

Edgar Filing: 1ST STATE BANCORP INC - Form 10-Q

1ST STATE BANCORP INC  
Form 10-Q  
May 14, 2004

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2004

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 0-25859

1st STATE BANCORP, INC.

-----  
(Exact Name of Registrant as Specified in Its Charter)

Virginia

56-2130744

-----  
(State or Other Jurisdiction of  
Incorporation or Organization)

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

445 S. Main Street, Burlington, North Carolina

27215

-----  
(Address of Principal Executive Offices)

-----  
(Zip Code)

(336) 227-8861

-----  
Registrant's Telephone Number, Including Area Code

N/A

-----  
(Former Name, Former Address and Former Fiscal Year, if Changed  
Since Last Report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of May 7, 2004, the issuer had 2,962,323 shares of common stock issued and outstanding.

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MARCH 31, 2004 AND SEPTEMBER 30, 2003

(IN THOUSANDS, EXCEPT SHARE DATA)

	At March 31, 2004
(Unaudited)	
ASSETS	
Cash and cash equivalents	\$ 8,385
Investment securities:	
Held to maturity (fair value of \$22,088 and \$19,397 at March 31, 2004 and September 30, 2003, respectively)	21,824
Available for sale (cost of \$85,767 and \$92,971 at March 31, 2004 and September 30, 2003, respectively)	85,368
Loans held for sale, at lower of cost or fair value	1,244
Loans receivable (net of allowance for loan losses of \$3,892 and \$3,856 at March 31, 2004 and September 30, 2003, respectively)	230,584
Real estate owned	513
Federal Home Loan Bank stock, at cost	1,425
Premises and equipment	8,253
Accrued interest receivable	1,886
Other assets	3,387
	-----
Total assets	\$ 362,869
	=====
LIABILITIES AND STOCKHOLDERS' EQUITY	
Liabilities:	
Deposit accounts	264,413
Advances from Federal Home Loan Bank	28,500
Advance payments by borrowers for property taxes and insurance	215
Dividend payable	296
Other liabilities	5,131
	-----
Total liabilities	298,555
	=====
Stockholders' Equity:	
Preferred stock, \$0.01 par value, 1,000,000 shares authorized; none issued	--
Common stock, \$0.01 par value, 7,000,000 shares authorized; 2,962,323 and 2,971,977 shares issued and outstanding at March 31, 2004 and September 30, 2003, respectively	33
Additional paid-in capital	35,930
Unallocated ESOP shares	(2,854)
Deferred compensation payable in treasury stock	5,802
Treasury stock	(13,448)
Retained income - substantially restricted	39,094
Accumulated other comprehensive income (loss) - net unrealized loss on investment securities available for sale	(243)
	-----
Total stockholders' equity	64,314
	=====
Total liabilities and stockholders' equity	\$ 362,869
	=====

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See accompanying notes to the consolidated financial statements.

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1st STATE BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF INCOME  
FOR THE THREE MONTHS ENDED MARCH 31, 2004 AND 2003  
(IN THOUSANDS, EXCEPT PER SHARE DATA)

(Unaudited)

	For the Three Months Ended March 31,	
	2004	2003
	-----	-----
Interest income:		
Interest and fees on loans	\$ 2,830	\$ 3,2
Interest and dividends on investments	1,116	1,0
Overnight deposits	8	
	-----	-----
Total interest income	3,954	4,3
	-----	-----
Interest expense:		
Deposit accounts	886	1,1
Borrowings	303	2
	-----	-----
Total interest expense	1,189	1,4
	-----	-----
Net interest income	2,765	2,9
Provision for loan losses	60	
	-----	-----
Net interest income after provision for loan losses	2,705	2,8
	-----	-----
Other income:		
Customer service fees	240	2
Commissions from sales of annuities and mutual funds	93	1
Mortgage banking income, net	113	4
Securities gains, net	88	
Other	56	
	-----	-----
Total other income	590	8
	-----	-----
Operating expenses:		
Compensation and related benefits	1,316	1,4
Occupancy and equipment	340	3
Real estate operations, net	(1)	
Other expenses	401	3
	-----	-----
Total operating expenses	2,056	2,1

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	-----	-----
Income before income taxes	1,239	1,5
Income taxes	460	5
	-----	-----
Net income	\$ 779	\$ 9
	=====	=====
Earnings per share:		
Basic	\$ 0.28	\$ 0.
Diluted	\$ 0.26	\$ 0.

See accompanying notes to the consolidated financial statements.

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1st STATE BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF INCOME  
FOR THE SIX MONTHS ENDED MARCH 31, 2004 AND 2003  
(IN THOUSANDS, EXCEPT PER SHARE DATA)

(UNAUDITED)

	For the Six Months Ended March 31,	
	2004	2003
	-----	-----
Interest income:		
Interest and fees on loans	\$ 5,684	\$ 6,6
Interest and dividends on investments	2,300	2,2
Overnight deposits	17	
	-----	-----
Total interest income	8,001	8,9
	-----	-----
Interest expense:		
Deposit accounts	1,805	2,4
Borrowings	619	5
	-----	-----
Total interest expense	2,424	3,0
	-----	-----
Net interest income	5,577	5,9
	-----	-----
Provision for loan losses	120	1
	-----	-----
Net interest income after provision for loan losses	5,457	5,8
	-----	-----
Other income:		
Customer service fees	446	4
Commissions from sales of annuities and mutual funds	165	2
Mortgage banking income, net	211	8

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Securities gains, net	185	
Other	109	1
	-----	-----
Total other income	1,116	1,6
	-----	-----
Operating expenses:		
Compensation and related benefits	2,648	2,7
Occupancy and equipment	683	7
Real estate operations, net	(5)	
Other expenses	833	8
	-----	-----
Total operating expenses	4,159	4,3
	-----	-----
Income before income taxes	2,414	3,1
	-----	-----
Income taxes	877	1,1
	-----	-----
Net income	\$ 1,537	\$ 1,9
	=====	=====
Earnings per share:		
Basic	\$ 0.55	\$ 0.
Diluted	\$ 0.52	\$ 0.

See accompanying notes to the consolidated financial statements

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1st STATE BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS'  
EQUITY AND COMPREHENSIVE INCOME  
FOR THE SIX MONTHS ENDED MARCH 31, 2004 AND 2003 (UNAUDITED)  
(In Thousands)

	Common stock	Additional paid-in capital	Unallocated ESOP shares	Deferred compensation payable in treasury stock	Treasury stock
	-----	-----	-----	-----	-----
Balance at September 30, 2002	\$33	35,623	(3,739)	5,466	(11,899)
Comprehensive income:					
Net income	--	--	--	--	--
Other comprehensive loss-unrealized loss on securities available-for-sale net of income taxes of \$169	--	--	--	--	--
Total comprehensive income					
Allocation of ESOP shares	--	72	298	--	--
Acquisition of treasury stock	--	--	--	--	(743)
Cash dividends declared (\$0.18 per share)	--	--	--	--	--
Cash dividends on unallocated ESOP shares	--	--	--	--	--
	---	-----	-----	-----	-----

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Balance at March 31, 2003	\$33	35,695	(3,441)	5,466	(12,642)
	===	=====	=====	=====	=====
Balance at September 30, 2003	\$33	35,778	(3,141)	5,466	(12,785)
Comprehensive income:					
Net income	--	--	--	--	--
Other comprehensive income-unrealized gain on securities available-for-sale net of income taxes of \$338	--	--	--	--	--
Total comprehensive income					
Allocation of ESOP shares	--	133	287	--	--
Acquisition of treasury stock	--	--	--	--	(663)
Deferred compensation	--	--	--	336	--
Exercise of stock options	--	19	--	--	--
Cash dividends declared (\$0.20 per share)	--	--	--	--	--
Cash dividends on unallocated ESOP shares	--	--	--	--	--
	----	-----	-----	-----	-----
Balance at March 31, 2004	\$33	35,930	(2,854)	5,802	(13,448)
	===	=====	=====	=====	=====

See accompanying notes to the consolidated financial statements.

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1st STATE BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE SIX MONTHS ENDED MARCH 31, 2004 AND 2003  
(UNAUDITED)  
(In Thousands)

	For the Six Months Ended March 31, 2004
	-----
Cash flows from operating activities:	
Net income	\$ 1,537
Adjustment to reconcile net income to net cash provided by operating activities:	
Provision for loan losses	120
Depreciation	342
Deferred tax expense (benefit)	(51)
Amortization of premiums and discounts, net	6
Deferred compensation	120
Release of ESOP shares	420
Loan origination fees and unearned discounts deferred, net of current amortization	(26)
Loss (gain) on sale of other real estate	(12)
Gain on sale of investment securities available for sale	(185)
Net (gain) loss on sale of loans	27
Proceeds from loans held for sale	13,544
Originations of loans held for sale	(14,170)
Decrease (increase) in other assets	(72)
Decrease in accrued interest receivable	81

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Decrease in other liabilities	(26)
	-----
Net cash provided by operating activities	1,655
	-----
Cash flows provided by (used in) investing activities:	
Proceeds from sale of FHLB stock	1,975
Purchases of FHLB stock	(1,725)
Purchases of investment securities held to maturity	(6,368)
Purchases of investment securities available for sale	(30,575)
Proceeds from sales of investment securities available for sale	10,993
Proceeds from maturities and issuer calls of investment securities available for sale	26,969
Proceeds from maturities and issuer calls of investment securities held to maturity	4,002
Net increase in loans receivable	(5,121)
Purchase of real estate acquired in settlement of loans	(250)
Purchases of premises and equipment	(182)
	-----
Net cash provided by (used in) investing activities	(282)
	-----

(Continued)

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1st STATE BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS - CONTINUED  
FOR THE SIX MONTHS ENDED MARCH 31, 2004 AND 2003  
(UNAUDITED)  
(In Thousands)

	FOR THE SIX MONTHS MARCH 2004
	-----
Cash flows from financing activities:	
Net increase (decrease) in deposits	\$ 1,701
Advances from the Federal Home Loan Bank	54,000
Repayments of advances from the Federal Home Loan Bank	(57,000)
Purchase of treasury stock	(663)
Exercise of stock options	19
Dividends paid on common stock	(562)
Increase in advance payments by borrowers for property taxes and insurance	158
	-----
Net cash used in financing activities	(2,347)
	-----
Net increase (decrease) in cash and cash equivalents	(974)
Cash and cash equivalents at beginning of period	9,359
	-----



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Cash and cash equivalents at end of period	\$ 8,385 =====
Payments are shown below for the following:	
Interest	\$ 2,420 =====
Income taxes	\$ 1,276 =====
Noncash investing and financing activities:	
Unrealized gains (losses) on investment securities available for sale	\$ 863 =====
Cash dividends declared but not paid	\$ 280 =====
Cash dividends on unallocated ESOP shares	\$ 32 =====

See accompanying notes to the consolidated financial statements.

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1st STATE BANCORP, INC. AND SUBSIDIARY  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 MARCH 31, 2004 (UNAUDITED) AND SEPTEMBER 30, 2003

NOTE 1. NATURE OF BUSINESS

1st State Bancorp, Inc. (the "Company") was incorporated under the laws of the Commonwealth of Virginia for the purpose of becoming the holding company for 1st State Bank (the "Bank") in connection with the Bank's conversion from a North Carolina-chartered mutual savings bank to a North Carolina-chartered stock savings bank (the "Converted Bank") pursuant to its Plan of Conversion (the "Stock Conversion"). Upon completion of the Stock Conversion, the Converted Bank converted from a North Carolina-chartered stock savings bank to a North Carolina commercial bank (the "Bank Conversion"), retaining the name 1st State Bank (the "Commercial Bank"), and the Commercial Bank succeeded to all of the assets and liabilities of the Converted Bank. The Stock Conversion and the Bank Conversion were consummated on April 23, 1999. The common stock of the Company began trading on the Nasdaq National Market System under the symbol "FSBC" on April 26, 1999.

NOTE 2. BASIS OF PRESENTATION

The accompanying consolidated financial statements (which are unaudited, except for the consolidated balance sheet at September 30, 2003, which is derived from the September 30, 2003 audited consolidated financial statements) have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (none of

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which were other than normal recurring accruals) necessary for a fair presentation of the financial position and results of operations for the periods presented have been included.

The results of operations for the three and six month periods ended March 31, 2004 are not necessarily indicative of the results of operations that may be expected for the year ending September 30, 2004. The preparation of consolidated financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make certain estimates. These amounts may be revised in future periods because of changes in the facts and circumstances underlying their estimation.

### NOTE 3. EARNINGS PER SHARE

For purposes of computing basic and diluted earnings per share, weighted average shares outstanding excludes unallocated ESOP shares that have not been committed to be released. The deferred compensation obligation discussed in Note 5 that is funded with shares of the Company's common stock has no net impact on the Company's earnings per share computations. Diluted earnings per share include the potentially dilutive effects of the Company's stock-based benefit plans. There were no anti-dilutive stock options for the three and six months ended March 31, 2004 and 2003. A reconciliation of the denominators of the basic and diluted earnings per share computations is as follows:

	THREE MONTHS ENDED MARCH 31,	
	2004	2003
Average shares issued and outstanding	2,963,492	2,995,000
Less: Unallocated ESOP shares	(149,487)	(179,000)
	2,814,005	2,816,000
Add: Potential common stock pursuant to stock option plan	157,118	122,000
	2,971,123	2,938,000

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	SIX MONTHS ENDED MARCH 31,	
	2004	2003
Average shares issued and outstanding	2,966,391	2,999,000
Less: Unallocated ESOP shares	(153,167)	(183,000)
	2,813,224	2,816,000
Add: Potential common stock pursuant to stock option plan	152,782	124,000
	2,966,006	2,940,000

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### NOTE 4. EMPLOYEE STOCK OWNERSHIP PLAN ("ESOP")

The Company sponsors an employee stock ownership plan (the "ESOP") whereby an aggregate number of shares amounting to 253,050 or 8% of the stock issued in the conversion was purchased for future allocation to employees. The ESOP was funded by an 11-year term loan from the Company in the amount of \$4,899,000. The loan is secured by the shares of stock purchased by the ESOP. During the three and six months ended March 31, 2004 and 2003, 7,280 and 7,360 and 14,640 and 15,288 shares of stock were committed to be released and approximately \$215,000 and \$181,000 and \$420,000 and \$371,000, respectively of compensation expense was recognized.

### NOTE 5. DEFERRED COMPENSATION

Directors and certain executive officers participate in a deferred compensation plan, which was approved by the Board of Directors on September 24, 1997. This plan generally provides for fixed payments beginning after the participant retires. Each participant is fully vested in his account balance under the plan. Directors may elect to defer their directors' fees and executive officers may elect to defer 25% of their salary and 100% of bonus compensation.

Prior to the Stock Conversion, amounts deferred by each participant accumulated interest at a rate equal to the highest rate of interest paid on the Bank's one-year certificates of deposit. In connection with the Stock Conversion, participants in the plan were given the opportunity to prospectively elect to have their deferred compensation balance earn a rate of return equal to the total return of the Company's stock. All participants elected this option concurrent with the Stock Conversion, so the Company purchases its common stock to fund this obligation. Refer to the Company's notes to consolidated financial statements, incorporated by reference in the Company's 2003 Annual Report on Form 10-K for a discussion of the Company's accounting policy with respect to this deferred compensation plan and the related treasury stock purchased by the Company to fund this obligation.

The expense related to this plan for each of the three and six months ended March 31, 2004 and 2003 was \$60,000 and \$60,000 and \$120,000 and \$120,000, respectively. This expense is included in compensation expense.

### NOTE 6. STOCK OPTION AND INCENTIVE PLAN

On June 6, 2000, the Company's stockholders approved the 1st State Bancorp, Inc. 2000 Stock Option and Incentive Plan (the "Plan"). The purpose of this plan is to advance the interests of the Company through providing select key employees and directors of the Bank with the opportunity to acquire shares. By encouraging such stock ownership, the Company seeks to attract, retain and motivate the best available personnel for positions of substantial responsibility and to provide incentives to the key employees and directors. Under the Plan, the Company granted 316,312 options to purchase its \$0.01 par value common stock. The exercise price per share is equal to the fair market value per share on the date of the grant. Options granted under the Stock Option Plan are 100% vested on the date of the grant, and all options expire 10 years from the date of the grant. As a result of the one-time cash dividend of \$5.17 paid on October 2, 2000, the exercise price for the options repriced from \$18.44 to \$14.71. There were 2,077 options exercised during the three months ended March 31, 2004. No options were granted during the three and six months ended March 31, 2004 and 2003. At March 31, 2004, 314,235 options are outstanding, all of which are exercisable.

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### NOTE 7. MORTGAGE SERVICING RIGHTS

The rights to service mortgage loans for others are included in other assets on the consolidated balance sheet. Mortgage servicing rights ("MSRs") are capitalized based on the allocated cost that is determined when the underlying loans are sold. MSRs are amortized over a period that approximates the life of the underlying loan as an adjustment of servicing income. Impairment reviews of MSRs are performed on a quarterly basis. As of March 31, 2004 and September 30, 2003, MSRs totaled \$520,000 and \$547,000, respectively, and no valuation allowance was required.

Amortization expense totaled \$57,000 and \$71,000 for the six months ended March 31, 2004 and 2003, respectively.

### NOTE 8. STANDBY LETTERS OF CREDIT

In November 2002, the FASB issued Interpretation No. 45 (FIN 45), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others", which addressed the disclosure to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees. FIN 45 requires the guarantor to recognize a liability for the non-contingent component of the guarantee, such as the obligation to stand ready to perform in the event that specified triggering events or conditions occur. The initial measurement of this liability is the fair value of the guarantee at inception. The recognition of the liability is required even if it is not probable that payments will be required under the guarantee or if the guarantee was issued with a premium payment or as part of a transaction with multiple events. The initial recognition and measurement provisions are effective for all guarantees within the scope of FIN 45 issued or modified after March 31, 2003. The Company issues standby letters of credit whereby the Company guarantees performance if a specified triggering event or condition occurs (primarily nonperformance under construction contracts entered into by construction customers). The guarantees generally expire within one year and may be automatically renewed depending on the terms of the guarantee. The maximum potential amount of undiscounted future payments related to standby letters of credit at March 31, 2004 is \$1.7 million. At March 31, 2004, the Company has recorded no liability for the current carrying amount of the obligation to perform as a guarantor and no contingent liability is considered necessary as such amounts are deemed immaterial. Substantially all standby letters of credit are secured by real estate and/or guaranteed by third parties in the event the Company had to advance funds to fulfill the guarantee.

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

#### FORWARD-LOOKING STATEMENTS

When used in this Form 10-Q, the words or phrases "will likely result," "are expected to," "will continue," "is anticipated," "estimate," "project" or similar expressions are intended to identify "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements are subject to certain risks and uncertainties including changes in economic conditions in our market area, changes in policies by regulatory agencies, fluctuations in interest rates, demand for loans in our market area, and competition that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. We wish to caution you not to place undue reliance on any such forward-looking statements, which speak only as of the date made. We wish to advise you that the factors listed above could affect our financial performance and could cause our actual results for future periods to differ materially from any opinions or statements

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expressed with respect to future periods in any current statements.

We do not undertake, and specifically disclaim any obligation, to publicly release the result of any revisions which may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

### GENERAL

1st State Bancorp, Inc. was formed in November 1998 and became the holding company for 1st State Bank on April 23, 1999.

Our business consists principally of attracting deposits from the general public and investing these funds in loans secured by single-family residential and commercial real estate, secured and unsecured commercial loans and consumer

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loans. Our profitability depends primarily on our net interest income, which is the difference between the income we receive on our loan and investment securities portfolios and our cost of funds, which consists of interest paid on deposits and borrowed funds. Net interest income also is affected by the relative amounts of interest-earning assets and interest-bearing liabilities. When interest-earning assets approximate or exceed interest-bearing liabilities, any positive interest rate spread will generate net interest income. Our profitability is also affected by the level of other income and operating expenses. Other income consists of miscellaneous fees related to our loans and deposits, mortgage banking income and commissions from sales of annuities and mutual funds. Operating expenses consist of compensation and benefits, occupancy related expenses, federal deposit insurance premiums, data processing, advertising and other expenses.

Our operations are influenced significantly by local economic conditions and by policies of financial institution regulatory authorities. Our cost of funds is influenced by interest rates on competing investments and by rates offered on similar investments by competing financial institutions in our market area, as well as general market interest rates. These factors can cause fluctuations in our net interest income and other income. Lending activities are affected by the demand for financing of real estate and other types of loans, which in turn is affected by the interest rates at which such financing may be offered. In addition, local economic conditions can impact the credit risk of our loan portfolio, in that local employers may be required to eliminate employment positions of many of our borrowers, and small businesses and other commercial borrowers may experience a downturn in their operating performance and become unable to make timely payments on their loans. Management evaluates these factors in estimating its allowance for loan losses, and changes in these economic conditions could result in increases or decreases to the provision for loan losses.

Our business emphasis has been to operate as a well capitalized, profitable and independent community-oriented financial institution dedicated to providing quality customer service. We are committed to meeting the financial needs of the communities in which we operate. We believe that we can be more effective in servicing our customers than many of our nonlocal competitors because of our ability to quickly and effectively provide senior management responses to customer needs and inquiries. Our ability to provide these services is enhanced by the stability of our senior management team.

Over the years, we have sought to gradually increase the percentage of our assets invested in commercial real estate loans, commercial loans and consumer loans, which have shorter terms and adjust more frequently to changes in

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interest rates than single-family residential mortgage loans. These loans generally carry added risk when compared to a single-family residential mortgage loan, so we have concurrently increased our allowance for loan losses as we have originated these loans.

Due to a general slowdown in the economy beginning in 2000, the Federal Reserve acted to provide a stimulus through a series of interest rate reductions that lowered the prime rate from 9.50% in January 2001 to 4.00% in June 2003. These reductions in prime tended to negatively impact the Company's net interest margin and net interest spread which resulted in lower net interest income for the Company. The Company's asset growth has been slower as a result of heavy refinancing as customers have taken advantage of these attractive interest rates. The fee income associated with the heavy refinancing volume has replaced some of the lost net interest income. Now as the refinancing activity has slowed, the Company is looking to replace lost net interest income possibly with leverage strategies. During periods of slow loan demand, the Company purchases more investments, and the Company uses short-term borrowings as an alternative to deposits for funding certain assets. The Company's balance sheet is currently asset sensitive, that is, rate sensitive assets exceed rate sensitive liabilities. We expect an increase in net interest income during periods of rising interest rates and decreased net interest income during periods of falling interest rates.

### CRITICAL ACCOUNTING POLICIES

The Company's significant accounting policies are set forth in Note 1 of the consolidated financial statements as of September 30, 2003, which was filed on the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2003. Of these significant accounting policies, the Company considers its policy regarding the allowance for loan losses to be its most critical accounting policy, because it requires management's most subjective and complex judgments. In addition, changes in economic conditions can have a significant impact on the allowance for loan losses and therefore the provision for loan losses and results of operations. The Company has developed appropriate policies and procedures for assessing the adequacy of the allowance for loan losses, recognizing that this process requires a number of assumptions and estimates with respect to its loan portfolio. The Company's assessments may be impacted in future periods by changes in economic conditions, the impact of regulatory examinations, and the discovery of

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information with respect to borrowers that is not known to management at the time of the issuance of the consolidated financial statements.

### COMPARISON OF FINANCIAL CONDITION AT MARCH 31, 2004 AND SEPTEMBER 30, 2003

Total assets were relatively flat from September 30, 2003 to March 31, 2004. Assets increased to \$362.9 million at March 31, 2004 from \$362.6 million at September 30, 2003. Increases in loans receivable, net and loans held for sale were offset by decreases in investment securities. Deposits increased by \$1.7 million from \$262.7 million at September 30, 2003 to \$264.4 million at March 31, 2004. These increases were offset by decreases in advances from the Federal home loan Bank. Borrowings from the Federal Home Loan Bank of Atlanta decreased \$3.0 million from \$31.5 million at September 30, 2003 to \$28.5 million at March 31, 2004.

Investment securities available for sale decreased \$5.7 million from \$91.1 million at September 30, 2003 to \$85.4 million at March 31, 2004. During the six months ended March 31, 2004, we purchased \$30.6 million of securities and received \$38.0 million in proceeds from sales, maturities and issuer calls of

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investment securities available for sale. Investment securities held to maturity increased \$2.4 million from \$19.5 million at September 30, 2003 to \$21.8 million at March 31, 2004. During the six months ended March 31, 2004, we purchased \$6.4 million of securities and received \$4.0 million in proceeds from maturities and issuer calls of investment securities held to maturity.

Loans held for sale increased to \$1.2 million at March 31, 2004 from \$645,000 at September 30, 2003. Loans receivable, net increased from \$225.7 million at September 30, 2003 to \$230.6 million at March 31, 2004. The increase in loans held for sale resulted from timing differences in the funding of loan sales. During the six months ended March 31, 2004, mortgage originations were considerably slower than in previous quarters as refinance activity slowed down in response to higher mortgage interest rates. During this same period, the Company saw growth in commercial loans and equity lines.

Stockholders' equity increased by \$1.6 million from \$62.7 million at September 30, 2003 to \$64.3 million at March 31, 2004 as a result of net income of \$1.5 million, release of ESOP shares of \$420,000 and a decrease in unrealized loss on available for sale securities of \$525,000. These increases were partially offset by cash dividends to stockholders declared of \$561,000 and purchases of treasury stock of \$663,000.

### COMPARISON OF OPERATING RESULTS FOR THE THREE MONTHS ENDED MARCH 31, 2004 AND 2003

**NET INCOME.** We recorded net income of \$779,000 for the quarter ended March 31, 2004, as compared to \$997,000 for the quarter ended March 31, 2003, representing a decrease of \$218,000, or 21.9%. For the three months ended March 31, 2004, basic and diluted earnings per share were \$0.28 and \$0.26, respectively, compared to the basic and diluted earnings per share for the quarter ended March 31, 2003 of \$0.35 and \$0.34, respectively. The decrease in net income resulted primarily from decreased net interest income and decreased other income that were offset partially by decreased operating expenses and decreased income tax expense. The decrease in net interest income resulted from lower net interest margins. The average prime interest rate for the quarter ended March 31, 2004 was 4.00%, a decrease of 25 basis points from 4.25%, which was the average prime for the quarter ended March 31, 2003. The repricing of loans and investments decreased the Company's average asset yield by 75 basis points whereas the average cost of funds decreased only 47 basis points during the quarter ended March 31, 2003.

**NET INTEREST INCOME.** Net interest income, the difference between interest earned on loans and investments and interest paid on interest-bearing liabilities, decreased by \$187,000 or 6.8% for the three months ended March 31, 2004, compared to the same quarter in the prior year. This decrease results from a \$443,000 decrease in interest income that was partially offset by the \$256,000 decrease in total interest expense. The average net interest rate spread decreased 28 basis points from 3.21% for the three months ended March 31, 2003 to 2.93% for the quarter ended March 31, 2004.

**INTEREST INCOME.** The decrease in interest income for the three months ended March 31, 2004 was the result of a decrease in yield on interest-earning assets of 75 basis points from 5.39% for the three months ended March 31, 2003 to 4.64% for the three months ended March 31, 2004. This decrease was partially offset by an increase of \$14.7 million in average interest-earning assets compared to the same quarter in the prior year. Average investment securities increased \$24.9 million, average interest-bearing overnight funds decreased \$11.1 million and average loans receivable increased

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\$918,000. The increase in average interest-earning assets increased interest income by approximately \$299,000 and the decrease in the average asset yield decreased interest income by approximately \$742,000.

INTEREST EXPENSE. Interest expense decreased in the three months ended March 31, 2004 due to a decrease in the cost of interest-bearing liabilities of 47 basis points from 2.18% for the three months ended March 31, 2003 to 1.71% for the three months ended March 31, 2004. This decrease was partially offset by an increase in average interest-bearing liabilities of \$12.9 million. Average interest-bearing deposits increased by \$4.5 million while average FHLB advances increased \$8.4 million for the three months ended March 31, 2004 compared to the same quarter in the prior year. The increase in average interest-bearing liabilities increased interest expense by approximately \$127,000 and the decrease in the average cost of interest-bearing liabilities decreased interest expense by approximately \$383,000.

The following table presents average balances and average rates earned/paid by the Company for the quarter ended March 31, 2004 compared to the quarter ended March 31, 2003.

	Three Months Ended March 31, 2004			
	-----			
	(Dollars in Thousand)			
	Average Balance	Interest	Average Yield/Cost	Aver Bala
	-----	-----	-----	-----
<b>Assets:</b>				
Loans receivable (1).....	\$ 229,683	\$ 2,830	4.93%	\$ 228
Investment securities (2).....	107,811	1,116	4.14	82
Interest-bearing overnight deposits .....	3,556	8	0.91	14
	-----	-----	-----	-----
Total interest-earning assets (3).....	341,050	3,954	4.64	326
Non interest-earning assets.....	20,970			21
	-----			-----
Total assets.....	\$ 362,020			\$ 347
	=====			=====
<b>Liabilities and stockholders' equity:</b>				
Interest bearing checking.....	35,538	18	0.21	33
Money market investment accounts.....	19,212	32	0.66	22
Passbook and statement savings.....	29,834	45	0.60	29
Certificates of deposit.....	163,530	791	1.93	158
FHLB advances.....	30,280	303	4.01	21
	-----	-----	-----	-----
Total interest-bearing liabilities.....	278,394	1,189	1.71	265
Non interest-bearing liabilities.....	19,822			19
	-----			-----
Total liabilities.....	298,216			284
Stockholders' equity.....	63,804			62
	-----			-----
Total liabilities and stockholders' equity	\$ 362,020			\$ 347
	=====			=====
Net interest income.....		\$ 2,765		
		=====		
Interest rate spread.....			2.93%	
			=====	



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Net interest margin (4).....	3.24%
	=====
Ratio of average interest-earning assets to average interest-bearing liabilities.....	122.51%
	=====

- 
- (1) Includes nonaccrual loans and loans held for sale, net of discounts and allowance for loan losses.
  - (2) Includes FHLB of Atlanta stock.
  - (3) Due to immateriality, the interest income and yields related to certain tax exempt assets have not been adjusted to reflect a fully taxable equivalent yield.
  - (4) Represents net interest income divided by the average balance of interest-earning assets.

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PROVISION FOR LOAN LOSSES. We charge provisions for loan losses to earnings to maintain the total allowance for loan losses at a level we consider adequate to provide for probable loan losses, based on existing loan levels and types of loans outstanding, nonperforming loans, prior loss experience, general economic conditions and other factors. We estimate the allowance using an allowance for loan losses model which takes into considerations all of these factors. Our policies require the review of assets on a regular basis, and we assign risk grades to loans based on the relative risk of the credit, considering such factors as repayment experience, value of collateral, guarantors, etc. Our credit management systems have resulted in low loss experience; however, there can be no assurances that such experience will continue. We believe we use the best information available to make a determination with respect to the allowance for loan losses, recognizing that future adjustments may be necessary depending upon a change in economic conditions.

The provision for loan losses was \$60,000 and net charge-offs were \$36,000 for the three months ended March 31, 2004 compared with a provision of \$60,000, and net charge-offs of \$0 for the three months ended March 31, 2003. Nonperforming loans at March 31, 2004 and September 30, 2003 were \$4.0 million and \$4.2 million, respectively. The majority of the non-performing loans resulted from two unrelated, distinct credits which are not necessarily indicative of the credit quality of the entire portfolio. There was no significant impact on the provision as these loans are well secured by property and equipment.

OTHER INCOME. Other income decreased \$281,000 from \$871,000 for the three months ended March 31, 2003 to \$590,000 for the three months ended March 31, 2004. Mortgage banking income, net decreased \$323,000 from \$436,000 for the three months ended March 31, 2003 to \$113,000 for the three months ended March 31, 2004. This decrease results from a decrease in volume of mortgage loan originations and sales. We sold loans totaling \$6.7 million in the three months ended March 31, 2004 compared with sales of \$23.8 million in the previous year for the comparable period. The increase in mortgage interest rates slowed the volume of mortgage originations and sales. Given the current level of mortgage interest rates, the Company believes that mortgage banking income will continue to decrease in future quarters due to lower refinancing activity. Commissions from sales of annuities and mutual funds decreased \$66,000 from \$159,000 for the quarter ended March 31, 2003 to \$93,000 for the quarter ended March 31, 2004. This decrease results from lower sales of annuities and mutual funds. The Company recorded gains on sales of investments of \$88,000 in the three months ended March 31, 2004 which were not present in the prior year.

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OPERATING EXPENSES. Total operating expenses were \$2.1 million and \$2.2 million for the three months ended March 31, 2004 and 2003, respectively. Expenses incurred in operating real estate owned were \$4,000 for the three months ended March 31, 2003 compared to income of \$1,000 for the three months ended March 31, 2004. The Company has been able to control expenses during this period of slower asset growth.

INCOME TAX EXPENSE. Income tax expense decreased \$125,000 from tax expense of \$585,000 for the three months ended March 31, 2003 to \$460,000 for the three months ended March 31, 2004. The effective tax rates were 37.1% and 37.0% for the three months ended March 31, 2004 and 2003, respectively.

### COMPARISON OF OPERATING RESULTS FOR THE SIX MONTHS ENDED MARCH 31, 2004 AND 2003

NET INCOME. We recorded net income of \$1.5 million for the six months ended March 31, 2004, a decrease of \$500,000, or 25.0% over the \$2.0 million reported in the six months ended March 31, 2003. For the six months ended March 31, 2004, basic and diluted earnings per share were \$0.55 and \$0.52, respectively. The Company reported basic and diluted earnings per share for the six months ended March 31, 2003 of \$0.70 and \$0.67, respectively. The decrease in net income resulted primarily from decreased net interest income and decreased other income. These decreases in income were partially offset by decreased operating expenses and decreased income taxes. The decrease in the net interest income resulted from lower net interest margins. The average prime interest rate for the six months ended March 31, 2004 was 4.00%, a decrease of 35 basis points from 4.35% which was the average prime for the six months ended March 31, 2003. The rate decrease caused a greater reduction in the average yield on earning assets than the average rate paid on interest-bearing liabilities.

NET INTEREST INCOME. Net interest income, the difference between interest earned on loans and investments and interest paid on interest-bearing liabilities, decreased by \$376,000 or 6.7% for the six months ended March 31, 2004, compared to the same six months in the prior year. This decrease reflects a \$963,000 decrease in interest income that was partially offset by the \$588,000 decrease in total interest expense. The average net interest rate spread decreased 27 basis points from 3.22% for the six months ended March 31, 2003 to 2.95% for the six months ended March 31, 2004.

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INTEREST INCOME. The decrease in interest income for the six months ended March 31, 2004 was due to a decrease in yield on interest-earning assets of 81 basis points from 5.51% for the six months ended March 31, 2003 to 4.70% for the six months ended March 31, 2004 that was partially offset by an increase of \$14.2 million in average interest-earning assets compared to the same period in the prior year. The increased volume of average interest-earning assets increased interest income by approximately \$592,000 and the decreased yield decreased interest income by approximately \$1.6 million. Average investment securities increased \$25.0 million compared with the prior year. This increase was offset in part by a decrease in average loans receivable of \$165,000 and a decrease of \$10.0 million in average interest bearing overnight funds.

INTEREST EXPENSE. Interest expense decreased in the six months ended March 31, 2004 due to a decrease in the cost of interest-bearing liabilities of 54 basis points from 2.29% for the six months ended March 31, 2003 to 1.75% for the six months ended March 31, 2004 that was partially offset by an increase of \$14.2 million in average interest-bearing liabilities. Average deposits increased by \$3.4 million, and average FHLB advances increased \$10.8 million for the six months ended March 31, 2004 compared to the same six months in the prior year. The increase in average interest-bearing liabilities increased interest expense by approximately \$317,000 and the decrease in the average cost of

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interest-bearing liabilities decreased interest expense by approximately \$905,000.

The following table presents average balances and average rates earned/paid by the Company for the six months ended March 31, 2004 compared to the six months ended March 31, 2003.

	Six Months Ended March 31, 2004			
	(Dollars in Thousands)			
	Average Balance	Interest	Average Yield/Cost	Average Balance
	-----	-----	-----	-----
<b>Assets:</b>				
Loans receivable (1).....	\$ 227,691	\$ 5,684	4.99%	\$ 227,691
Investment securities (2).....	108,883	2,300	4.22	83,333
Interest-bearing overnight deposits .....	3,786	17	0.91	13,333
	-----	-----	-----	-----
Total interest-earning assets (3).....	340,360	8,001	4.70	325,333
Non interest-earning assets.....	20,879			19,333
	-----			-----
Total assets.....	\$ 361,239			\$ 345,333
	=====			=====
<b>Liabilities and stockholders' equity:</b>				
Interest bearing checking.....	35,822	38	0.21	33,333
Money market investment accounts.....	19,406	65	0.67	21,333
Passbook and statement savings.....	30,095	92	0.61	29,333
Certificates of deposit.....	160,301	1,610	2.01	157,333
FHLB advances.....	31,863	619	3.89	21,333
	-----	-----	-----	-----
Total interest-bearing liabilities.....	277,487	2,424	1.75	263,333
Non interest-bearing liabilities.....	20,401			20,333
	-----			-----
Total liabilities.....	297,888			283,333
Stockholders' equity.....	63,351			62,333
	-----			-----
Total liabilities and stockholders' equity	\$ 361,239			\$ 345,333
	=====			=====
Net interest income.....		\$ 5,577		
		=====		
Interest rate spread.....			2.95%	
			=====	
Net interest margin (4).....			3.28%	
			=====	
Ratio of average interest-earning assets to average interest-bearing liabilities.....			122.66%	
			=====	

(1) Includes nonaccrual loans and loans held for sale, net of discounts and allowance for loan losses.

(2) Includes FHLB of Atlanta stock.

(3) Due to immateriality, the interest income and yields related to certain tax exempt assets have not been adjusted to reflect a fully taxable equivalent

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yield.

- (4) Represents net interest income divided by the average balance of interest-earning assets.

PROVISION FOR LOAN LOSSES. The provision for loan losses is charged to earnings to maintain the total allowance for loan losses at a level considered adequate to absorb estimated probable losses inherent in the loan portfolio based on existing loan levels and types of loans outstanding, nonperforming loans, prior loan loss experience, general economic conditions and other factors. Provisions for loan losses totaled \$120,000 for both the six months ended March 31, 2004 and 2003. The provision for loan losses was impacted by the continued shift in the portfolio to commercial loans which require a larger allocation of allowance for loan losses. The effects of this continued shift in the portfolio were offset to a certain degree in 2004 by a decrease in nonperforming loans. The Company has completed the foreclosure on some of the nonperforming loans and shifted those assets into real estate owned. Most of the real estate owned is under contract. The sale of these properties should be completed during the next quarter.

OTHER INCOME. Other income decreased \$500,000 from \$1.6 million for the six months ended March 31, 2003 to \$1.1 million for the six months ended March 31, 2004. Mortgage banking income, net decreased \$626,000 from \$837,000 for the six months ended March 31, 2003 to \$211,000 for the six months ended March 31, 2004. This decrease results from a decrease in volume of mortgage loan originations and sales. We sold loans totaling \$13.6 million in the six months ended March 31, 2004 compared with sales of \$45.8 million in the previous year for the comparable period. The increase in mortgage interest rates slowed the volume of mortgage originations and sales. Given the current level of mortgage interest rates, the Company believes that mortgage banking income will continue to decrease in future quarters due to lower refinancing activity. Commissions from sales of annuities and mutual funds decreased \$81,000 from \$246,000 for the six months ended March 31, 2003 to \$165,000 for the six months ended March 31, 2004. This decrease results from lower sales of annuities and mutual funds. The Company recorded gains on sales of investments of \$185,000 in the six months ended March 31, 2004 which were not present in the prior year.

OPERATING EXPENSES. Total operating expenses were \$4.2 million and \$4.3 million for the six months ended March 31, 2004 and 2003, respectively. Expenses incurred in operating real estate owned were \$9,000 for the six months ended March 31, 2003 compared to income of \$5,000 for the six months ended March 31, 2004. The Company has been able to control expenses during this period of slower asset growth.

INCOME TAX EXPENSE. Income tax expense decreased \$300,000 from tax expense of \$1.2 million for the six months ended March 31, 2003 to \$877,000 for the six months ended March 31, 2004. The effective tax rates were 36.3% and 36.9% for the six months ended March 31, 2004 and 2003, respectively. The decrease in the effective rate was primarily due to an increase in the ratio of state non-taxable income as a percentage of net income before taxes.

### COMMITMENTS, CONTINGENCIES AND OFF-BALANCE SHEET RISK

The Company is a party to financial instruments with off-balance sheet risk including commitments to extend credit under existing lines of credit and commitments to sell loans. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets.

Off-balance sheet financial instruments whose contract amounts represent credit and interest rate risk are summarized as follows:

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	March 31, 2004 -----	Septem -----
	(Dollars in thousands)	
Commitments to originate new loans	\$ 1,196	\$ 1
Commitments to originate new loans held for sale	326	
Unfunded commitments to extend credit under existing equity line and commercial lines of credit	56,537	57
Commercial letters of credit	1,692	
Commitments to sell loans held for sale	1,755	1

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The Company does not have any special purpose entities or other similar forms of off-balance sheet financing arrangements.

Commitments to originate new loans or to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Loan commitments generally expire within 30 to 45 days. Most equity line commitments are for a term of 15 years, and commercial lines of credit are generally renewable on an annual basis. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amounts of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the borrower.

Commitments to sell loans held for sale are agreements to sell loans to a third party at an agreed upon price. At March 31, 2004, the aggregate fair value of these commitments exceeded the book value of the loans to be sold.

CONTRACTUAL OBLIGATIONS

As of March 31, 2004

	PAYMENTS DUE BY PERIOD (DOLLARS IN THOUSANDS)				
	LESS THAN 1 YEAR -----	1-3 YEARS -----	4-5 YEARS -----	OVER 5 YEARS -----	TOTAL -----
Deposits	\$229,567	23,343	11,503	--	264,413
Advances from FHLB	8,500	--	20,000	--	28,500
Lease obligations	18	41	42	26	127
	-----	-----	-----	-----	-----
Total contractual cash obligations	\$238,085	23,384	31,545	26	293,040
	=====	=====	=====	=====	=====

ASSET QUALITY

At March 31, 2004, the Company had approximately \$4.5 million in

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nonperforming assets (nonaccrual loans and real estate owned) or 1.23% of total assets. At September 30, 2003, nonperforming assets were \$4.2 million or 1.17% of total assets. At March 31, 2004 and September 30, 2003, impaired loans totaled \$3.7 million and \$3.8 million, respectively, as defined by Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan." The impaired loans at March 31, 2004 and September 30, 2003 result from two and three, respectively, unrelated commercial loan customers, each of which have loans secured by commercial real estate and business assets in Alamance County. At March 31, 2004, the entire \$3.7 million of the impaired loans are on non-accrual status, and their related reserve for loan losses totaled \$160,000. The average carrying value of impaired loans was \$3.7 million during the six months ended March 31, 2004. Interest income of \$98,000 has been recorded on impaired loans in the six months ended March 31, 2004. The Bank's net chargeoffs for the six months ended March 31, 2004 were \$84,000. The Bank's allowance for loan losses was \$3.9 million at March 31, 2004 and September 30, 2003, and the ratio of the allowance for loan losses to total loans, net of loans in process and deferred loan fees was 1.66% and 1.68% at March 31, 2004 and September 30, 2003, respectively.

The following table presents an analysis of our nonperforming assets:

	At March 31, 2004 ----	At September 30, 2003 ----
Nonperforming loans:		
Nonaccrual loans	\$ 3,951	\$ 4,153
Loans 90 days past due and accruing	--	--
Restructured loans	--	--
	-----	-----
Total nonperforming loans	3,951	4,153
Other real estate	513	95
	-----	-----
Total nonperforming assets	\$ 4,464 =====	\$ 4,248 =====
Nonperforming loans to loans receivable, net	1.71%	1.84%
Nonperforming assets as a percentage of loans and other real estate owned	1.93%	1.88%
Nonperforming assets to total assets	1.23%	1.17%

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Regulations require that we classify our assets on a regular basis. There are three classifications for problem assets: substandard, doubtful and loss. We regularly review our assets to determine whether any assets require classification or re-classification. At March 31, 2004, we had \$5.0 million in classified assets consisting of \$4.5 million in substandard loans, \$24,000 in loss loans and \$513,000 in real estate owned. At September 30, 2003, we had \$4.9 million in substandard assets consisting of \$4.8 million in loans and \$95,000 in real estate owned. At March 31, 2003, we had \$5.0 million in substandard and loss loans and \$177,000 in real estate owned.

In addition to regulatory classifications, we also classify as "special mention" and "watch" assets that are currently performing in accordance with their contractual terms but may become classified or nonperforming assets in the future. At March 31, 2004, we have identified approximately \$5.3 million in

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assets classified as special mention and \$29.3 million as watch. At March 31, 2003, we had identified approximately \$1.1 million in assets classified as special mention and \$30.7 million as watch.

Included in the total of special mention assets are five loans with an aggregate outstanding balance of \$4.4 million at March 31, 2004 to a company affiliated with one of our directors. At December 31, 2003, these loans had been classified as watch. In addition, the director has the ability to borrow an additional \$35,956 from us under a line of credit. At September 30, 2003, the aggregate outstanding balance was \$4.5 million with additional availability of \$172,000. All the loans are secured by a first lien on all assets, including accounts receivable, inventory, equipment, furniture and real property occupied by the borrower. In addition, the director and his spouse have personally guaranteed repayment of the loans. At March 31, 2004, such loans were current with respect to their payment terms and, except for the waiver of certain debt covenants by the Bank, were performing in accordance with the related loan agreements. Based on an analysis of the borrower's current financial statements received in April 2004, management has concerns that the borrower may have difficulty in complying with the present loan repayment terms on an ongoing basis. Accordingly, this loan may become an impaired loan in future periods. Management will continue to closely monitor the performance of these loans in future periods.

### LIQUIDITY AND CAPITAL RESOURCES

The Bank must meet certain liquidity requirements established by the State of North Carolina Office of the Commissioner of Banks (the "Commissioner"). At March 31, 2004, the Bank's liquidity ratio exceeded such requirements. Liquidity generally refers to the Bank's ability to generate adequate amounts of funds to meet its cash needs. Adequate liquidity guarantees that sufficient funds are available to meet deposit withdrawals, fund loan commitments, maintain adequate reserve requirements, pay operating expenses, provide funds for debt service, pay dividends to stockholders and meet other general commitments.

Our primary sources of funds are deposits, principal and interest payments on loans, proceeds from the sale of loans, and to a lesser extent, advances from the FHLB of Atlanta. While maturities and scheduled amortization of loans are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and local competition.

Our most liquid assets are cash and cash equivalents. The levels of these assets are dependent on our operating, financing, lending and investing activities during any given period. At March 31, 2004, cash and cash equivalents totaled \$8.4 million. We have other sources of liquidity should we need additional funds. During the three and six months ended March 31, 2004, we sold loans totaling \$6.7 million and \$12.9 million, respectively. Additional sources of funds include FHLB of Atlanta advances. Other sources of liquidity include loans and investment securities designated as available for sale, which totaled \$86.6 million at March 31, 2004.

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We anticipate that we will have sufficient funds available to meet our current commitments. At March 31, 2004, we had \$1.2 million in commitments to originate new loans, \$56.5 million in unfunded commitments to extend credit under existing equity lines and commercial lines of credit and \$1.7 million in standby letters of credit. At March 31, 2004, certificates of deposit, which are scheduled to mature within one year, totaled \$126.8 million. We believe that a significant portion of such deposits will remain with us.

The Federal Deposit Insurance Corporation ("FDIC") requires the Bank to

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meet a minimum leverage capital requirement of Tier I capital to assets ratio of 4%. The FDIC also requires the Bank to meet a ratio of total capital to risk-weighted assets of 8%, of which 4% must be in the form of Tier I capital. The Commissioner requires the Bank at all times to maintain certain minimum capital levels. The Bank was in compliance with all capital requirements of the FDIC and the Commissioner at March 31, 2004 and is deemed to be "well capitalized."

The Federal Reserve also mandates capital requirements on all bank holding companies, including 1st State Bancorp, Inc. These capital requirements are similar to those imposed by the FDIC on the Bank. At March 31, 2004, the Company was in compliance with the capital requirements of the Federal Reserve.

On October 2, 2000, the Company paid a one-time special cash distribution of \$5.17 per share to its stockholders. The distribution was made to manage the Company's capital and enhance shareholder value. Returning capital to the stockholders reduced the Company's equity to asset ratio from 21.2% to 17.2%. The Company's equity to asset ratio at March 31, 2004 was 17.7%. The Company's capital level is sufficient to support future growth.

The Company has declared cash dividends per common share of \$0.10 for each of the three months ended March 31, 2004, September 30, 2003 and March 31, 2003. The Company's ability to pay dividends is dependent upon earnings. The Company's dividend payout ratio for the three months ended March 31, 2004, September 30, 2003 and March 31, 2003 was 38.5%, 31.2% and 29.4%, respectively.

### ACCOUNTING MATTERS

In March 2004, the SEC released Staff Accounting Bulletin No. 105 - Application of Accounting Principles to Loan Commitments. This bulletin requires all registrants to begin accounting for their issued loan commitments (including interest rate lock commitments) subject to Statement 133 as written options. Treatment as a written option would require those loan commitments to be reported as liabilities until either they are exercised (and a loan is made) or they expire unexercised. Staff Accounting Bulletin No. 105 must be applied to loan commitments that are issued after March 31, 2004. The adoption of Staff Accounting Bulletin No. 105 is not expected to have a material impact on the consolidated financial statements.

In January 2003, FASB Interpretation No. 46, "Consolidation of Variable Interest Entities, an interpretation of ARB No. 51", (Interpretation 46) was issued. Interpretation 46 addresses the consolidation by business enterprises of variable interest entities as defined in the Interpretation. Interpretation 46 applies immediately to variable interests in variable interest entities created after January 31, 2003, and to variable interests in variable interest entities obtained after January 31, 2003. In December 2003, the FASB issued FASB Interpretation No. 46 (revised December 2003), "Consolidation of Variable Interest Entities", which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN 46R replaces FASB Interpretation No. 46, "Consolidation of Variable Interest Entities", which was issued in January 2003. The Company will be required to apply FIN 46R to variable interests in VIEs created after December 31, 2003. The application of this revised interpretation is not expected to have a material effect on the consolidated financial statements.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the possible chance of loss from unfavorable changes in market prices and rates. These changes may result in a reduction of current and future period net interest income, which is the favorable spread earned from the excess of interest income on interest-earning assets over interest expense on



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interest-bearing liabilities.

The Company considers interest rate risk to be its most significant market risk, which could potentially have the greatest impact on operating earnings. The structure of the Company's loan and deposit portfolios is such that a significant decline in interest rates may adversely impact net market values and net interest income.

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The Company monitors whether material changes in market risk have occurred since September 30, 2003. The Company does not believe that any material adverse changes in market risk exposures have occurred since September 30, 2003.

### ITEM 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, management of the Company carried out an evaluation, under the supervision and with the participation of the Company's principal executive officer and principal financial officer, of the effectiveness of the Company's disclosure controls and procedures. Based on this evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. It should be noted that the design of the Company's disclosure controls and procedures is based in part upon certain reasonable assumptions about the likelihood of future events, and there can be no reasonable assurance that any design of disclosure controls and procedures will succeed in achieving its stated goals under all potential future conditions, regardless of how remote, but the Company's principal executive and financial officers have concluded that the Company's disclosure controls and procedures are, in fact, effective at a reasonable assurance level.

In addition, there have been no changes in the Company's internal control over financial reporting identified in connection with the evaluation described in the above paragraph that occurred during the Company's last fiscal quarter, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

From time to time, we are a party to various legal proceedings incident to our business. There currently are no legal proceedings to which we are a party, or to which any of our property was subject, except as described in the following paragraph, and none which are expected to result in a material loss. There are no pending regulatory proceedings to which we are a party or to which any of our properties is subject which are expected to result in a material loss.

A civil action was filed against 1st State Bank and Brokers, Incorporated by Michael Locklar in Davidson County Superior Court, in the State of North Carolina on May 16, 2003. Mr. Locklar has alleged in the action that 1st State Bank granted him an option to purchase certain real property located in Davidson County, North Carolina, which 1st State Bank wrongfully sold to Brokers,

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Incorporated for \$150,000 in breach of the option granted to Mr. Locklar. Mr. Locklar is seeking to set aside the conveyance of property to Brokers, Incorporated and to purchase the property from 1st State Bank for the option price. Brokers, Incorporated has filed a cross-claim against 1st State Bank seeking indemnification in the form of return of the purchase price they paid for the property, damages and attorneys fees should Locklar be successful in setting aside the real estate conveyance. 1st State Bank intends to vigorously contest Mr. Locklar's allegations.

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

- (a) Not applicable
- (b) Not applicable
- (c) Not applicable
- (d) Not applicable
- (e) The following table sets forth information regarding the Company's repurchases of its Common Stock during the quarter ended March 31, 2004.

PERIOD -----	(a) TOTAL NUMBER OF SHARES PURCHASED -----	(b) AVERAGE PRICE PAID PER SHARE -----	(c) TOTAL NUMBER OF SHARES PURCHASED AS PART OF PUBLICLY ANNOUNCED PLANS OR PROGRAMS -----
January 2004 Beginning date: January 29 Ending date: January 30	688	\$29.38	688
February 2004 Beginning date: February 3 Ending date: February 23	4,950	\$29.41	4,950
Total	5,638	\$29.40	5,638

(1) On August 20, 2002, the Company announced a 10% stock repurchase program to acquire up to 328,961 shares of the Company's common stock over a period of 18 months. These share purchases complete this repurchase program.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Company's Annual Meeting of Stockholders was held on February 3, 2004. At this meeting, 2,971,285 shares of the Company's common stock

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were represented in person or by proxy.

Stockholders voted in favor of the election of three nominees for director. The voting results for each nominee were as follows:

NOMINEE -----	VOTES IN FAVOR OF ELECTION -----	VOTES WITHHELD -----
James A. Barnwell, Jr.	2,595,101	2,405
James G. McClure	2,596,201	1,305
T. Scott Quakenbush	2,595,019	2,379

There were no broker nonvotes on the matter.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) EXHIBITS.  
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3.2 Bylaws, as amended of 1st State Bancorp, Inc.

31.1 Rule 13a-14(a) Certification of Chief Executive Officer

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31.2 Rule 13a-14(a) Certification of Chief Financial Officer

32 Section 1350 Certification

(b) REPORTS ON FORM 8-K.  
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The Registrant filed the following Current Reports on Form 8-K during the quarter ended March 31, 2004:

DATE OF REPORT -----	ITEM(S) REPORTED -----	FINANCIAL STATEMENTS FILED -----
January 28, 2004	7, 12	N/A
February 25, 2004	5	N/A

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### SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

1st STATE BANCORP, INC.

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Date: May 13, 2004

/s/ James C. McGill

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James C. McGill  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: May 13, 2004

/s/ A. Christine Baker

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A. Christine Baker  
Executive Vice President  
Treasurer and Secretary  
(Principal Financial and Accounting Officer)