HERITAGE FINANCIAL CORP /WA/
Form 10-Q
May 05, 2008
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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, 2008

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
Commission File Number 0-29480

HERITAGE FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Washington	**91-1857900**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
201 Fifth Avenue SW, Olympia, WA	**98501**
(Address of principal executive office)	**(ZIP Code)**

(360) 943-1500

(Registrant s telephone number, including area code)

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 x No ¨

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

Large accelerated filer ¨ Accelerated filer x 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 x

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

As of April 9, 2008 there were 6,688,430 common shares outstanding, with no par value, of the registrant.

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HERITAGE FINANCIAL CORPORATION

FORM 10-Q

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ITEM 1. HERITAGE FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Dollars in thousands, except for per share data)

(Unaudited)

	Three Months Ended March 31, 2008	2007
INTEREST INCOME:		
Interest and fees on loans	$ 14,168	$ 14,419
Taxable interest on investment securities	392	414
Nontaxable interest on investment securities	45	44
Interest on federal funds sold and interest bearing deposits	88	44
Dividends on Federal Home Loan Bank stock	8	3
Total interest income	14,701	14,924
INTEREST EXPENSE:		
Deposits	5,540	5,614
Other borrowings	97	413
Total interest expense	5,637	6,027
Net interest income	9,064	8,897
Provision for loan losses	360	180
Net interest income after provision for loan losses	8,704	8,717
NONINTEREST INCOME:		
Gains on sales of loans, net	42	2
Brokered mortgage income	88	181
Service charges on deposits	990	853
Rental income	83	80
Merchant visa income	700	655
Other income	343	262
Total noninterest income	2,246	2,033
NONINTEREST EXPENSE:		
Salaries and employee benefits	3,721	3,836
Occupancy and equipment	988	1,090
Data processing	384	380
Marketing	103	89
Office supplies and printing	95	99
Merchant visa	562	525
Professional services	163	171
State and local taxes	237	216
Other expense	717	779
Total noninterest expense	6,970	7,185
Income before federal income taxes	3,980	3,565

Federal income taxes	1,320	1,192
Net income	$ 2,660	$ 2,373
Earnings per share:		
Basic	$ 0.40	$ 0.37
Diluted	$ 0.40	$ 0.36
Dividends declared per share:	$ 0.210	$ 0.210

See Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(Dollars in thousands)

(Unaudited)

	March 31, 2008	December 31, 2007
Assets		
Cash on hand and in banks	$ 21,949	$ 28,401
Interest earning deposits	17,942	6,062
Investment securities available for sale	36,242	35,660
Investment securities held to maturity (market value of $3,402 and $3,929)	3,321	3,890
Loans held for sale	777	447
Loans receivable	776,418	779,319
Less: Allowance for loan losses	(10,690)	(10,374)
Loans receivable, net	765,728	768,945
Other real estate owned	169	169
Premises and equipment, at cost, net	14,726	14,819
Federal Home Loan Bank and Federal Reserve stock, at cost	3,227	3,227
Accrued interest receivable	4,071	4,401
Prepaid expenses and other assets	5,610	4,156
Deferred federal income taxes, net	2,274	2,364
Intangible assets, net	483	502
Goodwill	13,012	13,012
Total assets	$ 889,531	$ 886,055
Liabilities and Stockholders Equity		
Deposits	$ 792,983	$ 776,280
Advances from Federal Home Loan Bank	1,996	14,990
Other borrowings	1,639	1,951
Accrued expenses and other liabilities	6,116	7,867
Total liabilities	802,734	801,088
Stockholders equity:		
Common stock, no par value per share, 15,000,000 shares authorized; 6,688,505 and 6,642,972 shares outstanding at March 31, 2008 and December 31, 2007, respectively	25,368	24,985
Unearned compensation - ESOP	(427)	(447)
Retained earnings	62,040	60,780
Accumulated other comprehensive loss, net	(184)	(351)
Total stockholders equity	86,797	84,967
Total liabilities and stockholders equity	$ 889,531	$ 886,055

See Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY FOR THE THREE MONTHS ENDED MARCH 31, 2008 AND COMPREHENSIVE INCOME FOR THE THREE MONTHS ENDED

MARCH 31, 2008 AND 2007

(In Thousands)

(Unaudited)

	Number of common shares	Common stock	Unearned Compensation-ESOP	Retained earnings	Accumulated other comprehensive loss, net	Total stockholders equity
Balance at December 31, 2007	6,643	$ 24,985	$ (447)	$ 60,780	$ (351)	$ 84,967
Stock option compensation expense		54				54
Earned ESOP shares	2	22	20			42
Earned restricted stock shares		76				76
Restricted stock awards granted	24					
Tax benefit on dividends paid on unallocated ESOP shares and restricted stock shares		8				8
Exercise of stock options (including tax benefits from nonqualified stock options)	20	223				223
Net income				2,660		2,660
Change in fair value of securities available for sale, net of tax					167	167
Cash dividends declared				(1,400)		(1,400)
Balance at March 31, 2008	6,689	$ 25,368	$ (427)	$ 62,040	$ (184)	$ 86,797

Comprehensive Income	Three months ended March 31, 2008	2007
Net income	$ 2,660	$ 2,373
Change in fair value of securities available for sale, net of tax of $90 and $45	167	84
Comprehensive income	$ 2,827	$ 2,457

See Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the three months ended March 31, 2008 and 2007

(Dollars in thousands)

(Unaudited)

	2008	2007
Cash flows from operating activities:		
Net income	$ 2,660	$ 2,373
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	313	419
Deferred loan fees, net of amortization	(207)	59
Provision for loan losses	360	180
Net change in accrued interest receivable, prepaid expenses and other assets, accrued expenses and other liabilities	(2,850)	1,048
Recognition of compensation related to ESOP shares and restricted stock awards	118	73
Stock option compensation expense	54	87
Tax benefit realized from stock options exercised, restricted stock awards vested, and dividends on unallocated ESOP shares and restricted stock awards	(20)	(145)
Amortization of intangible assets	19	19
Deferred federal income tax		128
Origination of loans held for sale	(3,472)	(393)
Gain on sale of loans	(42)	
Proceeds from sale of loans	3,184	
Loss on sale of other real estate owned		20
Gain on sale of premises and equipment		(1)
Net cash provided by operating activities	117	3,867
Cash flows from investing activities:		
Loans originated, net of principal payments	3,064	(15,759)
Maturities of investment securities available for sale	5,996	2,584
Maturities of investment securities held to maturity	568	47
Purchase of investment securities available for sale	(6,309)	
Purchase of premises and equipment	(231)	(406)
Proceeds from sale of other real estate owned		205
Proceeds from sale of premises and equipment		5
Net cash (used in) provided by investing activities	3,088	(13,324)
Cash flows from financing activities:		
Net increase in deposits	16,703	16,911
Net decrease in borrowed funds	(12,994)	(7,820)
Repayments of long-term debt	(312)	
Cash dividends paid	(1,405)	(1,390)
Proceeds from exercise of stock options	211	533
Tax benefit realized from stock options exercised, restricted stock awards vested, and dividends on unallocated ESOP shares and restricted stock awards	20	145
Repurchase of common stock		(375)
Net cash provided by financing activities	2,223	8,004

Net increase (decrease) in cash and cash equivalents	5,428	(1,453)
Cash and cash equivalents at beginning of period	34,463	26,431
Cash and cash equivalents at end of period	$ 39,891	$ 24,978
Supplemental disclosures of cash flow information:		
Cash payments for:		
Interest expense	$ 6,303	$ 6,346
Federal income taxes		
Supplemental disclosures of cash flow information:		
Loans transferred to other real estate owned		(80)

See Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Three Months Ended March 31, 2008 and 2007

(Unaudited)

NOTE 1. Description of Business and Basis of Presentation

(a.) Description of Business

Heritage Financial Corporation (Company) is a bank holding company that was incorporated in the State of Washington in August 1997. We were organized for the purpose of acquiring all of the capital stock of Heritage Savings Bank upon our reorganization from a mutual holding company form of organization to a stock holding company form of organization. Effective September 1, 2004, Heritage Savings Bank switched its charter from a State Chartered Savings Bank to a State Chartered Commercial Bank and changed its legal name from Heritage Savings Bank to Heritage Bank. Effective September 1, 2005, Central Valley Bank (acquired by the Company in March 1999) changed its charter from a Nationally Chartered Commercial Bank to a State Chartered Commercial Bank.

We are primarily engaged in the business of planning, directing, and coordinating the business activities of our wholly owned subsidiaries: Heritage Bank and Central Valley Bank. The deposits of Heritage Bank and Central Valley Bank are insured by the Federal Deposit Insurance Corporation (FDIC) under the Deposit Insurance Fund (DIF). Heritage Bank conducts business from its main office in Olympia, Washington and its thirteen branch offices located in Thurston, Pierce, Mason and south King Counties of Washington State. Central Valley Bank conducts business from its main office in Toppenish, Washington and its five branch offices located in Yakima and Kittitas Counties of Washington State.

Our business consists primarily of lending and deposit relationships with small businesses including agribusiness and their owners in our market area, attracting deposits from the general public and originating for sale or investment purposes first mortgage loans on residential properties located in western and central Washington. We also make residential construction loans, income property loans, and consumer loans.

(b.) Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. These condensed consolidated financial statements should be read with our December 31, 2007 audited consolidated financial statements and its accompanying notes included in our Annual Report on Form 10-K. In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2008 are not necessarily indicative of the results that may be expected for the year ended December 31, 2008. In preparing the consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Actual results could differ from those estimates.

Certain amounts in the consolidated financial statements for the prior year have been reclassified to conform to the current consolidated financial statement presentation. These amounts include the segregation of brokered mortgage income from other income in the Consolidated Statements of Income and the reclassification of specific loans between loan categories. These reclassifications had no effect on net income.

NOTE 2. Stockholders Equity

(a.) Earnings per Share

The following table illustrates the reconciliation of weighted average shares used for earnings per share for the noted periods.

	Three months ended March 31,

	2008	**2007**
Basic:		
Weighted average shares outstanding	6,662,115	6,567,677
Less: Weighted average unvested restricted stock awards	(74,564)	(63,128)
Basic weighted average shares outstanding	6,587,551	6,504,549
Diluted:		
Basic weighted average shares outstanding	6,587,551	6,504,549
Incremental shares from unexercised stock options and unvested restricted stock awards	52,503	174,011
Weighted average shares outstanding	6,640,054	6,678,560

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Potential dilutive shares are excluded from the computation of earnings per share if their effect is anti-dilutive. For the three months ended March 31, 2008 and 2007, anti-dilutive shares outstanding related to options to acquire common stock totaled 440,987 and 105,600, respectively, as the exercise price was in excess of the market value.

(b.) Cash Dividend Declared

On March 25, 2008, we announced a quarterly cash dividend of 21.0 cents per share payable on April 30, 2008 to stockholders of record on April 15, 2008.

NOTE 3. Share Based Payment

The Company maintains a number of stock-based incentive programs, which are discussed in more detail in Note 4. Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123R (SFAS No. 123R) Share-based Payment. SFAS No. 123R requires that all stock-based compensation be recognized as an expense in the financial statements and that such cost be measured at the fair value of the award on the grant date. This statement was adopted using the modified prospective method of application, which requires the Company to recognize compensation expense on a prospective basis. Therefore, prior period financial statements have not been restated. Under this method, in addition to reflecting compensation expense for new share-based awards, expense is also recognized to reflect the remaining service period of awards that had been included in pro forma disclosures in prior periods.

Total stock-based compensation expense (excluding ESOP expense) for the three months ended March 31, 2008 and 2007 were as follows:

	2008	2007
	(Dollars in thousands)	
Compensation expense recognized	$ 130	$ 103
Related tax benefit recognized	31	10

As of March 31, 2008, the total unrecognized compensation expense related to non-vested stock awards was $1,029,000 and the related weighted average period over which it is expected to be recognized is approximately 3.1 years.

The fair value of options granted during the three months ended March 31, 2008 is estimated on the date of grant using the Black-Scholes option pricing model based on the assumptions noted in the following table (there were no options granted during the three months ended March 31, 2007). The expected term of share options is derived from historical data and represents the period of time that share options granted are expected to be outstanding. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. Expected volatility is based on historical volatility of Company shares. Expected dividend yield is based on dividends expected to be paid during the expected term of the share options.

Grant period ended	Weighted Average Risk Free Interest Rate	Expected Term in years	Expected Volatility	Expected Dividend Yield	Weighted Average Fair Value
March 31, 2008	2.38%	4.50	21%	4.30%	$ 2.38

NOTE 4. Stock Option and Award Plans

On September 24, 1996, Heritage Bank s stockholders approved the adoption of the 1997 stock option plan. On October 15, 1998, the Company s stockholders approved the adoption of the 1998 stock option plan, which is similar to the 1997 plan. The 1998 plan does not affect any options granted under the 1997 plan. On April 25, 2002, the Company s stockholders approved the adoption of the 2002 Incentive Stock Option Plan, the 2002 Director Nonqualified Stock Option Plan and the 2002 Restricted Stock Plan, which are generally similar to the 1997 and 1998 stock plans. On April 27, 2006, the Company s stockholders approved the adoption of the 2006 Incentive Stock Option Plan, the 2006 Director Nonqualified Stock Option Plan and the 2006 Restricted Stock Plan, which are generally similar to the 1997, 1998 and 2002 stock plans.

Under these stock option plans, on the date of grant, the exercise price of the option must at least equal the market value per share of the Company s common stock. The 1997 plan provides for the granting of options and stock awards up to 270,333 common

shares. The 1998 plan provides for the grant of stock options for up to 414,750 shares and stock awards for up to 69,431 shares. The 2002 and 2006 Incentive Stock Option plans provide for the grant of stock options for up to 451,500 and 400,000 shares, respectively. The 2002 and 2006 Director Nonqualified Stock Option Plans provide for the grant of stock options for up to 73,500 and 75,000 shares, respectively. The 2002 and 2006 Restricted Stock Plans provide for the grant of stock awards for up to 52,500 and 25,000 shares, respectively.

Stock options generally vest ratably over three years and expire five years after they become exercisable which amounts to an average term of seven years. Restricted Stock awards issued have a five-year cliff vesting. The Company issues new shares to satisfy share option exercises and restricted stock awards.

The following table summarizes stock option activity for the three months ended March 31, 2008.

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2007	518,658	$ 20.15		
Granted	17,550	19.99		
Exercised	(19,542)	10.79		
Forfeited or expired	(520)	13.60		
Outstanding at March 31, 2008	516,146	$ 20.50	3.4	$ 328
Exercisable at March 31, 2008	415,740	$ 19.57	2.8	$ 328

The total intrinsic value of options exercised during the three months ended March 31, 2008 and 2007, was $162,000 and $478,000, respectively. The total fair value of shares vested during the three months ended March 31, 2008 and 2007 was $110,000 and $998,000 respectively.

The following table summarizes restricted stock award activity for the three months ended March 31, 2008.

	Shares	Weighted-Average Grant Date Fair Value
Outstanding at December 31, 2007	65,945	$ 22.62
Granted	23,995	19.99
Vested		
Forfeited	(320)	23.40
Outstanding at March 31, 2008	89,620	$ 21.91

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NOTE 5. Fair Value Accounting

Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standards No. 157 (SFAS No. 157) Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value under Generally Accepted Accounting Principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements.

In accordance with SFAS No. 157, we group our financial assets and financial liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1 Valuations for assets and liabilities traded in active exchange markets, or interest in open-end mutual funds that allow the Company to sell its ownership interest back to the fund at net asset value (NAV) on a daily basis. Valuations are obtained from readily available pricing sources for market transactions involving identical assets, liabilities, or funds.

Level 2 Valuations for assets and liabilities traded in less active dealer, or broker markets, such as quoted prices for similar assets or liabilities or quoted prices in markets that are not active. Level 2 includes U.S. Treasury, U.S. government and agency debt securities, and mortgage-backed securities. Valuations are usually obtained from third party pricing services for identical or comparable assets or liabilities.

Level 3 Valuations for assets and liabilities that are derived from other valuation methodologies, such as option pricing models, discounted cash flow models and similar techniques, and not based on market exchange, dealer, or broker traded transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities.

The following table summarizes the balances of assets and liabilities measured at fair value on a recurring basis for the three months ended March 31, 2008.

	Total	Level 1	Level 2	Level 3
		(Dollars in thousands)		
Investment securities available for sale	$ 36,242	$ 10,550	$ 25,692	$

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion is intended to assist in understanding the financial condition and results of the Company. The information contained in this section should be read with the unaudited condensed consolidated financial statements and its accompanying notes, and the December 31, 2007 audited consolidated financial statements and its accompanying notes included in our recent Annual Report on Form 10-K.

Statements concerning future performance, developments or events, expectations for growth and market forecasts, and any other guidance on future periods, constitute forward-looking statements and are subject to a number of risks and uncertainties, which might cause actual results to differ materially from stated expectations. Specific factors include, but are not limited to, the effect of interest rate changes, risks associated with acquisition of other banks and opening new branches, the ability to control costs and expenses, and general economic conditions. Additional information on these and other factors, which could affect our financial results, are included in our filings with the Securities and Exchange Commission.

Overview

Heritage Financial Corporation is a bank holding company, which primarily engages in the business activities of our wholly owned subsidiaries: Heritage Bank and Central Valley Bank. We provide financial services to our local communities with an ongoing strategic focus in expanding our commercial lending relationships, market expansion and a continual focus on asset quality. Effective January 8, 1998, our common stock began to trade on the NASDAQ National Market under the symbol HFWA .

The following table provides relevant net interest income information for selected time periods. The average loan balances presented in the table are net of allowances for loan losses. Nonaccrual loans have been included in the tables as loans carrying a zero yield. Yields on tax-exempt securities and loans have not been stated on a tax-equivalent basis.

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	For the Three Months Ended March 31, 2008 Average Balance	Interest Earned/ Paid	Average Rate	2007 Average Balance	Interest Earned/ Paid	Average Rate
	(Dollars in thousands)					
Interest Earning Assets:						
Loans	$ 765,350	$ 14,168	7.45%	$ 737,640	$ 14,419	7.84%
Taxable securities	34,636	392	4.56	36,526	414	4.44
Nontaxable securities	4,918	45	3.67	4,765	44	3.64
Interest earning deposits	12,252	88	2.89	3,342	44	5.17
Federal Home Loan Bank stock	3,227	8	1.01	3,227	3	.40
Total interest earning assets	$ 820,383	$ 14,701	7.21%	$ 785,500	$ 14,924	7.59%
Noninterest earning assets	57,009			58,897		
Total assets	$ 877,392			$ 844,397		
Interest Bearing Liabilities:						
Certificates of deposit	$ 358,777	$ 3,941	4.42%	$ 338,020	$ 4,004	4.69%
Savings accounts	81,752	351	1.73	89,803	437	1.95
Interest bearing demand and money market accounts	230,956	1,248	2.17	199,006	1,173	2.25
Total interest bearing deposits	671,485	5,540	3.32	626,829	5,614	3.49
FHLB advances and other borrowings	7,640	97	5.10	28,900	413	5.88
Total interest bearing liabilities	$ 679,125	$ 5,637	3.34%	$ 655,729	$ 6,027	3.53%
Demand and other noninterest bearing deposits	104,022			100,890		
Other noninterest bearing liabilities	7,003			7,070		
Stockholders equity	87,242			80,708		
Total liabilities and stockholders equity	$ 877,392			$ 844,397		
Net interest income		$ 9,064			$ 8,897	
Net interest spread			3.87%			3.98%
Net interest margin			4.44%			4.59%
Average interest earning assets to average interest bearing liabilities			120.80%			119.79%

Financial Condition Data

Total assets increased $3.5 million (0.4%) to $889.5 million as of March 31, 2008 from the December 31, 2007 balance of $886.1 million. Deposits increased $16.7 million (2.2%) to $793.0 million as of March 31, 2008 from the December 31, 2007 balance of $776.3 million. For the same period, net loans, which exclude loans held for sale but are net of the allowance for loan losses, decreased $3.2 million (0.4%) to $765.7 million as of March 31, 2008 from the December 31, 2007 balance of $768.9 million. Commercial loans continue to be the largest segment of loans at 54.2% and 54.0% as a percentage of total loans as of March 31, 2008 and December 31, 2007, respectively.

Earnings Summary

Net income was $0.40 per diluted share for the three months ended March 31, 2008 compared to $0.36 per diluted share for the three months ended March 31, 2007, an increase of 11.1%. Actual earnings for the three months ended March 31, 2008 were $2,660,000 compared to $2,373,000 for the same period in 2007, an increase of 12.1%.

Return on average equity for the quarter ended March 31, 2008 was 12.26% compared to 11.92% for the same period last year. Average equity increased by $6.5 million to $87.2 million for the three months ended March 31, 2008 versus $80.7 million for the same period last year while net income increased by $287,000. The Company s capital position remains strong at 9.76% of total assets as of March 31, 2008, up from 9.27% at March 31, 2007.

Net Interest Income

Net interest income before provision for loan losses for the three months ended March 31, 2008 increased 1.9% to $9,064,000 from $8,897,000 for the same quarter in 2007. The net interest margin (net interest income divided by average interest earning assets) decreased to 4.44% for the current quarter from 4.59% for the same quarter last year. The lower net interest margin compared to the prior year have been largely due to a 300 basis point rate decrease in the federal funds target rate and a very competitive business environment.

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Interest income decreased $223,000 or 1.5%, for the three months ended March 31, 2008 as compared to the first quarter last year and interest expense decreased $390,000 or 6.5%, during this same period. Loans averaged $765.4 million with an average yield of 7.45% for the three months ended March 31, 2008 compared to average loans of $737.6 million with an average yield of 7.84% for the same period in 2007. Certificates of deposit averaged $358.8 million with an average cost of 4.42% for the three months ended March 31, 2008 compared to $338.0 million with an average cost of 4.69% for the same period in 2007.

Provision for Loan Losses

The provision for loan losses was $360,000 for the three months ended March 31, 2008, an increase of $180,000 over the provision for loan losses during the 1st quarter of 2007. The increase in the loss loan reserves was due to management s assessment of the increased risk in the loan portfolio due to the current economic environment as well as increases in potential problem loans.

Noninterest Income

Noninterest income increased 10.5% to $2,246,000 for the three months ended March 31, 2008 compared with $2,033,000 for the same quarter in 2007. This increase was primarily due to a $177,000 pre-tax gain recognized on the redemption of Class B common stock received from the Visa, Inc. IPO completed on March 18, 2008. In addition, there was an increase of $137,000, or 16.1%, in service charges on deposits primarily due to increased volume.

Noninterest Expense

Noninterest expense decreased 3.0% to $6,970,000 during the three months ended March 31, 2008 compared to $7,185,000 for the same period during 2007. This decrease was primarily due to decreases in salaries and benefits expense, occupancy and equipment expense, and other miscellaneous expenses.

The efficiency ratio for the quarter ended March 31, 2008 was 61.63% compared to 65.74% for the comparable quarter in 2007. The efficiency ratio improvement is primarily a result of decreased noninterest expense and increased noninterest income due to the factors listed above. The efficiency ratio consists of noninterest expense divided by the sum of net interest income before provision for loan losses plus noninterest income.

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Lending Activities

As indicated in the table below, total loans (including loans held for sale) decreased to $777.2 million at March 31, 2008 from $779.8 million at December 31, 2007.

	At March 31, 2008	% of Total	At December 31, 2007	% of Total
	(Dollars in thousands)			
Commercial	$ 421,514	54.2%	$ 421,405	54.0%
Real estate mortgages				
One-to-four family residential	57,163	7.4	57,579	7.4
Five or more family residential and commercial properties	161,143	20.7	163,715	21.0
Total real estate mortgages	218,306	28.1	221,294	28.4
Real estate construction				
One-to-four family residential	75,222	9.7	82,165	10.6
Five or more family residential and commercial properties	46,991	6.0	40,342	5.2
Total real estate construction	122,213	15.7	122,507	15.8
Consumer	17,036	2.2	16,641	2.1
Gross loans	779,069	100.2		