

SOUTHERN FIRST BANCSHARES INC  
Form 10-Q  
May 06, 2013

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

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

**For the Quarterly Period Ended March 31, 2013**

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

**For the Transition Period from                      to  
Commission file number 000-27719**

**Southern First Bancshares, Inc.**

(Exact name of registrant as specified in its charter)

**864-679-9000**

(Registrant's telephone number, including area code)

**Not Applicable**

(Former name, former address, and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No o

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 4,268,438 shares of common stock, par value \$0.01 per share, were issued and outstanding as of April 18, 2013.

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***SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY***

March 31, 2013 Form 10-Q

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**PART I. CONSOLIDATED FINANCIAL INFORMATION**

**Item 1. CONSOLIDATED FINANCIAL STATEMENTS**

***SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY  
CONSOLIDATED BALANCE SHEETS***

See notes to consolidated financial statements that are an integral part of these consolidated statements. Additional paid in capital, retained earnings and common shares outstanding as of December 31, 2012 have been adjusted to reflect the ten percent stock dividend issued in 2013.

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***SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF INCOME  
(Unaudited)***

See notes to consolidated financial statements that are an integral part of these consolidated statements. Earnings per share and common shares outstanding for the 2012 period have been adjusted to reflect the ten percent stock dividend issued in 2013.

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***SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(Unaudited)***

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

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***SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
FOR THE THREE MONTHS ENDED MARCH 31, 2013 AND 2012  
(Unaudited)***

See notes to consolidated financial statements that are an integral part of these consolidated statements. Common shares outstanding as of December 31, 2011 and 2012 have been adjusted to reflect the ten percent stock dividends issued in 2012 and 2013.

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

**(Unaudited)**

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

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

**NOTE 1 - Nature of Business and Basis of Presentation**

*Business Activity*

***Southern First Bancshares, Inc.*** (the "Company") is a South Carolina corporation that owns all of the capital stock of Southern First Bank (the "Bank") and all of the stock of Greenville First Statutory Trust I and II (collectively, the "Trusts"). On April 1, 2013, the Bank converted from a national bank charter to a South Carolina state bank charter and the bank name was changed from Southern First Bank, N.A. to Southern First Bank. As a national bank, the Bank's primary federal regulator was the Office of the Comptroller of the Currency (the "OCC"). Subsequent to the conversion to a state bank charter, the Bank's primary federal regulator is the Federal Deposit Insurance Corporation (the "FDIC"). The Bank is also regulated and examined by the South Carolina Board of Financial Institutions. The Bank is primarily engaged in the business of accepting demand deposits and savings deposits insured by the FDIC, and providing commercial, consumer and mortgage loans to the general public. The Trusts are special purpose non-consolidated entities organized for the sole purpose of issuing trust preferred securities.

*Basis of Presentation*

The accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three month period ended March 31, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 (Registration Number 000-27719) as filed with the Securities and Exchange Commission on March 5, 2013. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, the Bank. In accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 810, "Consolidation," the financial statements related to the special purpose subsidiaries, the Trusts, have not been consolidated.

*Use of Estimates*

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amount of income and expenses during the reporting periods. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, other real estate owned, fair value of financial instruments, evaluating other-than-temporary-impairment of investment securities and valuation of deferred tax assets.

*Reclassifications*

Certain amounts, previously reported, have been reclassified to state all periods on a comparable basis and had no effect on shareholders' equity or net income.

*Subsequent Events*

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Non-recognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management performed an evaluation to determine whether there have been any subsequent events since the balance sheet date and determined that no subsequent events occurred requiring accrual or disclosure.

As noted above, effective April 1, 2013, the Bank converted from a national bank charter to a South Carolina state bank charter and changed its name from Southern First Bank, N.A. to Southern First Bank after obtaining approval from the South

Carolina Board of Financial Institutions. This conversion was not as a result of any dispute or disagreement with the OCC. The charter conversion will not have substantial impact on the bank's current activities, products and services, although the bank expects certain annual cost savings related to regulatory fees.

On April 1, 2013, the Company redeemed a total of \$500,000 of its outstanding preferred stock from two preferred shareholders. Since July of 2012, the Company has redeemed a cumulative \$2.0 million of its outstanding preferred stock and reduced the balance to \$15.3 million.

#### *Recently Adopted Accounting Pronouncements*

The following is a summary of recently adopted authoritative pronouncements that have impacted the accounting, reporting, and/or disclosure of financial information by the Company.

The Comprehensive Income topic of the ASC was amended in June 2011. The amendment eliminated the option to present other comprehensive income as a part of the statement of changes in stockholders' equity and required consecutive presentation of the statement of net income and other comprehensive income. The amendments were applicable to the Company January 1, 2012 and have been applied retrospectively. In December 2011, the topic was further amended to defer the effective date of presenting reclassification adjustments from other comprehensive income to net income on the face of the financial statements while the FASB redeliberated the presentation requirements for the reclassification adjustments. In February 2013, the FASB further amended the Comprehensive Income topic clarifying the conclusions from such redeliberations. Specifically, the amendments do not change the current requirements for reporting net income or other comprehensive income in financial statements. However, the amendments do require an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, in certain circumstances an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income. These amendments, which become effective for the Company for the March 31, 2013 reporting period, did not have a material effect on the Company's financial statements.

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 or cash flows.

#### **NOTE 2 - Preferred Stock Issuance and Partial Redemption**

On February 27, 2009, as part of the Capital Purchase Program ("CPP"), the Company entered into a Securities Purchase Agreement with the U.S. Department of the Treasury (the "Treasury"), pursuant to which the Company sold 17,299 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series T (the "Series T Preferred Stock") and a warrant to purchase 399,970.34 shares of the Company's common stock (the "Warrant") for an aggregate purchase price of \$17.3 million in cash. The Series T Preferred Stock qualified as Tier 1 capital and was entitled to cumulative dividends at a rate of 5% per annum for the first five years and 9% per annum thereafter. The Warrant had a 10-year term and was immediately exercisable upon its issuance, with an exercise price, subject to anti-dilution adjustments equal to \$6.487 per share of the common stock.

On June 28, 2012, the Treasury sold its Series T Preferred Stock through a public offering structured as a modified Dutch auction. The Company bid on a portion of the Series T Preferred Stock in the auction after receiving approval from its regulators to do so. The clearing price per share for the preferred shares was \$904 (compared to a par value of \$1,000 per share), and the Company was successful in repurchasing 1,000 shares of the 17,299 shares of Series T Preferred Stock outstanding through the auction process. The remaining 16,299 shares of Series T Preferred Stock held by the Treasury were sold to unrelated third-parties through the auction process. Included in the September 30, 2012 operating results are approximately \$130,000 of costs incurred by the Company related to the offering. These costs are not tax-deductible. The net balance sheet impact was a reduction to shareholders' equity of \$904,000 which

is comprised of a decrease in Series T Preferred Stock of \$1.0 million and a \$96,000 increase to retained earnings related to the discount on the shares repurchased. The redemption of the \$1.0 million in preferred shares will save the Company \$50,000 annually in dividend expenses.

In addition, on July 25, 2012, the Company completed its repurchase of the Warrant from the Treasury for a mutually agreed upon price of \$1.1 million. The difference between the fair value of the Warrant, as originally recorded, and the \$1.1 million was \$343,000 which resulted in a decrease to additional paid in capital. The Company also recorded the remaining accretion of \$180,000 on the Series T Preferred Stock which brought the Preferred Stock to its par value. In conjunction with the repurchase of the Warrant, the Company obtained an interest only line of credit for \$1.5 million with another financial institution. Interest is payable quarterly at a rate of 5%, and the line of credit matures on February 3, 2014.

Following the settlement of the Warrant on July 25, 2012, the Treasury has completely eliminated its equity stake in the Company through the Capital Purchase Program. As a result, the executive compensation and corporate governance standards

that were applicable to the Company while the Treasury held shares of the Series T Preferred Stock are no longer applicable to our Company, and we have the option to increase the compensation for our executive officers and other senior employees on a going forward basis.

On January 3, 2013 and April 1, 2013, the Company redeemed a total of \$1.0 million of its outstanding preferred stock from three of its preferred shareholders. Since July of 2012, the Company has redeemed a cumulative \$2.0 million of its outstanding preferred stock and reduced the balance to \$15.3 million.

**NOTE 3 - Investment Securities**

The amortized costs and fair value of investment securities are as follows:

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Contractual maturities and yields on our investment securities at March 31, 2013 and December 31, 2012 are shown in the following table. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

The tables below summarize gross unrealized losses on investment securities and the fair market value of the related securities at March 31, 2013 and December 31, 2012, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position.

At March 31, 2013, the Company had 22 individual investments that were in an unrealized loss position for less than 12 months. The unrealized losses were primarily attributable to changes in interest rates, rather than deterioration in credit quality. The Company considers the length of time and extent to which the fair value of available-for-sale debt securities have been less

than cost to conclude that such securities are not other-than-temporarily impaired. We also consider other factors such as the financial condition of the issuer including credit ratings and specific events affecting the operations of the issuer, volatility of the security, underlying assets that collateralize the debt security, and other industry and macroeconomic conditions. As the Company has no intent to sell securities with unrealized losses and it is not more-likely-than-not that the Company will be required to sell these securities before recovery of amortized cost, we have concluded that the securities are not impaired on an other-than-temporary basis.

Other investments are comprised of the following and are recorded at cost which approximates fair value.

#### **NOTE 4 - Loans and Allowance for Loan Losses**

The following table summarizes the composition of our loan portfolio.

##### *Maturities and Sensitivity of Loans to Changes in Interest Rates*

The information in the following tables summarizes the loan maturity distribution by type and related interest rate characteristics based on the contractual maturities of individual loans, including loans which may be subject to renewal at their contractual maturity. Renewal of such loans is subject to review and credit approval, as well as modification of terms upon maturity. Actual repayments of loans may differ from the maturities reflected below, because borrowers have the right to prepay obligations with or without prepayment penalties.

## **Portfolio Segment Methodology**

### *Commercial*

Commercial loans are assessed for estimated losses by grading each loan using various risk factors identified through periodic reviews. We apply historic grade-specific loss factors to each class of loans. In the development of our statistically derived loan grade loss factors, we observe historical losses over a relevant period for each loan grade. These loss estimates are adjusted as appropriate based on additional analysis of external loss data or other risks identified from current economic



conditions and credit quality trends. The allowance also includes an amount for the estimated impairment on nonaccrual commercial loans and commercial loans modified in a troubled debt restructuring ("TDR"), whether on accrual or nonaccrual status.

*Consumer*

For consumer loans, we determine the allowance on a collective basis utilizing historic loss factors to represent our best estimate of inherent loss. We pool loans, generally by loan class with similar risk characteristics. In addition, we establish an allowance for consumer loans that have been modified in a TDR, whether on accrual or nonaccrual status. The allowance also includes an amount for the estimated impairment on nonaccrual consumer loans and consumer loans modified in a TDR, whether on accrual or nonaccrual status.

**Credit Quality Indicators**

*Commercial*

We manage a consistent process for assessing commercial loan credit quality by monitoring our loan grading trends and past due statistics. All loans are subject to individual risk assessment. Our categories include Pass, Special mention, Substandard, Doubtful, and Loss, each of which is defined by banking regulatory agencies. Delinquency statistics are also an important indicator of credit quality in the establishment of our allowance for loan losses.

The tables below provide a breakdown of outstanding commercial loans by risk category.

The following tables provide past due information for outstanding commercial loans and include loans on nonaccrual status as well as accruing TDRs.

As of March 31, 2013 and December 31, 2012, loans 30 days or more past due represented 0.94% and 1.11% of our total loan portfolio, respectively. Commercial loans 30 days or more past due were 0.66% and 0.94% of our total loan portfolio as of March 31, 2013 and December 31, 2012, respectively.

*Consumer*

We manage a consistent process for assessing consumer loan credit quality by monitoring our loan grading trends and past due statistics. All loans are subject to individual risk assessment. Our categories include Pass, Special mention, Substandard, Doubtful, and Loss, each of which is defined by banking regulatory agencies. Delinquency statistics are also an important indicator of credit quality in the establishment of our allowance for loan losses.

The tables below provide a breakdown of outstanding consumer loans by risk category.

The following tables provide past due information for outstanding consumer loans and include loans on nonaccrual status as well as accruing TDRs.

As of March 31, 2013 and December 31, 2012, consumer loans 30 days or more past due were 0.29% and 0.17%, respectively, of total loans.

**Nonperforming assets**

Following is a summary of our nonperforming assets, including nonaccruing TDRs.

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**Impaired Loans**

The table below summarizes key information for impaired loans. Our impaired loans include loans on nonaccrual status and loans modified in a TDR, whether on accrual or nonaccrual status. These impaired loans may have estimated impairment which is included in the allowance for loan losses. Our commercial and consumer impaired loans are evaluated individually to determine the related allowance for loan losses.

The following table provides the average recorded investment in impaired loans and the amount of interest income recognized on impaired loans after impairment by portfolio segment and class.

### **Allowance for Loan Losses**

The allowance for loan loss is management's estimate of credit losses inherent in the loan portfolio. The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

During the first quarter of 2013, management implemented a new allowance model to measure the estimated credit losses inherent in the loan portfolio. As a result, management has adjusted the historical loss period for the Commercial and Consumer portfolio segments to 12 quarters. Also, included in the general component of the allowance for loan losses for both portfolio segments is a margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating general losses in the portfolio. The new model's qualitative factors that measure the margin of imprecision have been updated to reflect the current lending environment. Lastly, the Consumer portfolio segment reserve now also includes an amount for the estimated impairment on nonaccrual consumer loans.

The following table summarizes the activity related to our allowance for loan losses:

The following tables summarize the activity in the allowance for loan losses by our commercial and consumer portfolio segments.

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The following table disaggregates our allowance for loan losses and recorded investment in loans by impairment methodology.

**NOTE 5 - Troubled Debt Restructurings**

At March 31, 2013, we had 34 loans totaling \$11.9 million and at December 31, 2012 we had 36 loans totaling \$14.2 million, which we considered as TDRs. The Company considers a loan to be a TDR when the debtor experiences financial difficulties and the Company provides concessions such that we will not collect all principal and interest in accordance with the original terms of the loan agreement. Concessions can relate to the contractual interest rate, maturity date, or payment structure of the note. As part of our workout plan for individual loan relationships, we may restructure loan terms to assist borrowers facing challenges in the current economic environment.

The following table summarizes the concession at the time of modification and the recorded investment in our TDRs before and after their modification during the three months ended March 31, 2013 and 2012, respectively.

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The following table summarizes loans modified as TDRs within the previous 12-month period for which there was a payment default during the three months ended March 31, 2013 and 2012, respectively.

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## **NOTE 6 - Fair Value Accounting**

FASB ASC 820, "Fair Value Measurement and Disclosures," defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. FASB ASC 820 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Following is a description of valuation methodologies used for assets recorded at fair value.

### *Investment Securities*

Securities available for sale are valued on a recurring basis at quoted market prices where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable securities. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange or U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities and debentures issued by government sponsored entities, municipal bonds and corporate debt securities. In certain cases where there is limited activity or less transparency around inputs to valuations, securities are classified as Level 3 within the valuation hierarchy. Securities held to maturity are valued at quoted market prices or dealer quotes similar to securities available for sale. The carrying value of Other Investments, such as Federal Reserve Bank and Federal Home Loan Bank ("FHLB") stock, approximates fair value based on their redemption provisions.

### *Loans*

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan may be considered impaired and an allowance for loan losses may be established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures the impairment in accordance with FASB ASC 310, "Receivables." The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At March 31, 2013, substantially all of the impaired loans were evaluated based on the fair value of the collateral. In accordance with FASB ASC 820, "Fair Value Measurement and Disclosures," impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company considers the impaired loan as nonrecurring Level 2. The Company's current loan and appraisal policies require the Bank to obtain updated appraisals on an "as is" basis at renewal, or in the case of an impaired loan, on an annual basis, either through a new external appraisal or an appraisal evaluation. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company considers the impaired loan as nonrecurring Level 3. The fair value of impaired loans may also be estimated using the present value of expected future cash flows to be realized on the loan, which is also considered a Level 3 valuation. These fair value estimates are subject to fluctuations in assumptions about the amount and timing of expected cash flows as well as the choice of discount rate used in the present value calculation.

*Other Real Estate Owned ("OREO")*

OREO, consisting of properties obtained through foreclosure or in satisfaction of loans, is reported at the lower of cost or fair value, determined on the basis of current appraisals, comparable sales, and other estimates of value obtained principally from independent sources, adjusted for estimated selling costs (Level 2). At the time of foreclosure, any excess of the loan balance over the fair value of the real estate held as collateral is treated as a charge against the allowance for loan losses. Gains or losses on sale and generally any subsequent adjustments to the value are recorded as a component of real estate owned activity. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company considers the OREO as nonrecurring Level 3.

*Assets and Liabilities Recorded at Fair Value on a Recurring Basis*

The tables below present the recorded amount of assets and liabilities measured at fair value on a recurring basis.

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

*Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis*

The Company is predominantly an asset based lender with real estate serving as collateral on more than 80% of loans as of March 31, 2013. Loans which are deemed to be impaired are valued net of the allowance for loan losses, and other real estate owned is valued at the lower of cost or net realizable value of the underlying real estate collateral. Such market values are generally obtained using independent appraisals, which the Company considers to be level 2 inputs. The tables below present the recorded amount of assets and liabilities measured at fair value on a nonrecurring basis.

For Level 3 assets and liabilities measured at fair value on a recurring or non-recurring basis as of March 31, 2013, the significant unobservable inputs used in the fair value measurements were as follows:

*Fair Value of Financial Instruments*

Financial instruments require disclosure of fair value information, whether or not recognized in the consolidated balance sheets, when it is practical to estimate the fair value. A financial instrument is defined as cash, evidence of an ownership interest in an entity or a contractual obligation which requires the exchange of cash. Certain items are specifically excluded from the disclosure requirements, including the Company's common stock, premises and equipment and other assets and liabilities.

The following is a description of valuation methodologies used to estimate fair value for certain other financial instruments.

Fair value approximates carrying value for the following financial instruments due to the short-term nature of the instrument: cash and due from banks, federal funds sold, federal funds purchased, and securities sold under agreement to repurchase.

*Bank Owned Life Insurance* - The cash surrender value of bank owned life insurance policies held by the Bank approximates fair values of the policies.

*Deposits* - Fair value for demand deposit accounts and interest-bearing accounts with no fixed maturity date is equal to the carrying value. The fair value of certificate of deposit accounts are estimated by discounting cash flows from expected maturities using current interest rates on similar instruments.

*FHLB Advances and Other Borrowings* - Fair value for FHLB advances and other borrowings are estimated by discounting cash flows from expected maturities using current interest rates on similar instruments.

*Junior subordinated debentures* - Fair value for junior subordinated debentures are estimated by discounting cash flows from expected maturities using current interest rates on similar instruments.

The Company has used management's best estimate of fair value based on the above assumptions. Thus, the fair values presented may not be the amounts that could be realized in an immediate sale or settlement of the instrument. In addition, any income taxes or other expenses, which would be incurred in an actual sale or settlement, are not taken into consideration in the fair value presented.

The estimated fair values of the Company's financial instruments at March 31, 2013 and December 31, 2012 are as follows:

**NOTE 7 - Earnings Per Common Share and Stock Dividend**

On January 15, 2013, the Company's Board of Directors approved a 10% stock dividend to the Company's shareholders. The record date for shareholders entitled to receive the stock dividend was February 1, 2013 and the distribution date was February 15, 2013. Certain amounts in our Consolidated Balance Sheets, including common shares outstanding, have been adjusted for the prior period to reflect the stock dividend. In addition, earnings per share and average shares outstanding in our Consolidated Statements of Income have been adjusted for the prior period to reflect the stock dividend.

The following schedule reconciles the numerators and denominators of the basic and diluted earnings per share computations for the three month period ended March 31, 2013. Dilutive common shares arise from the potentially dilutive effect of the Company's stock options that were outstanding at March 31, 2013. The assumed conversion of stock options can create a difference between basic and dilutive net income per common share. At March 31, 2013 and 2012, 74,802 and 86,902 options, respectively, were anti-dilutive in the calculation of earnings per share as their exercise price exceeded the fair market value.

**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

*The following discussion reviews our results of operations for the three month period ended March 31, 2013 as compared to the three month period ended March 31, 2012 and assesses our financial condition as of March 31, 2013 as compared to December 31, 2012. You should read the following discussion and analysis in conjunction with the accompanying consolidated financial statements and the related notes and the consolidated financial statements and the related notes for the year ended December 31, 2012 included in our Annual Report on Form 10-K for that period. Results for the three month period ended March 31, 2013 are not necessarily indicative of the results for the year ending December 31, 2013 or any future period.*

**Discussion of forward-looking statements**

This report, including information included or incorporated by reference in this report, contains statements which constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may relate to our financial condition, results of operation, plans, objectives, or future performance. These statements are based on many assumptions and estimates and are not guarantees of future performance. Our actual results may differ materially from those anticipated in any forward-looking statements, as they will depend on many factors about which we are unsure, including many factors which are beyond our control. The words "may," "would," "could," "should," "will," "expect," "anticipate," "predict," "project," "potential," "believe," "continue," "assume," "intend," "plan," and "estimate," as well as similar expressions, are meant to identify such forward-looking statements. Potential risks and uncertainties that could cause our actual results to differ from those anticipated in any forward-looking statements include, but are not limited to, those described under Item 1A- Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2012, as well as the following:

credit losses as a result of declining real estate values, increasing interest rates, increasing unemployment, changes in payment behavior or other factors;

credit losses due to loan concentration;

changes in the amount of our loan portfolio collateralized by real estate and weaknesses in the real estate market;

restrictions or conditions imposed by our regulators on our operations;

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

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

changes in political conditions or the legislative or regulatory environment, including governmental initiatives affecting the financial services industry;

changes in economic conditions resulting in, among other things, a deterioration in credit quality;

changes occurring in business conditions and inflation;

changes in access to funding or increased regulatory requirements with regard to funding;

increased cybersecurity risk, including potential business disruptions or financial losses;

changes in deposit flows;

changes in technology;

the adequacy of the level of our allowance for loan losses and the amount of loan loss provisions required in future periods;

examinations by our regulatory authorities, including the possibility that the regulatory authorities may, among other things, require us to increase our allowance for loan losses or write-down assets;

changes in monetary and tax policies;

changes in accounting policies and practices;  
the rate of delinquencies and amounts of loans charged-off;  
the rate of loan growth in recent years and the lack of seasoning of a portion of our loan portfolio;  
our ability to maintain appropriate levels of capital and to comply with our capital ratio requirements;  
our ability to attract and retain key personnel;  
our ability to retain our existing clients, including our deposit relationships;  
adverse changes in asset quality and resulting credit risk-related losses and expenses; and  
other risks and uncertainties detailed from time to time in our filings with the Securities and Exchange Commission (the "SEC").

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If any of these risks or uncertainties materialize, or if any of the assumptions underlying such forward-looking statements proves to be incorrect, our results could differ materially from those expressed in, implied or projected by, such forward-looking statements. For information with respect to factors that could cause actual results to differ from the expectations stated in the forward-looking statements, see "Risk Factors" under Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012. We urge investors to consider all of these factors carefully in evaluating the forward-looking statements contained in this Quarterly Report on Form 10-Q. We make these forward-looking as of the date of this document and we do not intend, and assume no obligation, to update the forward-looking statements or to update the reasons why actual results could differ from those expressed in, or implied or projected by, the forward-looking statements.

## OVERVIEW

We are a bank holding company headquartered in Greenville, South Carolina, and were incorporated in March 1999 under the laws of South Carolina. We provide a wide range of banking services and products to our clients through our wholly-owned bank subsidiary, Southern First Bank. We do not engage in any significant operations other than the ownership of our banking subsidiary. On March 6, 2013, the Bank was approved by the South Carolina Board of Financial Institutions to convert from a national bank charter to a South Carolina state bank charter, and change its name from Southern First Bank, N.A. to Southern First Bank. Both changes were effective beginning April 1, 2013.

The Bank is primarily engaged in the business of accepting demand deposits and savings deposits insured by the FDIC, and providing commercial, consumer and mortgage loans to the general public. We currently have eight offices located in Greenville, Lexington, Richland, and Charleston Counties of South Carolina. In December 2012, we opened our Charleston office at 480 East Bay Street, Charleston, South Carolina and our third full-service office in Columbia, South Carolina.

Our business model continues to be client-focused, utilizing relationship teams to provide our clients with a specific banker contact and support team responsible for all of their banking needs. The purpose of this structure is to provide a consistent and superior level of professional service, and we believe it provides us with a distinct competitive advantage. We consider exceptional client service to be a critical part of our culture, which we refer to as "ClientFIRST."

At March 31, 2013, we had total assets of \$821.7 million, a 3.0% increase from total assets of \$798.0 million at December 31, 2012. The largest components of our total assets are loans and securities which were \$655.9 million and \$82.7 million, respectively, at March 31, 2013. Comparatively, our loans and securities totaled \$636.9 million and \$86.0 million, respectively, at December 31, 2012. Our liabilities and shareholders' equity at March 31, 2013 totaled \$757.3 million and \$64.4 million, respectively, compared to liabilities of \$733.9 million and shareholders' equity of \$64.1 million at December 31, 2012. The principal component of our liabilities is deposits which were \$612.4 million and \$576.3 million at March 31, 2013 and December 31, 2012, respectively.

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

Our net income was \$961,000 and \$688,000 for the three months ended March 31, 2013 and 2012, respectively, an increase of \$273,000, or 39.7%. After our dividend payment to our preferred shareholders, net income to common shareholders was \$784,000, or diluted earnings per share ("EPS") of \$0.18, for the first quarter of 2013 as compared to

net income to common shareholders of \$399,000, or diluted EPS of \$0.09 for the same period in 2012. The increase in net income resulted primarily from increases in net interest income and noninterest income as well as a decrease in the provision for loan losses.

Economic conditions, competition, and the monetary and fiscal policies of the Federal government significantly affect most financial institutions, including the Bank. Lending and deposit activities and fee income generation are influenced by levels of business spending and investment, consumer income, consumer spending and savings, capital market activities, and competition among financial institutions, as well as customer preferences, interest rate conditions and prevailing market rates on competing products in our market areas.



## **Effect of Economic Trends**

The twelve months ended December 31, 2012 and the first three months of 2013 continue to reflect the tumultuous economic conditions which have negatively impacted the liquidity and credit quality of financial institutions in the United States. Concerns regarding increased credit losses from the weakening economy have negatively affected capital and earnings of most financial institutions. Financial institutions have experienced significant declines in the value of collateral for real estate loans, heightened credit losses, which have resulted in record levels of non-performing assets, charge-offs and foreclosures. In addition, during the past four years, hundreds of financial institutions failed or merged with other institutions, and two of the government sponsored housing enterprises were placed into conservatorship with the U.S. Government in 2008.

Liquidity in the debt markets remains low in spite of efforts by Treasury and the Federal Reserve to inject capital into financial institutions. The federal funds rate set by the Federal Reserve has remained at 0.25% since December 2008, following a decline from 4.25% to 0.25% during 2008 through a series of seven rate reductions.

The Treasury, the FDIC and other governmental agencies continue to enact rules and regulations to implement the Emergency Economic Stabilization Act of 2008 (the "EESA"), the Troubled Asset Relief Program (the "TARP"), the American Recovery and Reinvestment Act of 2009 (the "Recovery Act"), the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and related economic recovery programs, many of which contain limitations on the ability of financial institutions to take certain actions or to engage in certain activities if the financial institution is a participant in the CPP or related programs. Future regulations, or enforcement of the terms of programs already in place, may require financial institutions to raise additional capital. There can be no assurance as to the actual impact of the EESA, the TARP, the Recovery Act, the Dodd-Frank Act or any governmental program on the financial markets.

The weak economic conditions are expected to continue throughout 2013, and financial institutions likely will continue to experience heightened credit losses and higher levels of non-performing assets, charge-offs and foreclosures. In light of these conditions, financial institutions also face heightened levels of scrutiny from federal and state regulators. These factors negatively influenced, and likely will continue to negatively influence, earning asset yields at a time when the market for deposits is intensely competitive. As a result, financial institutions experienced, and are expected to continue to experience, pressure on credit costs, loan yields, deposit and other borrowing costs, liquidity, and capital.

## **results of operations**

### *Net Interest Income and Margin*

Our level of net interest income is determined by the level of earning assets and the management of our net interest margin. For the three month period ended March 31, 2013 our net interest income was \$6.9 million, a 12.2% increase over net interest income of \$6.1 million for the same period in 2012. In comparison, our average earning assets increased 6.0%, or \$43.2 million, during the first quarter of 2013 compared to the first quarter of 2012, while our interest bearing liabilities increased by \$32.6 million during the same period. The increase in average earning assets is primarily related to an increase in average loans, partially offset by a decrease in investment securities, while the increase in average interest-bearing liabilities is primarily a result of an increase in interest bearing deposits and FHLB advances.

We have included a number of tables to assist in our description of various measures of our financial performance. For example, the "Average Balances, Income and Expenses, Yields and Rates" table reflects the average balance of each category of our assets and liabilities as well as the yield we earned or the rate we paid with respect to each category during the three month period ended March 31, 2013 and 2012. A review of this table shows that our loans typically provide higher interest yields than do other types of interest-earning assets, which is why we direct a substantial

percentage of our earning assets into our loan portfolio. Similarly, the "Rate/Volume Analysis" table demonstrates the effect of changing interest rates and changing volume of assets and liabilities on our financial condition during the periods shown. We also track the sensitivity of our various categories of assets and liabilities to changes in interest rates, and we have included tables to illustrate our interest rate sensitivity with respect to interest-earning accounts and interest-bearing accounts.

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

**Average Balances, Income and Expenses, Yields and Rates**

(1) Annualized for the three month period.

(2) The tax-equivalent adjustment to net interest income adjusts the yield for assets earning tax-exempt income to a comparable yield on a taxable basis.

Our net interest margin, on a tax-equivalent basis, was 3.69% for the three months ended March 31, 2013 compared to 3.45% for the first quarter of 2012. The 24 basis point increase in net interest margin as compared to the same period in 2012, was driven primarily by a 41 basis point reduction in the cost of our interest bearing liabilities, offset in part by a 12 basis point reduction in the yield of our interest earning assets.

While our interest-bearing liabilities increased by \$32.6 million during the first quarter of 2013 as compared to the first quarter of 2012, our interest expense decreased by \$563,000 due to a 41 basis point decline in the rate paid on these liabilities. During the past 12 months, we have continued to reduce rates on all of our deposit products in line with the historically low Federal funds target rate. Consequently, the cost of our interest bearing deposits decreased 40 basis points from the first quarter of 2012. Also, during the past 12 months, we restructured \$45.0 million of our FHLB advances from a weighted average rate of 3.16% to a weighted average rate of 2.42%, which reduced the overall weighted average rate on our FHLB advances by 46 basis points.

In addition, our interest-earning assets increased by \$43.2 million as compared to the same quarter in 2012, while the yield on these assets decreased by 12 basis points. The decline in yield on our interest earning assets was driven primarily by reduced yields on our loan portfolio due to loans being originated or renewed at market rates which are lower than those in the past. Our average loan balances increased by \$55.9 million as of the first quarter of 2013, compared to the same period in 2012, while our loan yield decreased by 24 basis points during the same period.

Our net interest spread was 3.52% for the three months ended March 31, 2013 compared to 3.23% for the same period in 2012. The net interest spread is the difference between the yield we earn on our interest-earning assets and the rate we pay

on our interest-bearing liabilities. The 41 basis point reduction in rate on our interest-bearing liabilities, partially offset by an 12 basis point decline in yield on our earning assets, resulted in a 29 basis point increase in our net interest spread for the 2013 period.

#### *Rate/Volume Analysis*

Net interest income can be analyzed in terms of the impact of changing interest rates and changing volume. The following table sets forth the effect which the varying levels of interest-earning assets and interest-bearing liabilities and the applicable rates have had on changes in net interest income for the periods presented.

Net interest income, the largest component of our income, was \$6.9 million for the three month period ended March 31, 2013 and \$6.1 million for the three months ended March 31, 2012, a \$749,000, or 12.2% increase during the first quarter of 2013. The increase in net interest income is due to a \$186,000 increase in interest income, combined with a \$563,000 decrease in interest expense. While our interest earning assets increased by \$43.2 million during the first quarter of 2013 compared to the first quarter of 2012, the 41 basis point decline in the cost of our interest bearing liabilities had a larger impact on the increase in net interest income during the 2013 period.

#### *Provision for Loan Losses*

We have established an allowance for loan losses through a provision for loan losses charged as an expense on our consolidated statements of income. We review our loan portfolio periodically to evaluate our outstanding loans and to measure both the performance of the portfolio and the adequacy of the allowance for loan losses. Please see the discussion below under "Balance Sheet Review - Allowance for Loan Losses" for a description of the factors we consider in determining the amount of the provision we expense each period to maintain this allowance.

For the three months ended March 31, 2013 and 2012, we incurred a noncash expense related to the provision for loan losses of \$1.1 million and \$1.2 million, respectively, resulting in an allowance for loan losses of \$9.4 million and \$9.2 million for the 2013 and 2012 periods, respectively. The slightly lower provision for loan losses during the 2013 period relates primarily to the overall improvement in the credit quality of our loan portfolio during the first three months of 2013. The \$9.4 million allowance represented 1.41% of gross loans at March 31, 2013 while the \$9.2 million allowance was 1.51% of gross loans at March 31, 2012.

During the past twelve months, our loan balances increased by \$57.3 million, while the amount of our nonperforming and past due loans declined. Factors such as these are also considered in determining the amount of loan loss provision necessary to maintain our allowance for loan losses at an adequate level.

*Noninterest Income*

The following table sets forth information related to our noninterest income.

Noninterest income increased \$45,000, or 5.4%, in the first quarter of 2013 as compared to the same period in 2012. The increase in total noninterest income during this 2013 period resulted primarily from the following:

Loan fee income increased 29.5%, or \$59,000, resulting primarily from increased mortgage origination fee income of \$236,000.

Service fees on deposit accounts increased \$44,000, or 24.3%, primarily related to additional income from service charges on our checking, money market, and savings accounts.

Other income increased by 5.8%, or \$13,000, due primarily to increased income received from ATM and debit card transactions which is volume driven.

Partially offsetting these increases in noninterest income was a reduction in the gain on sale of investment securities from \$72,000 recognized during the 2012 period. We had no sales of investment securities during the first quarter of 2013.

The Dodd-Frank Act calls for new limits on interchange transaction fees that banks receive from merchants via card networks like Visa, Inc. and MasterCard, Inc. when a customer uses a debit card. In June 2011, the Federal Reserve approved the final rule which caps an issuer's base fee at 21 cents per transaction and allows an additional 5 basis point charge per transaction to help cover fraud losses. Although the rule technically does not apply to institutions with less than \$10 billion in assets, such as our Bank, there is concern that the price controls may harm community banks, which could be pressured by the marketplace to lower their own interchange rates. Our ATM/Debit card fee income is included in other noninterest income and was \$119,000 and \$108,000 for the three months ended March 31, 2013 and 2012, respectively.

*Noninterest expenses*

The following table sets forth information related to our noninterest expenses.

Noninterest expense was \$5.2 million for the three months ended March 31, 2013, a \$451,000, or 9.4%, increase from noninterest expense of \$4.8 million for the three months ended March 31, 2012.

The increase in total noninterest expenses resulted primarily from the following:

Compensation and benefits expense increased 21.7%, or \$527,000, relating primarily to increases in base compensation and benefits expenses. Base compensation increased by \$298,000 driven by the cost of 17 additional employees, 11 of which were hired to support our new Charleston and Forest Drive offices, and three of which were hired in relation to the expansion of our mortgage operations, combined with annual company-wide salary increases. Incentive compensation, which is based on certain targeted financial performance goals met by management, increased by \$59,000, while benefit expenses increased \$175,000 during the same period, compared to the first quarter of the prior year.

Occupancy expenses increased \$124,000, or 21.3%, driven by increased depreciation, utilities and maintenance expenses related to our two new offices in Charleston and Columbia, South Carolina.

Data processing and related costs increased 12.1%, or \$62,000, primarily related to the increased number of clients and accounts we serve, as well as additional services we provide to our clients.

Other expenses increased by \$115,000, or 45.5%, primarily related to additional costs associated with our two new offices, as well as \$55,000 related to a litigation settlement.

Partially offsetting these increases in noninterest expense were decreases resulting from:

Real estate owned activity decreased by \$258,000, due primarily to a loss on sale of \$203,000 and write-downs of \$52,000 recorded on properties held by us during the first quarter of 2012, compared to expenses of \$20,000 recorded during the 2013 period.

Insurance expense decreased by \$112,000, or 31.8%, due to lesser FDIC insurance premiums and a lower OCC assessment fee resulting from the termination of the formal agreement with the OCC in December 2012.

Our efficiency ratio, excluding gains on sale of investment securities and real estate owned activity, was 67.1% for the first quarter of 2013 compared to 65.3% for the same period in 2012. The efficiency ratio represents the percentage of one dollar of expense required to be incurred to earn a full dollar of revenue and is computed by dividing noninterest expense by the sum of net interest income and noninterest income. The higher efficiency ratio during the 2013 period relates primarily to the increase in noninterest expense due to the additional costs associated with opening our two new retail locations and expanding our mortgage operations capabilities.

We incurred income tax expense of \$444,000 for the three months ended March 31, 2013 as compared to \$299,000 during the same period in 2012. Our effective tax rate was 31.6% and 30.3% for the three months ended March 31, 2013 and 2012, respectively. The increase in income tax expense during the 2013 periods is primarily a result of the increase in our net income during the respective periods.

## **Balance Sheet Review**

### *Investment Securities*

At March 31, 2013, the \$82.7 million in our investment securities portfolio represented approximately 10.1% of our total assets. We held investment securities with a fair value of \$75.1 million and an amortized cost of \$73.6 million resulting in an unrealized gain of \$1.5 million. At December 31, 2012, the \$86.0 million in our investment securities portfolio represented approximately 10.8% of our total assets. We held investment securities with a fair value of \$78.2 million and an amortized cost of \$76.4 million for an unrealized gain of \$1.8 million.

### *Loans*

Since loans typically provide higher interest yields than other types of interest earning assets, a substantial percentage of our earning assets are invested in our loan portfolio. Average loans for the three months ended March 31, 2013 and 2012 were \$657.6 million and \$601.7 million, respectively. Before the allowance for loan losses, total loans

outstanding at March 31, 2013 and December 31, 2012 were \$665.2 and \$646.0 million, respectively.

The principal component of our loan portfolio is loans secured by real estate mortgages. As of March 31, 2013, our loan portfolio included \$538.9 million, or 81.0%, of real estate loans. As of December 31, 2012, real estate loans made up 80.9% of our loan portfolio and totaled \$522.5 million. Most of our real estate loans are secured by residential or commercial property. We obtain a security interest in real estate, in addition to any other available collateral. This collateral is taken to increase the likelihood of the ultimate repayment of the loan. Generally, we limit the loan-to-value ratio on loans to coincide with the

appropriate regulatory guidelines. We attempt to maintain a relatively diversified loan portfolio to help reduce the risk inherent in concentration in certain types of collateral and business types. We do not generally originate traditional long term residential mortgages to hold in our loan portfolio, but we do issue traditional second mortgage residential real estate loans and home equity lines of credit. Home equity lines of credit totaled \$78.8 million as of March 31, 2013, of which approximately 39% were in a first lien position, while the remaining balance was second liens. The average loan had a balance of approximately \$85,000 and a loan to value of 74%. Further, 0.59% of our total home equity lines of credit were over 30 days past due as of March 31, 2013.

Following is a summary of our loan composition at March 31, 2013 and December 31, 2012. Of the \$19.2 million in loan growth, \$12.9 million is related to our new East Bay Street office in Charleston with growth of \$8.3 million in non-owner occupied real estate, \$2.2 million in owner occupied real estate, and \$2.0 million in commercial business loans.

#### *Nonperforming assets*

Nonperforming assets include real estate acquired through foreclosure or deed taken in lieu of foreclosure and loans on nonaccrual status. Generally, a loan is placed on nonaccrual status when it becomes 90 days past due as to principal or interest, or when we believe, after considering economic and business conditions and collection efforts, that the borrower's financial condition is such that collection of the contractual principal or interest on the loan is doubtful. A payment of interest on a loan that is classified as nonaccrual is recognized as a reduction in principal when received. As of March 31, 2013 and December 31, 2012, we had no loans 90 days past due and still accruing.



Following is a summary of our nonperforming assets, including nonaccruing TDRs.

At March 31, 2013, nonperforming assets were \$8.8 million, or 1.07% of total assets and 1.33% of gross loans. Comparatively, nonperforming assets were \$9.9 million, or 1.24% of total assets and 1.53% of gross loans at December 31, 2012. Nonaccrual loans decreased \$1.1 million to \$8.8 million at March 31, 2013 from \$9.9 million at December 31, 2012. Nonaccrual loans at March 31, 2013 include two loans which were put on nonaccrual status during the first three months of 2013. In addition, during the first three months of 2013, two nonaccrual loans were transferred to OREO, and four nonaccrual loans were either fully or partially charged-off. The amount of foregone interest income on the nonaccrual loans in the first three months of 2013 was approximately \$237,000.

Nonperforming assets include other real estate owned which increased by \$803,000 from December 31, 2012. During the first three months of 2013 we added two properties for \$1.0 million and sold two properties for \$198,000. The balance at March 31, 2013 includes six commercial properties totaling \$2.4 million and three residential properties totaling \$124,000. All of these properties are located in the Upstate of South Carolina. We believe that these properties are appropriately valued at the lower of cost or market as of March 31, 2013.

At March 31, 2013 and 2012, the allowance for loan losses represented 148.55% and 91.6% of the total amount of nonperforming loans, respectively. A significant portion, or 82%, of nonperforming loans at March 31, 2013 is secured by real estate. Our nonperforming loans have been written down to approximately 64% of their original nonperforming balance. We have evaluated the underlying collateral on these loans and believe that the collateral on these loans is sufficient to minimize future losses. Based on the level of coverage on nonperforming loans and analysis of our loan portfolio, we believe the allowance for loan losses of \$9.4 million as of March 31, 2013 to be adequate.

As a general practice, most of our loans are originated with relatively short maturities of less than 10 years. As a result, when a loan reaches its maturity we frequently renew the loan and thus extend its maturity using the same credit standards as those used when the loan was first originated. Due to these loan practices, we may, at times, renew loans which are classified as nonperforming after evaluating the loan's collateral value and financial strength of its guarantors. Nonperforming loans are renewed at terms generally consistent with the ultimate source of repayment and rarely at reduced rates. In these cases the Company will seek additional credit enhancements, such as additional collateral or additional guarantees to further protect the loan. When a loan is no longer performing in accordance with its stated terms, the Company will typically seek performance under the guarantee.

In addition, at March 31, 2013, 81.0% of our loans are collateralized by real estate and 85.8% of our impaired loans are secured by real estate. The Company utilizes third party appraisers to determine the fair value of collateral dependent loans. Our current loan and appraisal policies require the Company to obtain updated appraisals on an "as is" basis at renewal, or in the case of an impaired loan, on an annual basis, either through a new external appraisal or an appraisal evaluation. In situations where a current appraisal is not available, we use the best available information (including recent appraisals for similar properties, communications with qualified real estate professionals, and other observable market data) to estimate the current fair value. Impaired loans are individually reviewed on a quarterly basis to determine the level of impairment based on external market data. As of March 31, 2013, we do not have any impaired real estate loans carried at a value in excess of the appraised value. We typically charge-off a portion or create a specific reserve for impaired loans when we do not expect repayment to occur as agreed upon under the original terms of the loan agreement.

As of March 31, 2013, impaired loans totaled \$15.3 million for which \$8.9 million of these loans have a reserve of approximately \$3.5 million allocated in the allowance. During the first three months of 2013, the average recorded investment in impaired loans was approximately \$16.5 million. Comparatively, impaired loans totaled \$17.6 million at December 31, 2012, and \$9.5 million of these loans had a reserve of approximately \$3.7 million allocated in the allowance. During 2012, the average recorded investment in impaired loans was approximately \$17.9 million.



*Allowance for Loan Losses*

We have established an allowance for loan losses through a provision for loan losses charged as an expense. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance, either in whole or in part, is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses was \$9.4 million and \$9.2 million at March 31, 2013 and 2012, respectively, or 1.41% and 1.51% of outstanding loans, respectively. At December 31, 2012, our allowance for loan losses was \$9.1 million, or 1.41% of outstanding loans, and we had net loans charged-off of \$4.4 million for the year ended December 31, 2012.

During the three months ended March 31, 2013, we charged-off \$944,000 of loans and recorded \$95,000 of recoveries on loans previously charged-off, for net charge-offs of \$849,000, or 0.52% of average loans. Comparatively, we charged-off \$942,000 million of loans and recorded \$13,000 of recoveries on loans previously charged-off, resulting in net charge-offs of \$929,000, or 0.62% of average loans for the first three months of 2012.

Following is a summary of the activity in the allowance for loan losses.

*Deposits and Other Interest-Bearing Liabilities*

Our primary source of funds for loans and investments is our deposits, advances from the FHLB, and structured repurchase agreements. In the past, we have chosen to obtain a portion of our certificates of deposits from areas outside of our market in order to obtain longer term deposits than are readily available in our local market. We have adopted guidelines regarding our use of brokered deposits that limit such deposits to 25% of total deposits and dictate that our current interest rate risk profile determines the terms. In addition, we do not obtain time deposits of \$100,000 or more through the Internet. These guidelines allow us to take advantage of the attractive terms that wholesale funding can offer while mitigating the related inherent risk.

Our retail deposits represented \$593.2 million, or 96.9%, of total deposits at March 31, 2013, while our out-of-market, or brokered, deposits represented \$19.3 million, or 3.1%, of total deposits. At December 31, 2012, retail deposits represented \$563.3 million, or 97.7%, of our total deposits and brokered CDs were \$13.0 million, representing 2.3% of our total deposits. Of the \$29.9 million increase in retail deposits, \$15.8 million is related to our two new retail offices which were opened in December 2012. Our loan-to-deposit ratio was 109% and 112% at March 31, 2013 and December 31, 2012, respectively.

The following table shows the average balance amounts and the average rates paid on deposits.

During the three months ended March 31, 2013, our average transaction account balances increased by \$12.9 million, or 3.7%, from the three months ended March 31, 2012. In addition, our average time deposit balances increased by \$12.0 million, or 5.7%, during the 2013 period.

During the past 12 months, we continued our focus on increasing core deposits, which exclude out-of-market deposits and time deposits of \$100,000 or more, in order to provide a relatively stable funding source for our loan portfolio and other earning assets. Our core deposits were \$460.2 million and \$427.9 million at March 31, 2013 and December 31, 2012, respectively.

All of our time deposits are certificates of deposits. The maturity distribution of our time deposits of \$100,000 or more at March 31, 2013 was as follows:

The Dodd-Frank Act also permanently raises the current standard maximum deposit insurance amount to \$250,000. The FDIC insurance coverage limit applies per depositor, per insured depository institution for each account ownership category. In addition, the FDIC provided unlimited deposit insurance coverage for noninterest-bearing transaction accounts (typically business checking accounts) and certain funds swept into noninterest-bearing savings accounts; however, the unlimited deposit insurance coverage for noninterest-bearing savings accounts expired on December 31, 2012. We are currently evaluating the potential impact of the expiration for unlimited deposit insurance coverage for noninterest-bearing saving accounts on our deposit strategy.

### **Liquidity and Capital Resources**

Liquidity represents the ability of a company to convert assets into cash or cash equivalents without significant loss, and the ability to raise additional funds by increasing liabilities. Liquidity management involves monitoring our sources and uses of funds in order to meet our day-to-day cash flow requirements while maximizing profits. Liquidity management is made more complicated because different balance sheet components are subject to varying degrees of management control. For example, the timing of maturities of our investment portfolio is fairly predictable and subject to a high degree of control at the time investment decisions are made. However, net deposit inflows and outflows are far less predictable and are not subject to the same degree of control.

At March 31, 2013 and December 31, 2012, our liquid assets, consisting of cash and due from banks and federal funds sold, amounted to \$36.2 million and \$29.4 million, or 4.4% and 3.7% of total assets, respectively. Our investment securities at March 31, 2013 and December 31, 2012 amounted to \$82.7 million and \$86.0 million, or 10.1% and 10.8% of total assets, respectively. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. However, approximately 44% of these securities are pledged against outstanding debt. Therefore, the related debt would need to be repaid prior to the securities being sold in order for these securities to be converted to cash.

Our ability to maintain and expand our deposit base and borrowing capabilities serves as our primary source of liquidity. We plan to meet our future cash needs through the liquidation of temporary investments, the generation of deposits, loan payoffs, and from additional borrowings. In addition, we will receive cash upon the maturity and sale of loans and the maturity of investment securities. We maintain three federal funds purchased lines of credit with correspondent banks totaling \$34.0 million for which there were no borrowings against the lines of credit at March 31, 2013.

We are also a member of the FHLB, from which applications for borrowings can be made. The FHLB requires that securities, qualifying mortgage loans, and stock of the FHLB owned by the Bank be pledged to secure any advances from the FHLB. The unused borrowing capacity currently available from the FHLB at March 31, 2013 was \$51.3 million, based on the Bank's \$5.6 million investment in FHLB stock, as well as qualifying mortgages available to secure any future borrowings. However, we are able to pledge additional securities to the FHLB in order to increase

our available borrowing capacity.

We believe that our existing stable base of core deposits, borrowings from the FHLB, and short-term repurchase agreements will enable us to successfully meet our long-term liquidity needs. However, as short-term liquidity needs arise, we have the ability to sell a portion of our investment securities portfolio to meet those needs.

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Total shareholders' equity at March 31, 2013 was \$64.4 million. At December 31, 2012, total shareholders' equity was \$64.1 million. The \$301,000 increase from December 31, 2012 is primarily related to net income of \$961,000 during the three month period ended March 31, 2013, offset partially by the \$500,000 repurchase of 500 shares of our preferred stock.

The following table shows the return on average assets (net income divided by average total assets), return on average equity (net income divided by average equity), and equity to assets ratio (average equity divided by average assets) annualized for the three months ended March 31, 2013 and the year ended December 31, 2012. Since our inception, we have not paid cash dividends.

Under the capital adequacy guidelines, regulatory capital is classified into two tiers. These guidelines require an institution to maintain a certain level of Tier 1 and Tier 2 capital to risk-weighted assets. Tier 1 capital consists of common shareholders' equity, excluding the unrealized gain or loss on securities available for sale, minus certain intangible assets. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight factor of 0% to 100% based on the risks believed to be inherent in the type of asset. Tier 2 capital consists of Tier 1 capital plus the general reserve for loan losses, subject to certain limitations. We are also required to maintain capital at a minimum level based on total average assets, which is known as the Tier 1 leverage ratio.

At both the holding company and bank level, we are subject to various regulatory capital requirements administered by the federal banking agencies. To be considered "well-capitalized," we must maintain total risk-based capital of at least 10%, Tier 1 capital of at least 6%, and a leverage ratio of at least 5%. To be considered "adequately capitalized" under these capital guidelines, we must maintain a minimum total risk-based capital of 8%, with at least 4% being Tier 1 capital. In addition, we must maintain a minimum Tier 1 leverage ratio of at least 4%. As of March 31, 2013, our capital ratios exceed those required to be well-capitalized.

In December 2010, the Basel Committee adopted the Basel III capital rules, which set new capital requirements for banking organizations. On June 7, 2012, the Federal Reserve requested comment on three proposed rules that, taken together, would establish an integrated regulatory capital framework implementing the Basel III regulatory capital reforms in the United States. As proposed, the U.S. implementation of Basel III would lead to significantly higher capital requirements and more restrictive leverage and liquidity ratios than those currently in place. The proposed rules indicated that the final rule would become effective on January 1, 2013, and the changes set forth in the final rules will be phased in from January 1, 2013 through January 1, 2019. However, due to the volume of public comments received, the final rule did not go into effect on January 1, 2013. The ultimate impact of the U.S. implementation of the new capital and liquidity standards on the Company and the Bank is currently being reviewed and is dependent upon the terms of the final regulations, which may differ from the proposed regulations. Requirements to maintain higher levels of capital or to maintain higher levels of liquid assets could adversely impact our net income and return on equity.

The following table summarizes the capital amounts and ratios of the Bank and the regulatory minimum requirements.

The following table summarizes the capital amounts and ratios of the Company and the minimum regulatory requirements.

The ability of the Company to pay cash dividends is dependent upon receiving cash in the form of dividends from the Bank. The dividends that may be paid by the Bank to the Company are subject to legal limitations and regulatory capital requirements. Further, the Company cannot pay cash dividends on its common stock during any calendar quarter unless full dividends on the Series T preferred stock for the dividend period ending during the calendar quarter have been declared and the Company has not failed to pay a dividend in the full amount of the Series T preferred stock with respect to the period in which such dividend payment in respect of its common stock would occur.

### **Effect of Inflation and Changing Prices**

The effect of relative purchasing power over time due to inflation has not been taken into account in our consolidated financial statements. Rather, our financial statements have been prepared on an historical cost basis in accordance with generally accepted accounting principles.

Unlike most industrial companies, our assets and liabilities are primarily monetary in nature. Therefore, the effect of changes in interest rates will have a more significant impact on our performance than will the effect of changing prices and inflation in general. In addition, interest rates may generally increase as the rate of inflation increases, although not necessarily in the same magnitude. As discussed previously, we seek to manage the relationships between interest sensitive assets and liabilities in order to protect against wide rate fluctuations, including those resulting from inflation.

### **Off-Balance Sheet Risk**

Commitments to extend credit are agreements to lend money to a client as long as the client has not violated any material condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of a fee. At March 31, 2013, unfunded commitments to extend credit were \$118.9 million, of which \$22.2 million was at fixed rates and \$96.7 million was at variable rates. At December 31, 2012, unfunded commitments to extend credit were \$115.6 million, of which approximately \$22.1 million was at fixed rates and \$93.5 million was at variable rates. A significant portion of the unfunded commitments related to consumer equity lines of credit. Based on historical experience, we anticipate that a significant portion of these lines of credit will not be funded. We evaluate each client's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by us upon extension of credit, is based on our credit evaluation of the borrower. The type of collateral varies but may include accounts receivable, inventory, property, plant and equipment, and commercial and residential real estate.

At March 31, 2013 and December 31, 2012, there was a \$2.4 million and \$2.3 million, respectively, commitment under letters of credit. The credit risk and collateral involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Since most of the letters of credit are expected to expire without being drawn upon, they do not necessarily represent future cash requirements.

Except as disclosed in this report, we are not involved in off-balance sheet contractual relationships, unconsolidated related entities that have off-balance sheet arrangements or transactions that could result in liquidity needs or other commitments that significantly impact earnings.

### **Market Risk and Interest Rate Sensitivity**

Market risk is the risk of loss from adverse changes in market prices and rates, which principally arises from interest rate risk inherent in our lending, investing, deposit gathering, and borrowing activities. Other types of market risks,

such as foreign currency exchange rate risk and commodity price risk, do not generally arise in the normal course of our business.



We actively monitor and manage our interest rate risk exposure in order to control the mix and maturities of our assets and liabilities utilizing a process we call asset/liability management. The essential purposes of asset/liability management are to ensure adequate liquidity and to maintain an appropriate balance between interest sensitive assets and liabilities in order to minimize potentially adverse impacts on earnings from changes in market interest rates. Our asset/liability management committee ("ALCO") monitors and considers methods of managing exposure to interest rate risk. We have both an internal ALCO consisting of senior management that meets at various times during each month and a board ALCO that meets monthly. The ALCOs are responsible for maintaining the level of interest rate sensitivity of our interest sensitive assets and liabilities within board-approved limits.

As of March 31, 2013, the following table summarizes the forecasted impact on net interest income using a base case scenario given upward and downward movements in interest rates of 100, 200, and 300 basis points based on forecasted assumptions of prepayment speeds, nominal interest rates and loan and deposit repricing rates. Estimates are based on current economic conditions, historical interest rate cycles and other factors deemed to be relevant. However, underlying assumptions may be impacted in future periods which were not known to management at the time of the issuance of the Consolidated Financial Statements. Therefore, management's assumptions may or may not prove valid. No assurance can be given that changing economic conditions and other relevant factors impacting our net interest income will not cause actual occurrences to differ from underlying assumptions. In addition, this analysis does not consider any strategic changes to our balance sheet which management may consider as a result of changes in market conditions.

### **Critical Accounting Policies**

We have adopted various accounting policies that govern the application of accounting principles generally accepted in the United States and with general practices within the banking industry in the preparation of our financial statements. Our significant accounting policies are described in the footnotes to our audited consolidated financial statements as of December 31, 2012, as filed in our Annual Report on Form 10-K.

Certain accounting policies involve significant judgments and assumptions by us that have a material impact on the carrying value of certain assets and liabilities. We consider these accounting policies to be critical accounting policies. The judgment and assumptions we use are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Our Critical Accounting Policies are the allowance for loan losses, fair value of financial instruments, other-than-temporary impairment analysis, other real estate owned, and income taxes. Because of the nature of the judgment and assumptions we make, actual results could differ from these judgments and estimates that could have a material impact on the carrying values of our assets and liabilities and our results of operations.

### **Accounting, Reporting, and Regulatory Matters**

#### *Recently Issued Accounting Standards*

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

The Balance Sheet topic of the ASC was amended in December 2011 for companies with financial instruments and derivative instruments that offset or are subject to a master netting agreement. The amendments require disclosure of both gross information and net information about instruments and transactions eligible for offset or subject to an agreement similar to a master netting agreement. The amendments were effective for reporting periods beginning on or after January 1, 2013 and required retrospective presentation for all comparative periods presented. Additionally, in January 2013 the FASB clarified that the amendments apply only to derivatives, repurchase agreements and reverse purchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance

with specific criteria contained in U.S. GAAP or subject to a master netting arrangement or similar agreement. These amendments did not have a material effect on the Company's financial statements.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on the consolidated financial statements upon adoption.

#### *Recent Regulatory Developments*

On June 8, 2010, the Bank entered into a formal agreement (the "Formal Agreement") with its primary regulator, the Office of the Comptroller of the Currency (the "OCC"). The Formal Agreement sought to enhance the Bank's existing practices and procedures in the areas of credit risk management, credit underwriting, liquidity, and funds management. In addition, on May 24, 2010, the OCC established Individual Minimum Capital Ratio levels of Tier 1 and total capital for the Bank that are higher than the minimum and well capitalized ratios applicable to all banks. Specifically, we were required to maintain total risk-based capital of at least 12%, Tier 1 capital of at least 10%, and a leverage ratio of at least 9%. On January 3, 2013, the OCC notified the Bank that effective December 19, 2012, it was no longer subject to the Formal Agreement nor was it subject to the Individual Minimum Capital Ratios established.

#### *Recent Legislative and Regulatory Initiatives to Address Financial and Economic Crises*

Markets in the United States and elsewhere have experienced extreme volatility and disruption over the past three plus years. These circumstances have exerted significant downward pressure on prices of equity securities and virtually all other asset classes, and have resulted in substantially increased market volatility, severely constrained credit and capital markets, particularly for financial institutions, and an overall loss of investor confidence. Loan portfolio performances have deteriorated at many institutions resulting from, among other factors, a weak economy and a decline in the value of the collateral supporting their loans. Dramatic slowdowns in the housing industry, due in part to falling home prices and increasing foreclosures and unemployment, have created strains on financial institutions. Many borrowers are now unable to repay their loans, and the collateral securing these loans has, in some cases, declined below the loan balance.

In response to the challenges facing the financial services sector, beginning in 2008 a multitude of new regulatory and governmental actions have been announced, including the EESA, the TARP, the Recovery Act, the Dodd-Frank Act, the Jumpstart Our Business Startups Act and related economic recovery programs. Some of the more recent actions include those described in Part I. Item 1. Business - Supervision and Regulation of our Annual Report on Form 10-K for the year ended December 31, 2012 as filed with the SEC. Although it is likely that further regulatory actions will arise as the Federal government attempts to address the economic situation, we cannot predict the effect that fiscal or monetary policies, economic control, or new federal or state legislation may have on our business and earnings in the future.

### **Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

See Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations - Market Risk and Interest Rate Sensitivity and - Liquidity Risk.

### **Item 4. CONTROLS AND PROCEDURES.**

#### *Evaluation of Disclosure Controls and Procedures*

Management, including our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed in the reports we file and submit under the Exchange Act is (i) recorded, processed, summarized and reported as and when required and (ii) accumulated and communicated to our management, including our Chief

Executive Officer and the Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

*Changes in Internal Control over Financial Reporting*

There has been no change in the Company's internal control over financial reporting during the three months ended March 31, 2013, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**Item 1. LEGAL PROCEEDINGS.**

There are no material pending legal proceedings to which the company is a party or of which any of its property is the subject.

**Item 1A RISK FACTORS.**

Not applicable

**Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.**

Not applicable

**Item 3. DEFAULTS UPON SENIOR SECURITIES.**

Not applicable

**Item 4. MINE SAFETY DISCLOSURES.**

Not applicable

**Item 5. OTHER INFORMATION.**

Not applicable

**Item 6. EXHIBITS.**

The exhibits required to be filed as part of this Quarterly Report on Form 10-Q are listed in the Index to Exhibits attached hereto and are incorporated herein by reference.

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**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.

**INDEX TO EXHIBITS**

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