

SOUTHERN BANCSHARES NC INC
Form 10-Q
May 11, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2005

Commission File No. 0-10852

SOUTHERN BANCSHARES (N.C.), INC.

(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of
incorporation or organization)

56-1538087
(I.R.S. Employer
Identification Number)

121 East Main Street Mount Olive, North Carolina
(Address of Principal Executive offices)

28365
(Zip Code)

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Registrant's Telephone Number, including Area Code: (919) 658-7000

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

Indicate the number of shares outstanding of the Registrant's common stock as of the close of the quarter covered by this report.

109,114 shares

Part I FINANCIAL INFORMATION

Item 1 Financial Statements.

SOUTHERN BANCSHARES (N.C.), INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands except for share data)	(Unaudited) March 31,	December 31,
	2005	2004 *
ASSETS		
Cash and due from banks	\$ 33,754	\$ 22,283
Overnight funds sold	27,440	35,872
Investment securities:		
Held-to-maturity, at amortized cost (fair value \$230,907 and \$236,172, respectively)	232,264	236,609
Available-for-sale, at fair value (amortized cost \$49,219 and \$43,600, respectively)	78,921	74,903
Loans	639,356	639,311
Loans held for sale	2,105	4,880
Less allowance for loan losses	(10,450)	(10,259)
Net loans	631,011	633,932
Premises and equipment	34,340	34,513
Goodwill	7,712	7,712
Accrued interest receivable	5,325	4,929
Intangible assets	3,309	3,687
Other assets	3,506	3,010
Total assets	<u>\$ 1,057,582</u>	<u>\$ 1,057,450</u>
LIABILITIES		
Deposits:		
Noninterest-bearing	\$ 183,588	\$ 183,762
Interest-bearing	723,312	726,760
Total deposits	906,900	910,522
Short-term borrowings	18,122	16,017
Long-term obligations	23,711	23,711
Accrued interest payable	1,753	1,447
Other liabilities	10,471	9,735
Total liabilities	<u>960,957</u>	<u>961,432</u>
SHAREHOLDERS EQUITY		
Series B non-cumulative preferred stock, no par value; \$3,573 and \$3,506 liquidation value at March 31, 2005 and December 31, 2004, respectively; 408,728 shares authorized; 350,593 and 350,593 shares issued and outstanding at March 31, 2005 and December 31, 2004, respectively	1,753	1,753
Series C non-cumulative preferred stock, no par value; \$397 liquidation value at both March 31, 2005 and December 31, 2004; 43,631 shares authorized; 39,657 shares issued and outstanding at both March 31, 2005	525	525

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and December 31, 2004

Common stock, \$5 par value; 158,485 shares authorized; 109,114 and 110,126 shares issued and outstanding at March 31, 2005 and December 31, 2004, respectively

	546	551
Surplus	10,000	10,000
Retained earnings	65,797	64,528
Accumulated other comprehensive income	18,004	18,661
	<u>96,625</u>	<u>96,018</u>
Total shareholders' equity	<u>96,625</u>	<u>96,018</u>
	<u>\$ 1,057,582</u>	<u>\$ 1,057,450</u>
Total liabilities and shareholders' equity	<u>\$ 1,057,582</u>	<u>\$ 1,057,450</u>

* Derived from audited consolidated financial statements

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

SOUTHERN BANCSHARES (N.C.), INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

	(Unaudited) Three Months Ended March 31,	
	2005	2004
(Dollars in thousands except for share and per share data)		
Interest income:		
Loans	\$ 10,184	\$ 9,371
Investment securities:		
U. S. Government	1,104	843
State, county and municipal	325	252
Other	508	349
Total investment securities interest income	1,937	1,444
Overnight funds sold	156	114
Total interest income	12,277	10,929
Interest expense:		
Deposits	2,829	2,466
Long-term obligations	475	474
Short-term borrowings	75	24
Total interest expense	3,379	2,964
Net interest income	8,898	7,965
Provision for loan losses	300	300
Net interest income after provision for loan losses	8,598	7,665
Noninterest income:		
Service charges on deposit accounts	1,651	1,722
Other service charges and fees	689	598
Gain on sale of loans	143	326
Investment securities gains, net	235	(2)
Other	139	139
Total noninterest income	2,857	2,783
Noninterest expense:		
Personnel	4,857	4,590
Data processing	928	844
Occupancy	888	891
Furniture and equipment	473	487
Intangibles amortization	418	465
Professional fees	218	187
Other	1,018	1,091
Total noninterest expense	8,800	8,555
Income before income taxes	2,655	1,893
Income taxes	755	398

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Net income	1,900	1,495
Other comprehensive income net of tax:		
Unrealized (losses) gains arising during period	(835)	954
Less: tax effect	322	(368)
Less: reclassification adjustment for (gains) losses included in net income	(235)	2
Less: tax effect	91	(1)
Total other comprehensive income	(657)	587
Comprehensive Income	\$ 1,243	\$ 2,082
Per share information:		
Net income per common share	\$ 16.51	\$ 12.62
Cash dividends declared on common shares	0.40	0.40
Weighted average common shares outstanding	109,851	111,472

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

SOUTHERN BANCSHARES (N.C.), INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

FOR THE THREE MONTHS ENDED MARCH 31, 2005 AND 2004

(Dollars in thousands except per share data)

(Unaudited)

	Preferred Stock						Accumulated			Total Shareholders Equity
	Series B		Series C		Common Stock		Retained Earnings	Other Compre- hensive Income		
	Shares	Amount	Shares	Amount	Shares	Amount				
Balance, December 31, 2003	358,316	\$ 1,745	39,657	\$ 552	111,530	\$ 558	\$ 10,000	\$ 59,919	\$ 15,744	\$ 88,518
Net income								1,495		1,495
Purchase and retirement of stock	(1,056)	(5)			(501)	(3)		(217)		(225)
Cash dividends:										
Common stock (\$.40 per share)								(44)		(44)
Preferred B (\$.22 per share)								(79)		(79)
Preferred C (\$.22 per share)								(9)		(9)
Unrealized gain on securities available-for-sale, net of tax									587	587
Balance, March 31, 2004	357,260	\$ 1,740	39,657	\$ 552	111,029	\$ 555	\$ 10,000	\$ 61,065	\$ 16,331	\$ 90,243
Balance, December 31, 2004	350,593	\$ 1,753	39,657	\$ 525	110,126	\$ 551	\$ 10,000	\$ 64,528	\$ 18,661	\$ 96,018
Net income								1,900		1,900
Purchase and retirement of stock					(1,012)	(5)		(501)		(506)
Cash dividends:										
Common stock (\$.40 per share)								(44)		(44)
Preferred B (\$.22 per share)								(77)		(77)
Preferred C (\$.22 per share)								(9)		(9)
Unrealized loss on securities available-for-sale, net of tax									(657)	(657)
Balance, March 31, 2005	350,593	\$ 1,753	39,657	\$ 525	109,114	\$ 546	\$ 10,000	\$ 65,797	\$ 18,004	\$ 96,625

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

SOUTHERN BANCSHARES (N.C.), INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Thousands)	(Unaudited)	
	Three months ended	
	March 31,	
	2005	2004
OPERATING ACTIVITIES:		
Net income	\$ 1,900	\$ 1,495
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	300	300
(Gains) losses on sales, donations and issuer calls of securities	(235)	2
Gain on sale of loans	(143)	(326)
Loss on sale of foreclosed assets	17	
Proceeds from sales of loans held for sale	17,118	13,253
Origination of loans held for sale	(15,950)	(14,209)
Net increase in intangible assets	(40)	(42)
Loss on sale or abandonment of premises and equipment	1	12
Net amortization of premiums on investments	3	212
Amortization of intangibles and mortgage servicing rights	418	465
Depreciation	663	679
Net (increase) decrease in accrued interest receivable	(396)	291
Net increase in accrued interest payable	306	100
Net increase in other assets	(1,561)	(435)
Net increase in other liabilities	736	425
NET CASH PROVIDED BY OPERATING ACTIVITIES	3,137	2,222
INVESTING ACTIVITIES:		
Proceeds from maturities and issuer calls of investment securities available-for-sale	6,065	12,672
Proceeds from maturities and issuer calls of investment securities held-to-maturity	17,840	7,492
Proceeds from sales of investment securities available-for-sale	207	
Purchases of investment securities held-to-maturity	(15,075)	(31,649)
Purchases of investment securities available-for-sale	(9,135)	(2,007)
Net decrease in loans	2,644	13,455
Purchases of premises and equipment	(491)	(558)
NET CASH PROVIDED (USED) BY INVESTING ACTIVITIES	2,055	(595)
FINANCING ACTIVITIES:		
Net decrease in demand and interest-bearing demand deposits	(1,181)	(526)
Net (decrease) increase in time deposits	(2,441)	7,523
Net proceeds (repayments) of short-term borrowed funds	2,105	(1,515)
Cash dividends paid	(130)	(132)
Purchase and retirement of stock	(506)	(225)
NET CASH (USED) PROVIDED BY FINANCING ACTIVITIES	(2,153)	5,125
NET INCREASE IN CASH AND CASH EQUIVALENTS	\$ 3,039	\$ 6,752
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF YEAR	58,155	84,572

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CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD	\$ 61,194	\$ 91,324
	_____	_____
SUPPLEMENTAL DISCLOSURES OF CASH PAID DURING THE PERIOD FOR:		
Interest	\$ 3,685	\$ 2,864
Income taxes	\$ 1,036	\$ 601
	_____	_____
SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING ACTIVITIES:		
Unrealized (losses) gains on available-for-sale securities, net of tax	\$ 657	\$ 587
Foreclosed loans transferred to other real estate	\$ 1,048	\$ 217

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

SOUTHERN BANCSHARES (N. C.), INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements

Note 1. Summary Of Significant Accounting Policies

Basis of Financial Statement Presentation

Southern BancShares (N. C.), Inc. (BancShares) is the holding company for Southern Bank and Trust Company (Southern), which operates 53 banking offices in eastern North Carolina. Southern, which began operations January 29, 1901, has a wholly-owned subsidiary, Goshen, Inc. whose insurance agency operations compliment the operations of its parent. BancShares and Southern are headquartered in Mount Olive, North Carolina. BancShares has no foreign operations and Banc Shares customers are principally located in eastern North Carolina.

The consolidated financial statements in this report are unaudited. In the opinion of management, all adjustments necessary for a fair presentation of the financial position and results of operations for the quarters presented have been included.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses for the reporting periods. Actual results could differ from those estimates. The statements should be read in conjunction with the consolidated financial statements and accompanying notes for the year ended December 31, 2004, included in the 2004 Annual Report on Form 10-K.

Principles of Consolidation

The consolidated financial statements include the accounts of BancShares and its wholly-owned subsidiary, Southern. The statements also include the accounts of Goshen, Inc., a wholly-owned subsidiary of Southern. BancShares financial resources are primarily provided by dividends from Southern. All significant intercompany balances have been eliminated in consolidation.

Cash And Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash, due from banks and overnight funds sold.

Goodwill and Other Intangible Assets

Intangible assets are composed primarily of goodwill, core deposit premiums and mortgage servicing rights. Core deposit premiums are generally amortized on an accelerated basis, over a period of 5 to 10 years as determined by independent third parties based on studies, and the useful lives are periodically reviewed for reasonableness. The net deposit premium balances were \$2.5 million and \$2.8 million at March 31, 2005 and December 31, 2004 respectively. Mortgage servicing rights (MSR) represent the estimated value of the right to service mortgage loans for others. Capitalization of MSR occurs when the underlying loans are sold. Capitalized MSR are amortized into income over the projected servicing life of the underlying loans. Capitalized MSR are periodically reviewed for impairment. The net MSR balances were \$825,000 and \$861,000 at March 31, 2005 and December 31, 2004 respectively. No valuation allowance for impairment was required at March 31, 2005 or at December 31, 2004.

The following is a summary of the gross carrying amounts and accumulated amortization of amortized intangible assets as of March 31, 2005 and December 31, 2004:

	March 31, 2005		December 31, 2004	
	Gross Carrying	Accumulated	Gross Carrying	Accumulated
	Amount	Amortization	Amount	Amortization
(Dollars in thousands)				
Amortized intangible assets:				
Branch acquisitions	\$ 14,691	\$ 12,230	\$ 14,691	\$ 11,888
Mortgage servicing rights	2,650	1,825	2,610	1,749
Total	\$ 17,341	\$ 14,055	\$ 17,301	\$ 13,637
Unamortized intangible assets:				
Goodwill	\$ 7,712	\$	\$ 7,712	\$
Pension	\$ 23	\$	\$ 23	\$

Southern issues standby letters of credit whereby Southern guarantees performance if a specified triggering event or condition occurs. 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, 2005 is \$5.8 million. At March 31, 2005, BancShares has recorded no liability for the current carrying amount of the obligation to perform as a guarantor, as such amounts are deemed immaterial.

SOUTHERN BANCSHARES (N.C.), INC. AND SUBSIDIARIES

Notes to consolidated financial statements

Dollars in thousands

Note 2. Investment securities

(In thousands)	March 31, 2005				December 31, 2004			
	Amortized	Gross	Gross	Fair	Amortized	Gross	Gross	Fair
	Cost	Unrealized Gains	Unrealized Losses	Value	Cost	Unrealized Gains	Unrealized Losses	Value
SECURITIES HELD-TO-MATURITY:								
U. S. Treasuries	\$ 190,806	\$	\$ (2,063)	\$ 188,743	\$ 185,798	\$	\$ (1,235)	\$ 184,563
U. S. Agencies	\$ 10,002	\$	\$ (15)	\$ 9,987	\$ 15,018	\$	\$ (46)	\$ 14,972
Obligations of states and political subdivisions	31,456	817	(96)	32,177	35,793	857	(13)	36,637
	<u>232,264</u>	<u>817</u>	<u>(2,174)</u>	<u>230,907</u>	<u>236,609</u>	<u>857</u>	<u>(1,294)</u>	<u>236,172</u>
SECURITIES AVAILABLE-FOR-SALE:								
U. S. Treasuries	4,986		(56)	4,930	0	0		0
U. S. Agencies					6,001		(7.00)	5,994
Marketable equity securities	33,749	29,519	(112)	63,156	26,766	30,991	(143)	57,614
Obligations of states and political subdivisions	6,336	191		6,527	6,401	238		6,639
Mortgage-backed securities	4,148	172	(12)	4,308	4,432	224		4,656
	<u>49,219</u>	<u>29,882</u>	<u>(180)</u>	<u>78,921</u>	<u>43,600</u>	<u>31,453</u>	<u>(150)</u>	<u>74,903</u>
Totals	<u>\$ 281,483</u>	<u>\$ 30,699</u>	<u>\$ (2,354)</u>	<u>\$ 309,828</u>	<u>\$ 280,209</u>	<u>\$ 32,310</u>	<u>\$ (1,444)</u>	<u>\$ 311,075</u>

Temporarily Impaired Securities Losses at March 31, 2005:

	Securities Owned		Securities Owned		Total	
	Less Than 12 Months		12 Months or Longer			
	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value

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						<u>Value</u>
U. S. Treasuries	\$ 1,229	\$ 99,593	\$ 890	\$ 94,080	\$ 2,119	\$ 193,673
U. S. Agencies			27	11,441	27	11,441
Obligations of states and political subdivisions	94	5,592	2	190	96	5,782
Subtotal, debt securities	1,323	105,185	919	105,711	2,242	210,896
Marketable equity securities	112	7,718			112	7,718
Total temporarily impaired securities	\$ 1,435	\$ 112,903	\$ 919	\$ 105,711	\$ 2,354	\$ 218,614

The unrealized losses on the above investment securities are the result of volatility in the investment markets during 2005. All unrealized losses on investment securities are considered by management to be temporary given the credit ratings on these investment securities and the short durations of the unrealized losses.

Note 3. ALLOWANCE FOR LOAN LOSSES

(Dollars in thousands)	Three Months Ended	
	March 31,	
	2005	2004
Balance at beginning of year	\$ 10,259	\$ 10,095
Provision for loan losses	300	300
Loans charged off	(134)	(125)
Loan recoveries	25	41
Balance at end of the period	<u>\$ 10,450</u>	<u>\$ 10,311</u>

Note 4. Earnings Per Common Share

Earnings per common share are computed by dividing income applicable to common shares by the weighted average number of common shares outstanding during the period. Income applicable to common shares represents net income reduced by dividends paid to preferred shareholders. Since BancShares had no potentially dilutive securities during 2005 or 2004, the computation of basic and diluted earnings per share is the same. The following table presents the components of the earnings per share computations:

(Dollars in thousands)	Three Months Ended	
	March 31,	
	2005	2004
Net income	\$ 1,900	\$ 1,495
Less: Preferred dividends	(86)	(88)
Net income applicable to common shares	<u>\$ 1,814</u>	<u>\$ 1,407</u>
Weighted average common shares outstanding during the period	<u>109,851</u>	<u>111,472</u>

Note 5. Related Parties

BancShares has entered into various service contracts with another bank holding company, First Citizens BancShares, Inc. (the Corporation) and its subsidiary First-Citizens Bank & Trust Company. The Corporation has two significant shareholders, who also are significant shareholders of BancShares.

The first significant shareholder is a director of BancShares and, at March 31, 2005, beneficially owned 32,751 shares, or 30.02%, of BancShares' outstanding common stock and 4,966 shares, or 1.42%, of BancShares' outstanding Series B preferred stock. At the same date, the second significant shareholder beneficially owned 27,422 shares, or 25.13%, of BancShares' outstanding common stock.

These two significant shareholders are directors and executive officers of the Corporation and at March 31, 2005, beneficially owned 2,539,188 shares, or 29.00%, and 1,378,970 shares, or 15.75%, of the Corporation's outstanding Class A common stock, and 666,254 shares, or 39.71%, and 208,622 shares, or 12.44%, of the Corporation's outstanding Class B common stock. The above totals include 465,104 Class A common shares, or 5.31%, and 104,644 Class B Common shares, or 6.24%, that are considered to be beneficially owned by both of the shareholders and, therefore, are included in each of their totals.

BancShares is related through common ownership with Fidelity Bancshares NC Inc, (Fidelity) and Heritage BancShares, Inc. (Heritage), in that the aforementioned two significant shareholders of BancShares and certain of their related parties are also significant shareholders of Fidelity and Heritage. Fidelity has contracted with BancShares for BancShares to service, on Fidelity's behalf, \$1.8 million of Fidelity's mortgage loans at March 31, 2005. BancShares also provides underwriting and processing services for mortgage loans originated through Fidelity and Heritage.

The following table lists the various charges paid to the Corporation during the three months ended March 31, 2005 and the three months ended March 31, 2004 in accordance with the aforementioned service contracts:

	Three Months Ended March 31,	
	2005	2004
(Dollars in thousands)		
Data and item processing	\$ 802	\$ 772
Forms, supplies and equipment	240	294
Internet Banking	42	41
Consulting fees	24	28
Trustee for employee benefit plans	18	17
Other services	19	15
	\$ 1,145	\$ 1,167

Note 6. Acquisitions

BancShares has consummated numerous bank branch acquisitions in recent years. All of the acquisitions have been accounted for under the purchase method of accounting, with the results of operations not included in BancShares Consolidated Statements of Income until after the transaction date. The proforma impact of the acquisitions, as though they had been made at the beginning of the periods presented, is not considered material to BancShares consolidated financial statements.

There were no acquisitions during the three months ended March 31, 2005 or the three months ended March 31, 2004. BancShares acquired two branches from Capital Bank located in Seaboard, North Carolina and Woodland, North Carolina on September 13, 2004. BancShares acquired deposits of \$28.0 million, loans of \$10.7 million and cash of \$15.4 million. BancShares paid \$1.9 million for the Seaboard and Woodland branch acquisitions.

Note 7. Retirement Plans

Southern has a noncontributory, defined benefit pension plan which covers substantially all full-time employees. Employees who qualify under length of service and other requirements participate in the noncontributory defined benefit pension plan. Under the plan, retirement benefits are based on years of service and average earnings. The policy is to fund the maximum amount allowable for federal income tax purposes. The plan's assets consist primarily of investments in First-Citizens Bank & Trust Company common trust funds, which include listed common stocks and fixed income securities. It is Southern's policy to determine the service cost and projected benefit obligation using the Projected Unit Credit Cost method.

The following sets forth pertinent information regarding the components of net periodic benefit pension plan costs:

Components of net periodic benefit cost:

(in thousands)

	<u>Pension Benefits</u>	
	<u>2005</u>	<u>2004</u>
Three months ended March 31:		
Service cost	\$ 248	\$ 223
Interest cost	294	281
Expected return on assets	(274)	(248)
Amortization cost:		
Prior service cost	2	2
Net loss	90	88
Total amortizations	92	90
Net periodic benefit cost	\$ 360	\$ 346

The expected long-term rate of return on plan assets is 8.50% for 2005.

Employer contributions

In its December 31, 2004 financial statements, BancShares disclosed that it expected to contribute approximately \$1.0 million to its plan trusts in 2005. For the three months ended March 31, 2005, BancShares had not made a contribution to its plan trusts. BancShares expects to contribute approximately \$1.3 million to its plan trusts by December 31, 2005.

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

SOUTHERN BANCSHARES (N.C.), INC. AND SUBSIDIARY

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS - THREE MONTHS ENDED MARCH 31, 2005 VS. THREE MONTHS ENDED MARCH 31, 2004

INTRODUCTION

This discussion provides information concerning changes in the consolidated financial condition and results of operations of Southern BancShares (N.C.), Inc. (BancShares) and its subsidiary, Southern Bank and Trust Company (Southern). The comments are intended to supplement, and should be reviewed in conjunction with, the consolidated financial statements, related notes and selected financial data presented elsewhere herein. The comments should also be read in conjunction with the consolidated financial statements and accompanying notes for the year ended December 31, 2004, included in the 2004 Annual Report on Form 10-K.

BancShares' earnings and cash flows are primarily derived from the commercial banking activities conducted by Southern. Southern's commercial banking activities include commercial and consumer lending, deposit and cash management products and various other financial management products and services typically associated with commercial banking. Southern gathers interest-bearing and noninterest-bearing deposits from retail and commercial customers and gathers supplemental short-term funding through various non-deposit sources. The liquidity generated from these funding sources is primarily invested in interest-earning assets consisting of various types of loans, investment securities, overnight funds sold investments and the banking premises and equipment used in the delivery of financial services.

Numerous factors influence customer demand for Southern's deposit and loan products including the overall economy within Southern's eastern North Carolina markets and the level of financial services competition within those markets. During the majority of 2005 and 2004 relatively low interest rates, managed by the Federal Reserve, significantly impacted customer demand for both deposit and loan products. The low interest rate market caused some customers, anticipating increases in rates, to choose shorter term deposit products including short-term certificates of deposit, transaction, savings and money market accounts. The low interest rate market provided many customers with an opportunity to refinance existing loans at much lower rates, provided some customers the ability to reduce their overall loan requirements and provided some customers an opportunity to increase their loan balances at much lower interest rates.

The overall strength of the economy also influences the quality and collectability of loans and the level of customer bankruptcies. Southern utilizes various asset and liability management tools to minimize the potential adverse impact of economic trends and to maximize opportunities provided by favorable economic trends.

Financial institutions typically focus their strategic planning and operating goals on maximizing profitability and the improvement of the return on average assets and return on average shareholders' equity performance profitability measures. BancShares has historically placed significant emphasis on asset quality, liquidity and capital conservation, even when those goals may ultimately be detrimental to current period earnings performance as reflected by the return on average assets and return on average shareholders' equity performance measures. Accordingly, BancShares' return on average assets and return on average equity have historically compared unfavorably to financial institutions of similar size.

BancShare's strategic analyses of its corporate and competitive strengths indicate many opportunities for growth and expansion of financial services within its markets. Southern operates in diverse eastern North Carolina geographic markets that offer opportunities to expand varying types of services to existing customers as well as opportunities to expand market share through strategic acquisitions of existing branch locations from competitor financial institutions. Southern also believes that, through superior customer service, there are opportunities to increase earnings performance by attracting customers of its financial competitors.

BancShares focuses on mitigating, where possible, growth and profitability risks. BancShares has limited control of risks such as economic, competitive and regulatory risks. Southern considers overall economic risk to be its greatest risk area. Primarily, economic risks of recession, rapid changes in market interest rates and significant increases in inflation are of the most concern to management. Southern's smaller asset size and limited capital resources, as compared to its primary market financial service competitors, require significant and constant management attention to all areas of economic risk.

An analysis of BancShares' overall financial condition and growth can be made by examining the changes and trends in the interest-earning asset and interest-bearing liability components in the following tables, discussions, consolidated financial statements and notes to the consolidated financial statements. Tables and discussions are also presented detailing the impact of branch acquisitions, capital position, loan loss experience, allowance for loan losses, non-interest expenses and non-interest income.

The net income of BancShares increased approximately \$405,000 from \$1.5 million in the first three months of 2004 to \$1.9 million in the first three months of 2005, an increase of 27.09%. This increase resulted primarily from a \$933,000 before tax increase in net interest income for 2005. The opening of a new branch in May 2004 and the acquisition of two branches in September 2004 resulted in increased net interest income, increased noninterest income, increased personnel expense and increased operating expenses for the three months ended March 31, 2005.

Per share net income available to common shares for the first three months of 2005 was \$16.51, an increase of \$3.89, or 30.82%, from \$12.62 for the first three months of 2004. The annualized return on average equity increased to 7.84%, for the period ended March 31, 2005, from 6.65% for the period ended March 31, 2004.

At both March 31, 2005 and December 31, 2004, BancShares' assets totaled \$1.1 billion. During this three month period, cash and due from banks increased \$11.5 million, or 51.48% from \$22.3 million to \$33.8 million. During this three month period, overnight funds sold decreased \$8.4 million, or 23.51% from \$35.9 million to \$27.4 million. During this three month period, loans, excluding loans held for sale, increased \$45,000, or 0.01%, from \$639.3 million to \$639.4 million. During the three months ended March 31, 2005 investment securities decreased \$327,000, or 0.10% from \$311.5 million at December 31, 2004 to \$311.2 million at March 31, 2005. Total deposits decreased \$3.6 million, or 0.40% from \$910.5 million at December 31, 2004 to \$906.9 million at March 31, 2005 primarily due to seasonal impact of customer agricultural business activity and customer tax payments. The annualized return on average assets at March 31, 2005 increased to 0.72% compared to 0.59% for the period ended March 31, 2004.

CRITICAL ACCOUNTING POLICIES

BancShares' significant accounting policies are set forth in note 1 of the consolidated financial statements in the annual report on Form 10-K. Of these significant accounting policies, BancShares considers its policy regarding the allowance for loan losses to be its single 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. BancShares 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.

BancShares' assessments may be impacted in future periods by changes in economic conditions, the impact of regulatory examinations, and the discovery of information with respect to borrowers which is not known to management at the time of the issuance of the consolidated financial statements. For additional discussion concerning BancShares' allowance for loan losses and related matters, see ASSET QUALITY AND PROVISION FOR LOAN LOSSES.

ACQUISITIONS, NEW OFFICES AND CONSOLIDATIONS

An analysis of BancShares' financial condition and growth can be made by examining the changes and trends in interest-earning assets and interest-bearing liabilities. Such an analysis also requires an evaluation of noninterest income and noninterest expenses. In recent years, increasing total noninterest income has been a significant focus for BancShares. The introduction of new revenue sources and modifications to existing products and services has allowed service-related noninterest income to grow.

In recent years the recognition of gains and losses on sales of mortgage loans and the recognition of gains and losses on sales of available-for-sale securities has also had a significant impact on total noninterest income. Management does not consider these sources of noninterest income to be core sources of revenues for BancShares. The sale of mortgage loans also results in the recognition of mortgage servicing rights (MSR) income. MSR income represents the estimated value of the right to service mortgage loans for others. Capitalization of MSR occurs when the underlying mortgage loans are sold and the servicing rights for the mortgage loans sold are retained. Capitalized MSR is amortized into income over the projected servicing life of the underlying loans.

Franchise expansion has also contributed to growth in noninterest income, but has also resulted in large increases in noninterest expenses, especially personnel-related costs, occupancy expenses, equipment expenses and intangible asset amortization expenses.

BancShares did not acquire any additional locations in the three months ended March 31, 2005 or in the three months ended March 31, 2004. On May 10, 2004 BancShares opened a de novo branch in Manteo, North Carolina to expand the Kill Devil Hills financial services market. On September 13, 2004 BancShares acquired an existing branch in Seaboard, North Carolina and an existing branch in Woodland, North Carolina from Capital Bank. These two branch acquisitions expanded BancShares northeastern North Carolina market service area into Northampton County. The two Capital Bank Northampton county branch acquisitions added \$28.0 million of deposits, \$10.7 million of loans and \$15.4 million of cash. BancShares paid \$1.9 million for the Seaboard and Woodland branch acquisitions.

Applications have been approved to open de novo Southern Branches in Red Oak, North Carolina and Winterville, North Carolina. The Red Oak branch, the 54th location for BancShares, is expected to open in the third quarter of 2005. The Winterville branch is expected to open in the second quarter of 2006.

Management continues to look for growth opportunities offered through existing branch acquisition opportunities and to plan for de novo expansion within its eastern North Carolina markets. The acquisition of existing branches from other financial institutions results in the payment of acquisition premiums which are allocated to non-earning assets or charged to operating earnings over time.

INTEREST INCOME

Interest-earning assets include loans, investment securities and overnight investments. Interest-earning assets reflect varying interest rates based on the risk level and maturity of the asset. Riskier investments typically carry a higher rate and exposes BancShares to potentially higher levels of default. Southern has historically focused on maintaining high asset quality requiring management to perform significant underwriting and monitoring procedures. Southern's investment portfolio includes primarily United States Treasury and Government agency securities. The level of investment securities is primarily the result of overall loan and deposit trends. When deposit growth exceeds loan growth, the excess liquidity primarily increases investment securities. When loan growth exceeds deposit growth, maturing investment securities are utilized to fund loan growth rather than being reinvested into the securities market. Southern maintains an operating liquidity level of overnight funds sold investments with other financial institutions that are within Southern's risk tolerance levels.

Loan production is principally driven by the eastern North Carolina economy. Management primarily seeks commercial lending opportunities collateralized by real estate. Traditional mortgage loan production is also a goal of management. Most of the mortgage loan production is sold into the mortgage secondary market with the Bank retaining the loan servicing rights. Loan demand in recent years for consumer loans has declined as consumers have responded to retailer financing promotions and utilized mortgage equity lines of credit to finance purchases.

During 2005, management anticipates increased commercial loan growth due to the continued relatively low interest rate environment and an expected slowly improving eastern North Carolina economy. Market interest rates are expected to slowly increase during the remainder of 2005 and into 2006. Loan demand among retail customers has shifted to open-end credit products such as equityline loans. Growth in equityline loans is also expected during the remainder of 2005 and 2006.

To minimize the potential adverse impact of interest rate fluctuations, management monitors the maturity and repricing distribution of the loan portfolio. BancShares offers variable rate loan products and fixed rate callable loans to reduce interest rate risk.

Interest and fees on loans increased \$813,000, or 8.68%, from \$9.4 million for the three months ended March 31, 2004 to \$10.2 million for the three months ended March 31, 2005. This increase resulted from both increased loan portfolio balances and increased loan yields. Average loans for the three months ended March 31, 2005 were \$641.8 million, an increase of \$13.9 million, or 2.21%, from \$627.9 million for the prior year period. This increase in average loans was principally the result of growth within the existing branches, the addition of a de novo branch in May 2004 and two branch acquisitions in September 2004. The yield on the loan portfolio increased to 6.44% for the three months ended March 31, 2005 from 6.14% for the three months ended March 31, 2004 primarily as a result of the continued increasing interest rate market being managed by the Federal Reserve.

As a result of the continued generally slow recovery of the eastern North Carolina economy, 2005 loan production opportunities have also continued to be relatively limited in several of Southern's markets. As a result of the deposit growth in Southern's existing markets, the 2004 Seaboard and Woodland acquisitions, relatively weak loan demand and the relatively low interest rate market managed by the Federal Reserve, management has made investments in primarily three-year maturity or less, held-to-maturity, U. S. Treasury securities.

Management continues to maintain a portfolio of securities with relatively short maturities and call dates, consistent with BancShares' focus on liquidity. The weighted average investment maturity at March 31, 2005 was 29.0 months compared to 18.5 months at December 31, 2004. Investment securities available for sale include marketable equity securities that are recorded at their fair value, with the unrealized net gain or loss included as a component of shareholders' equity, net of deferred taxes.

Interest income from investment securities, including U. S. Treasury and Government obligations, obligations of state and county subdivisions and other securities increased \$493,000 or 34.14%, from \$1.4 million in the three months ended March 31, 2004 to \$1.9 million in the three months ended March 31, 2005. This increase was due to both an increase in yields for the three months ended March 31, 2005 and an increase in average investment securities. The average investment securities for the three months ended March 31, 2005 was \$278.8 million compared to \$258.4 million for the same 2004 period. The increase in volume principally resulted from increased average U. S. Treasury investments. The yield on investment securities was 2.82% for the three-month period ended March 31, 2005 and 2.52% for the three-month period ended March 31, 2004.

Interest income on overnight funds sold increased \$42,000, or 36.84%, from \$114,000 for the three months ended March 31, 2004 to \$156,000 for the three months ended March 31, 2005. This increase in income resulted from a decrease in the average overnight funds sold to \$25.4 million for the three months ended March 31, 2005 from an average of \$50.4 million for the three months ended March 31, 2004 more than offset by an increase in the average overnight funds sold yields from 0.90% for the three months ended March 31, 2004, to 2.45% for the three months ended March 31, 2005.

Total interest income increased \$1.3 million or 12.33%, from \$10.9 million for the three months ended March 31, 2004 to \$12.3 million for the three months ended March 31, 2005. This increase was the result of increases in both average earning assets and average earning asset yields.

Average earning asset yields for the three months ended March 31, 2005 increased to 5.26% from the 4.93% yield on average earning assets for the three months ended March 31, 2004 as a result of the overall increase in market rates. Average earning assets increased from \$910.6 million in the three months ended March 31, 2004 to \$946.0 million for the three months ended March 31, 2005. This \$35.4 million increase in the average earning assets resulted primarily from growth within the existing branches, the opening of the de novo branch and the branch acquisitions discussed above.

INTEREST EXPENSE

Interest-bearing liabilities include interest-bearing deposits, short-term borrowings and long-term obligations. Southern's primary funding source is deposits. Other short-term funding sources include commercial repurchase agreements and a borrowing line of credit from First-Citizens Bank & Trust Company.

During the quarter ended March 31, 2004, the year ended December 31, 2004 and the quarter ended March 31, 2005, BancShares had long-term obligations including 8.25% junior subordinated debentures totaling \$23.7 million issued to Southern Capital Trust I with a maturity date of 2028. Southern Capital Trust I is a wholly-owned finance subsidiary of BancShares. During the second quarter of 2005, in order to lower BancShares annual interest costs by approximately \$308,000, Southern Capital Trust I plans to redeem the \$23.7 million of 8.25% long-term obligations and Southern Capital Trust I will be dissolved. Southern Capital Trust II will then be formed as a wholly-owned finance subsidiary of BancShares and will issue \$23.7 million of 6.95% long-term obligations. The \$23.7 million of 6.95% long-term obligations will qualify as Tier 1 Capital for BancShares, be redeemable in whole or in part after April 28, 2010 and will mature in 2035. BancShares will fully and unconditionally guarantee the repayment of the \$23.7 million 6.95% trust preferred securities.

BancShares has historically avoided excessive reliance on time deposit accounts with balances in excess of \$100,000. At March 31, 2005, the time deposits greater than \$100,000 were 13.19% of total deposits, compared to 14.73 % of March 31, 2004 total deposits.

Total interest expense increased \$415,000, or 14.00%, from \$3.0 million in the three months ended March 31, 2004 to \$3.4 million for the three months ended March 31, 2005. BancShares' total cost of funds increased from 1.61% for the three months ended March 31, 2004 to 1.79% for the three months ended March 31, 2005 as a result of the overall increase in market rates. Average interest-bearing deposits were \$724.8 million in the three months ended March 31, 2005, an increase of \$15.1 million from the \$709.7 million average in the three months ending March 31, 2004. The increase in interest-bearing deposits was primarily the result of growth within the existing branches, the opening of the de novo branch and the branch acquisitions discussed above.

NET INTEREST INCOME

A principal objective of BancShares' asset/liability function is to manage interest rate risk or the exposure to changes in interest rates. Management maintains portfolios of interest-earning assets and interest-bearing liabilities with maturities or repricing opportunities that protect against wide interest rate fluctuations, thereby limiting, to the extent possible, the ultimate interest rate exposure. As a result of the continued relatively weak eastern North Carolina economy, consumer concerns over the economy's impact on the equity markets and the Federal Reserve continuing to manage relatively low but rising interest rates, many consumers have moved cash into the shorter maturity deposit products of the Bank.

Net interest income before provision for loan losses was \$8.9 million for the three months ended March 31, 2005 and \$8.0 million for the three months ended March 31, 2004.

The interest rate spread for the three months ended March 31, 2005 was 3.47%, an increase of 16 basis points from the 3.31% interest rate spread for the three months ended March 31, 2004. The increase in the interest rate spread was primarily due to the average rate on interest-bearing liabilities repricing upward at a slower rate than the upward repricing of interest-earning assets.

ASSET QUALITY AND PROVISION FOR LOAN LOSSES

Maintaining excellent asset quality is one of the key performance measures for, and a primary focus area of, BancShares' Management. BancShares and Southern dedicate significant resources to ensuring prudent lending practices, loan performance monitoring and management and prudent, timely recognition of losses. In some cases property that was used as collateral for loans is foreclosed to satisfy repayment of the loan. Upon completion of foreclosure, this property is classified as an other real estate nonperforming asset. Other real estate nonperforming assets are aggressively marketed by Management.

Management evaluates the risk characteristics of the loan portfolio under current economic conditions, reviews the financial condition of borrowers, estimates the fair market value of the loan collateral and considers any other pertinent factors to estimate current credit losses. Southern provides an allowance for loan losses on a reserve basis and includes in operating expenses a provision for loan losses determined by management. The allowance is reduced by charge-offs and increased by subsequent recoveries. Management's periodic evaluation of the adequacy of the allowance is based on Southern's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect borrowers' experience, the estimated value of any underlying collateral, current economic conditions and other risk factors. Management believes it has established the allowance in accordance with accounting principles generally accepted in the United States of America and in consideration of the current economic environment. While management uses the best information available to make evaluations, future adjustments may be necessary.

In addition, various regulatory agencies, as an integral part of their examination process, periodically review Southern's allowance for loan losses and losses on other real estate owned. Such agencies may require Southern to recognize additions to the allowances based on the examiners' judgments about information available to them at the time of their examinations.

During the first three months of 2005 management charged-off loans totaling \$134,000 and received recoveries of \$25,000, resulting in net charge-offs of \$109,000. During the same period in 2004, \$125,000 in loans were charged-off and recoveries of \$41,000 were received, resulting in net charge-offs of \$84,000. As a result of the relatively weak but slowly improving 2005 eastern North Carolina economy, Southern has experienced a \$25,000, or 29.76%, increase in net loan charge-offs for the three months ended March 31, 2005 compared to the three months ended March 31, 2004. The ratio of net annualized charge-offs to average loans decreased from 0.16% for the year ended December 31, 2004 to an annualized 0.07% for the three months ended March 31, 2005. With both an increase in 2005 average loans and an increase in 2005 net loan charge-offs, management recorded \$300,000 as a provision for loan losses for the three months ended March 31, 2005. Management also recorded \$300,000 as a provision for loan losses for the three months ended March 31, 2004. The March 31, 2005 allowance for loan losses has accordingly increased \$191,000 from December 31, 2004. The following table presents comparative Asset Quality ratios of BancShares:

	March 31, 2005	December 31, 2004	March 31, 2004
Ratio of annualized net loans charged off to average loans	0.07%	0.16%	0.05%
Allowance for loan losses to loans excluding loans held-for-sale	1.63%	1.60%	1.67%
Non-performing loans to loans excluding loans held-for-sale	0.24%	0.26%	0.61%
Non-performing loans and assets to total assets	0.24%	0.21%	0.42%
Allowance for loan losses to non-performing loans	676.81%	616.53%	275.25%

Loans, net of loans held-for-sale, increased \$45,000, or 0.01% from \$639.3 million at December 31, 2004 to \$639.4 million at March 31, 2005. The allowance for loan losses represented 1.63% of loans, excluding loans held-for-sale, at March 31, 2005 compared to 1.60% of loans, excluding loans held-for-sale, at December 31, 2004. The ratio of the allowance for loan losses to loans, net of loans held-for-sale, was impacted by management's decision to add to the provision for loan losses due to the continued relative weakness in the economy, increased loans, increased net loan charge-offs and an increase in foreclosed other real estate.

The ratio of nonperforming loans to loans, net of loans held-for-sale, decreased from 0.26% at December 31, 2004 to 0.24% at March 31, 2005. Nonperforming loans and assets to total assets increased to 0.24% at March 31, 2005 from 0.21% at December 31, 2004 primarily as a result of increased other real estate. BancShares had \$1.0 million of assets classified as other real estate at March 31, 2005 compared to \$525,000 of assets classified as other real estate at December 31, 2004. The allowance for loan losses represented 676.81% of nonperforming loans at March 31, 2005, an increase from 616.53% at December 31, 2004.

Performance improvements resulted primarily from the reduction of nonperforming loans to \$1.5 million at March 31, 2005 from \$1.7 million at December 31, 2004. The nonperforming loans at March 31, 2005 included \$288,000 of nonaccrual loans, \$1.3 million of accruing loans 90 days or more past due and no restructured loans.

Management considers the March 31, 2005 allowance for loan losses to be adequate to cover the losses and risks inherent in the loan portfolio at March 31, 2005 and will continue to monitor its portfolio and to adjust the relative level of the allowance as needed. BancShares had impaired loans of \$122,000 at March 31, 2005 compared to \$832,000 at December 31, 2004. The reduction in impaired loans primarily resulted from the foreclosure of one loan that is included in Other Real Estate at March 31, 2005. No additional allowances for loan losses were required for these impaired loans.

Management actively maintains a current loan watch list and knows of no other loans which are material and (i) represent or result from trends or uncertainties which management reasonably expects will materially impact future operating results, liquidity or capital resources, or (ii) represent material credits about which management is aware of any information which causes management to have serious doubts as to the ability of such borrowers to comply with the loan repayment terms.

NONINTEREST INCOME

Management considers the growth of noninterest income essential to maintaining profitability performance levels. The primary sources of noninterest income are deposit and loan related service charges and fees. Other significant noncore, noninterest income is derived from the sale of mortgage loans into the secondary market and the periodic sale of available-for-sale investment securities.

Income from other service charges and fees includes mortgage loan commitment fees, mortgage loan servicing fees, automated teller machine fees, check cashing fees and other miscellaneous non-deposit-related customer service fees. Increases in this category of noninterest income are primarily the result of customer account growth within the existing branches, the opening of new branches and the acquisitions of existing branches from other financial institutions. In the three months ended March 31, 2004 the increased mortgage lending activity resulting from the relatively low interest rates resulted in increases in mortgage-related non-interest income fees and service charges. In the three months ended March 31, 2005 mortgage lending opportunities have declined from 2004 levels and, accordingly, mortgage-related non-interest income fees and service charges have also declined from 2004 levels.

Southern sells mortgage loan production into the secondary mortgage markets and retains servicing on the majority of loans sold. The resulting interest rate market managed by the Federal Reserve and the timing of interest rate changes within the market directly impacts the level of gains or losses that are realized on mortgage loans sold. Gain on sale of mortgage loans decreased \$183,000 for the three months ended March 31, 2005, from \$326,000 in the three months ended March 31, 2004, as a result of both decreased mortgage loan production and decreased sales of mortgage loans into the secondary market.

During the three months ended March 31, 2005, BancShares realized a \$74,000 increase in noninterest income primarily as a result of an increase of \$237,000 in investment securities gains, a \$183,000 decrease in gains on sale of loans and a \$20,000 increase in service charges and fees in the three months ended March 31, 2005 compared to the three months ended March 31, 2004.

Service charges on deposit accounts and other service charges and fees for the three months ended March 31, 2005 increased \$20,000 over the three months ended March 31, 2004 primarily as a result of growth within the existing branches, the de novo branches opened and the branch acquisitions discussed above.

NONINTEREST EXPENSE

The primary noninterest expenses are personnel salaries and benefits, occupancy and equipment costs and data processing costs related to branch office operations. Noninterest expenses also include the expensing of intangibles amortization resulting from the acquisition of existing branch locations from other financial institutions and the amortizing of mortgage servicing rights resulting from the sale of mortgage loans into the secondary mortgage market.

Noninterest expense increased \$245,000 or 2.86%, from \$8.6 million in the three months ended March 31, 2004 to \$8.8 million in the three months ended March 31, 2005.

The noninterest expense increase was primarily due to an increase in personnel expense of \$267,000, or 5.82%, from \$4.6 million at March 31, 2004 to \$4.9 million at March 31, 2005 and increased data processing and other expenses resulting principally from growth in the existing branches, the de novo branch addition and the branch acquisitions discussed above.

INCOME TAXES

In the three months ended March 31, 2005 BancShares recorded income tax expense of \$755,000. In the three months ended March 31, 2004, BancShares recorded income tax expense of \$398,000. The resulting effective tax rate for the three months ended March 31, 2005 was 28.44%. The tax rate for the year ended December 31, 2004 was 25.05%. The estimated tax rate at March 31, 2005 is higher than the actual full year 2004 effective rate due to a reduction in the level of projected 2005 tax free income to projected earnings for 2005. The estimated tax rate at March 31, 2005 of 28.44% and the effective tax rate of 25.05% for the year ended December 31, 2004 differ from the federal statutory rate of 34.00% primarily due to tax exempt income.

SHAREHOLDERS EQUITY AND CAPITAL ADEQUACY

Included in shareholders' equity is accumulated other comprehensive income which consists of unrealized net gains on securities available-for-sale at the date of the period identified. BancShares owns corporate stock and debt securities investments in several financial institutions. As a result of the daily equity market movement of the value of the individual investment instruments, the net after tax value of these investments above or below the recorded cost of the investments, as of the period date indicated, is reported as accumulated other comprehensive income within shareholders' equity.

The Federal Reserve Board, which regulates BancShares, and the Federal Deposit Insurance Corporation, which regulates Southern, have established minimum capital guidelines for the institutions they supervise.

Regulatory guidelines define minimum requirements for Southern's leverage capital ratio. Leverage capital equals total equity less goodwill and certain other intangibles and is measured relative to total adjusted assets as defined by regulatory guidelines. According to these guidelines, Southern's leverage capital ratio at March 31, 2005 was 7.62%. At December 31, 2004, Southern's leverage capital ratio was 7.39%. Both of these ratios exceed the minimum threshold designated as "well capitalized" by the FDIC.

Southern is also required to meet minimum requirements for Risk Based Capital (RBC). Southern's assets, including loan commitments and other off-balance sheet items, are weighted according to federal guidelines for the risk considered inherent in each asset. At March 31, 2005, Southern's Total RBC ratio was 13.65%. At December 31, 2004 the RBC ratio was 13.45%. Both of these ratios exceed the minimum threshold designated as "well capitalized" by the FDIC.

The regulatory capital ratios above reflect increases in assets and liabilities from acquisitions Southern has made. Each acquisition has resulted in BancShares recording intangible assets in its consolidated financial statements, which are deducted from total equity in the above ratio calculations.

Accumulated other comprehensive income was \$18.0 million at March 31, 2005 compared to \$18.7 million at December 31, 2004. Although a part of total shareholders' equity, accumulated other comprehensive income is not included in the calculation of either the RBC or leverage capital ratios pursuant to regulatory definitions of these capital requirements. The following table presents capital adequacy calculations and ratios of Southern:

	Actual		Minimum for capital adequacy purposes		Minimum to be well capitalized under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of March 31, 2005:						
(Dollars in thousands)						
Total capital (to risk-weighted assets)	\$ 90,302	13.65%	\$ 52,921	8.00%	\$ 66,152	10.00%
Tier 1 capital (to risk-weighted assets)	76,336	11.54%	26,461	4.00%	39,691	6.00%
Tier 1 capital (to average assets)	76,336	7.62%	40,063	4.00%	50,079	5.00%

Actual

ISSUER REPURCHASES OF EQUITY SECURITIES

The following table contains information regarding repurchases by BancShares of shares of its outstanding equity securities during the quarter ended March 31, 2005:

<u>Period</u>	<u>Total Number of Shares Repurchased (1)</u>	<u>Average Price Paid per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans</u>	<u>Maximum Number of Shares that may yet be Purchased Under the Plans</u>
Month #1: 01/01/05 through 01/31/05				
Common Stock		N/A	N/A	N/A
Series B Preferred Stock		N/A	N/A	N/A
Series C Preferred Stock		N/A	N/A	N/A
Month #2: 02/01/05 through 02/28/05				
Common Stock	60	\$ 500.00	N/A	N/A
Series B Preferred Stock		N/A	N/A	N/A
Series C Preferred Stock		N/A	N/A	N/A
Month #3: 03/01/05 through 03/31/05				
Common Stock	952	\$ 500.00	N/A	N/A
Series B Preferred Stock		N/A	N/A	N/A
Series C Preferred Stock		N/A	N/A	N/A
Total numbers of shares:				
Common Stock	1,012	\$ 500.00	N/A	N/A
Series B Preferred Stock		N/A	N/A	N/A
Series C Preferred Stock		N/A	N/A	N/A

(1) All purchases were made in unsolicited transactions pursuant to general authority given each year by BancShares Board of Directors and not pursuant to a formal repurchase plan or program. Under that authority, BancShares is authorized to repurchase shares of its capital stock from time to time in unsolicited private transactions and/or on the open market. Purchases are subject to various conditions, including price and volume limitations and compliance with applicable law.

Under similar authority, during the three months ended March 31, 2004, BancShares repurchased an aggregate of 1,056 shares of Series B Preferred Stock and 501 shares of Common Stock.

LIQUIDITY

Liquidity refers to the ability of Southern to generate sufficient funds to meet its financial obligations and commitments at a reasonable cost. Maintaining liquidity ensures that funds will be available for reserve requirements, customer demand for loans, withdrawal of deposit balances and maturities of other deposits and liabilities. Past experiences help management anticipate cyclical demands and amounts of cash required. These obligations can be met by existing cash reserves or funds from maturing loans and investments, but in the normal course of business are met by deposit growth.

In assessing liquidity, many relevant factors are considered, including stability of deposits, quality of assets, economy of the markets served, business concentrations, competition and BancShares' overall financial condition. BancShares' liquid assets include cash and due from banks, overnight funds sold and investment securities available-for-sale. The liquidity ratio, which is defined as cash plus short term available-for-sale securities divided by deposits plus short term liabilities, was 26.89% at March 31, 2005 and 26.57% at December 31, 2004.

The Statement of Cash Flows discloses the principal sources and uses of cash from operating, investing and financing activities for the three months ended March 31, 2005 and for the three months ended March 31, 2004. Southern has no brokered deposits. Jumbo time deposits are considered to include all time deposits of \$100,000 or more. Almost all jumbo time deposit customers have other relationships with Southern, including savings, demand and other time deposits, and in some cases, loans. At March 31, 2005 jumbo time deposits represented 13.19% of total deposits. At December 31, 2004 jumbo time deposits represented 13.07% of total deposits.

Management believes that BancShares has the ability to generate sufficient amounts of cash to cover normal requirements and any additional needs which may arise, within realistic limitations, and management is not aware of any known demands, commitments or uncertainties that will affect liquidity in a material way.

BancShares has obligations under existing contractual obligations that will require payments in future periods. The following table presents aggregated information about such payments to be made in future periods. Transaction deposit accounts with indeterminate maturities have been classified as having payments due in less than one year.

CONTRACTUAL OBLIGATIONS

As of March 31, 2005

(In thousands)

	Payments due by period				Total
	Less than 1 year	1-3 years	4-5 years	Over 5 years	
Deposits	\$ 771,948	\$ 101,250	\$ 33,702		\$ 906,900
Short-term borrowings	18,122				18,122
Long-term obligations				23,711	23,711
Lease obligations	46	93	12		151

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Total contractual obligations	<u>\$ 790,116</u>	<u>\$ 101,343</u>	<u>\$ 33,714</u>	<u>\$ 23,711</u>	<u>\$ 948,884</u>
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ACCOUNTING AND OTHER MATTERS

In December 2003, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position (SOP) 03-3, Accounting for Loans or Certain Debt Securities Acquired in a Transfer. The SOP addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment in loans or debt securities acquired in a transfer if those differences relate to a deterioration of credit quality. The SOP also prohibits companies from carrying over or creating a valuation allowance in the initial accounting for loans acquired that meet the scope criteria of the SOP. The SOP is effective for loans acquired in fiscal years beginning after December 15, 2004. The adoption of this SOP did not have a material impact on the Company's financial position or results of operations.

In December 2004, the FASB issued SFAS No. 123(R), Accounting for Stock-Based Compensation (SFAS No. 123(R)). SFAS No. 123(R) establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS No. 123(R) requires that the fair value of such equity instruments be recognized as an expense in the historical financial statements as services are performed. Prior to SFAS No. 123(R), only certain pro forma disclosures of fair value were required. The provisions of this Statement are effective for the first interim reporting period of the first fiscal year that begins after June 15, 2005. Accordingly, we will adopt SFAS No. 123(R) commencing with the quarter ending March 31, 2006. The Company does not have a stock option plan and adoption of SFAS No. 123(R) will not have any effect on the consolidated financial statements.

OTHER MATTERS

Management is not aware of any other trends, events, uncertainties or current recommendations by regulatory authorities that will have or that are reasonably likely to have a material effect on BancShares' liquidity, capital resources or other operations.

COMMITMENTS, CONTINGENCIES AND OFF-BALANCE SHEET RISK

In the normal course of business there are various commitments and contingent liabilities outstanding, such as guarantees, commitments to extend credit, etc., which are not reflected in the accompanying financial statements.

Southern is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit, standby letters of credit and undisbursed advances on customer lines of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheet.

Southern is exposed to credit loss, in the event of nonperformance by the other party to the financial instrument, for commitments to extend credit and standby letters of credit which is represented by the contractual notional amount of those instruments. Southern uses the same credit policies in making these commitments and conditional obligations as it does for on-balance-sheet instruments.

Commitments to extend credit and undisbursed advances on customer lines of credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many commitments expire without being drawn, the total commitment amounts do not necessarily represent future cash requirements. Southern evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by Southern, upon extension of credit is based on management's credit evaluation of the borrower. Collateral held varies but may include trade accounts receivable, property, plant, and equipment and income-producing commercial properties.

Standby letters of credit are commitments issued by Southern to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. Outstanding standby letters of credit at March 31, 2005 were \$5.8 million compared to \$5.9 million at December 31, 2004. Outstanding commitments to lend at March 31, 2005 were \$183.7 million compared to \$182.1 million at December 31, 2004. Undisbursed advances on customer lines of credit were \$62.7 million at March 31, 2005 compared to \$64.3 million at December 31, 2004. Outstanding standby letters of credit and commitments to lend at March 31, 2005 generally expire within one year, whereas commitments associated with undisbursed advances on customer lines of credit at March 31, 2005 generally expire within one to five years.

At March 31, 2005, commitments to sell loans amounted to \$9.5 million. At December 31, 2004 commitments to sell loans amounted to \$11.5 million.

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

Southern grants agribusiness, commercial and consumer loans to customers primarily in eastern North Carolina. Although Southern has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent upon the agricultural industry.

BancShares is also involved in various legal actions arising in the normal course of business. Management is of the opinion that the outcome of such actions will not have a material adverse effect on the consolidated financial condition of BancShares.

REGULATORY MATTERS

The Sarbanes-Oxley Act of 2002 (the S-O Act) is significant federal legislation that was signed into law on July 30, 2002 that addresses accounting, corporate governance and disclosure issues relating to public companies. Some of the provisions of the S-O Act became effective immediately, while others are still in the process of being implemented. In general, the S-O Act mandates important new corporate governance, financial reporting and disclosure requirements intended to enhance the accuracy and transparency of public companies' reported financial results.

The S-O Act establishes new responsibilities for corporate Chief Executive Officers and Chief Financial Officers, Boards of Directors and Audit Committees of the Boards of Directors in the financial reporting process. The S-O Act also created a new regulatory body to oversee outside auditors of public companies. The economic and operational effects of the S-O Act on public companies, including BancShares, have been, and will continue to be, significant in terms of the increased time, resources and operating costs associated with complying with the new law. Because the S-O Act, for the most part, applies equally to large and small public companies, it will continue to present BancShares with particular challenges. Increased audit fees and compliance costs associated with compliance with the S-O Act could have a negative effect on operating results of BancShares.

FORWARD-LOOKING STATEMENTS

The foregoing discussion may contain statements that could be deemed forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and the Private Securities Litigation Reform Act. Forward-looking statements are inherently subject to risks and uncertainties because they include projections, predictions, expectations or beliefs about future events or results that are not statements of historical fact. Such statements are often characterized by the use of qualifiers such as expect, believe, estimate, plan, project or other statements concerning opinions or judgments of BancShares and its management about future events. Factors that could influence the accuracy of such forward-looking statements include, but are not limited to, the financial success or changing strategies of BancShares' customers, actions of government regulators, the level of market interest rates, and general economic conditions.

Item 3 Quantitative and Qualitative Disclosures About Market Risk:

Market risk reflects the risk of economic loss resulting from adverse changes in market price and interest rates. This risk of loss can be reflected in either diminished current market values or reduced potential net interest income in future periods. BancShares' market risk arises primarily from interest rate risk inherent in its lending and deposit taking activities. The structure of BancShares' loan and deposit portfolios is such that a significant increase in the prime rate may adversely impact net interest income. Historical prepayment experience is considered as well as management's expectations based on the interest rate environment as of March 31, 2005. Management seeks to manage this risk through the use of shorter term maturities. The composition and size of the investment portfolio is managed so as to reduce the interest rate risk in the deposit and loan portfolios while at the same time maximizing the yield generated from the investment portfolio.

The table below presents in tabular form the contractual balances and the estimated fair value of financial instruments at their expected maturity dates as of March 31, 2005. The expected maturity categories take into consideration historical prepayment experience as well as management's expectations based on the interest rate environment as of March 31, 2005. For core deposits without contractual maturity (i.e., interest bearing checking, savings and money market accounts), the table presents principal cash flows as maturing in 2006 since they are subject to immediate repricing. Weighted average variable rates in future periods are based on the implied forward rates in the yield curve as of March 31, 2005.

(Dollars in thousands, unaudited)	Maturing in the years ended March 31						Total	Fair Value
	2006	2007	2008	2009	2010	Thereafter		
Assets								
Loans								
Fixed rate	\$ 60,509	\$ 47,102	\$ 53,130	\$ 26,652	\$ 21,538	\$ 103,719	\$ 312,650	\$ 311,840
Average rate (%)	7.07%	6.98%	7.04%	6.94%	6.83%	6.73%	6.91%	
Variable rate	\$ 119,100	\$ 62,952	\$ 52,089	\$ 44,170	\$ 22,728	\$ 27,772	\$ 328,811	\$ 328,811
Average rate (%)	6.41%	6.23%	6.10%	6.07%	6.13%	6.00%	6.23%	
Investment securities								
Fixed rate	\$ 124,144	\$ 103,914	\$ 3,791	\$ 3,196	\$ 964	\$ 75,176	\$ 311,185	\$ 309,828
Average rate (%)	2.12%	2.86%	4.49%	2.12%	5.73%	6.55%	3.08%	
Liabilities								
Savings and interest bearing checking								
Fixed rate	\$ 513,762						\$ 513,762	\$ 513,762
Average rate (%)	0.60%						0.60%	
Certificates of deposit								
Fixed rate	\$ 254,649	\$ 54,142	\$ 45,374	\$ 33,702			\$ 387,867	\$ 400,768
Average rate (%)	2.07%	3.04%	3.62%	3.44%			2.50%	
Variable rate	\$ 3,537	\$ 1,734					\$ 5,271	\$ 5,271
Average rate (%)	1.22%	1.29%					1.24%	
Short-term borrowings								
Variable rate	\$ 18,122						\$ 18,122	\$ 18,122
Average rate (%)	1.84%						1.84%	
Long-term debt								
Fixed rate						23,711	\$ 23,711	\$ 23,924
Average rate (%)						7.85%	7.85%	

A principal objective of BancShares' asset/liability function is to manage interest rate risk or the exposure to changes in interest rates. Management maintains portfolios of interest-earning assets and interest-bearing liabilities with maturities or repricing opportunities that will protect against wide interest rate fluctuations, thereby limiting, to the extent possible, the ultimate interest rate exposure. The table below provides BancShares' interest-sensitivity position as of March 31, 2005, which reflected a one year negative interest-sensitivity gap of \$275.2 million. As a result of this one year negative gap, increases in interest rates could have an unfavorable impact on net interest income.

One measure of the impact of BancShares' interest-sensitivity negative gap is to model the impact of an immediate 100 basis point rate change on net interest income. BancShares, in addition to gap analysis, also utilizes a funds management model that indicates, at March 31, 2005, BancShares could realize a \$979,000 decrease in net interest income if an immediate 100 basis point decrease were to occur. BancShares' funds management model at March 31, 2005 indicates that BancShares could realize a \$363,000 increase in net interest income if an immediate 100 basis point increase were to occur.

INTEREST-SENSITIVITY ANALYSIS

(Dollars in thousands, unaudited)

	March 31, 2005				
	1-90	91-180	181-365	Non-Rate	Total
	Days	Days	Days	Sensitive	
	Days	Days	Days	1 year	
	Sensitive	Sensitive	Sensitive		
Earning Assets:					
Loans	\$ 55,760	\$ 32,856	\$ 90,993	\$ 461,852	\$ 641,461
Investment securities	38,837	23,596	61,712	187,040	311,185
Temporary investments	27,535				27,535
Total earning assets	\$ 122,132	\$ 56,452	\$ 152,705	\$ 648,892	\$ 980,181
Interest-Bearing Liabilities:					
Savings and core time deposits	396,672	47,533	62,561	96,945	603,711
Time deposits of \$100,000 and more	41,088	18,512	21,994	38,007	119,601
Short-term borrowings	18,122				18,122
Long-term obligations				23,711	23,711
Total interest-bearing liabilities	\$ 455,882	\$ 66,045	\$ 84,555	\$ 158,663	\$ 765,145
Interest sensitivity gap	\$ (333,750)	\$ (9,593)	\$ 68,150	\$ 490,229	\$ 215,036
Cumulative interest sensitivity gap	\$ (333,750)	\$ (343,343)	\$ (275,193)	\$ 215,036	\$ 215,036

It should be noted that this analysis reflects BancShares' interest sensitivity as of a single point in time and may not reflect the effects of repricings of assets and liabilities in various interest rate environments.

Item 4 Controls and Procedures:

BancShares' management, including its Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of the design and operation of BancShares' disclosure controls and procedures, as defined in Section 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act), and have concluded that, as of the end of the period covered by this Report, those disclosure controls and procedures were effective, in all material respects, to ensure that information required to be disclosed by BancShares in reports it files or submits under the Exchange Act is recorded, processed, summarized and reported within the required time periods.

No change occurred in BancShares' internal control over financial reporting during the period covered by this report that was identified in connection with the above evaluation and that has materially affected, or is reasonably likely to materially affect, BancShares' internal control over financial reporting.

Part II OTHER INFORMATION

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Information regarding BancShares' repurchases of its outstanding equity securities is incorporated herein by reference to the information in Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations under the caption Issuer Repurchases of Equity Securities.

Item 6 Exhibits

The following exhibits are filed or furnished with this Report:

- 31.1 Certification of BancShares Chief Executive Officer pursuant to Rule 13a-14(a)
- 31.2 Certification of BancShares Chief Financial Officer pursuant to Rule 13a-14(a)
- 32 Certification of BancShares Chief Executive Officer and Chief Financial Officer pursuant to 18 U. S. C. Section 1350

SIGNATURES

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

SOUTHERN BANCSHARES (N.C.), INC.

May 10, 2005

/s/ John C. Pegram, Jr.

Date

John C. Pegram, Jr.,
Chairman of the Board, President and Chief Executive Officer

May 10, 2005

/s/ David A. Bean

Date

David A. Bean,
Secretary, Treasurer and Chief Financial Officer

EXHIBIT INDEX

<u>Exhibit Number</u>	<u>Exhibit</u>
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32	Certification of BancShares Chief Executive Officer and Chief Financial Officer pursuant to 18 U. S. C. Section 1350