine months ended September 30, 2014 and 2013	6
	Notes to Financial Statements	7
ITEM 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	16
ITEM 3.	Quantitative and Qualitative Disclosures about Market Risk	21
ITEM 4.	Controls and Procedures	21
PART II OTHER INFORMATION		
ITEM 1.	Legal Proceedings	21
ITEM 1A.	Risk Factors	21
ITEM 2.	Unregistered Sales of Equity Securities and Use of Proceeds	46
ITEM 3.	Defaults Upon Senior Securities	47
ITEM 4.	Mine Safety Disclosures	47
ITEM 5.	Other Information	47
ITEM 6.	Exhibits	47
Signatures		48
Exhibits		49

Table of Contents

Part I FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

ALDEYRA THERAPEUTICS, INC.

BALANCE SHEETS (Unaudited)

	September 30, 2014	December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$ 10,142,137	$ 3,262,354
Prepaid expenses and other current assets	202,612	8,412
Total current assets	10,344,749	3,270,766
Deferred offering cost		472,467
Fixed Assets, net	5,768	
Total assets	$ 10,350,517	$ 3,743,233
LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (DEFICIT)		
Current liabilities:		
Accounts payable	$ 482,470	$ 341,853
Convertible notes payable - related parties		85,000
Accrued interest on convertible notes payable - related parties		2,125
Accrued expenses	363,661	117,873
Current portion of credit facility		58,160
Total current liabilities	846,131	605,011
Credit facility, net of current portion and debt discount	1,240,828	1,129,015
Accrued deferred offering costs		394,368
Convertible preferred stock warrant liability		253,247
Convertible preferred stock warrant liabilities - related parties		3,265,620
Total liabilities	2,086,959	5,647,261
Commitments and contingencies (Note 13)		
Redeemable convertible preferred stock:		
Series A Preferred Stock, $0.001 par value, none authorized, issued and outstanding as of September 30, 2014 and 24,000,000 shares authorized; 980,391 shares issued and outstanding as of December 31, 2013 (Liquidation preference of $36,000,000)		29,291,865

Series B Preferred Stock, $0.001 par value, none authorized, issued and outstanding as of September 30, 2014 and 38,000,000 shares authorized; 1,316,681 shares issued and outstanding as of December 31, 2013 (Liquidation preference of $20,377,506)		9,025,433
Total redeemable convertible preferred stock		38,317,298
Stockholders equity (deficit):		
Preferred stock, $0.001 par value, 15,000,000 shares authorized, none issued and outstanding as of September 30, 2014; none authorized, issued or outstanding as of December 31, 2013		
Common stock, voting, $0.001 par value; 150,000,000 authorized and 5,565,415 shares issued and outstanding as of September 30, 2014; 65,000,000 shares authorized; 327,365 shares issued and outstanding as of December 31, 2013	5,565	327
Additional paid-in capital	52,324,911	1,102,685
Accumulated deficit	(44,066,918)	(41,324,338)
Total stockholders equity (deficit)	8,263,558	(40,221,326)
Total liabilities, redeemable convertible preferred stock and stockholders equity (deficit)	$ 10,350,517	$ 3,743,233

The accompanying notes are an integral part of these unaudited financial statements.

3

Table of Contents

ALDEYRA THERAPEUTICS, INC.

STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS) (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	**2013**	**2014**	**2013**
Operating expenses:				
Research and development	$ 1,195,668	$ 666,040	$ 2,303,854	$ 1,141,323
General and administrative	772,467	500,416	2,555,692	1,302,361
Loss from operations	(1,968,135)	(1,166,456)	(4,859,546)	(2,443,684)
Other income (expense):				
Change in fair value of preferred stock warrant liabilities		940,700	2,327,502	627,100
Change in fair value of convertible preferred stock rights and rights option liabilities		9,551,186		5,628,986
Interest income		7	3	23
Other expenses		(1,987)		(1,987)
Interest expense	(41,071)	(14,467)	(210,539)	(45,172)
Total other income (expense), net	(41,071)	10,475,439	2,116,966	6,208,950
Net income (loss) and comprehensive income (loss)	(2,009,206)	9,308,983	(2,742,580)	3,765,266
Accretion of preferred stock		(189,792)	(333,082)	(463,046)
Allocation of undistributed earnings to preferred stockholders		(8,241,671)		(2,986,631)
Deemed dividend			(4,053,570)	
Net income (loss) attributable to common stockholders	$ (2,009,206)	$ 877,520	$ (7,129,232)	$ 315,589
Net income (loss) per share attributable to common stockholders:				
Basic	$ (0.36)	$ 2.76	$ (2.21)	$ 1.00
Diluted	$ (0.36)	$ (9.81)	$ (2.89)	$ (5.37)
Weighted average common shares outstanding:				
Basic	5,565,413	317,375	3,229,338	314,972

Diluted	5,565,413	979,837	3,272,730	1,106,031

The accompanying notes are an integral part of these unaudited financial statements.

Table of Contents

ALDEYRA THERAPEUTICS, INC.

STATEMENTS OF REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (DEFICIT) (Unaudited)

	Redeemable Convertible Preferred Stock					Stockholders Equity (Deficit)				
	Series A Preferred Stock		Series B Preferred Stock			Common Voting Stock				
	Shares	Amount	Shares	Amount	Total Redeemable Convertible Preferred Stock	Shares	Amount	Additional Paid-in Capital	Accumulated Deficit	St
,	980,391	$ 29,291,865	1,316,681	$ 9,025,433	$ 38,317,298	327,365	$ 327	$ 1,102,685	$ (41,324,338)	$ (
n								1,571,895		
d s		78,037		255,045	333,082			(333,082)		
ck, ce						1,500,000	1,500	9,975,408		
f	(980,391)	(29,369,902)	(1,316,681)	(9,280,478)	(38,650,380)	3,642,799	3,643	38,646,736		
of						74,001	74	1,191,290		
						21,250	21	169,979		
									(2,742,580)	
0,						5,565,415	$ 5,565	$ 52,324,911	$ (44,066,918)	$

The accompanying notes are an integral part of these unaudited financial statements.

Table of Contents

ALDEYRA THERAPEUTICS, INC.

STATEMENTS OF CASH FLOWS (Unaudited)

	Nine months ended September 30, 2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ (2,742,580)	$ 3,765,266
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Stock-based compensation	1,571,895	1,328,474
President and CEO contributed services		32,221
Amortization of debt discount non-cash interest expense	138,653	22,005
Change in fair value of warrant liability, purchase rights and warrant purchase rights	(2,327,502)	(6,256,086)
Depreciation	339	
Change in assets and liabilities:		
(Increase) decrease		
Prepaid expenses and other current assets	(194,200)	(1,548)
Deferred offering costs		(50,000)
Accounts payable	140,617	(7,241)
Security deposit		
Accrued interest on convertible notes related	(2,125)	

parties		
Accrued deferred offering costs		50,000
Accrued expenses	245,788	11,457
Net cash used in operating activities	(3,169,115)	(1,105,452)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisitions of property and equipment	(6,107)	
Net cash used in investing activities	(6,107)	
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common stock, net of issuance costs	10,055,005	
Repayments of credit facility		(104,167)
Net proceeds from issuance of Series B redeemable convertible preferred stock		2,750,436
Net cash provided by financing activities	10,055,005	2,646,269
NET INCREASE IN CASH	6,879,783	1,540,817
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	3,262,354	1,223,638

12

Table of Contents

Income Taxes

Earnings before taxes for the first six months of 2005 were $1,770,810 as compared to $1,204,746 for the first six months of 2004, an increase of $566,064, or 46.99%. Income tax expense for the first six months of 2005 increased by $232,017, to $488,427, when compared to $256,410 the same period in 2004. The effective tax rate increased to 27.58% for the first six months of 2005 when compared to 21.28% in June of 2004.

Three Months Ended June 30, 2005 and 2004, Compared

Summary

Net income for the three months ended June 30, 2005 increased $142,796, or 29.30%.

Net Interest Income

Total interest income increased $1,122,706, or 32.24%, in the second quarter of 2005 as compared to 2004. Average interest-earning assets were $293,932,785 for the second quarter of 2005, as compared to $254,255,961 for the same period in 2004, an increase of $39,676,824, or 15.61%. A substantial portion of this growth is due to the expansion of the Banks loan portfolio as the Bank expands into new markets and strengthens its position in its existing markets. The average rate earned during the second quarter of 2005 was 6.27% as compared to 5.48% in 2004, reflecting the continuing impact of increases in rates by the Federal Reserve Board during the past and current year.

Total interest expense increased by $349,052 or 40.34% in the second quarter of 2005, when compared to the same period in 2004. Average interest bearing liabilities increased to $225,255,997 in 2005 from $203,089,335 in 2004, an increase of $22,166,662, or 10.91%. The average rate paid increased to 2.16% in 2005 as compared to 1.70% in 2004.

The net interest margin increased to 4.72% for the second quarter of 2005, as compared to 4.60% for the same period in 2004. This was due to the increase in interest rates by the Federal Reserve Board and the fact that the Bank s assets have repriced faster than the Bank s liabilities.

Provision for Loan Losses

The provision for loan losses totaled $195,000 for the second quarter of 2005 as compared to $180,000 for the same period in 2004. The provision reflected both the growth and improvement in credit quality in the loan portfolio. For further discussion of the provision for loan losses, see the Allowance for Loan Losses discussion below.

Table of Contents

Noninterest Income

Total noninterest income increased $47,253 or 6.32% for the second quarter of 2005. Service charges on deposits increased $5,841, or 1.00%, for the second quarter of 2005 as compared to 2004. This increase is primarily due to a decrease in insufficient fund charges on checks and a substantial increase in ATM network fees and point of sale interchange for the period. Other income increased during the second quarter of 2005 by $40,640 or 29.21% as compared to 2004. This increase is primarily due to the net gain of $43,000 on the sale of OREO in June of 2004.

Noninterest Expense

Total noninterest expense increased $446,884, or 17.07%, during the second quarter of 2005 compared to the same quarter of 2004. Salaries and benefits increased $216,535, or 15.25%, in the second quarter of 2005 as compared to the same quarter of 2004. This increase is primarily due to the expansion of the Bank into new markets and increased health care costs for the Bank. Occupancy expense increased $32,697, or 7.15%, in the second quarter of 2005, largely associated with branch expansion. Other expenses increased $197,652 or 26.64% during the second quarter of 2005 as compared to 2004, reflecting increases in general operating expenses related to the Bank s expansion and the $103,201 of write downs that value the OREO properties at their fair market values.

Income Taxes

Earnings before taxes for the second quarter of 2005 were $925,468 as compared to $566,445 in the second quarter of 2004, an increase of $359,023 or 63.38%. Income tax expense for the second quarter increased $216,227 to $295,349, when compared to $79,122 for the same period in 2004. The effective tax rate increased to 31.92% in 2005 from 13.97% in 2004.

Financial Condition and Liquidity

Total assets on June 30, 2005 increased $12,087,415 or 3.88% from December 31, 2004. Average total assets for the first six months of 2005 were $317,534,874. The ratio of loans (net of allowance) to deposits plus repurchase agreements on June 30, 2005 was 76.27% as compared to 72.46% on December 31, 2004.

Cash and Cash Equivalents

Federal Funds Sold and interest bearing balances in other banks as of June 30, 2005 decreased by $19,596,577, or by 71.27%, from December 31, 2004. This decrease is attributed to the increase in loans, as the Bank shifts investments from lower earning assets to higher yielding investments.

Table of Contents

Loans

Net loans increased by $17,398,130 or 8.74% at June 30, 2005, from December 31, 2004. Agricultural lending and commercial real estate loans contributed the majority of this loan growth.

Allowance for Loan Losses

The allowance for loan losses is maintained at a level which, in management s opinion, is appropriate to provide for estimated losses in the portfolio at the balance sheet date. Factors considered in determining the adequacy of the allowance include historical loan loss experience, the amount of past due loans, loans classified from the most recent regulatory examinations and internal reviews, general economic conditions and the current portfolio mix. The amount charged to operating expenses is that amount necessary to maintain the allowance for loan losses at a level indicative of the associated risk, as determined by management, of the current portfolio.

The allowance for loan losses consists of two portions: the classified portion and the nonclassified portion. The classified portion is based on identified problem loans and is calculated based on an assessment of credit risk related to those loans. Specific loss estimate amounts are included in the allowance based on assigned loan classifications as follows: monitor (5%), substandard (15%), doubtful (50%), loss (100%) and specific reserves based on identifiable losses. Any loan categorized loss is charged off in the period in which the loan is so categorized.

The nonclassified portion of the allowance is for inherent losses which probably exist as of the evaluation date even though they may not have been identified by the more specific processes for the classified portion of the allowance. This is due to the risk of error and inherent imprecision in the process. This portion of the allowance is particularly subjective and requires judgments based upon qualitative factors which do not lend themselves to exact mathematical calculations. Some of the factors considered are changes in credit concentrations, loan mix, historical loss experience, non-accrual and delinquent loans and the general economic environment in the Corporation s markets. However, unfavorable changes in the factors used by management to determine the adequacy of the allowance, including increased loan delinquencies and subsequent charge-offs, or the availability of new information, could require additional provisions, in excess of normal provisions, to the allowance for loan losses in future periods.

While the total allowance is described as consisting of a classified and a nonclassified portion, these terms are primarily used to describe a process. Both portions are available to support inherent losses in the loan portfolio. Management realizes that general economic trends greatly affect loan losses, and no assurances can be made that future charges to the allowance for loan losses will not be significant in relation to the amount provided during a particular period, or that future evaluations of the loan portfolio based on conditions then prevailing will not require sizable charges to income. Management does, however, consider the allowance for loan losses to be appropriate for the reported periods.

Table of Contents

The allowance for possible loan losses represents 1.21% of gross loans at June 30, 2005, as compared to 1.29% at year-end 2004. This slight decrease is acceptable to management because it is attributable to the cyclical nature of the Company s agricultural lending as seen in previous years. The bank expects a slight increase in the percentage of allowance for possible loan losses to gross loans in subsequent periods as the related agricultural loans are paid down from their current position.

The amount of loans on which the accrual of interest had been discontinued has decreased to $963,741 at June 30, 2005, as compared to $1,201,692 at December 31, 2004. Net charged-off loans for the first six months of 2005 were $321,000, as compared to $138,477 for the same period in 2004. The increase in charged-off loans is due to the Bank s decision to write off a selection of loans following a routine analysis of the loan portfolio during the second quarter of 2005.

Non-performing Assets: The following table sets forth the Corporation s non-performing assets at June 30, 2005 and December 31, 2004. Under the Corporation s nonaccrual policy, a loan is placed on nonaccrual status when collectibility of principal and interest is in doubt or when principal and interest is 90 days or more past due except for credit cards, which continue to accrue interest after ninety days.

The amount of impaired loans determined under SFAS No. 114 and 118 has been considered in the summary of non-performing assets below. These credits were considered in determining the adequacy of the allowance for loan losses and are regularly monitored for changes within a particular industry or general economic trends, which could cause the borrowers financial difficulties. At June 30, 2005 the Bank had $704,462 in impaired loans, compared to $697,017 at December 31, 2004.

Table of Contents

	Description	June 30, 2005	December 31, 2004
		(Dollars in Thousands)	
A	Loans accounted for on a nonaccrual basis	$ 964	$ 1,202
B	Loans which are contractually past due ninety days or more as to interest or principal payments (excluding balances included in (A) above)	$ 4	$ 14
C	Loans, the terms of which have been renegotiated to provide a reduction or deferral of interest or principal because of a deterioration in the financial position of the borrower	$ 324	$ 351
D	Other non-performing assets	$1,164	$ 1,384

Investment Securities

Total investments available for sale have increased $18,487,439 at June 30, 2005 as compared to December 31, 2004 due to the Bank investing federal funds into higher yields in the investment portfolio. As available for sale, all investments are marked-to-market on a monthly basis with unrealized gains and losses, net of tax, adjusted through a component of stockholders equity. Management considers all unrealized losses within the investment portfolio to be temporary. As of June 30, 2005, the investment portfolio had a net unrealized gain of $203,287.

Premises and Equipment

Premises and equipment decreased $123,986 during the first six months of 2005. Because renovations to the Monroeville and Atmore branch locations due to Hurricane Ivan, construction of new buildings at the existing Atmore Southside and Magnolia Springs locations, and continued expansion into the Florida Panhandle and Baldwin County, Alabama, the Company expects the amount of premises and equipment and their associated depreciation expense to increase in the near future.

Deposits

Table of Contents

Total deposits decreased $2,485,087, or .98%, at June 30, 2005 from December 31, 2004, including a decrease of $9,437,934 on noninterest bearing deposits. Interest bearing deposits increased $6,952,847 at June 30, 2005, from December 31, 2004. The decrease in deposits is attributable to the increased use of sweep accounts offered through the Financial Services division by the Bank s customers. The balance of funds held in sweep accounts as of June 30, 2005 was $5,328,578.

Hurricanes Ivan and Dennis

The Bank continues to repair damage caused in September 2004 by Hurricane Ivan, including at the corporate office in Atmore, Alabama. The branch in Monroeville, Alabama, which was rendered unusable, has been remodeled and reopened in the first quarter of 2005.

The Bank s market area also suffered lesser effects from Hurricane Dennis in July 2005. The Bank continues to expect no material financial impact from the hurricane damage to its various offices. Management also continues to expect that the Corporation will not experience any material adverse impact to future earning due to hurricane related damage to the local economies in the Bank s markets, and at the current time does not expect any increases in loan loss provisions because of the hurricanes.

Liquidity

One of the Bank s goals is to provide adequate funds to meet changes in loan demand or any potential increase in the normal level of deposit withdrawals. This goal is accomplished primarily by generating cash from operating activities and maintaining sufficient short-term assets. These sources, coupled with a stable deposit base, allow the Bank to fund earning assets and maintain the availability of funds. Management believes that the Bank s traditional sources of maturing loans and investment securities, cash from operating activities and a strong base of core deposits are adequate to meet the Bank s liquidity needs for normal operations. To provide additional liquidity, the Bank utilizes short-term financing through the purchase of federal funds, and maintains a borrowing relationship with the Federal Home Loan Bank to provide liquidity. Should the Bank s traditional sources of liquidity be constrained, forcing the Bank to pursue avenues of funding not typically used, the Bank s net interest margin could be impacted negatively. The Corporation s bank subsidiary has an Asset Liability Management Committee, which has as its primary objective the maintenance of specific funding and investment strategies to achieve short-term and long-term financial goals. The Corporation s liquidity at June 30, 2005 is considered adequate by management. Also see Item 3 below.

Capital Adequacy

The Corporation has generally relied primarily on internally generated capital growth to maintain capital adequacy. Total stockholders equity on June 30, 2005, was $27,163,868, an increase of $818,774, or 3.11%, from December 31, 2004. This net increase is a combination of current period earnings, reduced by a decrease in the unrealized gains on securities available for sale and the declaration of dividends as of June 30, 2005.

Table of Contents

Primary capital to total assets at June 30, 2005, was 9.52%, as compared to 8.44% at year-end 2004. Total capital and allowances for loan losses to total assets at June 30, 2005, was 11.16%, as compared to 9.27% at December 31, 2004. The Corporation s risk based capital was $33,124,000, or 13.44% of risk adjusted assets, at June 30, 2005, as compared to $31,827,000, or 14.12%, at year-end 2004. The minimum requirement is 8.00%. Based on management s projections, existing internally generated capital and the capital previously raised by issuance of trust preferred securities should be sufficient to satisfy capital requirements in the foreseeable future for existing operations, and for some expansion efforts. Continued growth into new markets may require the Corporation to further access external funding sources. There can be no assurance that such funding sources will be available to the Corporation.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the risk of loss from adverse changes in market prices and rates. The Bank s market risk arises principally from interest rate risk inherent in its lending, deposit and borrowing activities. Management actively monitors and manages its interest rate risk exposure. Although the Bank manages other risk, such as credit quality and liquidity risk, in the normal course of business, management considers interest rate risk to be its most significant market risk. Interest rate risk could potentially have the largest material effect on the Bank s financial condition and results of operations. Other types of market risks, such as foreign currency exchange rate risk, generally do not arise in the Bank s normal course of business activities to any significant extent.

The Bank s profitability is affected by fluctuations in interest rates. Management s goal is to maintain a reasonable balance between exposure to interest rate fluctuations and earnings. A sudden and substantial increase in interest rates may adversely impact the Bank s earnings to the extent that the interest rates on interest-earning assets and interest-bearing liabilities do not change at the same speed, to the same extent or on the same basis.

The Bank s Asset Liability Management Committee (ALCO) monitors and considers methods of managing the rate and sensitivity repricing characteristics of the balance sheet components consistent with maintaining acceptable levels of changes in the net portfolio value (NPV) and net interest income. NPV represents the market values of portfolio equity and is equal to the market value of assets minus the market value of liabilities, with adjustments made for off- balance sheet items over a range of assumed changes in market interest rates. A primary purpose of the Bank s ALCO is to manage interest rate risk to effectively invest the Bank s capital and to preserve the value created by its core business operations. As such, certain management monitoring processes are designed to minimize the impact of sudden and sustained changes in interest rates on NPV and net interest income.

The Bank s exposure to interest rate risk is reviewed on a quarterly basis by the Board of Directors and the ALCO. Interest rate risk exposure is measured using interest rate sensitivity analysis to determine the Bank s change in NPV in the event of hypothetical changes in interest rates. Further,

Table of Contents

interest rate sensitivity gap analysis is used to determine the repricing characteristics of the Bank s assets and liabilities. The ALCO is charged with the responsibility to maintain the level of sensitivity of the Bank s net interest margin within Board approved limits.

Interest rate sensitivity analysis is used to measure the Bank s interest rate risk by computing estimated changes in NPV of its cash flows from assets, liabilities, and off-balance sheet items in the event of a range of assumed changes in market interest rates. This analysis assesses the risk of loss in market risk sensitive instruments in the event of a sudden and sustained 100 300 basis points increase or decrease in the market interest rates. The Bank uses the HNC Asset Liability Model, which takes the current rate structure of the portfolio and shocks for each rate level and calculates the new market value equity at each level. The Bank s Board of Directors has adopted an interest rate risk policy, which establishes maximum allowable decreases in net interest margin in the event of a sudden and sustained increase or decrease in market interest rates. The following table presents the Bank s projected change in NPV for the various rate shock levels as of December 31, 2004, the most recent date for which the Corporation has a completed analysis. Management does not expect the analysis as of June 30, 2005 to change materially from the December 31, 2004 analysis. All market risk sensitive instruments presented in this table are held to maturity or available for sale. The Bank has no trading securities.

Change in Interest Rates (Basis Points)	Market Value Equity	Change in Market Value Equity	Change in Market Value Equity %
300	62,661	7,699	25
200	59,449	5,789	19
100	55,215	5,113	10
0	50,102		
-100	44,151	(5,951)	(12)
-200	37,105	(12,997)	(26)
-300	29,308	(20,794)	(42)

The preceding table indicates that at December 31, 2004, in the event of a sudden and sustained increase in prevailing market interest rates, the Bank s NPV would be expected to increase and that in the event of a sudden decrease in prevailing market interest rates, the Bank s NPV would be expected to decrease. The growth in variable rate loans has caused the Corporation to become more asset sensitive over the period of a year, but the net interest margin remains fairly stable in all interest rate environments tested. The Bank does not foresee any material change in the above data during the first six months of 2005.

Computation of prospective effects of hypothetical interest rate changes included in these forward-looking statements are subject to certain risks, uncertainties, and assumptions including relative levels of market interest rates, loan prepayments and deposit decay rates, and should not be relied upon as indicative of actual results. Further, the computations do not contemplate any actions the Bank could undertake in response to changes in interest rates.

Table of Contents

Item 4. Controls and Procedures

Based on evaluation of the Corporation s disclosure controls and procedures (as such term is defined in Rules 13a-4(c) under the Securities Exchange Act of 1934, as amended (the Exchange Act)), as of the end of the period covered by this quarterly report, the principal executive officer and the principal financial officer of the Corporation have concluded that as of such date the Corporation s disclosure controls and procedures were effective to ensure that information the Corporation is required to disclose in its filings under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission s rules and forms, and to ensure that information required to be disclosed by the Corporation in the reports that it files under the Exchange Act is accumulated and communicated to the Corporation s management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

The Corporation has engaged consultants to assist the Corporation in its evaluation of internal controls in anticipation of the upcoming effectiveness of regulations under Section 404 of the Sarbanes-Oxley Act of 2002. There was no change in the Corporation s internal controls over financial reporting during the period covered by this quarterly report that has materially affected, or is reasonably likely to materially affect, the Corporation s internal control over financial reporting.

Forward Looking Statements

When used or incorporated by reference herein, the words anticipate , estimate , expect , project , target , goal , and similar expressions, are intended to identify forward-looking statements within the meaning of Section 27A of the Securities Act of 1933. Such forward-looking statements are subject to certain risk, uncertainties, and assumptions including those set forth herein. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those expected or projected. These forward-looking statements speak only as of the date they are made. The Corporation expressly disclaims any obligations or undertaking to publicly release any updates or revisions to any forward-looking statement contained herein to reflect any change in the Corporation s expectations with regard to any change in events, conditions or circumstances on which any such statement is based.

Table of Contents

PART II OTHER INFORMATION

Item 4. Submission of Matters to a Vote of Security Holders.

(a) A description of actions taken at the annual meeting of security holders of United Bancorporation of Alabama, Inc. on May 4, 2005 was reported under Item 4 of the Corporation s Form 10-Q for the quarter ended March 31, 2005, and is incorporated by reference herein.

Item 6. Exhibits

(a) Exhibits.

31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of principal accounting officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification of principal accounting officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002

S I G N A T U R E S

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.

UNITED BANCORPORATION OF ALABAMA, INC.

Date: August 13, 2005

/s/ Robert R. Jones, III

Robert R. Jones, III
President and CEO