SOUTHERN FIRST BANCSHARES INC
Form 10-Q
November 14, 2008

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

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2008

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 000-27719

Southern First Bancshares, Inc.

(Exact name of registrant as specified in its charter)

South Carolina	58-2459561
(State or other jurisdiction of incorporation)	(I.R.S. Employer Identification No.)
100 Verdae Boulevard, Suite 100 Greenville, S.C.	29606
(Address of principal executive offices)	(Zip Code)

864-679-9000
(Registrant s telephone number, including area code)

Not Applicable
(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 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 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 [ ]	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]

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date:
3,044,863 shares of common stock, $.01 par value per share, were issued and outstanding as of November 10,, 2008.

SOUTHERN FIRST BANCSHARES, INC.
PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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

SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)

	September 30, 2008	December 31, 2007
	(Unaudited)	(Audited)
Assets		
Cash and due from banks	$ 9,189	$ 7,714
Federal funds sold	12,003	9,257
Investment securities available for sale	68,703	64,010
Investment securities held to maturity-		
(fair value $12,635 and $14,573)	12,854	14,819
Other investments, at cost	8,461	8,678
Loans, net	554,782	503,098
Property and equipment, net	9,921	5,391
Accrued interest receivable	2,931	3,324
Other real estate owned	2,061	268
Bank owned life insurance	11,719	8,907
Deferred income taxes	3,321	2,003
Other assets	621	660
Total assets	$ 696,566	$ 628,129

Liabilities		
Deposits	$ 477,828	$ 412,821
Official checks outstanding	3,159	819
Federal Home Loan Bank advances and related debt	161,700	158,520
Junior subordinated debentures	13,403	13,403
Accrued interest payable	2,064	2,739
Accounts payable and accrued expenses	763	1,549
Total liabilities	658,917	589,851
Shareholders equity		
Preferred stock, par value $.01 per share, 10,000,000 shares authorized, no shares issued	-	-
Common stock, par value $.01 per share 10,000,000 shares authorized, 3,016,118 and 2,946,456 issued and outstanding at September 30, 2008 and December 31, 2007, respectively	30	29
Nonvested restricted stock	(30)	(41)
Additional paid-in capital	31,504	31,034
Accumulated other comprehensive income (loss)	(2,497)	96
Retained earnings	8,642	7,160
Total shareholders equity	37,649	38,278
Total liabilities and shareholders equity	$ 696,566	$ 628,129

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

SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME

(Dollars in thousands, except share data)

	For the three months ended September 30,		For the nine months ended September 30,	
	2008	**2007**	**2008**	**2007**
	(Unaudited)			
Interest income				
Loans	$ 8,720	$ 9,096	$ 26,630	$ 25,315
Investment securities	1,282	1,107	3,837	3,228
Federal funds sold	57	77	238	441
Total interest income	10,059	10,280	30,705	28,984

Interest expense				
Deposits	3,531	4,015	11,495	11,533
Borrowings	1,685	1,842	5,195	5,094
Total interest expense	5,216	5,857	16,690	16,627
Net interest income	4,843	4,423	14,015	12,357
Provision for loan losses	650	450	1,950	1,290
Net interest income after provision for loan losses	4,193	3,973	12,065	11,067
Noninterest income				
Loan fee income	38	45	126	121
Service fees on deposit accounts	177	111	468	293
Income from bank owned life insurance	114	96	312	278
Gain on sale of securities	7	-	7	-
Other than temporary impairment on investment securities	(1,841)	-	(1,841)	-
Real estate owned activity	(7)	(70)	(58)	109
Other income	85	65	245	188
Total noninterest income (loss)	(1,427)	247	(741)	989
Noninterest expenses				
Compensation and benefits	1,625	1,547	5,149	4,479
Professional fees	127	131	368	416
Marketing	154	139	450	387
Insurance	141	116	413	328
Occupancy	437	337	1,134	1,081
Data processing and related costs	347	310	1,012	865
Telephone	50	29	126	97
Other	159	176	560	459
Total noninterest expenses	3,040	2,785	9,212	8,112
Income (loss) before income tax expense	(274)	1,435	2,112	3,944
Income tax expense (benefit)	(148)	478	630	1,278
Net income (loss)	$ (126)	$ 957	$ 1,482	$ 2,666
Earnings (loss) per common share				
Basic	$ (0.04)	$ .32	$ .50	$ .91
Diluted	$ (0.04)	$ .30	$ .47	$ .82
Weighted average common shares outstanding				
Basic	3,002,205	2,946,456	2,984,947	2,941,007
Diluted	3,002,205	3,235,959	3,175,274	3,241,437

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

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SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY
AND COMPREHENSIVE INCOME
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2008 AND 2007

(Dollars in thousands, except share data)

(Unaudited)

	Common stock Shares	Amount	Nonvested restricted stock	Additional paid-in capital	Accumulated other comprehensive income(loss)	Retained Earnings	Total share-holders equity
December 31, 2006	2,933,868	$ 29	$ -	$ 30,846	$ (16)	$ 3,724	$ 34,583
Net income	-	-	-	-	-	2,666	2,666
Comprehensive income, net of tax - Unrealized holding loss on securities available for sale	-	-	-	-	(239)	-	(239)
Comprehensive income	-	-	-	-	-	-	2,427
Proceeds from exercise of stock options and warrants	10,088	-	-	63	-	-	63
Issuance of restricted stock	2,500	-	(54)	54	-	-	-
Amortization of deferred compensation on restricted stock	-	-	10	-	-	-	10
Compensation expense related to stock options	-	-	-	9	-	-	9
September 30, 2007	**2,946,456**	**$ 29**	**$ (44)**	**$ 30,972**	**$ (255)**	**$ 6,390**	**$ 37,092**
December 31, 2007	2,946,456	$ 29	$ (41)	$ 31,034	$ 96	$ 7,160	$ 38,278
Net income	-	-	-	-	-	1,482	1,482
Comprehensive income, net of tax -							

Unrealized holding loss on securities available for sale	-	-	-	-	(2,593)	-	(2,593)
Comprehensive income (loss)	-	-	-	-	-	-	(1,111)
Proceeds from exercise of stock options and warrants	69,662	1	-	428	-	-	429
Amortization of deferred compensation on restricted stock	-	-	11	-	-	-	11
Compensation expense related to stock options	-	-	-	42	-	-	42
September 30, 2008	**3,016,118**	**$ 30**	**$ (30)**	**$ 31,504**	**$ (2,497)**	**$ 8,642**	**$ 37,649**

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

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SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

	For the nine months ended September 30,	
	2008	**2007**
	(Unaudited)	
Operating activities		
Net income	$ 1,482	$ 2,666
Adjustments to reconcile net income to cash provided by (used for) operating activities:		
Provision for loan losses	1,950	1,290
Depreciation and other amortization	389	361
Accretion and amortization of securities discounts and premium, net	111	63
Loss on sale of real estate	67	181
Gain on sale of property held for sale	-	(319)
Gain on sale of investment securities	(7)	-
Other than temporary impairment on investment securities	1,841	-
Compensation expense related to stock options	53	18

Increase in cash surrender value of bank owned life insurance	(312)	(278)
Decrease in deferred tax asset	17	26
Decrease in other assets, net	430	121
Increase (decrease) in other liabilities, net	880	(2,141)
Net cash provided by operating activities	6,901	1,988
Investing activities		
Increase (decrease) in cash realized from:		
Origination of loans, net	(55,541)	(82,306)
Purchase of property and equipment	(4,918)	(1,055)
Purchase of investment securities:		
Available for sale	(27,666)	(21,083)
Other investments	(909)	(2,042)
Payments and maturity of investment securities:		
Available for sale	17,130	5,706
Held to maturity	1,936	1,816
Other investments	1,125	810
Purchase of bank owned life insurance	(2,500)	(390)
Proceeds from sale of property held for sale	-	2,355
Proceeds from sale of real estate acquired in settlement of loans	47	467
Net cash used for investing activities	(71,296)	(95,722)
Financing activities		
Increase (decrease) in cash realized from:		
Increase in deposits, net	65,007	69,560
Increase in short-term borrowings	-	10,000
Proceeds from the exercise of stock options and warrants	429	63
Increase in Federal Home Loan Bank advances and related debt	3,180	25,000
Net cash provided by financing activities	68,616	104,623
Net increase in cash and cash equivalents	4,221	10,889
Cash and cash equivalents at beginning of the period	16,971	16,579
Cash and cash equivalents at end of the period	$ 21,192	$ 27,468
Supplemental information		
Cash paid for		
Interest	$ 17,366	$ 16,307
Income taxes	$ 1,317	$ 1,252
Schedule of non-cash transactions		
Transfer of property and equipment to property held for sale	$ -	$ 2,035
Foreclosure of real estate	$ 1,907	$ -

Unrealized loss on securities, net of income taxes	$ (2,593)	$ (239)

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

SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Nature of Business and Basis of Presentation

Business activity

Southern First Bancshares, Inc., (the Company) is a South Carolina corporation that owns all of the capital stock of Southern First Bank, N.A. (the Bank) and all of the stock of Greenville First Statutory Trust I and II (collectively (the Trusts)). On July 2, 2007, the Company and Bank changed their names to Southern First Bancshares, Inc. and Southern First Bank, N.A., respectively. The Bank is a national bank organized under the laws of the United States located in Greenville County, South Carolina. The Bank is primarily engaged in the business of accepting demand deposits and savings deposits insured by the Federal Deposit Insurance Corporation, and providing commercial, consumer and mortgage loans to the general public. The Trusts are special purpose subsidiaries organized for the sole purpose of issuing trust preferred securities.

Basis of Presentation

The accompanying financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three-month and nine-month periods ended September 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008. For further information, refer to the consolidated financial statements and footnotes thereto included in the company s Form 10-K for the year ended December 31, 2007 (Registration Number 000-27719) as filed with the Securities and Exchange Commission. The consolidated financial statements include the accounts of Southern First Bancshares, Inc., and its wholly owned subsidiary Southern First Bank, N.A. In accordance with Financial Accounting Standards Board (FASB) Interpretation No. 46, the financial statements related to the special purpose subsidiaries, Greenville First Statutory Trust I and Trust II, have not been consolidated.

Cash and Cash Equivalents

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

Note 2 Other than Temporary Impairment on Investment Securities

During the three months ended September 30, 2008, we recorded an impairment charge of $1.8 million, pre-tax, on our Federal National Mortgage Association (FNMA) preferred stock, which was determined to have suffered an other-than-temporary impairment as a result of the Government s decision on September 7, 2008 to place the FNMA and Federal Home Loan Mortgage Corporation (FHLMC) under conservatorship.

As a result of the passage of the Emergency Economic Stabilization Act of 2008, the Bank s ability to utilize the loss on the FNMA preferred stock against ordinary income was considered in determining that the company did not need to establish a valuation for the the deferred tax asset that was recorded related to the $1.8 million impairment charge.

Note 3 Property Held for Sale

In February 2007, we decided to actively market the sale of our former main office and corporate headquarters building. Accordingly, we reclassified the building from property and equipment to property held for sale, in accordance with Statement of Financial Accounting Standards (SFAS) No. 144 Accounting for the Impairment and Disposal of Long-Lived Assets, and ceased depreciation of the building. In March 2007 we received a sales contract on the building. Based on the sales contract, adjusted for estimated commissions and other selling costs, we recorded a $375,000 gain in the carrying value of the building at the end of the first quarter of 2007. The $375,000 gain was partially offset by other unrelated real estate operating expenses of $46,407. The net gain on real estate operations recorded in the three months ended March 31, 2007 was $328,593.

On April 13, 2007, we completed the sale of the former main office building. Based on the higher carrying value established at March 31, 2007, we incurred a loss of approximately $55,000 on the sale which was recorded in the second quarter of 2007.

Note 4 Earnings per Share

The following schedule reconciles the numerators and denominators of the basic and diluted earnings per share computations for the three and nine months ended September 30, 2008 and 2007. Dilutive common shares arise from the potentially dilutive effect of the company s stock options and warrants that are outstanding. The assumed conversion of stock options and warrants can create a difference between basic and dilutive net income per common share.

At September 30, 2008 and 2007, 59,750 and 13,000 options, respectively, were anti-dilutive in the calculation of earnings per share as their exercise price exceeded the fair market value (dollars in thousands, except share data).

	Three months ended September 30,	
	2008	**2007**
Basic Earnings Per Share		
Average common shares	3,002,205	2,946,456
Net income (loss)	$ (126)	$ 957
Earnings (loss) per share	$ (0.04)	$ 0.32
Diluted Earnings Per Share		
Average common shares	3,002,205	2,946,456
Average dilutive common shares	-	289,503
Adjusted average common shares	3,002,205	3,235,959
Net income (loss)	$ (126)	$ 957
Earnings (loss) per share	$ (0.04)	$ 0.30

	Nine months ended September 30,	
	2008	**2007**
Basic Earnings Per Share		
Average common shares	2,984,947	2,941,007
Net income	$ 1,482	$ 2,666
Earnings per share	$ 0.50	$ 0.91
Diluted Earnings Per Share		
Average common shares	2,984,947	2,941,007
Average dilutive common shares	190,327	300,430
Adjusted average common shares	3,175,274	3,241,437
Net income	$ 1,482	$ 2,666
Earnings per share	$ 0.47	$ 0.82

Note 5 Stock Based Compensation

The company has a stock-based employee compensation plan. On January 1, 2006, the company adopted the fair value recognition provisions of SFAS No. 123(R), Accounting for Stock-Based Compensation, to account for compensation costs under its stock option plan.

In adopting SFAS No. 123(R), the company elected to use the modified prospective method to account for the transition from the intrinsic value method to the fair value recognition method. Under the modified prospective method, compensation cost is recognized from the adoption date forward for all new stock options granted and for any outstanding unvested awards as if the fair value method had been applied to those awards as of the date of grant.

The fair value of the option grant is estimated on the date of grant using the Black-Scholes option-pricing model. The following assumptions were used for grants: expected volatility of 10.00% for 2008 and 2007, risk-free interest rate of 4.60% for 2008 and 2007, expected lives of the options 10 years, and the assumed dividend rate was zero.

Note 6 Fair Value Measurement

Effective January 1, 2008, the Company adopted SFAS No. 157, Fair Value Measurements which provides a framework for measuring and disclosing fair value under generally accepted accounting principles. SFAS No. 157 requires disclosures about the fair value of assets and liabilities recognized in the balance sheet in periods subsequent to initial recognition, whether the measurements are made on a recurring or on a nonrecurring basis.

SFAS No. 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS No. 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1

Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include certain debt and equity securities and derivative contracts that are traded in an active exchange market.

Level 2

Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include fixed income securities and mortgage-backed securities that are held in the Company s available-for-sale portfolio, certain derivative contracts and impaired loans.

Level 3

Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. These methodologies may result in a significant portion of the fair value being derived from unobservable data.

Assets measured at fair value on a recurring basis as of September 30, 2008 are as follows:

	Quoted market price in active markets (Level 1) (Dollars in thousands)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Investment securities available for sale	$ 174	$ 63,830	$ 4,698
Other investments	-	-	8,461
Total	$ 174	$ 63,830	$ 13,159

The Company has no liabilities carried at fair value or measured at fair value on a recurring or nonrecurring basis.

The Company is predominantly an asset based lender with real estate serving as collateral on approximately 79% of loans. Loans which are deemed to be impaired are valued on a nonrecurring basis at the lower of cost or market value of the underlying real estate collateral. Such market values are generally obtained using independent appraisals, which the Company considers to be level 2 inputs. The aggregate carrying amount, net of specific reserves, of impaired loans at September 30, 2008 was $3.4 million.

FASB Staff Position No. 157-2 delays the implementation of SFAS No. 157 until the first quarter of 2009 with respect to goodwill, other intangible assets, real estate and other assets acquired through foreclosure and other non-financial assets measured at fair value on a nonrecurring basis.

The table below presents a reconciliation for the period of January 1, 2008 to September 30, 2008, for all Level 3 assets that are measured at fair value on a recurring basis.

	Investment securities available for sale (Dollars in thousands)		Other investments	
Beginning balance	$	8,244	$	8,678
Total realized and unrealized gains or losses:				
Included in earnings	-		-	
Included in other comprehensive income	(2,928)		-	
Purchases and sales	-		(217)	
Principal reductions	(618)		-	
Transfers in and/or out of Level 3	-		-	
Ending Balance	$	4,698	$	8,461

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.

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

DISCUSSION OF FORWARD-LOOKING STATEMENTS

This report contains statements which constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements are based on many assumptions and estimates and are not guarantees of future performance. Our actual results may differ materially from those anticipated in any forward-looking statements, as they will depend on many factors about which we are unsure, including many factors which are beyond our control. The words may, would, could, will, expect, anticipate, believe, intend, plan, and estimate, as well as similar expressions, are meant to identify such forward-looking statements. Potential risks and uncertainties that could cause our actual results to differ from those anticipated in any forward-looking statements include, but are not limited to, those described in our Form 10-K for the year ended December 31, 2007 under Item 1A- Risk Factors and the following:

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

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

changes in political conditions or the legislative or regulatory environment;

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

changes occurring in business conditions and inflation;

changes in technology;

changes in deposit flows,

changes in monetary and tax policies;

the level of allowance for loan loss;

the rate of delinquencies and amounts of charge-offs;

the rates of loan growth and the lack of seasoning of our loan portfolio;

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

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

changes in the securities markets; and

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

These risks are exacerbated by the recent developments in national and international financial markets, and we are unable to predict what effect these uncertain market conditions will have on our company. During 2008, the capital and credit markets have experienced extended volatility and disruption. In the last 90 days, the volatility and disruption have reached unprecedented levels. There can be no assurance that these unprecedented recent developments will not materially and adversely affect our business, financial condition and results of operations.

We undertake no obligation to publicly update or otherwise revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

Overview

We were incorporated in March 1999 to organize and serve as the holding company for Greenville First Bank, N.A. On July 2, 2007, we changed our name to Southern First Bancshares, Inc. and the bank s name to Southern First Bank, N.A., although we will continue to operate as Greenville First Bank in Greenville County. Our primary reason for the name change was related to our expansion into the Columbia, South Carolina market. Since we opened our bank in January 2000, we have experienced consistent growth in total assets, loans and deposits which has continued during the first nine months of 2008.

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

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

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

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

In response to financial conditions affecting the banking system and financial markets and the potential threats to the solvency of investment banks and other financial institutions, the United States government has taken unprecedented actions. On October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act of 2008 (the EESA). Pursuant to the EESA, the U.S. Treasury will have the authority to, among other things, purchase mortgages, mortgage-backed securities, and other financial instruments from financial institutions for the purpose of stabilizing and providing liquidity to the U.S. financial markets. On October 14, 2008, the U.S. Department of Treasury announced the Capital Purchase Program under the EESA, pursuant to which the Treasury intends to make senior preferred stock investments in participating financial institutions. We are evaluating whether to participate in the Capital Purchase Program. Regardless of our participation, governmental intervention and new regulations under these programs could materially and adversely affect our business, financial condition and results of operations.

Critical Accounting Policies

We have adopted various accounting policies that govern the application of accounting principles generally accepted in the United States and with general practices within the banking industry in the preparation of our financial statements. Our significant accounting policies are described in the footnotes to our audited consolidated financial statements as of December 31, 2007, as filed in our annual report on Form 10-K.

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

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

Effect of Economic Trends

Following an economic decline and historically low interest rates that ended in the first six months of 2004, the Federal Reserve began increasing short-term rates as the economy showed signs of strengthening. Between July 2004 and July 2006, the Federal Reserve increased rates at 17 of their meetings for a total of 425 basis points. Between July 2006 and September 18, 2007, the Federal Reserve allowed short-term rates to remain unchanged. Beginning in July 2004 and continuing until September 18, 2007, our rates on both short-term or variable rate interest-earning assets and interest-bearing liabilities increased. The momentum of the 17 rate increases resulted in higher rates on interest-earning assets and higher interest-bearing liabilities during the first nine months of 2007; subsequently, as fixed rate loans, deposits, and borrowings matured during this period they repriced at higher interest rates. In late September 2007, the Federal Reserve reversed their position and lowered the short-term rates initially by 50 basis points and by an additional 50 basis points in the fourth quarter of 2007. The Federal Reserve has continued to aggressively decrease rates by lowering the short-term rate 225 basis points in the first nine months of 2008 which has caused the rates on our short-term or variable rate assets and liabilities to decline in 2008. In addition, the Federal Reserve has decreased rates an additional 100 basis points in October 2008. The following discussion includes our analysis of the effect that we anticipate changes in interest rates will have on our financial condition. However, we can give no assurances as to the future actions of the Federal Reserve or to the anticipated results that will actually occur.

Results of Operations

Income Statement Review

Summary

Three months ended September30, 2008 and 2007

For the three months ended September 30, 2008, we incurred a net loss of $126,000 compared to net income of $957,000 for the three months ended September 30, 2007, a decrease of $1.1million, or 113.3%. The $1.1 million decrease in net income resulted primarily from an impairment charge of $1.2 million, net of taxes, related to our FNMA preferred stock, as well as increases of $255,000 in noninterest expenses and $200,000 in the provision for loan losses, partially offset by increases of $420,000 in net interest income and $166,000 in noninterest income, excluding the impairment charge.

Excluding the impairment charge, our earnings were $1.1 million for the third quarter 2008, a $115,000, or 12.0% increase from the same period in 2007. Our efficiency ratio improved to 57.8% for the three months ended September 30, 2008 from 58.8% for the same period in 2007. The lower efficiency ratio is due primarily to our having established a presence in the Columbia market and expansion costs related to the Columbia office that are being absorbed as the office increases loan and deposit production. Our efficiency ratio is computed by dividing noninterst expense by the sum of net interest income, excluding the gain on sale and impairment charge on securities and real estate activity, and noninterest income.

Nine months ended September 30, 2008 and 2007

Our net income was $1.5 million and $2.7 million for the nine months ended September 30, 2008 and 2007, respectively, a decrease of $1.2 million, or 44.4%. The decrease in net income resulted primarily from an impairment charge of $1.2 million, net of taxes, related to our FNMA preferred stock, as well as increases of $1.1 million in noninterest expenses and $660,000 in the provision for loan losses, partially offset by increases of $1.7 million in net interest income and $110,000 in noninterest income, excluding the impairment charge.

Excluding the impairment charge, our earnings for the nine month period ended September 30, 2008 were virtually unchanged from the same period in 2007 at $2.7 million. Our efficiency ratio improved to 60.8% for the nine months ended September 30, 2008 from 61.3% for the same period in 2007. The lower efficiency ratio is due primarily to our having established a presence in the Columbia market and expansion costs related to the Columbia office that are being absorbed as the office increases loan and deposit production. Our efficiency ratio is computed by dividing noninterest expense by the sum of net interest income, excluding the gain on sale and impairment charge on securities and real estate activity, and noninterest income.

Net Interest Income

Our level of net interest income is determined by the level of earning assets and the management of our net interest margin. The continuous growth in our loan portfolio is the primary driver of the increase in net interest income. During the nine months ended September 30, 2008, our average loan portfolio increased $96.8 million compared to the average for the nine months ended September 30, 2007. The actual growth in the first nine months of 2008 was $52.4 million. We anticipate that growth in loans will continue to drive growth in assets and subsequently, growth in net interest income. However, we expect to incur lower levels of growth during the remainder of 2008. In an effort to maximize our utilization of capital, we anticipate managing the level of loan growth to ensure the bank remains well-capitalized.

Our past decision to grow the loan portfolio created the need for a higher level of capital and the need to increase deposits and borrowings. This loan growth strategy also resulted in a significant portion of our assets being in higher earning loans rather than in lower yielding investments. At September 30, 2008, net loans represented 79.6% of total assets while investments and federal funds sold represented 14.6% of total assets. However, as described below, we have also increased our level of deposits significantly.

The historically low interest rate environment that was experienced between January of 2000 and July of 2004 allowed us to obtain short-term borrowings and wholesale certificates of deposit at rates that were lower than certificate of deposit rates being offered in our local market. Therefore, we decided not to begin our retail deposit office expansion program until the beginning of 2005. This funding strategy allowed us to continue to operate in one location until 2005, maintain a smaller staff, and not incur marketing costs to advertise deposit rates, which in turn allowed us to focus on the fast growing loan portfolio.

We opened two retail deposit offices in 2005 and two additional offices in July of 2008. We also converted our Columbia loan production office into a full service branch facility during the third quarter of 2007. We now have four retail offices in the Greenville market and two retail offices in the Columbia market. Our focus for these locations is to obtain low cost transaction accounts, resulting in an increase in both the percentage of assets being funded by in market retail deposits as well as the percentage of low-cost transaction accounts to total deposits. We believe that this growth strategy will provide additional clients in our two market areas and will eventually provide a lower alternative cost of funding. At September 30, 2008, retail deposits represented $285.2 million, or 40.9% of total assets, borrowings represented $175.1 million, or 25.1% of total assets, and wholesale out-of-market deposits represented $192.6 million, or 27.7% of total assets.

Our net interest income margin for the nine months ended September 30, 2008 exceeded our net interest spread because we had more interest-earning assets than interest-bearing liabilities. Average interest-earning assets exceeded average interest-bearing liabilities by $51.2 million and $48.7 million for the nine months ended September 30, 2008 and 2007, respectively.

In addition to the growth in both assets and liabilities, and the ratio of interest-earning assets to interest-bearing liabilities, net interest income is also affected by the timing of the repricing of our assets and liabilities and the changes in interest rates earned on our assets and interest rates paid on our liabilities. Until September 18, 2007, our yields on interest earning assets and the rates that we paid for our deposits and borrowings continued to increase primarily as a result of the actions taken by the Federal Reserve to raise short-term rates prior to July 30, 2006. Our fixed rate loans were being originated or renewed at higher rates, while the rates on new or maturing interest-bearing liabilities were also higher than in the past. Given the fact that the Federal Reserve increased short-term rates by 425 basis points between July 2004 and July 2006 and allowed rates to remain unchanged until September 18, 2007, we believed during most of 2006 and the first nine months of 2007 that short-term interest rates were at or near their peak. Therefore, we chose to increase the amount of fixed rate loans in our loan portfolio, and we targeted to have a significant portion of our liabilities to reprice within a twelve month period. On September 18, 2007, the Federal Reserve began to decrease short-term rates with an initial 50 basis point reduction and continued the decrease with an additional 275 basis points through the end of 2007 and the first nine months of 2008. While the bank had more liabilities than assets that repriced down during the nine months ended September 30, 2008 due to the competition for deposits and the overall low market rates, we were not able to lower the rates on our liabilities in proportion to the reduction in rates experienced on our assets. With the recent 100 basis point reduction in short-term rates in October 2008, we anticipate that our net interest margin will decline during the next three months as many of our interest-earning assets and interest-bearing liabilities reprice to lower rates.

As more fully discussed in the Market Risk and Liquidity and Interest Rate Sensitivity sections below, at September 30, 2008, approximately 58% of our loans had fixed rates. For the past two years, we have placed more emphasis on fixed rate loans; however, we have recently changed our focus to increasing the amount of variable rate loans in our portfolio. Our fixed rate loans as a percentage of total loans decreased from 60% at September 30, 2007 to 58% at September 30, 2008. While increasing our percentage of fixed rate loans during the past three years, our focus has been to obtain short-term liabilities to fund our asset growth. This strategy has resulted in our ability to move from being asset sensitive to being liability sensitive for the next twelve months.

At September 30, 2008, 76.0% of our interest-bearing liabilities were either variable rate or had a maturity of less than one year. Of the $286.8 million of interest-bearing liabilities set to reprice within three months, 44.3% or $127.1 million are transaction, money market or savings accounts which are already at or near their lowest rates and provide little opportunity for benefit should market rates continue to decline or stay constant. However, certificates of deposit that are currently maturing or renewing are repricing at low rates. We expect to benefit, even if market rates increase slightly as these deposits reprice. At September 30, 2008, we had $148.8 million more liabilities than assets that reprice within the next twelve months. Included in our FHLB advances and related debt, are a number of borrowings with callable features as of September 30, 2008. We believe that the optionality on many of these borrowings will not be exercised until interest rates increase significantly. In addition, we believe that the interest rates that we pay on the majority of our interest-bearing transaction accounts would only be impacted by a portion of any change in market rates. This key assumption is utilized in our overall evaluation of our level of interest sensitivity.

We have included a number of tables to assist in our description of various measures of our financial performance. For example, the Average Balances tables shows the average balance of each category of our assets and liabilities as well as the yield we earned or the rate we paid with respect to each category during the three and nine month periods ended September 30, 2008 and 2007. A review of these tables shows that our loans typically provide higher interest yields than do other types of interest-earning assets, which is why we direct a substantial percentage of our earning assets into our loan portfolio. Similarly, the Rate/Volume Analysis table demonstrates the effect of changing interest rates and changing volume of assets and liabilities on our financial condition during the periods shown. A review of these tables shows that as short-term rates continued to rise, the increase in net interest income is more effected by the changes in rates than in prior years. We also track the sensitivity of our various categories of assets and liabilities to changes in interest rates, and we have included tables to illustrate our interest rate sensitivity with respect to interest-earning accounts and interest-bearing accounts. Finally, we have included various tables that provide detail about our investment securities, our loans, our deposits, and other borrowings.

The following tables set forth information related to our average balance sheets, average yields on assets, and average costs of liabilities. We derived these yields by dividing income or expense by the average balance of the corresponding assets or liabilities. We derived average balances from the daily balances throughout the periods indicated. During the three and nine month periods ended September 30, 2008 and 2007, we had less than $100,000 in interest-bearing deposits in other banks and no securities purchased with agreements to resell. All investments owned have an original maturity of over one year. Nonaccrual loans are included in the following tables. Loan yields have been reduced to reflect the negative impact on our earnings of loans on nonaccrual status. The net of capitalized loan costs and fees are amortized into interest income on loans.

Average Balances, Income and Expenses, and Rates

For the Three Months Ended September 30,

2008			**2007**		
Average Balance	**Income/ Expense**	**Yield/ Rate(1)**	**Average Balance**	**Income/ Expense**	**Yield/ Rate(1)**