

1ST CONSTITUTION BANCORP
Form 10KSB
March 20, 2003
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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549**

FORM 10-KSB

(Mark One)

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

For the fiscal year ended December 31, 2002

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

For the transition period from _____ to _____

Commission file Number: 000-32891

1ST CONSTITUTION BANCORP

(Name of Small business Issuer in Its Charter)

New Jersey

22-3665653

(State of Other Jurisdiction of Incorporation or Organization)

(I.R.S. Employer Identification No.)

2650 Route 130, P.O. Box 634, Cranbury

08512

(Address of Principal Executive Offices)

(Zip Code)

(609) 655-4500

(Issuer's Telephone Number, Including Area Code)

SECURITIES REGISTERED UNDER SECTION 12 (B) OF THE ACT:

Title of Each Class

Name of Each Exchange On Which
Registered

None

None

SECURITIES REGISTERED UNDER SECTION 12(G) OF THE ACT:

Common Stock, No Par Value

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(Title of Class)

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

Check if no disclosure of delinquent filers in response to Item 405 of Regulation S-B is contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

The issuer's revenues for the most recent fiscal year were \$16,131,939.

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common stock was last sold, or the average bid and asked price of such common equity, as of March 14, 2003, was \$38,317,053.60.

The number of shares of the issuer's common stock outstanding as of March 14, 2003 was 1,489,367.

Portions of the issuer's definitive Proxy Statement for its 2003 annual meeting of security holders are incorporated by reference into Part III of this report.

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PART I

**Item 1. Description of Business.
1st Constitution Bancorp**

1st Constitution Bancorp (the Company) is a bank holding company registered under the Bank Holding Company Act of 1956, as amended. The Company was organized under the laws of New Jersey in February 1999 for the purpose of acquiring all of the issued and outstanding stock of 1st Constitution Bank (the Bank) and thereby enabling the Bank to operate within a bank holding company structure. The Company became an active bank holding company on July 1, 1999. The Bank is a wholly-owned subsidiary of the Company. Other than its investment in the Bank, the Company currently conducts no other significant business activities.

As of December 31, 2002, the Company, on a consolidated basis, had total assets of approximately \$268.7 million, total deposits of approximately \$219.0 million, total loans of approximately \$151.0 million and total shareholders' equity of approximately \$21.0 million.

The main office of the Company and the Bank is located at 2650 Route 130 North, Cranbury, New Jersey 08512, and the telephone number is (609) 655-4500.

1st Constitution Bank

The Bank, a commercial bank formed under the laws of the State of New Jersey, engages in the business of commercial and retail banking. As a community bank, the Bank offers a wide range of services (including demand, savings and time deposits and commercial and consumer/installment loans) to individuals, small businesses and not-for-profit organizations principally in Middlesex, Mercer and Somerset Counties, New Jersey. The Bank conducts its operations through its main office located in Cranbury, New Jersey, and five branch offices in downtown Cranbury, Hamilton Square, Plainsboro, Princeton and Montgomery Township, New Jersey. The Bank's deposits are insured up to applicable legal limits by the Federal Deposit Insurance Corporation (FDIC).

Management efforts focus on positioning the Bank to meet the financial needs of the communities in Middlesex, Mercer and Somerset Counties and to provide financial services to individuals, families, institutions and small businesses. To achieve this goal, the Bank is focusing its efforts on:

personal service;

expansion of its branch network;

innovative product offerings; and

technological advances and e-commerce

Personal Service

The Bank provides a wide range of commercial and consumer banking services to individuals, families, institutions and small businesses in central New Jersey. The Bank's focus is to understand the needs of the community and the customers and tailor products, services and advice to meet those needs. The Bank seeks to provide a high level of personalized banking services, emphasizing quick and flexible

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responses to customer demands.

Expansion of Branch Banking

The Bank continually evaluates opportunities for branch bank expansion, either mini branches or full service banks, to continue to grow and meet the needs of the community. During the first quarter of 2002, the Bank opened a sixth branch banking office located at The Windrows at Princeton, New Jersey. Negotiations are also underway to open a seventh office in Jamesburg, Middlesex County, which, if negotiations are successful, is projected to open in the second quarter of 2003. The Company can provide no assurance that negotiations will be successful or, if successful, that the new branch will open on the anticipated schedule.

Significant bank merger activity has occurred in recent years. During 2001, the state's largest bank, Summit Bancorp, merged with Fleet Bancorp, a Northeast super regional bank with locations in New Jersey. This merger resulted in the closing of several branch locations throughout the Bank's market area.

In 2000, the Bank introduced 1st Choice Banking, a seamless cash management solution that links checking and investments into one account for customers. With a minimum balance of \$10,000, customers enjoy all the flexibility of a free checking account while earning an investment rate of return which keeps pace with the current short-term money markets.

Technological Advances and e-Commerce. The Bank recognizes that customers want to receive service via their most convenient delivery channel, be it the traditional branch office, by telephone, ATM, or the Internet. For this reason, the Bank continues to enhance its e-Commerce capabilities. At www.1stconstitution.com, customers have easy access to online banking, including account access, and to the Bank's bill payment system. Consumers can apply online for loans and interact with senior management through the e-mail system. Business customers have access to cash management information and transaction capability through the Bank's online Business Express product offering. This overall expansion in electronic banking offers the Bank's customers another means to access the Bank's services easily and at their own convenience.

Competition

The Bank experiences substantial competition in attracting and retaining deposits and in making loans. In attracting deposits and borrowers, the Bank competes with commercial banks, savings banks, and savings and loan associations, as well as regional and national insurance companies and non-bank financial institutions, regulated small loan companies and local credit unions, regional and national issuers of money market funds and corporate and government borrowers. Within the direct market area of the Bank, there are a significant number of offices of competing financial institutions. In New Jersey generally, and in the Bank's local market specifically, large commercial banks, as well as savings banks and savings and loan associations, hold a dominant market share and there has been significant merger activity in the last few years, creating even larger competitors. Locally, the Bank's most direct competitors include Fleet Bank, PNC Bank and Sovereign Bank. The Bank is at a competitive disadvantage compared with these larger regional commercial and savings banks. By virtue of their larger capital, asset size or reserves, many of such institutions have substantially greater lending limits (ceilings on the amount of credit a bank may provide to a single customer that are linked to the institution's capital) and other resources than the Bank. Many such institutions are empowered to offer a wider range of services, including trust services, than the Bank and, in some cases, have lower funding costs (the price a bank must pay for deposits and other borrowed monies used to make loans to customers) than the Bank.

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In addition to having established deposit bases and loan portfolios, these institutions, particularly large regional commercial and savings banks, have the financial ability to finance extensive advertising campaigns and to allocate considerable resources to locations and products perceived as profitable.

In recent years non-bank financial institutions have begun to offer services that compete for deposits with the Bank, such as brokerage firms and insurance companies offering such instruments as short-term money market funds, corporate and government securities funds, mutual funds and annuities. It is expected that competition in these areas will continue to increase. Some of these competitors are not subject to the same degree of regulation and supervision as the Company and the Bank and therefore may be able to offer customers more attractive products than the Bank.

However, management of the Bank believes that loans to small and mid-sized businesses and professionals are not always of primary importance to the larger banking institutions, whereas they represent the main commercial loan business of the Bank. The Bank competes for this segment of the market by providing responsive personalized services, local decision-making, and knowledge of its customers and their businesses.

Lending Activities

The Bank's lending activities include both commercial and consumer loans. Loan originations are derived from a number of sources including real estate broker referrals, mortgage loan companies, direct solicitation by the Bank's loan officers, existing depositors and borrowers, builders, attorneys, walk-in customers and, in some instances, other lenders. The Bank has established disciplined and systematic procedures for approving and monitoring loans that vary depending on the size and nature of the loan.

Commercial Lending

The Bank offers a variety of commercial loan services including term loans, lines of credit, equipment and receivable financing loans. A broad range of short-to-medium term commercial loans, both secured and unsecured, are made available to businesses for working capital (including inventory and receivables), business expansion (including acquisition and development of real estate and improvements), and the purchase of equipment and machinery. The Bank also makes construction loans to real estate developers for the acquisition, development and construction of residential subdivisions.

Commercial loans are granted based on the borrower's ability to generate cash flow to support its debt obligations and other cash related expenses. A borrower's ability to repay commercial loans is substantially dependent on the success of the business itself and on the quality of its management. As a general practice, the Bank takes as collateral a security interest in any available real estate, equipment, inventory, receivables or other personal property of its borrowers, although occasionally the Bank makes commercial loans on an unsecured basis. Generally, the Bank requires personal guaranties of its commercial loans to offset the risks associated with such loans.

Residential Consumer Lending

A portion of the Bank's lending activities consists of the origination of fixed and adjustable rate residential mortgage loans secured by owner-occupied property located in the Bank's primary market areas. Home mortgage lending is unique in that a broad geographic territory may be serviced by originators working from strategically placed offices either within the Bank's traditional banking facilities or from affordable storefront locations in commercial buildings. The Bank offers construction loans, second mortgage home improvement loans and home equity lines of credit.

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The Bank finances the construction of individual, owner-occupied houses on the basis of written underwriting and construction loan management guidelines. First mortgage construction loans are made to contractors on both a pre-sold and a speculation basis. Such loans are also made to qualified individual borrowers and are generally supported by a take-out commitment from a permanent lender. The Bank makes residential construction loans to individuals who intend to erect owner occupied housing on a purchased parcel of real estate. The construction phase of these loans have certain risks, including the viability of the contractor, the contractor's ability to complete the project and changes in interest rates.

In most cases, the Bank will sell its mortgage loans with terms of 15 years or more in the secondary market. The sale to the secondary market allows the Bank to hedge against the interest rate risks related to such lending operations. This brokerage arrangement allows the Bank to accommodate its clients' demands while eliminating the interest rate risk for the 15 to 30 year period generally associated with such loans.

The Bank in most cases requires borrowers to obtain and maintain title, fire, and extended casualty insurance, and where required by applicable regulations, flood insurance. The Bank maintains its own errors and omissions insurance policy to protect against loss in the event of failure of a mortgagor to pay premiums on fire and other hazard insurance policies. Mortgage loans originated by the Bank customarily include a due on sale clause, which gives the Bank the right to declare a loan immediately due and payable in certain circumstances, including, without limitation, upon the sale or other disposition by the borrower of the real property subject to a mortgage. In general, the Bank enforces due on sale clauses. Borrowers are typically permitted to refinance or repay loans at their option without penalty.

Non-Residential Consumer Lending

Non-residential consumer loans made by the Bank include loans for automobiles, recreation vehicles, and boats, and personal (secured and unsecured) and deposit account secured loans. The Bank also conducts various indirect lending activities through established retail companies in its market areas. Non-residential consumer loans are attractive to the Bank because they typically have a shorter term and carry higher interest rates than are charged on other types of loans. Non-residential consumer loans, however, do pose additional risk of collectability when compared to traditional types of loans, such as residential mortgage loans granted by commercial banks.

Consumer loans are granted based on employment and financial information solicited from prospective borrowers as well as credit records collected from various reporting agencies. Stability of the borrower, willingness to pay and credit history are the primary factors to be considered. The availability of collateral is also a factor considered in making such a loan. The Bank seeks collateral that can be assigned and has good marketability with a clearly adequate margin of value. The geographic area of the borrower is another consideration, with preference given to borrowers in the Bank's primary market areas.

Supervision and Regulation

Banking is a complex, highly regulated industry. The primary goals of the bank regulatory scheme are to maintain a safe and sound banking system and to facilitate the conduct of monetary policy. In furtherance of those goals, Congress has created several largely autonomous regulatory agencies and enacted a myriad of legislation that governs banks, bank holding companies and the banking industry. This regulatory framework is intended primarily for the protection of depositors and not for the protection of the Company's stockholders. Descriptions of, and references to, the statutes and regulations below are brief summaries thereof, and do not purport to be complete. The descriptions are qualified in their entirety by reference to the specific statutes and regulations discussed.

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The Company

State and Federal Bank Holding Company Regulations

The Company is a bank holding company within the meaning of the Bank Holding Company Act of 1956, as amended (the "BHCA"). As a bank holding company, the Company is required to file with the Federal Reserve Board an annual report and such additional information as the Federal Reserve Board may require pursuant to the BHCA. The Federal Reserve Board may also make examinations of the Company and its subsidiaries. The Company is subject to capital standards similar to, but separate from, those applicable to the Bank.

Under the BHCA, bank holding companies that are not financial holding companies (as defined below) generally may not acquire the ownership or control of more than 5% of the voting shares, or substantially all the assets, of any company, including a bank or another bank holding company, without the Federal Reserve Board's prior approval. The Company has not applied to become a financial holding company but did obtain such approval to acquire the shares of the Bank. A bank holding company that does not qualify as a financial holding company is generally limited in the types of activities in which it may engage to those that the Federal Reserve Board had recognized as permissible for bank holding companies prior to the date of enactment of the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 ("GLBA"). At present, the Company does not engage in any significant activity other than owning the Bank.

A holding company and its banking subsidiary are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit or lease or sale of any property or the furnishing of services.

In addition to federal bank holding company regulation, the Company is registered as a bank holding company with the New Jersey Department of Banking and Insurance (the "Department"). The Company is required to file with the Department copies of the reports it files with the federal banking and securities regulators.

Capital Adequacy

The Company is required to comply with minimum capital adequacy standards established by the Federal Reserve. There are two basic measures of capital adequacy for bank holding companies and the depository institutions that they own: a risk based measure and a leverage measure. All applicable capital standards must be satisfied for a bank holding company to be considered in compliance.

The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), required each federal banking agency to revise its risk-based capital standards to ensure that those standards take adequate account of interest rate risk, concentration of credit risk and the risks of non-traditional activities. In addition, pursuant to FDICIA, each federal banking agency has promulgated regulations, specifying the levels at which a bank would be considered well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized, and to take certain mandatory and discretionary supervisory actions based on the capital level of the institution.

The regulations implementing these provisions of FDICIA provide that a bank will be classified as well capitalized if it (i) has a total risk-based capital ratio of at least 10.0 percent, (ii) has a Tier 1 risk-based capital ratio of at least 6.0 percent, (iii) has a Tier 1 leverage ratio of at least 5.0 percent, and (iv) meets certain other requirements. A bank will be classified as adequately capitalized if it (i) has a total risk-based capital ratio of at least 8.0 percent, (ii) has a Tier 1 risk-based capital ratio of at least 4.0

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percent, (iii) has a Tier 1 leverage ratio of (a) at least 4.0 percent, or (b) at least 3.0 percent if the institution was rated 1 in its most recent examination, and (iv) does not meet the definition of well capitalized. A bank will be classified as undercapitalized if it (i) has a total risk-based capital ratio of less than 8.0 percent, (ii) has a Tier 1 risk-based capital ratio of less than 4.0 percent, or (iii) has a Tier 1 leverage ratio of (a) less than 4.0 percent, or (b) less than 3.0 percent if the institution was rated 1 in its most recent examination. A bank will be classified as significantly undercapitalized if it (i) has a total risk-based capital ratio of less than 6.0 percent, (ii) has a Tier 1 risk-based capital ratio of less than 3.0 percent, or (iii) has a Tier 1 leverage ratio of less than 3.0 percent. An institution will be classified as critically undercapitalized if it has a tangible equity to total assets ratio that is equal to or less than 2.0 percent. An insured depository institution may be deemed to be in a lower capitalization category if it receives an unsatisfactory examination.

As of December 31, 2002, the Bank's capital ratios exceed the requirements to be considered a well capitalized institution under the FDIC regulations.

The risk-based capital guidelines for bank holding companies such as the Company currently require a minimum ratio of total capital to risk-weighted assets (including off-balance sheet activities, such as standby letters of credit) of 8%. At least half of the total capital is required to be Tier 1 capital, consisting principally of common shareholders' equity, noncumulative perpetual preferred stock, a limited amount of cumulative perpetual preferred stock and minority interest in the equity accounts of consolidated subsidiaries, less goodwill. The remainder (Tier 2 capital) may consist of a limited amount of subordinated debt and intermediate-term preferred stock, certain hybrid capital instruments and other debt securities, perpetual preferred stock and a limited amount of the general loan loss allowance. At December 31, 2002, the Company maintained a Tier 1 capital ratio of 13.84% and total qualifying capital ratio of 14.75%.

In addition to the risk-based capital guidelines, the federal banking regulators established minimum leverage ratio (Tier 1 capital to total assets) guidelines for bank holding companies. These guidelines provide for a minimum leverage ratio of 3% for those bank holding companies which have the highest regulatory examination ratings and are not contemplating or experiencing significant growth or expansion. All other bank holding companies are required to maintain a leverage ratio of at least 1% to 2% above the 3% stated minimum. The Company's leverage ratio at December 31, 2002 was 9.64%.

Restrictions on Dividends

The primary source of cash to pay dividends, if any, to the Company's stockholders and to meet the Company's obligations is dividends paid to the Company by the Bank. Dividend payments by the Bank to the Company are subject to the New Jersey Banking Act of 1948 (the Banking Act) and the Federal Deposit Insurance Act (the FDIA). Under the Banking Act and the FDIA, the Bank may not pay any dividends, if after paying the dividend, it would be undercapitalized under applicable capital requirements. In addition to these explicit limitations, the federal regulatory agencies are authorized to prohibit a banking subsidiary or bank holding company from engaging in an unsafe or unsound banking practice. Depending upon the circumstances, the agencies could take the position that paying a dividend would constitute an unsafe or unsound banking practice.

It is the policy of the Federal Reserve Board that bank holding companies should pay cash dividends on common stock only out of income available over the immediately preceding year and only if prospective earnings retention is consistent with the organization's expected future needs and financial condition. The policy provides that bank holding companies should not maintain a level of cash dividend that undermines the bank holding company's ability to serve as a source of strength to its banking subsidiary. A bank holding company may not pay dividends when it is insolvent.

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The Bank has never paid a cash dividend, and the Bank's Board of Directors does not plan to pay a cash dividend in the foreseeable future. The Bank paid a stock dividend every year from 1993 to 1999 when it was acquired by the Company. The Company has paid a 5% stock dividend every year since its formation in 1999.

Priority on Liquidation

The Company is a legal entity separate and distinct from the Bank. The rights of the Company as the sole shareholder of the Bank, and therefore the rights of the Company's creditors and shareholders, to participate in the distributions and earnings of the Bank when the Bank is not in bankruptcy, are subject to various state and federal law restrictions as discussed above under the heading "Restrictions of Dividends." Under state corporation and other laws and federal bankruptcy laws, the Company's right as shareholder to participate in the distribution of assets of the Bank upon the Bank's liquidation or reorganization will be subject to the prior claims of creditors of the Bank. In the event of a liquidation or other resolution of an insured depository institution such as the Bank, the claims of depositors and other general or subordinated creditors are entitled to a priority of payment over the claims of holders of an obligation of the institution to its shareholders (the Company) or any shareholder or creditor of the Company. The claims on the Bank by creditors include obligations in respect of federal funds purchased and certain other borrowings, as well as deposit liabilities.

Recent Legislation

The Gramm-Leach-Bliley Financial Modernization Act of 1999 (the "GLBF") became effective in early 2000. The GLBF:

allows bank holding companies meeting management, capital and Community Reinvestment Act standards to engage in a substantially broader range of nonbanking activities than is permissible for a bank holding company, including insurance underwriting and making merchant banking investments in commercial and financial companies; if a bank holding company elects to become a financial holding company, it files a certification, effective in 30 days, and thereafter may engage in certain financial activities without further approvals;

allows banks to establish subsidiaries to engage in certain activities which a financial holding company could engage in if the bank meets certain management, capital and Community Reinvestment Act standards;

allows insurers and other financial services companies to acquire banks and removes various restrictions that currently apply to bank holding company ownership of securities firms and mutual fund advisory companies; and

establishes the overall regulatory structure applicable to financial holding companies that also engage in insurance and securities operations.

The FRB has adopted a regulation which allows bank holding companies to submit certifications by February 15, 2000 to become financial holding companies on March 13, 2000. The FRB also promulgated regulations on procedures which would be used against financial holding companies which have depository institutions that fall out of compliance with the management or capital criteria. Only financial holding companies can own insurance companies and engage in merchant banking. The Company has not elected to become a financial holding company and the Bank has no financial

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subsidiaries. The GLBF also modified other financial laws, including laws related to financial privacy and community reinvestment.

As part of the USA Patriot Act, signed into law on October 26, 2001, Congress adopted the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 (the Act). The Act authorizes the Secretary of the Treasury, in consultation with the heads of other government agencies, to adopt special measures applicable to financial institutions such as banks, bank holding companies, broker-dealers and insurance companies. Among its other provisions, the Act requires each financial institution: (i) to establish an anti-money laundering program; (ii) to establish due diligence policies, procedures and controls that are reasonably designed to detect and report instances of money laundering in United States private banking accounts and correspondent accounts maintained for non-United States persons or their representatives; and (iii) to avoid establishing, maintaining, administering, or managing correspondent accounts in the United States for, or on behalf of, a foreign bank that does not have a physical presence in any country. In addition, the Act expands the circumstances under which funds in a bank account may be forfeited and requires covered financial institutions to respond under certain circumstances to requests for information from federal banking agencies within 120 hours.

Treasury regulations implementing the due diligence requirements were issued in 2002. These regulations required minimum standards to verify customer identity, encouraged cooperation among financial institutions, federal banking agencies, and law enforcement authorities regarding possible money laundering or terrorist activities, prohibited the anonymous use of concentration accounts, and required all covered financial institutions to have in place an anti-money laundering compliance program.

The Act also amends the BHCA and the Bank Merger Act to require the federal banking agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing an application under these acts.

Additional proposals to change the laws and regulations governing the banking and financial services industry are frequently introduced in Congress, in the state legislatures and before the various bank regulatory agencies. The likelihood and timing of any such changes and the impact such changes might have on the Company cannot be determined at this time.

The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act), which became law on July 30, 2002, added new legal requirements for public companies affecting corporate governance, accounting and corporate reporting.

The Sarbanes-Oxley Act provides for, among other things:

- a prohibition on personal loans made or arranged by the issuer to its directors and executive officers (except for loans made by a bank subject to Regulation O);

- independence requirements for audit committee members;

- independence requirements for company auditors;

- certification of financial statements and reports on Forms 10-K, 10-KSB, 10-Q, and 10-QSB by the chief executive officer and the chief financial officer;

- the forfeiture of bonuses or other incentive-based compensation and profits from the sale of an issuer's securities by directors and senior officers in the twelve month period following initial publication of any financial statements that later require restatement due to corporate misconduct;

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disclosure of off-balance sheet transactions;

two-business day filing requirements for insiders filing Forms 4;

disclosure of a code of ethics for financial officers and filing a Form 8-K for a change or waiver of such code;

real time filing of periodic reports;

posting of certain Securities and Exchange Commission filings and other information on the company website;

the reporting of securities violations up the ladder by both in-house and outside attorneys;

restrictions on the use of non-GAAP financial measures;

the formation of a public accounting oversight board; and

various increased criminal penalties for violations of securities laws.

The Sarbanes-Oxley Act contains provisions which became effective upon enactment on July 30, 2002 and provisions which will become effective from within 30 days to one year from enactment. The SEC has been delegated the task of enacting rules to implement various provisions. In addition, each of the national stock exchanges and Nasdaq has proposed new corporate governance rules, including rules strengthening director independence requirements for boards, the adoption of corporate governance codes and charters for the nominating, corporate governance and audit committees.

The Bank

The Bank, a New Jersey-chartered commercial bank, is subject to supervision and examination by the New Jersey Department of Banking and Insurance. Because the deposits of the Bank are insured by the Federal Deposit Insurance Corporation (the FDIC) the Bank is also subject to regulation by the FDIC.

The Bank must comply with various requirements and restrictions under federal and state law, including the maintenance of reserves against deposits, restrictions on the types and amounts of loans that may be granted and the interest that may be charged thereon, limitations on the types of investments that may be made and the services that may be offered and restrictions on dividends as described in the preceding section. Consumer laws and regulations also affect the operations of the Bank. In addition to the impact of regulation, commercial banks are affected significantly by the actions of the Federal Reserve Board which influence the money supply and credit availability in the national economy.

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Community Reinvestment Act

Under the Community Reinvestment Act (CRA), as implemented by FDIC regulations, a bank has a continuing and affirmative obligation, consistent with its safe and sound operation, to help meet the credit needs of its entire community, including low- and moderate-income neighborhoods. CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution's discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with CRA. CRA requires the FDIC to assess an institution's record of meeting the credit needs of its community and to take such record into account in its evaluation of certain applications by the applicable institution. The CRA requires public disclosure of an institution's CRA rating and requires that the FDIC provide a written evaluation of an institution's CRA performance utilizing a four-tiered descriptive rating system. An institution's CRA rating is considered in determining whether to grant charters, branches and other deposit facilities, relocations, mergers, consolidations and acquisitions. Performance less than satisfactory may be the basis for denying an application. The Bank is currently rated satisfactory under CRA.

Insurance of Deposits

The Bank's deposits are insured up to a maximum of \$100,000 per depositor under the Bank Insurance Fund (BIF). The Federal Deposit Insurance Corporation Improvements Act of 1991 (FDICIA) is applicable to depository institutions and deposit insurance. FDICIA requires the FDIC to establish a risk-based assessment system for all insured depository institutions. Under this legislation, the FDIC is required to establish an insurance premium assessment system based upon: (i) the probability that the insurance fund will incur a loss with respect to the institution, (ii) the likely amount of the loss, and (iii) the revenue needs of the insurance fund. In compliance with this mandate, the FDIC has developed a matrix that sets the assessment premium for a particular institution in accordance with its capital level and overall rating by the primary regulator. Under the matrix as currently in effect, the assessment rate ranges from 0 to 27 basis points of assessed deposits. The Bank is also subject to a quarterly FICO assessment.

Employees

The Company has two paid employees. Banking operations are conducted by the Bank, and as of December 31, 2002, the Bank had 58 full-time employees and 9 part-time employees. Neither the Bank's nor the Company's employees are represented by any collective bargaining group. The Bank and the Company each considers its relations with such employees to be good.

Special Factors

The Common Stock of the Company is speculative in nature and involves a significant degree of risk. The special factors below are not listed in order of importance.

Competition

The Company faces significant competition from many other banks, savings institutions and other financial institutions which have branch offices or otherwise operate in the Company's market area. Non-bank financial institutions, such as securities brokerage firms, insurance companies and money market funds, have also recently been permitted to engage in activities which compete directly with traditional bank business which has also led to greater competition. Many of these competitors have substantially greater financial resources than the Company, including larger capital bases that allow them to attract customers seeking larger loans than the Company is able to accommodate and the ability to aggressively advertise their products. There can be no assurance that the Company and the Bank will be able to

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successfully compete in the future. See DESCRIPTION OF BUSINESS -- Competition.

Economic Conditions and Related Uncertainties

Commercial banking is affected, directly and indirectly, by local, domestic, and international economic and political conditions, and by government monetary and fiscal policies. Conditions such as inflation, recession, unemployment, volatile interest rates, tight money supply, scarce natural resources, real estate values, international conflicts and other factors beyond the control of the Company may adversely affect the potential profitability of the Company. Management does not expect any particular factor to affect the Company's results of operations. However, a downtrend in several areas, such as real estate, construction and consumer spending, could have a material adverse impact on the Company's ability to maintain or increase profitability.

Federal and State Government Regulation

The operations of the Company and the Bank are heavily regulated and will be affected by present and future legislation and by the policies established from time to time by various federal and state regulatory authorities. In particular, the monetary policies of the Federal Reserve Board have had a significant effect on the operating results of banks in the past and are expected to continue to do so in the future. Among the instruments of monetary policy used by the Federal Reserve Board to implement its objectives is changes in the discount rate charged on bank borrowings. It is not possible to predict what changes, if any, will be made to the monetary policies of the Federal Reserve Board or to existing federal and state legislation or the effect that such changes may have on the future business and earnings prospects of the Company.

The Company and the Bank are subject to examination, supervision and comprehensive regulation by various federal and state agencies. Compliance with the rules and regulations of these agencies may be costly and may limit growth and restrict certain activities, including payment of dividends, investments, loans and interest rate charges, interest rates paid on deposits, and location of offices. The Bank is also subject to capitalization guidelines set forth in federal legislation. See BUSINESS -- Supervision and Regulation.

The laws and regulations applicable to the banking industry could change at any time, and we cannot predict the impact of these changes on our business and profitability. Because government regulation greatly affects the business and financial results of all commercial banks and bank holding companies, the cost of compliance could adversely affect the Company's ability to operate profitably.

Forward Looking Statements

When used in this and in future filings by the Company with the Securities and Exchange Commission (the SEC), in the Company's press releases and in oral statements made with the approval of an authorized executive officer of the Company, the words or phrases "will," "will likely result," "could," "anticipates," "believes," "continues," "expects," "plans," "will continue," "is anticipated," "estimated," "project" or "outlook" (including confirmations by an authorized executive officer of the Company of any such expressions made by a third party with respect to the Company) are intended to identify forward looking statements. The Company wishes to caution readers not to place undue reliance on any such forward looking statements, each of which speak only as of the date made. Such statements are subject to certain risks and uncertainties that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. Factors that may cause actual results to differ from those results expressed or implied, include, but are not limited to, those

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listed above under Special Factors, the overall economy and the interest rate environment; the ability of customers to repay their obligations; the adequacy of the allowance for loan losses; competition; significant changes in accounting, tax or regulatory practices and requirements; and technological changes. Although management has taken certain steps to mitigate any negative effect of the aforementioned items, significant unfavorable changes could severely impact the assumptions used and have an adverse effect on profitability. Such risks and other aspects of the Company's business and operations are described in Description of the Business and Management's Discussion and Analysis of Financial Condition and Results of Operations. The Company has no obligation to publicly release the result of any revisions which may be made to any forward-looking statements to reflect anticipated or unanticipated events or circumstances occurring after the date of such statements.

Item 2. Description of Property

General

The Company's and the Bank's principal office in Cranbury, New Jersey (the Principal Office), which it occupies under a lease, was sold in December 2000 by Constitution Center, LLC, a limited liability company which includes certain Company and Bank directors as members, to an unrelated third party. See Certain Relationships and Related Transactions. The new building owner assumed the existing lease and terms. The current lease provides for an aggregate monthly rental fee of \$18,277, subject to annual rental increases plus real estate taxes and certain common space charges allocated by the landlord and expires in December 2010. The Bank has two additional five year renewal periods. The Bank also has the right of first refusal to purchase the premises of which the Principal Office is a part on the same terms and conditions as contained in any bona fide offer.

The Bank leases approximately 2,400 square feet for its branch office in Montgomery Township, New Jersey for an aggregate monthly rental fee of \$6,130. This lease expires on September 30, 2004.

The Bank leases approximately 3,780 square feet for its branch office in downtown Cranbury, New Jersey for an aggregate monthly rental fee of \$3,600. This lease expires on August 15, 2007 and the Bank may renew the lease for one five-year periods at aggregate monthly rental rates adjusted based on the consumer price index. The Bank has the right of first refusal to purchase this branch office on the same terms and conditions as contained in any bona fide offer. Notwithstanding receipt of a bona fide offer, the Bank also has the option to purchase this branch office at any time during the initial term or renewal term provided the Bank has exercised its option to renew the lease for the branch office.

The Bank leases approximately 283 square feet for its branch office located in The Windows at Princeton Forrestal, Princeton, New Jersey, for an aggregate monthly rental fee of \$150. The lease expires on August 20, 2006, and the Bank has three five-year renewal options for this space.

In March 1998, the Bank entered into a lease for its branch located in Plainsboro, New Jersey. This lease expires on June 8, 2003 and provides for the rental of approximately 2,000 square feet. The Bank has three five-year renewal options for this space. The aggregate monthly payment for this lease is \$2,874, with annual escalations.

The Bank entered into a lease for the branch located in Hamilton Square, New Jersey in April 1999. This lease expires in July, 2014 and provides for a rental of approximately 4,170 square feet. The Bank has two five-year renewal options for this space. The aggregate monthly rental payment for this lease is \$8,730, with annual escalations.

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Management believes the foregoing facilities are suitable for the Company's and the Bank's present and projected operations.

Item 3. Legal Proceedings

None.

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted for a vote of the Company's shareholders during the fourth quarter of 2002.

PART II**Item 5. Market for Common Equity and Related Shareholder Matters**

The common stock of the Company commenced trading on the Nasdaq National Market System under the trading symbol "FCCY" on December 28, 2001. Prior to that time, the Company's common stock was traded in the over the counter market and bid and ask prices were available from the OTC Bulletin Board. The following are the high and low bid prices for 2002 and 2001, based on information obtained from the OTC Bulletin Board. All such bid prices reflect inter-dealer prices, without retail mark-up, mark-down or commissions and may not necessarily represent actual transactions.

	2002		2001	
	High Bid	Low Bid	High Bid	Low Bid
First Quarter	\$ 20.00	\$ 17.46(1)	\$ 14.86	\$ 9.07(1)
Second Quarter	21.31	18.59(1)	\$ 12.92	\$ 11.73(1)
Third Quarter	19.96	17.24(1)	\$ 16.50	\$ 12.60(1)
Fourth Quarter	27.56	19.95(1)	\$ 19.95	\$ 14.65(1)

(1) Prices have been retroactively adjusted for the 5% stock dividend paid January 31, 2003.

As of March 14, 2003, there were approximately 392 holders of the Company's common stock.

The Company paid a 5% stock dividend on January 31, 2003 and January 31, 2002. The Company has never paid a cash dividend and there are no plans to pay a cash dividend at this time. The Company will retain its earnings in order to provide capital for growth of the Bank.

Item 6. Management's Discussion and Analysis or Plan of Operation

This discussion should be read in conjunction with the consolidated financial statements, notes and tables included elsewhere in this report. Throughout the following sections, the Bank is defined as 1ST Constitution Bancorp and its wholly owned subsidiaries, 1ST Constitution Bank and 1ST Constitution Capital Trust I. The purpose of this discussion and analysis is to assist in the understanding and evaluation of the Bank's financial condition, changes in financial condition and results of operations.

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2002 Overview

The Bank's record earnings for 2002 reflect continuing momentum across a broad range of products and services offerings. Increased lending activity, coupled with a rise in demand deposits fueled record earnings and balance sheet growth.

Management believes that the Bank has positioned itself for continued success with the combination of a strong capital base, a commitment to provide exceptional customer service and a commitment to maintain the technology necessary to provide its clients with easy access to financial products and services.

Critical Accounting Policies and Estimates

Management's Discussion and Analysis of Financial Condition and Results of Operation is based upon the Bank's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the Bank to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. Note 1 to the Bank's Audited Consolidated Financial Statements for the year ended December 31, 2002, contains a summary of the Bank's significant accounting policies. Management believes the Bank's policy with respect to the methodology for the determination of the allowance for loan losses involves a higher degree of complexity and requires management to make difficult and subjective judgments which often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions or estimates could materially impact results of operations. This critical policy and its application is periodically reviewed with the Audit Committee and the Board of Directors. The allowance for loan losses is based upon management's evaluation of the adequacy of the allowance, including an assessment of known and inherent risks in the portfolio, giving consideration to the size and composition of the loan portfolio, actual loan loss experience, level of delinquencies, detailed analysis of individual loans for which full collectibility may not be assured, the existence and estimated net realizable value of any underlying collateral and guarantees securing the loans, and current economic and market conditions. Although management uses the best information available, the level of the allowance for loan losses remains an estimate which is subject to significant judgment and short-term change. Various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the Bank to make additional provisions for loan losses based upon information available to them at the time of their examination. Furthermore, the majority of the Bank's loans are secured by real estate in the State of New Jersey. Accordingly, the collectibility of a substantial portion of the carrying value of the Bank's loan portfolio is susceptible to changes in local market conditions and may be adversely affected should real estate values decline or the Central New Jersey area experience an adverse economic shock. Future adjustments to the allowance for loan losses may be necessary due to economic, operating, regulatory and other conditions beyond the Bank's control.

Summary of Financial Performance

Net income amounted to a new record level of \$2,687,322, a 24.9% increase, compared to the previous record results of \$2,152,001 reported in 2001. Earnings were primarily enhanced by commercial loan and demand deposits growth experienced throughout the year. On a diluted per share basis, net income increased 22.7% to \$1.73 in 2002 compared to \$1.41 in 2001.

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Driven by commercial loan growth, the Bank's loan portfolio increased 20.9% in 2002 compared to 2001. At December 31, 2002, total loans outstanding reached \$151,049,736 compared to \$124,937,483 at the end of 2001. Asset quality remained strong in 2002 as illustrated by the ratio of nonperforming loans to total loans of 0.10% in 2002 and 0.49% in 2001. The allowance for loan losses totaled \$1,669,882 or 1.11% of total loans, covering over ten times the balance of total nonperforming loans. The Bank's deposit base increased 18.8% to total \$218,994,998 at December 31, 2002. Deposit products were competitively priced throughout the year to fund loan growth.

Return on average assets (ROA) was 1.06% in 2002 compared to 1.03% in 2001. For 2002 The Bank's return on average equity (ROE) was 14.09% compared to 13.17% in 2001. This measurement indicates how effectively a company can generate net income on the capital invested by its shareholders.

Results of Operations

The Bank reported record earnings of \$2,687,322 or \$1.73 per share (diluted) for the year ended December 31, 2002 compared to \$2,152,001 or \$1.41 per share (diluted) in 2001. Net income and diluted earnings per share grew 24.9% and 22.7%, respectively, in 2002. The Bank posted net income of \$1,729,778 or \$1.15 per share (diluted) in 2000.

Net Interest Income

Net interest income, the Bank's largest and most significant component of operating income, is the difference between interest and fees earned on loans and other earning assets, and interest paid on deposits and borrowed funds. This component represented 83.5% of the Bank's net revenues in 2002. Net interest income also depends upon the relative amount of interest earning assets, interest-bearing liabilities, and the interest rate earned or paid on them.

The following tables set forth the Bank's consolidated average balances of assets and liabilities and shareholders' equity as well as interest income and expense on related items, and the Bank's average yield or rate for the years ended December 31, 2002, 2001, 2000, 1999 and 1998. The average rates are derived by dividing interest income and expense by the average balance of assets and liabilities, respectively.

Table of Contents**Index to Financial Statements****Average Balance Sheets with Resultant Interest and Rates**(yields
on a tax
equivalent
basis)

	2002			2001			2000		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Assets:									
Federal Funds Sold/Short-Term Investments	\$ 11,743,276	\$ 198,659	1.69%	\$ 12,982,838	\$ 412,274	3.18%	\$ 3,758,186	\$ 240,055	6.39%
Investment Securities:									
U.S. Treasury Bonds	0	0		164,096	8,407	5.12%	494,042	25,592	5.18%
Collateralized Mortgage Obligations	79,604,274	3,598,438	4.52%	61,040,382	3,663,462	6.00%	45,961,785	3,104,238	6.75%
States and Political Subdivisions	3,722,838	243,340	6.54%	3,312,135	232,075	7.01%	2,184,257	146,911	6.73%
Total	83,327,112	3,841,778	4.61%	64,516,613	3,903,943	6.05%	48,640,084	3,276,741	6.74%
Loan Portfolio:									
Commercial	30,758,677	2,275,368	7.40%	23,804,565	2,532,392	10.64%	25,892,635	2,809,913	10.85%
Installment	14,435,272	1,095,210	7.59%	14,755,091	1,182,582	8.01%	15,158,706	1,179,061	7.78%
Commercial Mortgages and Construction Wholesale	71,547,571	4,640,234	6.49%	58,004,941	4,472,315	7.71%	34,840,215	3,062,187	8.79%
Residential Mortgages and Construction Retail	19,892,071	1,268,682	6.38%	19,842,072	1,545,547	7.79%	17,690,917	1,411,992	7.98%
All Other Loans	8,525,695	1,067,307	12.52%	7,537,883	822,201	10.91%	5,889,591	859,934	14.60%
Total (1)	145,159,286	10,346,801	7.13%	123,944,552	10,555,037	8.52%	99,472,064	9,323,088	9.37%
Total Interest-Earning Assets	240,229,674	14,387,238	5.99%	201,444,003	14,871,254	7.38%	151,870,334	12,839,884	8.45%
Allowance for Loan Losses	(1,554,474) 9,134,645			(1,271,319) 6,476,212			(1,029,538) 5,610,092		

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Cash and
Due
From
Banks
Other

Assets	5,118,255			2,833,836				3,513,307		
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Total Assets	\$ 252,928,100			\$ 209,482,732				\$ 159,964,195		
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Liabilities and Shareholders Equity:

Interest-Bearing Liabilities:

Money Market and NOW Accounts	\$ 76,698,669	\$ 980,605	1.28%	\$ 50,474,834	\$ 1,264,832	2.51%	\$ 42,898,014	\$ 1,396,912	3.26%
Savings Accounts	15,548,553	184,759	1.19%	10,738,835	252,584	2.35%	10,600,178	288,724	2.72%
Certificates of Deposit	59,131,266	2,166,251	3.66%	52,943,869	2,952,410	5.58%	43,590,728	2,533,022	5.81%
Certificates of Deposit of \$100,000 and Over	18,619,750	629,594	3.38%	26,149,741	1,232,808	4.71%	8,446,002	511,190	6.05%
Federal Funds Purchased/Other Borrowed Funds	19,769,886	921,982	4.66%	19,924,483	1,038,504	5.21%	13,903,824	894,552	6.43%
Trust Preferred Securities	3,621,299	216,081	5.89%						

Total Interest-Bearing Liabilities	193,389,423	5,099,272	2.64%	160,231,762	6,741,138	4.21%	119,438,746	5,624,400	4.71%
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Net Interest Spread (2)			3.35%			3.17%			3.74%
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Demand Deposits	39,021,155			30,209,573			25,596,993		
Other Liabilities	1,447,781			2,704,081			1,715,203		
Total Liabilities	233,858,359			193,145,416			146,750,942		
Shareholders Equity	19,069,741			16,337,316			13,213,254		

Total Liabilities and Shareholders Equity	\$ 252,928,100			\$ 209,482,732			\$ 159,964,195		
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Net Interest Margin (3)	\$ 9,287,966	3.87%	\$ 8,130,116	4.04%	\$ 7,215,484	4.75%
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Table of Contents**Index to Financial Statements****Average Balance Sheets with Resultant Interest and Rates**

(yields on a tax equivalent basis)

	1999			1998		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Assets:						
Federal Funds Sold/Short-Term Investments	\$ 3,426,114	\$ 168,684	4.92%	\$ 4,044,708	\$ 240,854	5.95%
Investment Securities:						
U.S. Treasury Bonds	835,475	46,620	5.58%	3,907,312	240,942	6.17%
Collateralized Mortgage Obligations	39,076,271	2,493,490	6.38%	24,091,551	1,503,969	6.24%
States and Political Subdivisions	1,582,653	107,724	6.81%	1,349,601	93,359	6.92%
Total	41,494,399	2,647,834	6.38%	29,348,464	1,838,270	6.26%
Loan Portfolio:						
Commercial	21,115,219	2,019,239	9.56%	14,255,298	1,606,989	11.27%
Installment	13,542,197	1,020,378	7.53%	13,460,119	1,026,494	7.63%
Commercial Mortgages and Construction Wholesale	30,339,251	2,503,163	8.25%	26,115,001	2,036,951	7.80%
Residential Mortgages and Construction Retail	17,263,568	1,313,025	7.61%	15,967,516	1,201,698	7.53%
All Other Loans	4,885,578	495,192	10.14%	3,112,159	409,417	13.16%
Total (1)	87,145,813	7,350,998	8.44%	72,910,093	6,281,549	8.62%
Total Interest-Earning Assets	132,066,326	10,167,516	7.70%	106,303,265	8,360,673	7.86%
Allowance for Loan Losses	(871,581)			(706,169)		
Cash and Due From Banks	5,954,894			4,822,809		
Other Assets	2,644,170			1,829,821		
Total Assets	\$ 139,793,809			\$ 112,249,726		
Liabilities and Shareholders Equity:						
Interest-Bearing Liabilities:						
Money Market and NOW Accounts	\$ 33,681,758	\$ 1,137,997	3.38%	\$ 28,185,714	\$ 1,046,425	3.71%
Savings Accounts	9,956,583	271,485	2.73%	8,815,710	244,689	2.78%
Certificates of Deposit	43,300,649	2,348,077	5.42%	29,907,645	1,671,748	5.59%
Certificates of Deposit of \$100,000 and Over	6,969,581	367,723	5.28%	8,469,513	481,104	5.68%
Federal Funds Purchased/Other Borrowed Funds	9,489,603	378,234	3.99%	7,814,622	274,692	3.52%

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Trust Preferred Securities						
Total Interest-Bearing Liabilities	103,398,174	4,503,516	4.36%	83,193,204	3,718,658	4.47%
Net Interest Spread (2)			3.34%			3.39%
Demand Deposits	21,842,138			18,298,818		
Other Liabilities	2,232,419			1,529,266		
Total Liabilities	127,472,731			103,021,288		
Shareholders' Equity	12,321,077			9,228,438		
Total Liabilities and Shareholders' Equity	\$ 139,793,808			\$ 112,249,726		
Net Interest Margin (3)		\$ 5,664,000	4.29%		\$ 4,642,015	4.36%

- (1) Loan origination fees are considered an adjustment to interest income. For the purpose of calculating loan yields, average loan balances include nonaccrual loans with no related interest income.
- (2) The interest rate spread is the difference between the average yield on interest earning assets and the average rate paid on interest bearing liabilities.
- (3) The net interest margin is equal to net interest income divided by average interest earning assets.

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Changes in net interest income and margin result from the interaction between the volume and composition of earning assets, interest bearing liabilities, related yields, and associated funding costs. The Rate/Volume table demonstrates the impact on net interest income of changes in the volume of interest earning assets and interest bearing liabilities and changes in interest rates earned and paid.

The Bank's net interest income totaled \$9,209,044 in 2002, an increase of 14.3% from the \$8,054,847 reported in 2001. As indicated in the Rate/Volume Table, the principal factor contributing to the 2002 increase in net interest income was a decrease in the interest expense of \$1,641,866, resulting from decreased deposit and interest-bearing liability market rates of interest. This was partially offset by decreases in both loan and investment securities yields due to the lower interest rate environment in 2002.

The Bank's net interest income totaled \$8,054,847 in 2001, an increase of 12.4% from the \$7,167,837 reported in 2000. As indicated in the Rate/Volume Table, the principal factor contributing to the 2001 increase in net interest income was an increase in the tax-equivalent interest income of \$2,031,370 resulting from increased loan and investment securities volumes. This was partially offset by decreases in both loan and investment securities yields due to the lower interest rate environment in 2001.

Rate/Volume Table	Amount of Increase (Decrease)					
	2002 versus 2001 Due to Change in:			2001 versus 2000 Due to Change in:		
(Tax-equivalent basis)	Volume	Rate	Total	Volume	Rate	Total
Interest Income:						
Loans:						
Commercial	\$ 739,918	(\$996,942)	(\$257,024)	(\$224,851)	(\$52,670)	(\$277,521)
Installment	(25,400)	(61,972)	(87,372)	(31,372)	34,893	3,521
Commercial Mortgages and Construction- Wholesale	875,579	(707,660)	167,919	1,911,291	(501,163)	1,410,128
Residential Mortgages and Construction- Retail	3,895	(280,760)	(276,865)	169,415	(35,860)	133,555
All Other Loans	115,758	129,348	245,106	210,120	(247,854)	(37,734)
Total loans	1,709,750	(1,917,986)	(208,236)	2,034,603	(802,654)	1,231,949
Investment Securities :						
U.S. Treasury Bonds	(8,407)	0	(8,407)	(16,990)	(195)	(17,185)
Collat. Mortg. Obligations / Mortg. Backed Securities	1,113,834	(1,178,859)	(65,024)	960,871	(401,647)	559,224
States and political subdivisions	28,790	(17,525)	11,265	77,477	7,686	85,163
Total Investment Securities	1,134,217	(1,196,384)	(62,165)	1,021,358	(394,156)	627,202
Federal Funds Sold / Short-Term Investments	(39,418)	(174,197)	(213,615)	441,156	(268,937)	172,219

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Total Interest Income	2,804,549	(3,288,567)	(484,016)	3,497,117	(1,465,747)	2,031,370
Interest Expense :						
Money Market and NOW Accounts	658,218	(942,444)	(284,226)	215,807	(347,887)	(132,080)
Savings Accounts	113,028	(180,853)	(67,825)	3,426	(39,566)	(36,140)
Certificates of Deposit	345,257	(1,131,416)	(786,159)	531,532	(112,144)	419,388
Certificates of Deposit of \$100,000 and Over	(305,042)	(298,172)	(603,214)	952,935	(231,317)	721,618
Federal Funds Purchased / Other Borrowed Funds	(8,054)	(108,469)	(116,523)	350,354	(206,402)	143,952
Trust Preferred Securities	216,081	0	216,081	0	0	0
Total interest expense	1,019,488	(2,661,354)	(1,641,866)	2,054,054	(937,316)	1,116,738
Net Interest Income	\$ 1,785,061	(\$627,212)	\$ 1,157,850	\$ 1,443,063	(\$528,431)	\$ 914,632

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Average interest earning assets increased by \$38,785,671 or 19.3% to \$240,229,674 in 2002 from \$201,444,003 in 2001, with increases in 2002 of \$21,214,734 in loans and \$18,810,499 in investment securities compared to 2001. Led by commercial mortgages and construction loans, the Bank's average loan portfolio grew by 17.1% and loan yields averaged 7.13% in 2002, 139 basis points lower than 2001. This decrease was primarily the result of 2002 loan growth at lower yields amid a decreasing interest rate environment for the majority of the year. The Bank's average investment securities portfolio grew 29.2%, and the yield on that portfolio decreased 144 basis points when comparing 2002 to 2001. Overall, the yield on interest earning assets decreased 139 basis points to 5.99% in 2002 from 7.38% in 2001.

Average interest earning assets increased by \$49,573,669 or 32.6% to \$201,444,003 in 2001 from \$151,870,334 in 2000, with increases in 2001 of \$24,472,488 in loans and \$15,876,529 in investment securities compared to 2000. Led by commercial mortgages and construction loans, the Bank's average loan portfolio grew by 24.6% and loan yields averaged 8.52% in 2001, 85 basis points lower than 2000. This decrease was primarily the result of 2001 loan growth at lower yields amid a decreasing interest rate environment for the majority of the year. The Bank's average investment securities portfolio grew 32.6%, and the yield on that portfolio decreased 69 basis points when comparing 2001 to 2000. Overall, the yield on interest earning assets decreased 107 basis points to 7.38% in 2001 from 8.45% in 2000.

Interest expense was \$5,099,272 for 2002, a decrease of \$1,641,866 or 24.4% from \$6,741,138 for 2001. This decrease in interest expense is principally attributable to higher levels of interest-bearing liabilities priced at a significantly lower market interest rate level. Money market and NOW accounts increased on average by \$26,223,835 in 2002, as compared to 2001, to contribute to the funding of loan portfolio growth. The cost on these deposits decreased 123 basis points in 2002 from 2001. Average interest bearing liabilities rose 20.7% in 2002 from 2001. The cost of total interest bearing liabilities decreased 157 basis points to 2.64% in 2002 from 4.21% in 2001.

Interest expense was \$6,741,138 for 2001, an increase of \$1,116,738 or 19.9% from \$5,624,400 for 2000. This increase in interest expense is principally attributable to higher levels of money market and NOW deposits and other borrowed funds. Certificates of deposit of \$100,000 and over were aggressively priced throughout 2001 to contribute to the funding of loan growth. The cost on these deposits decreased 134 basis points in 2001 from 2000. Average interest-bearing liabilities rose 34.2% in 2001 from 2000. The cost of total interest-bearing liabilities decreased 50 basis points to 4.21% in 2001 from 4.71% in 2000.

Net interest income was \$9,209,044 in 2002, an increase of 14.3% from \$8,054,847 in 2001. The principal factor contributing to the improvement was an increase in interest income due to increased loan and security volumes. This was partially offset by decreases in loan and security yields and an increase in interest expense resulting from increased volumes of money market and NOW deposits and other borrowed funds.

The net interest margin (tax equivalent basis), which is net interest income divided by average interest earning assets, was 3.87% in 2002 compared with 4.04% in 2001 and 4.75% in 2000. The principal factor causing the decrease in the Bank's net interest margin was the sharp decline in market interest rates that existed in 2001 and continued throughout 2002. This resulted in yields on short-term investments and floating rate loans tied to the prime rate to decline more quickly than those of the Bank's interest-bearing liabilities. As a result of the interest rate movement, the yield on the Bank's total interest-earning assets declined 139 basis points and the cost of interest-bearing liabilities decreased 157 basis points compared to 2001.

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Average non-interest bearing demand deposits increased 29.2% to \$39,021,155 in 2002 from \$30,209,573 in 2001. Business checking accounts and expanding new business relationships have generated most of this increase. Throughout the comparative periods, increases in average non-interest bearing deposits contributed to the increases in net interest income.

Non-Interest Income

Non-interest income increased by \$318,401, or 21.2% to \$1,823,623 in 2002 from \$1,505,222 in 2001. Non-interest income in 2001 increased by \$639,344, or 73.8% from a posted total of \$865,878 for 2000.

Service charges on deposit accounts represent a significant source of non-interest income. Service charge revenues increased by \$115,103, or 28.6% to \$517,415 in 2002 from \$402,312 in 2001. Service charge income totaled \$326,441 in 2000. This component of non-interest income represented 28.4%, 26.7% and 37.7% of the total non-interest income in 2002, 2001 and 2000, respectively. Service charge income increased in 2002 and 2001 as a result of the Bank's increasing deposit base and growing number of new accounts subject to service charges. Management continues to utilize a strategy of requiring compensating balances from its commercial customers. Those who meet balance requirements are not assessed service charges.

The Bank also generates non-interest income from a variety of fee-based services. These include safe deposit rentals, wire transfer service fees and Automated Teller Machine fees for non-customers. Deposit and service fee charges are monitored annually by Management to reflect current costs amid the Bank's competitive market.

Gains on sales of loans, net, increased by \$252,742, or 35.0% in 2002 to \$974,305 from \$721,563 in 2001. Gains on sales of loans, net, totaled \$285,681 in 2000. The declining interest rate environment that existed during 2002 and 2001 greatly fueled the volume of mortgage loan originations and subsequent secondary market mortgage loan sales. In 2000, a higher rate environment existed that resulted in the lesser levels of reported gains on loan sales for that year.

The Bank recorded net securities gains of \$131,436 and \$26,247 in 2001 and 2000, respectively. These gains were primarily the result of modest portfolio restructurings. Their purpose was to improve the Bank's longer-term interest rate risk position.

Non-Interest Expense

Non-interest expense increased by \$715,047 or 12.2% to \$6,585,978 in 2002, from \$5,870,931 in 2001. Non-interest expense in 2001 increased 15.2% to \$5,870,931 from \$5,095,732 in 2000. The largest increase in non-interest expense in 2002 compared to 2001 was in salaries and employees benefits. To a lesser extent, occupancy, and other non-interest expense also reflect increases for the comparable periods. The largest increase in non-interest expense in 2001 compared to 2000 was in salaries and employee benefits and, to a lesser extent, net occupancy expense.

The table below presents the major components of non-interest expense for the years indicated.

Salaries and employee benefits, which represent the largest portion of non-interest expense, increased by \$495,180 or 16.3% in 2002 compared to 2001. These expenses increased in 2001 by \$521,997 or 20.8% over 2000. The 2002 increase reflects the increase in staffing for the mortgage loan origination function plus normal salary increases. In past years, the Bank engaged independent

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contractors to originate mortgage loans that are sold in the secondary market. In 2001, the Bank employed four full-time mortgage originators and ceased using independent contractors for this function. The increase in the level of salaries and employee benefits for 2001 versus 2000 was due to an increase in staffing levels to support the Bank's strong balance sheet growth. Salaries and employee benefits as a percent of average assets were 1.39% in 2002, 1.45% in 2001 and 1.57% in 2000.

During 2002, net occupancy expense increased by \$16,000 to \$740,088 from \$724,088 in 2001. The increase in occupancy expenses in 2002 compared to 2001, and in 2001 compared to 2000, was due primarily to contractual rent increases at most of the Bank's branch offices.

The occupancy expense component of total non-interest expense as a percentage of average assets was 0.29% in 2002, 0.35% in 2001 and 0.44% in 2000, respectively.

Regulatory, professional and other fees increased by \$51,981 or 13.5% to \$436,701 in 2002 from \$384,720 in 2001. These expenses increased in 2001 by \$80,457 or 26.4% over 2000. During 2001, the Bank applied for listing on the Nasdaq National Market System to provide quotations for its shares and provide improved share liquidity. An increased level of legal and accounting fees were incurred to successfully achieve this listing in late 2001.

Equipment expenses increased by \$140,352 or 45.2% to \$451,054 in 2002 from \$310,702 in 2001. Equipment expense includes depreciation on furniture and equipment as well as maintenance on that equipment. During the fourth quarter of 2002, the Bank completed a major conversion of its EDP software and hardware used throughout the Bank to process all loan and deposit transactions as well as maintain its financial records. This resulted in additional expenses for employee training, supplies and materials and EDP processing service agreements. Throughout 2001 and 2000, Management continued to upgrade equipment thereby increasing processing capability to enhance productivity. The Bank's enhanced technology has allowed Management to further diversify business and consumer product lines.

The Bank's ratio of non-interest expense to average assets improved to 2.60% for 2002 compared to 2.80% for 2001 and 3.19% for 2000.

An important industry productivity measure is the efficiency ratio. The efficiency ratio is calculated by dividing total operating expenses by net interest income and other income. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same or greater volume of income, while a decrease would indicate a more efficient allocation of resources. The Bank's efficiency ratio decreased in 2002 to 59.7% compared to 61.4% in 2001, and 63.4% in 2000.

	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>
Salaries and employee benefits	\$ 3,527,890	\$ 3,032,710	\$ 2,510,713	\$ 2,238,497	\$ 1,970,901
Occupancy expense	740,088	724,088	709,169	589,886	476,172
Equipment expense	451,054	310,702	286,632	242,714	155,446
Marketing	237,268	190,233	208,294	190,807	178,143
Computer services	432,875	494,686	415,627	314,970	299,690
Regulatory, professional and other fees	436,701	384,720	304,263	206,720	226,085
Office expense	311,346	330,358	255,387	233,908	195,130
All other expenses	448,756	403,434	405,647	407,711	357,943
Total	\$ 6,585,978	\$ 5,870,931	\$ 5,095,732	\$ 4,425,213	\$ 3,859,510

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Financial Condition

Interest-Earning Assets and Interest-Bearing Liabilities

Average interest-earning assets increased by \$38,785,671, or 19.3% to \$240,229,674 in 2002 from \$201,444,003 in 2001, reflecting growth in the loan and investment securities portfolios. Loans increased by \$21,214,734, or 17.1%, to average \$145,159,286 in 2002, while investment securities increased by \$18,810,499, or 29.2%, to average \$83,327,112 in 2002. The growth in interest-earning assets was funded by increases in money market and NOW accounts, demand deposits, other borrowed funds and shareholders' equity.

As a result of interest rates decreasing in the latter part of 2000 and continuing through the years 2001 and 2002, the annual average rate earned on interest-earning assets decreased 139 basis points to 5.99% in 2002 from 7.38% in 2001.

Average interest-bearing liabilities increased by \$53,157,661, or 20.7% to \$193,389,423 in 2002 from \$160,231,762 in 2001. The increase resulted primarily from growth in money market and NOW accounts as well as certificates of deposit. The average balance of money market and NOW accounts increased by \$26,223,835, or 52.0%, to \$76,698,669 in 2002 from \$50,474,834 in 2001. The average balance of certificates of deposit under \$100,000 increased by \$6,187,397 or 11.7%, to \$59,131,266 in 2002 from \$52,943,869 in 2001 primarily due to customers seeking a secure investment for their funds during a period of economic turbulence and falling interest rates. The average interest rate paid on interest-bearing liabilities decreased 157 basis points to 2.64% in 2002.

Cash and Cash Equivalents

At December 31, 2002, cash and cash equivalents totaled \$9,594,374 compared to \$21,928,214 at December 31, 2001. Cash and cash equivalents at December 31, 2002 consisted of cash and due from banks of \$9,542,010 and federal funds sold/short-term investments of \$52,364. The corresponding balances at December 31, 2001 were \$8,173,550 and \$13,754,664, respectively. The higher balances of cash and cash equivalents at December 31, 2001 were primarily due to late December interest-bearing deposits balances raised to fund loan growth and manage the Bank's liquidity position.

Securities

The Bank's investment securities portfolio amounted to \$89,200,779, or 33.2% of total assets at December 31, 2002 compared to \$67,639,984 or 30.3% of total assets at December 31, 2001. On an average balance basis, the investment securities portfolio represented 34.7% and 32.0% of average interest-earning assets for the years ended December 31, 2002 and 2001, respectively. The average yield earned on the portfolio was 4.61% in 2002, a decrease of 144 basis points from 6.05% earned in 2001.

Securities available for sale are investments that may be sold in response to changing market and interest rate conditions or for other business purposes. Securities available for sale consist primarily of U.S. Government and Federal agency securities as well as mortgage-backed securities. Activity in this portfolio is undertaken primarily to manage liquidity and interest rate risk and to take advantage of market conditions that create economically more attractive returns. At December 31, 2002, available-for-sale securities amounted to \$82,028,866, an increase of \$20,423,809, or 33.2%, from year-end 2001.

There were no sales of securities available for sale during 2002. Sales of securities available for sale generated a gain of \$131,436 in 2001. Proceeds from maturities and prepayments of securities available for sale amounted to \$40,436,189 in 2002 and \$33,742,940 in 2001. At December 31, 2002, the

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portfolio had a level of net unrealized gains of \$1,235,942, compared to net unrealized losses of \$64,610 at the end of the prior year. These unrealized gains/(losses) are reflected net of tax in shareholders' equity as other comprehensive income or loss.

Securities held to maturity, which are carried at amortized historical cost, are investments for which there is the positive intent and ability to hold to maturity. The held-to-maturity portfolio consists primarily of obligations of states and political subdivisions. At December 31, 2002, securities held to maturity totaled \$7,171,913, an increase of \$1,136,986, or 18.8%, from \$6,034,927 the prior year. The market value of the held-to-maturity portfolio at year-end 2002 was \$7,434,715, resulting in a net unrealized gain of \$262,802.

Loans

The loan portfolio, which represents the Bank's largest asset, is a significant source of both interest and fee income. Elements of the loan portfolio are subject to differing levels of credit and interest rate risk. The Bank's primary lending focus continues to be commercial loans, owner-occupied commercial mortgage loans and tenanted commercial real estate loans. Total loans averaged \$145,159,286 during 2002, an increase of \$21,214,734, or 17.1%, compared to an average of \$123,944,552 in 2001. Growth in the average loan portfolio balance was generated primarily by an increase of \$13,542,630 or 23.3%, in commercial mortgage and construction wholesale loans. At December 31, 2002, total loans amounted to \$151,049,736 compared to \$124,937,483 the prior year, an increase of \$26,112,253 or 20.9%. The average yield earned on the loan portfolio was 7.13% in 2002 compared to 8.52% in 2001, a decrease of 139 basis points. This decrease is primarily due to the lower interest rate environment that existed throughout 2002.

Commercial loans averaged \$30,758,677 for 2002, an increase of \$6,954,112 or 29.2% compared to 2001. Commercial loans are made to small to middle market businesses and are typically working capital loans used to finance inventory, receivables or equipment needs. These loans are generally secured by business assets of the commercial borrower. The average yield on the commercial loan portfolio decreased 324 basis points to 7.40% in 2002 from 10.64% the prior year. The declining interest rate environment that existed throughout 2002, especially the lower average prime rate, and competitive pricing resulted in the decreased yield on this portfolio.

Commercial mortgages and construction wholesale loans averaged \$71,547,571 for 2002, an increase of 23.3% compared to 2001. Generally, these loans represent owner-occupied or investment properties and complement a broader commercial relationship with the borrower. Construction loans are structured to provide for advances only after work is completed and inspected by qualified professionals. The average yield on the commercial mortgages and construction wholesale loan portfolio decreased 122 basis points to 6.49% from 7.71% the prior year.

Residential mortgages and construction retail loans averaged \$19,892,071 for 2002, an increase of 0.3% compared to 2001. These loans consist primarily of residential mortgage loans, home equity loans and business loans secured by residential real estate. The average yield on this portfolio decreased 141 basis points to 6.38% for 2002 from 7.79% the prior year.

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The following table provides information concerning the interest rate sensitivity of the Bank's commercial and commercial real estate loans and construction loans at December 31, 2002.

Type	Maturity Range			Total
	Within One Year	After One But Within Five Years	After Five Years	