SIERRA BANCORP
Form 10-Q
May 09, 2006

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2006

Commission file number: 000-33063

SIERRA BANCORP

(Exact name of Registrant as specified in its charter)

California	**33-0937517**
(State of Incorporation)	**(IRS Employer Identification No)**

86 North Main Street, Porterville, California 93257

(Address of principal executive offices) (Zip Code)

(559) 782-4900

(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 Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

YES þ NO ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large accelerated filer ¨ Accelerated filer þ Non-accelerated filer ¨

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

YES ¨ NO þ

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Common stock, no par value, 9,776,780 shares outstanding as of May 1, 2006

FORM 10-Q

Table of Contents

PART I - FINANCIAL INFORMATION

Item 1

SIERRA BANCORP

CONSOLIDATED BALANCE SHEETS

(dollars in thousands, unaudited)

	March 31, 2006	December 31, 2005
ASSETS		
Cash and due from banks	$ 41,627	$ 50,147
Federal Funds Sold		
Total Cash & Cash Equivalents	41,627	50,147
Securities available for sale	197,495	193,676
Loans and leases:		
Gross loans and leases	795,041	741,360
Allowance for loan and lease losses	(10,297)	(9,330)
Deferred loan and lease fees, net	(2,933)	(2,250)
Net Loans and Leases	781,811	729,780
Restricted stock	7,517	5,299
Premises and equipment, net	18,128	18,055
Operating leases, net	2,966	2,113
Other real estate		533
Accrued interest receivable	5,536	5,100
Other assets	47,150	47,983
TOTAL ASSETS	$ 1,102,230	$ 1,052,686
LIABILITIES AND SHAREHOLDERS EQUITY		
LIABILITIES		
Deposits:		
Demand	$ 280,866	$ 282,451
Interest bearing demand	75,718	69,088
Savings	72,406	71,901
MMDA s	112,008	107,045
TDOA s, IRA s & KEOGH S	22,923	22,480
Time deposits < $100,000	89,629	90,639
Time deposits ≥ $100,000	154,615	172,067
Total Deposits	808,165	815,671
Federal funds purchased and repurchase agreements	24,428	26,791
Short Term Borrowings	96,800	41,070
Long Term Borrowings	46,000	46,000
Accrued interest payable	2,153	1,459
Other liabilities	11,402	12,004
Junior subordinated debentures	30,928	30,928
TOTAL LIABILITIES	1,019,876	973,923
SHAREHOLDERS EQUITY		
Common stock, no par value; 24,000,000 shares authorized; 9,769,880 and 9,723,320 shares issued and outstanding at March 31, 2006 and December 31, 2005, respectively	12,894	12,221

Retained earnings		71,564		68,382
Accumulated other comprehensive income		(2,104)		(1,840)
TOTAL SHAREHOLDER S EQUITY		82,354		78,763
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$	1,102,230	$	1,052,686

SIERRA BANCORP

CONSOLIDATED STATEMENTS OF INCOME & COMPREHENSIVE INCOME

(dollars in thousands, except per share data, unaudited)

	For the Quarter Ended March 31, 2006	For the Quarter Ended March 31, 2005
INTEREST INCOME:		
Federal funds sold and interest bearing deposits	$ 7	$ 26
US Treasury securities	4	4
US Gov t agencies	187	60
State and political subdivisions	475	334
Mortgage-backed securities	1,424	1,557
Loans and leases, including fee income	15,922	12,678
Total interest income	18,019	14,659
INTEREST EXPENSE:		
Interest on deposits	3,077	1,677
Interest on borrowed funds	1,463	1,154
Total interest expense	4,540	2,831
Net Interest Income	13,479	11,828
Provision for loan losses	1,050	1,000
Net Interest Income after Provision for Loan Losses	12,429	10,828
OTHER OPERATING INCOME:		
Service charges on deposit accounts	1,476	1,258
Gains on sales of loans		527
Other	1,327	874
Total other operating income	2,803	2,659
OTHER OPERATING EXPENSES:		
Salaries and employee benefits	4,191	4,066
Occupancy expense	1,548	1,497
Other	2,844	3,173
Total other operating expenses	8,583	8,736
INCOME BEFORE PROVISION FOR INCOME TAXES	6,649	4,751
Provision for income taxes	2,199	1,490
NET INCOME	$ 4,450	$ 3,261
Other comprehensive (loss), unrealized (loss) on securities available for sale, net of income taxes	(265)	(1,408)
COMPREHENSIVE INCOME	$ 4,185	$ 1,853
PER SHARE DATA		
Book value	$ 8.43	$ 7.49
Cash dividends	$ 0.13	$ 0.11
Earnings per share basic	$ 0.46	$ 0.34
Earnings per share diluted	$ 0.43	$ 0.31
Average shares outstanding, basic	9,752,930	9,723,454
Average shares outstanding, diluted	10,271,219	10,386,027

4

SIERRA BANCORP

CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands, unaudited)

	Three Months Ended March 31, 2006	2005
Cash Flows from Operating Activities		
Net income	$ 4,450	$ 3,261
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sales of loans		(527)
Loss (Gain) on sale of other real estate	18	(39)
Writedown to OREO	133	260
Expense for options granted under 123(R)	101	
Provision for loan losses	1,050	1,000
Depreciation and amortization	834	791
Net amortization on securities premiums and discounts	205	358
Decrease (Increase) in unearned net loan fees	683	(54)
Increase in cash surrender value of life insurance policies	(185)	(157)
Proceeds from sales of loans held for sale		32,648
Originations of loans held for sale		(31,802)
(Increase) Decrease in interest receivable and other assets	(1,413)	392
Increase in other liabilities	263	1,028
Tax benefit from equity based compensation	(171)	
Net cash provided by operating activities	5,968	7,159
Cash Flows from Investing Activities		
Maturities of securities available for sale	413	1,785
Proceeds from sales/calls of securities available for sale	65	
Purchases of securities available for sale	(11,394)	(14,729)
Principal paydowns on securities available for sale	6,387	9,215
(Increase) Decrease in loans receivable, net	(53,764)	12,555
Purchases of premises and equipment, net	(1,760)	(363)
Proceeds from sales of other real estate	399	69
Net cash (used in) provided by investing activities	(59,654)	8,532
Cash Flows from Financing Activities		
(Decrease) Increase in deposits	(7,506)	26,390
Increase (Decrease) in borrowed funds	55,730	(28,800)
(Decrease) Increase in repurchase agreements	(2,363)	4,533
Cash dividends paid	(1,268)	(1,070)
Stock repurchased		(214)
Stock options exercised	402	1,157
Tax benefit from equity based compensation	171	
Net cash provided by financing activities	45,166	1,996
(Decrease) Increase in cash and due from banks	(8,520)	17,687
Cash and Cash Equivalents		
Beginning of period	50,147	36,735
End of period	$ 41,627	$ 54,422

SIERRA BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2006

Note 1 The Business of Sierra Bancorp

Sierra Bancorp (the Company) is a California corporation registered as a bank holding company under the Bank Holding Company Act of 1956, as amended, and is headquartered in Porterville, California. The Company was incorporated in November 2000 and acquired all of the outstanding shares of Bank of the Sierra (the Bank) in August 2001. The Company s principal subsidiary is the Bank, and the Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. The Company s principal source of income is dividends from the Bank, but the Company intends to explore supplemental sources of income in the future. The expenditures of the Company, including (but not limited to) the payment of dividends to shareholders, if and when declared by the Board of Directors, and the cost of servicing debt, will generally be paid from cash raised via capital trust pass-through securities and retained at the holding company level, and dividends paid to the Company by the Bank.

At the present time, the Company s only other direct subsidiaries are Sierra Capital Trust I, which was formed in November 2001 solely to facilitate the issuance of capital trust pass-through securities, and Sierra Statutory Trust II, formed in March 2004 also for the purpose of issuing capital trust pass-through securities. Pursuant to FASB Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46), Sierra Capital Trust I and Sierra Statutory Trust II are not reflected on a consolidated basis in the financial statements of the Company. References herein to the Company include the Sierra Bancorp and its consolidated subsidiary, the Bank, unless the context indicates otherwise.

The Bank is a California state-chartered bank headquartered in Porterville, California. It was incorporated in September 1977, opened for business in January 1978, and has grown to be the largest independent bank headquartered in the South San Joaquin Valley. The Bank is a multi-community independent bank that offers a full range of retail and commercial banking services primarily in the central and southern sections of the San Joaquin Valley. We currently operate twenty full service branch offices throughout this geographic footprint. The Bank s two newest branches opened in Reedley in December 2005 and Bakersfield in February 2006, and our next branch is expected to open in the city of Delano in the third quarter of 2006. In addition to these full-service branches, the Bank has an agricultural credit unit and an SBA lending unit with staff located at our corporate headquarters, and eight offsite ATMs. The Bank s deposit accounts are insured by the Federal Deposit Insurance Corporation (FDIC) up to maximum insurable amounts.

Note 2 Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in a condensed format, and therefore do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The information furnished in these interim statements reflects all adjustments that are, in the opinion of management, necessary for a fair statement of the results for such period. Such adjustments are of a normal recurring nature, unless otherwise disclosed in this Form 10-Q. The results of operations in the interim statements are not necessarily indicative of the results that may be expected for any other quarter, or for the full year. Certain amounts reported for 2005 have been reclassified to be consistent with the reporting for 2006. The interim financial information should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2005 as filed with the Securities and Exchange Commission.

Note 3 Current Accounting Developments

On December 16, 2004, the FASB published Statement No. 123 (Revised 2004), Share-Based Payment. Statement 123(R) covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. It revises FASB Statement No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. This statement requires that stock-based compensation transactions be recognized as compensation expense in the income statement based on their fair values at the date of grant. Companies transitioning to fair value based accounting for stock-based compensation are required to use the modified prospective method, whereby they must recognize equity compensation cost from the beginning of the period in which the recognition provisions are first applied as if the fair value method had been previously used to account for all equity compensation awards granted, modified, or settled in fiscal years beginning after December 31, 1994. As allowed by SEC release no. 33-8568, the Company began expensing unvested stock options commencing January 1, 2006. The impact was an increase of $100,000 in first quarter 2006 pre-tax compensation expense. In prior periods, the Company disclosed the pro-forma impact of this accounting methodology pursuant to previously accepted accounting principles.

Note 4 Supplemental Disclosure of Cash Flow Information

During the three months ended March 31, 2006 and 2005, cash paid for interest due on interest-bearing liabilities was $3.8 million and $1.9 million, respectively. There was no cash paid for income taxes during the three months ended March 31, 2006, or for the three months ended March 31, 2005. There was no real estate acquired in the settlement of loans for the three months ended March 31, 2006 or the three months ended March 31, 2005. There were no loans made to finance the sale of other real estate for the three months ended March 31, 2006 or the three months ended March 31, 2005.

Note 5 Stock Based Compensation

The Company s stock-based employee compensation plan, the 1998 Stock Option Plan, was assumed from Bank of the Sierra in August 2001 in conjunction with the Company s acquisition of all of the outstanding shares of the Bank. Until the adoption of Statement 123(R) on January 1, 2006, the 1998 Stock Option Plan was accounted for under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations, and no stock-based employee compensation expense was reflected in net income since all options granted under this plan had an exercise price equal to or greater than the market value of the underlying common stock on the date of grant. However, pro-forma adjustments to the Company s consolidated net earnings and earnings per share have been disclosed as if the Company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

The Company is currently using the Black-Scholes model to value stock options. The multiple option approach is used to allocate the resulting valuation to actual expense commencing in 2006, and to pro-forma expense for disclosure purposes for periods prior to that. Under the multiple option approach, an employee s options for each vesting period are separately valued and amortized. This appears to be the FASB-preferred method for option grants with multiple vesting periods, which is the case for most options granted by the Company. The following table illustrates the pro-forma effect on net income and earnings per share for the first quarter of 2005:

	For the 3-month period ended: March 31, 2005	
Net income, as reported (in $000 s)	$	3,261
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects (in $000 s)		45
Pro forma net income (in $000 s)	$	3,216
Basic earnings per share - as reported	$	0.34
Basic earnings per share - pro forma	$	0.33
Diluted earnings per share - as reported	$	0.31
Diluted earnings per share - pro forma	$	0.31
Weighted average fair value of options granted during period	$	6.18
Assumptions for determining fair values:		
Dividend yield		1.95%
Projected stock price volatility		30.03%
Risk-free interest rate		3.80%
Expected option term (from option date)		5.8 years

There were no stock options granted by the Company in the first quarter of 2006. Pursuant to the provisions of Statement 123(R), a total of $100,000 was reflected in the Company s income statement during the first quarter of 2006 as pre-tax compensation expense related to outstanding and unvested stock options.

Note 6 Earnings Per Share

Earnings per share for all periods presented in the Consolidated Statements of Income are computed based on the weighted average number of shares outstanding during each period retroactively restated for stock splits and dividends. There were 9,752,930 weighted average shares outstanding during the first quarter of 2006, and 9,723,454 during the first quarter of 2005. Diluted earnings per share include the effect of the potential issuance of common shares, which for the Company is limited to shares that would be issued on the exercise of outstanding stock options. The dilutive effect of all options outstanding was calculated using the treasury stock method, excluding anti-dilutive transactions and adjusting for unamortized expense and windfall tax benefits. For the first quarter of 2006, the dilutive effect of options outstanding totaled 518,289 shares, which were added to basic weighted average shares outstanding for purposes of calculating diluted earnings per share. Likewise, for the first quarter of 2005, shares totaling 662,573 were added to basic weighted average shares outstanding in order to calculate diluted earnings per share.

Note 7 Comprehensive Income

Comprehensive income includes net income and other comprehensive income. The Company s only source of other comprehensive income is derived from unrealized gains and losses on investment securities available-for-sale. Reclassification adjustments, resulting from gains or losses on investment securities that were realized and included in net income of the current period that also had been included in other comprehensive income as unrealized holding gains or losses in the period in which they arose, are excluded from comprehensive income of the current period. The Company s comprehensive income was as follows (dollars in thousands):

	For the 3-month period ended:	
	March 31, 2006	**March 31, 2005**
Net income	$ 4,450	$ 3,261
Other comprehensive (loss)/income:		
Unrealized holding (loss)/gain	(502)	(2,392)
Less: reclassification adjustment	0	0
Pre-tax other comprehensive (loss)/income	(502)	(2,392)
Less: tax impact of above	(237)	(984)
Net other comprehensive (loss)/income	(265)	(1,408)
Comprehensive income	$ 4,185	$ 1,853

Note 8 Financial Instruments with Off-Balance-Sheet Risk

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business, in order to meet the financing needs of its customers. These financial instruments consist of commitments to extend credit and standby letters of credit. They involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet.

The Company s exposure to credit loss in the event of nonperformance by the other party for commitments to extend credit and letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and letters of credit as it does for loans included on the balance sheet.

The following financial instruments represent off-balance-sheet credit risk (dollars in thousands):

	March 31, 2006	**December 31, 2005**
Commitments to extend credit	$ 300,062	$ 270,608
Standby letters of credit	$ 17,820	$ 16,630
Commercial letters of credit	$ 12,023	$ 0
Credit card commitments	$ 46,322	$ 45,906

Commitments to extend credit consist primarily of unfunded single-family residential construction loans and home equity lines of credit, and commercial real estate construction loans and commercial revolving lines of credit. Construction loans are established under standard underwriting guidelines and policies and are secured by deeds of trust, with disbursements made over the course of construction. Commercial revolving lines of credit have a high degree of industry diversification. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Standby letters of credit are generally unsecured and are issued by the Bank to guarantee the performance of a customer to a third party, while commercial letters of credit represent the Bank s commitment to pay a third party on behalf of a customer upon fulfillment of contractually-specified requirements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. Credit card commitments represent available balances on credit cards and are unsecured.

PART I - FINANCIAL INFORMATION

ITEM 2

MANAGEMENT S DISCUSSION AND

ANALYSIS OF FINANCIAL CONDITION

AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

This Form 10-Q includes forward-looking statements that involve inherent risks and uncertainties. Words such as expects , anticipates , believes , projects , and estimates or variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed, forecast in, or implied by such forward-looking statements.

A variety of factors could have a material adverse impact on the Company s financial condition or results of operations, and should be considered when evaluating the potential future financial performance of the Company. These include but are not limited to the possibility of deterioration in economic conditions in the Company s service areas; risks associated with fluctuations in interest rates; liquidity risks; increases in nonperforming assets and net credit losses that could occur, particularly in times of weak economic conditions or rising interest rates; the loss in market value of available-for-sale securities that could result if interest rates change substantially or an issuer has real or perceived financial difficulties; and risks associated with the multitude of current and future laws and regulations to which the Company is and will be subject.

CRITICAL ACCOUNTING POLICIES

The Company s financial statements are prepared in accordance with accounting principles generally accepted in the United States. The financial information and disclosures contained within those statements are significantly impacted by Management s estimates and judgments, which are based on historical experience and various other assumptions that are believed to be reasonable under current circumstances. Actual results may differ from those estimates under different conditions.

Critical accounting policies are those that involve the most complex and subjective decisions and assessments, and have the greatest potential impact on the Company s stated results of operations. In Management s opinion, the Company s critical accounting policies deal with the following areas: the establishment of the Company s allowance for loan and lease losses, as explained in detail in the Provision for Loan and Lease Losses and Allowance for Loan and Lease Losses sections of this discussion and analysis; loan origination costs, which are estimated in the aggregate by loan type based on an annual evaluation of expenses (primarily salaries and benefits) associated with successful loan originations and are allocated to individual loans as they are booked, but can actually vary significantly for individual loans depending on the characteristics of such loans; income taxes, especially with regard to the ability of the Company to recover deferred tax assets, as discussed in the Provision for Income Taxes and Other Assets sections of this discussion and analysis; goodwill, which is evaluated annually for impairment based on changes in the market capitalization of the Company; and equity-based compensation, which is discussed in greater detail in Note 5 to the consolidated financial statements. Critical accounting areas are evaluated on an ongoing basis to ensure that the Company s financial statements incorporate the most recent expectations with regard to these areas.

OVERVIEW OF THE RESULTS OF OPERATIONS

AND FINANCIAL CONDITION

RESULTS OF OPERATIONS SUMMARY

Net income for the quarter ended March 31, 2006 was $4.5 million compared with $3.3 million for the quarter ended March 31, 2005, an improvement of 36%. Basic and diluted earnings per share for the first quarter of 2006 were $0.46 and $0.43, compared to $0.34 and $0.31 for the first quarter of 2005. The Company s annualized return on average equity was 22.46% and annualized return on average assets was 1.70% for the quarter ended March 31, 2006, compared to a return on equity of 18.32% and return on assets of 1.32% for the quarter ended March 31, 2005. The primary drivers behind the variance in net income for the first quarter of 2006 relative to the first quarter of 2005 are as follows:

Net interest income increased by $1.7 million, or 14%, due mainly to the addition of $63 million in average loans and a 42 basis point net interest margin gain.

Service charges on deposits were up by $218,000, or 17%, due to new charges for higher-risk accounts.

There was no loan sale income in the first quarter of 2006 since no loans were sold, but $21 million in mortgage loans were sold in March 2005 at a $527,000 gain.

Other non-interest income increased by $453,000, or 52%, due to increases in various components of core operating income and because of a prior-year charge of $330,000 to write down our investment in Diversified Holdings, a title insurance holding company.

Despite two additional branches, salaries and benefits expense and occupancy expense each increased by only 3%. The expense recognized for salaries and benefits was not as great as expected in part because of an increase in deferred salaries related to loan originations and a decline in the cost of benefits, and reduced maintenance and repair costs had a beneficial impact on occupancy expense.

Other operating expenses fell by a combined $329,000, or 10%, primarily because of a $273,000, or 55%, drop in advertising and marketing costs, although much of the marketing expense decline is due to timing issues and these costs are likely to escalate later in the year.

FINANCIAL CONDITION SUMMARY

The Company s total assets were slightly over $1.10 billion at March 31, 2006, an increase of $50 million, or 5%, over total assets of $1.05 billion at December 31, 2005. The most significant characteristics of and changes in the Company s balance sheet during the first quarter of 2006 are outlined below:

Gross loan and lease balances increased by $54 million, or 7%, ending the quarter at $795 million. The increase was mostly organic growth resulting from strong loan demand in our service areas.

Overall, nonperforming assets remain at nominal levels, ending the quarter unchanged at 0.11% of gross loans plus other real estate owned (OREO). Non-accruing loans increased slightly, but the Company s single remaining OREO property at year-end 2005 was sold in March 2006 and the OREO balance at the end of the first quarter was zero.

Total time deposits fell by $18 million during the quarter due mainly to the loss of a single account, and non-interest demand deposits were down by about $2 million. On the other hand, NOW, savings, and money market deposits increased by a combined $12 million.

Short-term borrowings from the Federal Home Loan Bank increased by $56 million to compensate for the overall drop in deposits and to fund loan growth.

EARNINGS PERFORMANCE

The Company earns income from two primary sources. The first is net interest income, which is interest income generated by earning assets less interest expense on interest-bearing liabilities. The second is non-interest income, which primarily consists of customer service charges and fees but also comes from non-customer sources such as bank-owned life insurance. The majority of the Company s non-interest expenses are operating costs that relate to providing a full range of banking services to our customers.

NET INTEREST INCOME AND NET INTEREST MARGIN

Net interest income for the first quarter of 2006 was $13.5 million compared to $11.8 million in the first quarter of 2005, an increase of $1.7 million, or 14%. The level of net interest income depends on several factors in combination, including growth in earning assets, yields on earning assets, the cost of interest-bearing liabilities, the relative volumes of earning assets and interest-bearing liabilities, and the mix of products which comprise the Company s earning assets, deposits, and other interest-bearing liabilities.

The following Distribution, Rate and Yield table shows, for the periods noted, the average balance of each principal balance sheet category and the amount of interest income or interest expense associated with that category. This table also shows the calculated yields on each major component of the Company s investment and loan portfolio, the average rates paid on each key segment of the Company s interest bearing liabilities, and the net interest margin.

Average Balances and Rates

(dollars in thousands, except per share data)

	For the Quarter Ended March 31, 2006 (a) (b) (f)			For the Quarter Ended March 31, 2005 (a) (b) (f)		
	Average Balance	Income/ Expense	Average Rate/Yield	Average Balance	Income/ Expense	Average Rate/Yield
Assets						
Investments:						
Federal funds sold/Due from time	$ 793	$ 7	3.58%	$ 4,145	$ 26	2.54%
Taxable	$ 148,301	$ 1,615	4.42%	$ 166,014	$ 1,621	3.96%
Non-taxable	$ 48,001	$ 475	6.17%	$ 33,121	$ 334	6.20%
Equity	$ 11	$	0.00%	$ 8	$	0.00%
Total Investments	$ 197,106	$ 2,097	4.84%	$ 203,288	$ 1,981	4.30%
Loans and Leases:(c)						
Agricultural	$ 8,813	$ 189	8.70%	$ 11,573	$ 198	6.94%
Commercial	$ 129,161	$ 2,900	9.11%	$ 121,341	$ 2,189	7.32%
Real Estate	$ 548,360	$ 11,314	8.37%	$ 496,892	$ 9,038	7.38%
Consumer	$ 52,031	$ 1,165	9.08%	$ 49,397	$ 977	8.02%
Consumer Credit Cards	$ 7,770	$ 210	10.96%	$ 8,725	$ 221	10.27%
Direct Financing Leases	$ 9,659	$ 144	6.05%	$ 3,207	$ 55	6.96%
Other	$ 315	$	0.00%	$ 1,647	$	0.00%
Total Loans and Leases	$ 756,109	$ 15,922	8.54%	$ 692,782	$ 12,678	7.42%
Total Interest Earning Assets (e)	$ 953,215	$ 18,019	7.78%	$ 896,070	$ 14,659	6.71%
Other Earning Assets	$ 5,548			$ 7,048		
Non-Earning Assets	$ 102,466			$ 95,775		
Total Assets	$ 1,061,229			$ 998,893		
Liabilities and Shareholders Equity						
Interest Bearing Deposits:						
NOW	$ 67,614	$ 16	0.10%	$ 65,825	$ 15	0.09%
Savings Accounts	$ 70,758	$ 91	0.52%	$ 69,784	$ 91	0.53%
Money Market	$ 111,482	$ 387	1.41%	$ 131,599	$ 214	0.66%
TDOA s, IRA & KEOGH s	$ 22,672	$ 158	2.83%	$ 22,191	$ 98	1.79%
Certificates of Deposit<$100,000	$ 90,131	$ 732	3.29%	$ 84,056	$ 402	1.94%
Certificates of Deposit≥$100,000	$ 173,656	$ 1,693	3.95%	$ 141,719	$ 857	2.45%
Total Interest Bearing Deposits	$ 536,313	$ 3,077	2.33%	$ 515,174	$ 1,677	1.32%
Borrowed Funds:						
Federal Funds Purchased	$ 14,192	$ 167	4.77%	$ 695	$ 4	2.33%
Repurchase Agreements	$ 25,838	$ 36	0.57%	$ 27,554	$ 24	0.35%
Short Term Borrowings	$ 36,285	$ 290	3.24%	$ 26,289	$ 161	2.48%
Long Term Borrowings	$ 46,000	$ 330	2.91%	$ 75,000	$ 466	2.52%
TRUPS	$ 30,928	$ 640	8.39%	$ 30,928	$ 499	6.54%
Total Borrowed Funds	$ 153,243	$ 1,463	3.87%	$ 160,466	$ 1,154	2.92%
Total Interest Bearing Liabilities	$ 689,556	$ 4,540	2.67%	$ 675,640	$ 2,831	1.70%

Demand Deposits	$ 277,247			$ 239,870		
Other Liabilities	$ 14,079			$ 11,207		
Shareholders Equity	$ 80,347			$ 72,176		
Total Liabilities and Shareholders Equity	$ 1,061,229			$ 998,893		
Interest Income/Interest Earning Assets			7.78%			6.71%
Interest Expense/Interest Earning Assets			1.93%			1.28%
Net Interest Income and Margin(d)		$ 13,479	5.85%		$ 11,828	5.43%

(a) Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.

(b) Yields and net interest margin have been computed on a tax equivalent basis.

(c) Loan fees have been included in the calculation of interest income. Loan fees were approximately $478 thousand and $466 thousand for the quarters ended March 31, 2006 and 2005.
Loans are gross of the allowance for possible loan losses.

(d) Represents net interest income as a percentage of average interest-earning assets.

(e) Non-accrual loans have been included in total loans for purposes of total earning assets.

(f) Annualized

The Volume and Rate Variances table below sets forth the dollar difference in interest earned and paid for each major category of interest-earning assets and interest-bearing liabilities for the noted periods, and the amount of such change attributable to changes in average balances (volume) or changes in average interest rates. Volume variances are equal to the increase or decrease in average balance times prior period rates, and rate variances are equal to the increase or decrease in average rate times prior period average balances. Variances attributable to both rate and volume changes are equal to the change in rate times the change in average balance.

<u>Volume & Rate Variances</u>

(dollars in thousands)

	Quarter Ended March 31, 2006 over 2005			
		Increase (decrease) due to		
	Volume	Rate	Rate/Volume	Net
Assets:				
Investments:				
Federal funds sold / Due from time	$ (21)	11	(9)	$ (19)
Taxable	$ (173)	187	(20)	$ (6)
Non-taxable[1]	$ 150	(6)	(3)	$ 141
Equity	$			$
Total Investments	$ (44)	$ 192	$ (32)	$ 116
Loans and Leases:				
Agricultural	$ (47)	50	(12)	$ (9)
Commercial	$ 141	536	35	$ 711
Real Estate	$ 936	1,214	126	$ 2,276
Consumer	$ 52	129	7	$ 188
Consumer Credit Cards	$ (24)	14	(1)	$ (11)
Direct Financing Leases	$ 110	(7)	(14)	$ 89
Other	$			$
Total Loans and Leases	$ 1,168	$ 1,936	$ 141	$ 3,244
Total Interest Earning Assets	$ 1,123	$ 2,128	$ 109	$ 3,360
Liabilities				
Interest Bearing Deposits:				
NOW	$	1		$ 1
Savings Accounts	$ 1	(1)		$
Money Market	$ (33)	243	(37)	$ 173
TDOA s & IRA s	$ 2	57	1	$ 60
Certificates of Deposit < $100,000	$ 29	281	20	$ 330
Certificates of Deposit ≥ $100,000	$ 193	525	118	$ 836
Total Interest Bearing Deposits	$ 192	$ 1,106	$ 102	$ 1,400
Borrowed Funds:				
Federal Funds Purchased	$ 78	4	81	$ 163
Repurchase Agreements	$ (1)	14	(1)	$ 12
Short Term Borrowings	$ 61	49	19	$ 129
Long Term Borrowings	$ (180)	72	(28)	$ (136)
TRUPS	$	141		$ 141
Total Borrowed Funds	$ (42)	$ 280	$ 71	$ 309
Total Interest Bearing Liabilities	$ 150	$ 1,386	$ 173	$ 1,709

Net Interest Margin/Income	$ 973	$ 742	$ (64)	$ 1,651

(1) Yields on tax exempt income have not been computed on a tax equivalent basis.

As shown above, pure volume variances contributed $973,000 to net interest income in the first quarter of 2006 relative to the first quarter of 2005. Favorable changes in interest rates supplemented this amount by $742,000, and the combined rate/volume variance was a negative $64,000. The positive volume variance is mainly due to growth in average interest-earning assets without significant corresponding growth in interest-bearing liabilities, as can be seen in the Distribution, Rate & Yield table.

Average interest-earning assets were $57 million higher in the first quarter of 2006 than in the first quarter of 2005, an increase of 6%. The increase was due to growth of $63 million, or 9%, in average loan balances, slightly offset by a decline of $6 million, or 3%, in average investment balances. Average non-interest assets were about 10% of average total assets in the first quarters of both 2006 and 2005; however, the average balance of demand deposits, other liabilities, and shareholders equity increased to 35% of average assets from 32%. Average demand deposits grew by $37 million, or 16%, other liabilities grew by $3 million, or 26%, and shareholders equity increased by $8 million, or 11%, all of which exceeded the rate of growth in the aggregate balance sheet. The increase in the relative level of non-interest liabilities and equity contributed to the Company s profitability by reducing our need to obtain interest-bearing funds, as evidenced by the fact that interest-bearing liabilities increased by only $14 million, or 2%. Note that the volume increase in earning assets added $1.1 million to interest income, while the volume increase in interest-bearing liabilities added only $150,000 to interest expense.

The calculated rate increase for the first quarter of 2006 relative to the first quarter of 2005 is 107 basis points for interest-earning assets and 97 basis points for interest-bearing liabilities. The increase is higher for earning assets because of a relatively high level of variable-rate loans, which have experienced rate increases as the prime rate has risen. The favorable rate increase differential is enhanced by the spread between interest-earning assets and interest-bearing liabilities (otherwise known as the net interest position). The Company s net interest position was $220 million in the first quarter of 2005, the base period for the rate variance calculations, thus the rate increase for earning assets was applied to a substantially larger volume than the rate increase for interest-bearing liabilities and had a relatively larger impact.

The Company s net interest margin is tax-equivalent net interest income expressed as a percentage of average earning assets, and it is affected by many of the same factors discussed relative to our rate and volume variances. Our net interest margin was 5.85% in the first quarter of 2006 as compared to 5.43% in the first quarter of 2005, an increase of 42 basis points. A substantial portion of the Company s earning assets are variable-rate loans that re-price immediately when the Company s prime lending rate is changed, versus a large base of core deposits that are generally slower to re-price. This causes the Company s balance sheet to be slightly asset-sensitive, which means that all else being equal, the Company s net interest margin will be lower during periods when short-term interest rates are falling and higher when rates are rising. This effect has been visible during 2005 and 2006, as the Company s net interest margin has increased in strong correlation to rising short-term market interest rates.

Our net interest margin was also favorably affected by an increase in the Company s net interest position. As noted above, in the first quarter of 2005 the net interest position was $220 million, or 22% of average assets, but in the first quarter of 2006 it rose to $264 million, or 25% of average assets. The expansion in the Company s net interest position was enabled by the combined $48 million increase in average demand deposits, equity, and other liabilities, which was only slightly offset by a $5 million increase in average non-interest assets. A drop of $3.5 million, or 85%, in average nonperforming assets also had a beneficial impact on our net interest margin.

Management anticipates that the Company s net interest margin could experience some compression if short-term interest rates do not continue to rise, nevertheless we feel that net interest income will continue to increase if loans and core deposits grow as planned. However, no assurance can be given that this will, in fact, occur.

PROVISION FOR LOAN AND LEASE LOSSES

Credit risk is inherent in the business of making loans. The Company sets aside an allowance for loan and lease losses through periodic charges to earnings, which are reflected in the income statement as the provision for loan and lease losses. These charges are in amounts sufficient to achieve an allowance for loan and lease losses that, in management s judgment, is adequate to absorb losses inherent in the Company s loan portfolio.

For the quarter ended March 31, 2006, the Company s provision for loan and lease losses was $50,000 greater than the amount provided in the first quarter of 2005, an increase of 5%. Because of robust growth in loans during the first quarter of 2006, the loan loss provision was slightly higher despite the prior-year s build-up of a specific reserve for a large unsecured loan that was placed on non-accrual status and subsequently charged off prior to year-end. The procedures for monitoring the adequacy of the allowance, and detailed information on the allowance, are included below in Allowance for Loan and Lease Losses .

NON-INTEREST REVENUE AND OPERATING EXPENSE

The following table provides details on the Company s non-interest income and non-interest expense for the first quarter of 2006 relative to the first quarter of 2005.

Non Interest Income/Expense

(dollars in thousands, unaudited)

	For the Quarter Ended March 31,			
	2006	% of Total	2005	% of Total
OTHER OPERATING INCOME:				
Service charges on deposit accounts	$ 1,476	52.66%	$ 1,258	47.31%
Other service charges, commissions & fees	$ 1,071	38.21%	$ 816	30.69%
Gains on sales of loans	$	0.00%	$ 527	19.82%
Loan servicing income	$ 13	0.46%	$ 33	1.24%
Bank owned life insurance	$ 185	6.60%	$ 253	9.51%
Other	$ 58	2.07%	$ (228)	-8.57%
Total non-interest income	$ 2,803	100.00%	$ 2,659	100.00%
As a percentage of average earning assets (2)		1.19%		1.19%
OTHER OPERATING EXPENSES:				
Salaries and employee benefits	$ 4,191	48.83%	$ 4,066	46.54%
Occupancy costs				
Furniture & equipment	$ 817	9.52%	$ 806	9.23%
Premises	$ 731	8.52%	$ 691	7.91%
Advertising and marketing costs	$ 223	2.60%	$ 496	5.68%
Data processing costs	$ 238	2.77%	$ 298	3.41%
Deposit services costs	$ 446	5.20%	$ 304	3.48%
Loan services costs				
Loan processing	$ 62	0.72%	$ 87	1.00%
ORE owned	$ 146	1.70%	$ 222	2.54%
Credit card	$ 180	2.10%	$ 146	1.67%
Other operating costs				
Telephone & data communications	$ 199	2.32%	$ 203	2.32%
Postage & mail	$ 111	1.29%	$ 128	1.47%
Other	$ 470	5.47%	$ 409	4.68%
Professional services costs				
Legal & accounting	$ 261	3.04%	$ 351	4.02%
Other professional service	$ 287	3.34%	$ 328	3.75%
Stationery & supply costs	$ 179	2.09%	$ 145	1.66%
Sundry & tellers	$ 42	0.49%	$ 56	0.64%
Total non-interest Expense	$ 8,583	100.00%	$ 8,736	100.00%
As a % of average earning assets		3.63%		3.92%
Efficiency Ratio (1)	51.53%		57.78%	

(1) Tax Equivalent

(2) Annualized

The Company s results reflect an increase of $144,000, or 5%, in total other operating income for the quarter ended March 31, 2006 relative to the quarter ended March 31, 2005. Total other operating income was 1.19% of average earning assets for both quarters.

Service charges on deposit accounts increased by $218,000, or 17%, primarily because of the implementation of risk-based pricing for certain deposit accounts in September 2005. This resulted in additional fees related to higher-risk business accounts, which added $182,000 to pre-tax income for the first quarter of 2006. Despite significantly higher average transaction account balances, other service charges on deposit accounts increased only minimally because many of the transaction accounts added during the past year are initially free of service charges, and because hard-dollar charges for business accounts on analysis have declined as the earnings credit rate for those accounts has increased.

Other service charges, commissions, and fees increased by $255,000, or 31%, due to increases in a variety of categories such as check card interchange fees, bill-pay income, currency order charges, and leasing rental income. For gains on the sale of loans, there were no loans sold in the first quarter of 2006, while the first quarter of 2005 includes a $527,000 gain on the sale of $21 million in residential mortgage loans. Loan servicing income was down since the number of loans being serviced for others continues to decline.

Bank-owned life insurance (BOLI) income declined by $68,000, or 27%. At March 31, 2006 the Company had $18.7 million invested in single-premium general account BOLI, with an interest credit rate that does not change frequently and is floored at no less than 3%. This balance includes $2 million of BOLI that was purchased in August of 2005. Income from this BOLI is used to fund expenses associated with executive salary continuation plans and a directors retirement plan. In addition, however, at March 31, 2006 the Company had approximately $1.3 million invested in separate account BOLI used to hedge deferred compensation arrangements for certain directors and senior officers. These BOLI accounts have returns pegged to participant-directed investment allocations, and are thus subject to loss of principal depending on equity market movements. The decline in BOLI income for the quarter was due in part to slightly lower rates on the Company s general account BOLI, but was mainly the result of lower returns on separate account BOLI linked to deferred compensation balances.

Other non-interest income includes gains and losses on investments, gains on the disposition of fixed assets and real properties, and rental income generated by the Company s alliance with Investment Centers of America. There were no investment gains or losses recorded for either the first quarter of 2006 or the first quarter of 2005. Other non-interest income increased by $286,000 for the quarter, however, due to the $330,000 write-down of the Company s $1 million investment in Diversified Holdings Corporation, a title insurance holding company, in the first quarter of 2005. That investment was subsequently written down by an additional $240,000 in the fourth quarter of 2005, to the level of expected proceeds from the sale of the primary operating subsidiaries of that company.

Total operating expense (non-interest expense) was $8.6 million for the three months ended March 31, 2006, a decline of $153,000, or 2%, relative to total operating expense of $8.7 million for the same period in 2005. As discussed further below, the decline was largely due to lower marketing expenses. Because of this decline and because average earning assets increased, non-interest expenses fell to 3.6% of average earning assets for the first quarter of 2006 relative to 3.9% in the first quarter of 2005.

The largest component of non-interest expense, Salaries and employee benefits, increased by $125,000, or 3%, for the first quarter of 2006 relative to the first quarter of 2005. Salaries alone increased by $254,000, or 9%, due to the following: Regular annual increases; employee salaries for the new Reedley and Bakersfield Riverlakes branches; and selective staff additions in our back office operations to support branch growth. The increase in salaries would have been greater if not for the increase of $177,000, or 24%, in salaries that are directly related to successful loan originations and are thus deferred and amortized as an adjustment to loan yields pursuant to FAS 91. This credit against current salaries was higher because of the substantial increase in loan origination activity in the first quarter of 2006. The cost of benefits dropped by $127,000, or 10%, due to lower workers compensation insurance premiums and lower deferred compensation costs. In spite of the minimal increase in aggregate salaries and benefits, they rose to 48.8% of total non-interest expense for the first three months of 2006 from 46.5% in the first three months of 2005, due to the overall decline in total non-interest expense. The Company had 353 full-time equivalent employees at March 31, 2006, and 342 full-time equivalents at March 31, 2005.

Occupancy expense, including furniture and equipment maintenance and depreciation, increased by only $51,000, or 3%, for the first quarter of 2006 relative to the first quarter of 2005. The increase was relatively low due to a drop in costs related to maintenance and repairs. Occupancy expense was 18.0% of total non-interest expense for the first three months of 2006, up from 17.1% for the first three months of 2005, with the increase again caused by the overall decline in non-interest expense.

Perhaps the most notable change in expenses occurred in advertising and marketing costs. Marketing expense decreased $273,000, or 55%, in large part because of the discontinuation of a deposit-oriented marketing campaign that added approximately $125,000 to expenses in the first quarter of 2005. Newspaper, radio, and television advertising was also down by $124,000 for the quarter, although it is expected that these expenses will increase later in the year.

Other sizeable changes in non-interest expenses include OREO expense, other operating costs, legal and accounting costs, and expenses related to other professional services. OREO expenses were $76,000 lower due to a decline in charges to write down OREO properties. With the sale of our final remaining property in the first quarter of 2006, the balance of OREO has been completely eliminated as of March 31, 2006. The other category under other operating costs is up by $61,000, or 15%, for the first quarter of 2006 compared to the first quarter of 2005, due to higher depreciation expense on operating leases and higher pass-through losses on our increased limited partnership investment in tax credit funds. Lower internal audit costs and lower legal costs contributed to the decline of $90,000, or 26%, in legal and accounting costs. The cost of other professional services was $41,000 lower, mainly because of lower accruals for our directors retirement plan.

Because the percentage increase in net interest plus other income was greater than the percentage change in non-interest expense, the Company s tax-equivalent overhead efficiency ratio declined to 51.5% for the first quarter of 2006 relative to 57.8% for the first quarter of 2005. The overhead efficiency ratio represents total operating expense divided by the sum of fully tax-equivalent net interest and non-interest income, with the provision for loan losses, investment gains and losses, and other extraordinary income and expenses excluded from the equation.

PROVISION FOR INCOME TAXES

The Company sets aside a provision for income taxes on a monthly basis. This tax provision was $2.2 million for the first quarter of 2006 and $1.5 million for the first quarter of 2005, representing 33% and 31%, respectively, of pre-tax income for those periods. The amount of the tax provision is determined by applying the Company s statutory income tax rates to pre-tax book income, adjusted for permanent differences between pre-tax book income and actual taxable income. Such permanent differences include but are not limited to tax-exempt interest income, increases in the cash surrender value of bank-owned life insurance, California Enterprise Zone deductions, certain expenses that are not allowed as tax deductions, and tax credits. Since permanent differences have not increased at the same rate as pre-tax income, much of the $1.9 million increase in pre-tax income is taxable at the Company s marginal tax rate of approximately 41%. Thus, the provision for income taxes increased slightly as a percentage of pre-tax income.

BALANCE SHEET ANALYSIS

EARNING ASSETS

INVESTMENTS

The major components of the Company s earning asset base are its investments and loans, and the detailed composition and growth characteristics of both are significant determinants of the financial condition of the Company. The Company s investments are analyzed in this section, while the loan and lease portfolio is discussed in a later section of this Form 10-Q.

The Company s investments consist of debt and marketable equity securities (together, the investment portfolio), investments in the time deposits of other banks, and overnight fed funds sold. These serve several purposes: 1) they provide liquidity to even out cash flows from the loan and deposit activities of customers; 2) they provide a source of pledged assets for securing public deposits, bankruptcy deposits and certain borrowed funds which require collateral; 3) they constitute a large base of assets with maturity and interest rate characteristics that can be changed more readily than the loan portfolio, to better match changes in the deposit base and other funding sources of the Company; 4) they are an alternative interest-earning use of funds when loan demand is light; and 5) they can provide partially tax exempt income.

Although the Company currently has the intent and the ability to hold the securities in its investment portfolio to maturity, the securities are all marketable and are classified as available for sale to allow maximum flexibility with regard to interest rate risk and liquidity management. Pursuant to SFAS 115, the balance of available for sale securities is carried on the Company s financial statements at its estimated fair market value, with monthly tax-effected mark-to-market adjustments made vis-à-vis the accumulated other comprehensive income account in shareholders equity. The following table sets forth the Company s investment portfolio by investment type as of the dates noted:

Investment Portfolio

(dollars in thousands, unaudited)

	March 31, 2006		December 31, 2005	
	Amortized Cost	Fair Market Value	Amortized Cost	Fair Market Value
Available for Sale				
US Treasury securities	$ 503	$ 494	$ 504	$ 495
US Gov t agencies	17,355	17,089	17,360	17,143
Mortgage-backed securities	133,879	129,974	134,455	131,050
State & political subdivisions	49,380	49,929	44,477	44,977
Other equity securities	6	9	6	11
Total Investment Securities	$ 201,123	$ 197,495	$ 196,802	$ 193,676