

FIRST RELIANCE BANCSHARES INC
Form 10-Q
August 14, 2006

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C.

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended June 30, 2006

OR

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Transition Period from _____ to _____

Commission File Number 000-49757

FIRST RELIANCE BANCSHARES, INC.

(Exact name of the registrant as specified in its charter)

South Carolina
*(State or other jurisdiction of
incorporation or organization)*

80-0030931
*(I.R.S. Employer
Identification No.)*

**2170 West Palmetto Street
Florence, South Carolina 29501**
(Address of principal executive offices, including zip code)

(843) 656-5000
(Issuer's telephone number, including area code)

State the number of shares outstanding of each of the issuer's classes of common equity as of the latest practicable date:

3,409,259 shares of common stock, par value \$0.01 per share, as of July 31, 2006

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

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YesNo

FIRST RELIANCE BANCSHARES, INC.

Item 1. Financial Statements

The financial statements of First Reliance Bancshares, Inc. are set forth in the following pages.

Condensed Consolidated Balance Sheets

	June 30, 2006	December 31, 2005
	(Unaudited)	(Audited)
Assets		
Cash and due from banks	\$ 10,072,241	\$ 7,264,897
Federal funds sold		22,442,000
	<u>10,072,241</u>	<u>29,706,897</u>
Total cash and cash equivalents	10,072,241	29,706,897
Securities available-for-sale	36,101,846	37,121,479
Nonmarketable equity securities	2,473,850	1,745,850
Investment in trust	310,000	310,000
	<u>38,885,696</u>	<u>39,177,329</u>
Total investment securities	38,885,696	39,177,329
Loans held for sale	12,336,366	7,994,603
Loans receivable	349,035,226	311,544,385
Less allowance for loan losses	(3,831,630)	(3,419,368)
	<u>345,203,596</u>	<u>308,125,017</u>
Loans, net	345,203,596	308,125,017
Premises and equipment, net	11,285,542	10,020,537
Accrued interest receivable	2,138,115	2,189,742
Other real estate owned	1,166,985	345,550
Cash surrender value life insurance	9,910,831	3,752,165
Other assets	2,133,385	1,726,044
	<u>\$ 433,132,757</u>	<u>\$ 403,037,884</u>
Total assets	\$ 433,132,757	\$ 403,037,884
Liabilities and Shareholders Equity		
Deposits		
Noninterest-bearing transaction accounts	\$ 46,021,304	\$ 39,222,574
Interest-bearing transaction accounts	25,316,061	29,437,107
Savings	89,859,516	79,663,175
Time deposits \$100,000 and over	104,737,742	113,268,921
Other time deposits	87,949,894	72,845,121
	<u>353,884,517</u>	<u>334,436,898</u>
Total deposits	353,884,517	334,436,898
Securities sold under agreement to repurchase	5,278,809	3,859,904
Fed Funds Purchased	955,000	
Advances from Federal Home Loan Bank	29,800,000	23,500,000
Junior subordinated debentures	10,310,000	10,310,000
Accrued interest payable	420,874	446,303
Other liabilities	1,087,928	834,144
	<u>401,737,128</u>	<u>373,387,249</u>
Total liabilities	401,737,128	373,387,249
Shareholders Equity		
Common stock, \$.01 par value; 20,000,000 shares authorized, 3,399,599 and 3,306,117 shares issued and outstanding at June 30, 2006 and December 31, 2005, respectively	34,064	33,061

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Capital surplus	24,984,291	24,127,329
Treasury stock		(9,896)
Restricted stock	(83,456)	
Retained earnings	7,008,467	5,611,847
Accumulated other comprehensive income (loss)	(547,737)	(111,706)
	<u> </u>	<u> </u>
Total shareholders' equity	31,395,629	29,650,635
	<u> </u>	<u> </u>
Total liabilities and shareholders' equity	\$ 433,132,757	\$ 403,037,884
	<u> </u>	<u> </u>

See notes to condensed consolidated financial statements.

FIRST RELIANCE BANCSHARES, INC.

Condensed Consolidated Statements of Income
(Unaudited)

	Six Months Ended June 30,		Three Months Ended June 30,	
	2006	2005	2006	2005
Interest income:				
Loans, including fees	\$ 13,479,849	\$ 9,534,875	\$ 7,082,161	\$ 5,229,173
Investment securities:				
Taxable	530,540	351,478	260,191	169,193
Nontaxable	314,908	253,621	162,507	127,650
Federal funds sold	275,795	76,400	97,924	71,071
Other interest income	59,153	36,900	33,135	23,217
Total	14,660,245	10,253,274	7,635,918	5,620,304
Interest expense:				
Time Deposits over \$100,000	2,127,855	1,553,581	1,067,676	864,881
Other deposits	3,372,780	1,613,977	1,828,021	964,852
Other interest expense	773,699	566,378	362,979	311,741
Total	6,274,334	3,733,936	3,258,676	2,141,474
Net interest income	8,385,911	6,519,338	4,377,242	3,478,830
Provision for loan losses	690,786	566,152	440,501	393,600
Net interest income after provision for loan losses	7,695,125	5,953,186	3,936,741	3,085,230
Noninterest income:				
Service charges on deposit accounts	774,587	674,447	410,208	345,842
Gain on sales of mortgage loans	939,181	308,989	580,731	203,492
Brokerage fees	59,775	69,896	28,310	38,894
Credit life insurance commissions	10,608	15,277	4,179	7,616
Other charges, commissions and fees	125,874	96,785	66,108	49,988
Gain (loss) on sale of other real estate	17,657	(63,341)	17,657	(33,316)
Other non-interest income	263,541	148,725	145,575	80,029
Total	2,191,223	1,250,778	1,252,768	692,545
Noninterest expenses:				
Salaries and employee benefits	4,499,706	3,578,170	2,259,071	1,872,090
Occupancy expense	561,588	382,071	272,602	223,676
Furniture and equipment expense	359,273	360,464	196,695	186,246
Other operating expenses	2,486,816	1,736,678	1,293,730	907,690
Total	7,907,383	6,057,383	4,022,098	3,189,702
Income before income taxes	1,978,965	1,146,581	1,167,411	588,073
Income tax expense	582,346	331,579	344,495	158,670
Net income	\$ 1,396,619	\$ 815,002	\$ 822,916	\$ 429,403
Earnings per share				
Basic earnings per share	\$ 0.41	\$ 0.25	\$ 0.24	\$ 0.13
Diluted earnings per share	\$ 0.39	\$ 0.24	\$ 0.23	\$ 0.13

See notes to condensed consolidated financial statements.

FIRST RELIANCE BANCSHARES, INC.

Condensed Consolidated Statements of Shareholders Equity and Comprehensive Income
For the six months ended June 30, 2006 and 2005
(Unaudited)

	Common Stock		Surplus	Restricted Stock	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
	Shares	Amount						
Balance, December 31, 2004	3,203,942	\$ 32,039	\$ 23,428,034	\$	\$ (7,396)	\$ 3,664,301	\$ 241,671	\$ 27,358,649
Net income for the period						815,002		815,002
Other comprehensive loss, net of tax benefit of \$17,383							(33,744)	(33,744)
Comprehensive income								781,258
Issuance of shares to 401k	8,743	88	112,696					112,784
Purchase of treasury stock					(2,500)			(2,500)
Exercise of stock options	64,000	640	325,720					326,360
Balance, June 30, 2005	3,276,685	\$ 32,767	\$ 23,866,450	\$	\$ (9,896)	\$ 4,479,303	\$ 207,927	\$ 28,576,551
Balance, December 31, 2005	3,306,117	\$ 33,061	\$ 24,127,329	\$	\$ (9,896)	\$ 5,611,847	\$ (111,706)	\$ 29,650,635
Net income for the period						1,396,619		1,396,619
Other comprehensive loss, net of tax benefit of \$223,659							(436,031)	(436,031)
Comprehensive income								960,588
Issuance of shares to 401K	15,111	151	213,541					213,692
Restricted Stock	6,796	68	100,066	(83,456)				16,678
Sale of treasury stock					9,896			9,896
Exercise of stock options	78,371	784	543,354					544,138
Balance, June 30, 2006	3,406,395	\$ 34,064	\$ 24,984,290	\$ (83,456)	\$	\$ 7,008,466	\$ (547,737)	\$ 31,395,627

See notes to condensed consolidated financial statements.

FIRST RELIANCE BANCSHARES, INC.

Condensed Consolidated Statements of Cash Flows
(Unaudited)

	Six Months Ended June 30,	
	2006	2005
Cash flows from operating activities:		
Net income	\$ 1,396,619	\$ 815,002
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	690,786	566,152
Depreciation and amortization expense	435,488	395,690
Writedown of other real estate owned	119,146	75,550
Accretion and premium amortization	31,167	43,244
Disbursements from loans held-for-sale	(61,608,586)	(25,876,576)
Proceeds from sales of mortgages held-for-sale	57,266,823	25,431,294
Deferred income tax provision	(500,140)	(13,566)
Gain on sales of other real estate	(17,657)	
(Increase) decrease in interest receivable	51,627	(422,910)
Increase (decrease) in interest payable	(25,429)	41,772
Increase in other liabilities	253,784	464,926
Increase in other assets	(6,000,815)	(385,463)
Net cash provided (used) by operating activities	(7,907,187)	1,135,115
Cash flows from investing activities:		
Net increase in loans to customers	(38,962,711)	(65,759,008)
Purchases of securities available-for-sale	(1,421,226)	(1,577,004)
Calls and maturities on securities available-for-sale	1,750,001	2,498,993
Proceeds on sales of securities available-for-sale		438,416
Purchases of non marketable equity securities	(728,000)	(413,650)
Proceeds on sales of other real estate	270,422	194,442
Purchases of premises and equipment	(1,541,883)	(1,817,466)
Net cash used by investing activities	(40,633,397)	(66,873,643)
Cash flows from financing activities:		
Net increase in deposit accounts	19,447,619	71,290,204
Net increase in federal funds purchased	955,000	
Net increase in securities sold under agreements to repurchase	1,418,905	690,960
Advances from the Federal Home Loan Bank	6,300,000	4,100,000
Proceeds from issuance of shares to 401K	213,692	439,114
Sale (purchase) of treasury stock	9,896	(2,500)
Proceeds from the exercise of stock options	544,138	
Issuance of restricted stock	16,678	
Net cash provided by financing activities	28,905,929	76,517,808
Net increase (decrease) in cash and cash equivalents	(19,634,656)	10,779,230
Cash and cash equivalents, beginning of period	29,706,897	4,845,535
Cash and cash equivalents, end of period	\$ 10,072,241	\$ 15,624,765
Cash paid during the period for		
Income taxes	\$ 497,959	\$ 287,308
Interest	\$ 6,299,763	\$ 3,692,164

See notes to condensed consolidated financial statements.

FIRST RELIANCE BANCSHARES, INC.

**Notes to Condensed Consolidated Financial Statements
(Unaudited)**

Note 1 Nature of Business and Basis of Presentation

Business activity

First Reliance Bancshares, Inc. is a South Carolina corporation that owns all of the capital stock of First Reliance Bank and all of the stock of First Reliance Capital Trust 1 (the Trust). The bank is a state chartered bank organized under the laws of South Carolina located in Florence 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 for the sole purpose of issuing trust preferred securities.

Basis of Presentation

The accompanying financial statements have been prepared in accordance with the requirements for interim financial statements and, accordingly, they are condensed and omit disclosures, which would substantially duplicate those contained in the most recent annual report to shareholders. The financial statements as of June 30, 2006 and 2005 and for the interim periods then ended are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation. The financial information as of December 31, 2005 has been derived from the audited financial statements as of that date. For further information, refer to the financial statements and the notes included in First Reliance Bancshares, Inc.'s 2005 Annual Report on Form 10-KSB.

Note 2 - Recently Issued Accounting Pronouncements

The following is a summary of recent authoritative pronouncements that affect accounting, reporting, and disclosure of financial information by the Company:

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140. This Statement amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. This Statement resolves issues addressed in SFAS No. 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company does not believe that the adoption of SFAS No. 155 will have a material impact on its financial position, results of operations and cash flows.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140. This Statement amends FASB No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, with respect to the accounting for separately recognized servicing assets and servicing liabilities. SFAS No. 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract; requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable; permits an entity to choose its subsequent measurement methods for each class of separately recognized servicing assets and servicing liabilities; at its initial adoption, permits a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights, without calling into question the treatment of other available-for-sale securities under Statement 115, provided that the available-for-sale securities are identified in some manner as offsetting the entity's exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value; and requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities. An entity should adopt SFAS No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006. The Company does not believe the adoption of SFAS No. 156 will have a material impact on its financial position, results of operations and cash flows.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations and cash flows.

FIRST RELIANCE BANCSHARES, INC.

Notes to Condensed Consolidated Financial Statements
(Unaudited)**Note 3 - Equity Incentive Plan**

During the first quarter of 2006, the Company adopted the 2006 Equity Incentive Plan. The 2006 Equity Incentive Plan provides for the granting of dividend equivalent rights, options, performance unity awards, phantom shares, stock appreciation rights, and stock awards of up to 350,000 shares of the Company's common stock to officers, employees, directors, consultants, and other service providers of the Company, or any Affiliate of the Company.

During the six months ended June 30, 2006, the Company granted 45,774 stock appreciation rights. The stock appreciation right entitles the individual to receive the excess of the fair market value from the grant date to the exercise date in a settlement of Company stock. The Company has funded the liability through charges to earnings. The accrued liability for the stock appreciation rights at June 30, 2006 was \$12,773.

A summary of the status of the Company's stock appreciation rights as of the three months ended June 30, 2006. Changes during the period are presented below:

	Three months ended June 30, 2006	
	Shares	Weighted Average Exercise Price
Outstanding at April 1	45,774	\$ 14.87
Granted		
Exercised		
Forfeited	(273)	14.85
Outstanding at June 30, 2006	45,501	\$ 14.87

A summary of the status of the Company's stock appreciation rights as of the six months ended June 30, 2006. Changes during the period are presented below:

	Six months ended June 30, 2006	
	Shares	Weighted Average Exercise Price
Outstanding at January 1		\$
Granted	45,774	14.87
Exercised		
Forfeited	(273)	14.85
Outstanding at June 30, 2006	45,501	\$ 14.87

During the six months ended June 30, 2006, the Company granted 6,796 shares of restricted stock, pursuant to the 2006 Equity Incentive Plan. The shares cliff vest in three years and are fully vested on March 28, 2009. The weighted average fair value of restricted stock granted in six months ended June 30, 2006 was \$14.86. Compensation cost associated with the grant was \$16,679 for the six months ended June 30, 2006.

FIRST RELIANCE BANCSHARES, INC.

Notes to Condensed Consolidated Financial Statements
(Unaudited)**Note 3 - Equity Incentive Plan**, *continued*

A summary of the status of the Company's restricted stock as of the three months ended June 30, 2006. Changes during the period are presented below:

	Three months ended June 30, 2006	
	Shares	Weighted Average Exercise Price
Outstanding at April 1	6,796	\$ 14.86
Granted		
Exercised		
Forfeited	(25)	14.85
Outstanding at June 30, 2006	6,771	\$ 14.86

A summary of the status of the Company's restricted stock as of the six months ended June 30, 2006. Changes during the period are presented below:

	Six months ended June 30, 2006	
	Shares	Weighted Average Exercise Price
Outstanding at January 1		\$
Granted	6,796	14.86
Exercised		
Forfeited	(25)	14.85
Outstanding at June 30, 2006	6,771	\$ 14.86

Note 4 - Stock-Based Compensation

On January 1, 2006, the Company adopted the fair value recognition provisions of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 123(R), *Accounting for Stock-Based Compensation*, to account for compensation costs under its stock option and other equity incentive plans. The Company previously utilized the intrinsic value method under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees (as amended)* (APB 25). Under the intrinsic value method prescribed by APB 25, no compensation costs were recognized for the Company's stock options because the option exercise price in its plans equals the market price on the date of grant. Prior to January 1, 2006, the Company only disclosed the pro forma effects on net income and earnings per share as if the fair value recognition provisions of SFAS 123(R) had been utilized.

During the second quarter of 2005, the Company accelerated the vesting of all outstanding options and recognized the pro forma effects in that quarter. No options have been issued since June 2005. As discussed in Note 3, compensation expense related to stock appreciation rights amounted to \$12,773 for the six months ended June 30, 2006. The following table illustrates the effect on net income and earnings per share as if the fair value based method had been applied to all outstanding and unvested awards in each period.

FIRST RELIANCE BANCSHARES, INC.

Notes to Condensed Consolidated Financial Statements
(Unaudited)**Note 4 - Stock-Based Compensation** - continued

	Six Months Ended June 30,	
	2006	2005
Net income, as reported	\$ 1,396,619	\$ 815,002
Add: Stock-based compensation expense included in reported net income, net of related tax effects	12,773	
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(12,773)	767,326
Pro forma net income	\$ 1,396,619	\$ 47,676
Earnings per share:		
Basic - as reported	\$ 0.41	\$ 0.25
Basic - pro forma	\$ 0.41	\$ 0.01
Diluted - as reported	\$ 0.39	\$ 0.24
Diluted - pro forma	\$ 0.39	\$ 0.01
	Three Months Ended June 30,	
	2006	2005
Net income, as reported	\$ 822,916	\$ 429,403
Add: Stock-based compensation expense included in reported net income, net of related tax effects	7,237	
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(7,237)	400,707
Pro forma net income	\$ 822,916	\$ 28,696
Earnings per share:		
Basic - as reported	\$ 0.24	\$ 0.13
Basic - pro forma	\$ 0.24	\$ 0.01
Diluted - as reported	\$ 0.23	\$ 0.13
Diluted - pro forma	\$ 0.23	\$ 0.01

FIRST RELIANCE BANCSHARES, INC.

Notes to Condensed Consolidated Financial Statements
(Unaudited)**Note 5 - Earnings Per Share**

The following schedule reconciles the numerators and denominators of the basic and diluted earnings per share computations for the three and six month periods ended June 30, 2006 and 2005. 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.

	Six Months Ended June 30, 2006		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic earnings per share			
Income available to common shareholders	\$ 1,396,619	3,366,162	\$ <u>0.41</u>
Effect of dilutive securities			
Stock options		185,510	
Non vested restricted stock		730	
		<u> </u>	
Diluted earnings per share			
Income available to common shareholders plus assumed conversions	<u>\$ 1,396,619</u>	<u>3,552,402</u>	<u>\$ 0.39</u>

	Six Months Ended June 30, 2005		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic earnings per share			
Income available to common shareholders	\$ 815,002	3,234,456	\$ <u>0.25</u>
Effect of dilutive securities			
Stock options		187,085	
		<u> </u>	
Diluted earnings per share			
Income available to common shareholders plus assumed conversions	<u>\$ 815,002</u>	<u>3,421,541</u>	<u>\$ 0.24</u>

FIRST RELIANCE BANCSHARES, INC.

Notes to Condensed Consolidated Financial Statements
(Unaudited)**Note 5 - Earnings Per Share - continued**

	Three Months Ended June 30, 2006		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic earnings per share			
Income available to common shareholders	\$ 822,916	3,387,741	\$ 0.24
Effect of dilutive securities			
Stock options		181,211	
Non-vested restricted stock		928	
Diluted earnings per share			
Income available to common shareholders plus assumed conversions	\$ 822,916	3,569,880	\$ 0.23

	Three Months Ended June 30, 2005		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic earnings per share			
Income available to common shareholders	\$ 429,403	3,252,018	\$ 0.13
Effect of dilutive securities			
Stock options		169,225	
Diluted earnings per share			
Income available to common shareholders plus assumed conversions	\$ 429,403	3,421,243	\$ 0.13