

GERMAN AMERICAN BANCORP, INC.  
Form 10-Q  
November 07, 2008

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period Ended September 30, 2008

Or

Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Transition Period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-11244

German American Bancorp, Inc.  
(Exact name of registrant as specified in its charter)

Indiana  
(State or other jurisdiction of  
incorporation or organization)

35-1547518  
(I.R.S. Employer  
Identification No.)

711 Main Street, Jasper, Indiana 47546  
(Address of Principal Executive Offices and Zip Code)

Registrant's telephone number, including area code: (812) 482-1314

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company:

Large Accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).  
YES  NO

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

Class	Outstanding at November 3, 2008
Common Stock, no par value	11,029,869

**CAUTION REGARDING FORWARD-LOOKING STATEMENTS AND ASSOCIATED RISKS**

Information included in or incorporated by reference in this Quarterly Report on Form 10-Q, our other filings with the Securities and Exchange Commission (the “SEC”) and our press releases or other public statements, contains or may contain “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Please refer to a discussion of our forward-looking statements and associated risks in Item 2 of Part I of this Report (“Management’s Discussion and Analysis of Financial Condition and Results of Operations”) at the conclusion of that Item 2 under the heading “Forward-Looking Statements and Associated Risks.”

---

\*\*\*\*\*

INDEX

PART I.	FINANCIAL INFORMATION	3
Item 1.	Financial Statements	3
	Consolidated Balance Sheets - September 30, 2008 and December 31, 2007	3
	Consolidated Statements of Income and Comprehensive Income - Three and Nine Months Ended September 30, 2008 and 2007	4-5
	Consolidated Statements of Cash Flows - Nine Months Ended September 30, 2008 and 2007	6
	Notes to Consolidated Financial Statements - September 30, 2008	7-15
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	16-24
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	25
Item 4.	Controls and Procedures	26
PART II.	OTHER INFORMATION	26
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	26
Item 6.	Exhibits	26
	SIGNATURES	27
	INDEX OF EXHIBITS	28

**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

**GERMAN AMERICAN BANCORP, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(unaudited, dollars in thousands except per share data)

	September 30, 2008	December 31, 2007
<b>ASSETS</b>		
Cash and Due from Banks	\$ 22,741	\$ 25,283
Federal Funds Sold and Other Short-term Investments	16,047	2,631
Cash and Cash Equivalents	38,788	27,914
Securities Available-for-Sale, at Fair Value	147,947	148,300
Securities Held-to-Maturity, at Cost (Fair value of \$3,544 and \$4,496 on September 30, 2008 and December 31, 2007, respectively)	3,491	4,464
Loans Held-for-Sale	4,993	5,697
Loans	889,085	870,643
Less: Unearned Income	(2,278)	(2,922)
Allowance for Loan Losses	(9,358)	(8,044)
Loans, Net	877,449	859,677
Stock in FHLB of Indianapolis and Other Restricted Stock, at Cost	10,621	10,621
Premises, Furniture and Equipment, Net	22,807	22,783
Other Real Estate	3,757	1,517
Goodwill	9,655	9,655
Intangible Assets	3,363	4,030
Company Owned Life Insurance	23,144	22,533
Accrued Interest Receivable and Other Assets	32,586	14,519
<b>TOTAL ASSETS</b>	<b>\$ 1,178,601</b>	<b>\$ 1,131,710</b>
<b>LIABILITIES</b>		
Non-interest-bearing Demand Deposits	\$ 147,196	\$ 136,212
Interest-bearing Demand, Savings, and Money Market Accounts	420,827	353,643
Time Deposits	338,340	387,566
Total Deposits	906,363	877,421
FHLB Advances and Other Borrowings	157,893	144,170
Accrued Interest Payable and Other Liabilities	13,324	13,003
<b>TOTAL LIABILITIES</b>	<b>1,077,580</b>	<b>1,034,594</b>
<b>SHAREHOLDERS' EQUITY</b>		
Preferred Stock, \$10 par value; 500,000 shares authorized, no shares issued	—	—
Common Stock, no par value, \$1 stated value; 20,000,000 shares authorized	11,030	11,029
Additional Paid-in Capital	68,367	68,408
Retained Earnings	21,210	16,681

Edgar Filing: GERMAN AMERICAN BANCORP, INC. - Form 10-Q

Accumulated Other Comprehensive Income	414	998
<b>TOTAL SHAREHOLDERS' EQUITY</b>	<b>101,021</b>	<b>97,116</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 1,178,601</b>	<b>\$ 1,131,710</b>
End of period shares issued and outstanding	11,030,288	11,029,484

See accompanying notes to consolidated financial statements.

**GERMAN AMERICAN BANCORP, INC.**  
**CONSOLIDATED STATEMENTS OF INCOME**  
**AND COMPREHENSIVE INCOME**  
(unaudited, dollars in thousands except per share data)

	<b>Three Months Ended</b>	
	<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>INTEREST INCOME</b>		
Interest and Fees on Loans	\$ 14,414	\$ 16,585
Interest on Federal Funds Sold and Other Short-term Investments	97	145
Interest and Dividends on Securities:		
Taxable	2,045	1,694
Non-taxable	173	214
<b>TOTAL INTEREST INCOME</b>	<b>16,729</b>	<b>18,638</b>
<b>INTEREST EXPENSE</b>		
Interest on Deposits	4,893	7,326
Interest on FHLB Advances and Other Borrowings	1,390	1,581
<b>TOTAL INTEREST EXPENSE</b>	<b>6,283</b>	<b>8,907</b>
<b>NET INTEREST INCOME</b>	<b>10,446</b>	<b>9,731</b>
Provision for Loan Losses	838	941
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>9,608</b>	<b>8,790</b>
<b>NON-INTEREST INCOME</b>		
Trust and Investment Product Fees	618	653
Service Charges on Deposit Accounts	1,293	1,122
Insurance Revenues	1,402	1,349
Other Operating Income	787	672
Net Gains on Sales of Loans and Related Assets	330	212
Net Loss on Securities	(106)	—
<b>TOTAL NON-INTEREST INCOME</b>	<b>4,324</b>	<b>4,008</b>
<b>NON-INTEREST EXPENSE</b>		
Salaries and Employee Benefits	5,225	5,395
Occupancy Expense	807	810
Furniture and Equipment Expense	601	519
Data Processing Fees	355	338
Professional Fees	365	257
Advertising and Promotion	250	250
Supplies	143	160
Other Operating Expenses	1,413	1,395
<b>TOTAL NON-INTEREST EXPENSE</b>	<b>9,159</b>	<b>9,124</b>
Income before Income Taxes	4,773	3,674
Income Tax Expense	1,454	1,166
<b>NET INCOME</b>	<b>\$ 3,319</b>	<b>\$ 2,508</b>

<b>COMPREHENSIVE INCOME</b>	\$	4,404	\$	3,761
Earnings Per Share and Diluted Earnings Per Share	\$	0.30	\$	0.23
Dividends Per Share	\$	0.14	\$	0.14

See accompanying notes to consolidated financial statements.

**GERMAN AMERICAN BANCORP, INC.**  
**CONSOLIDATED STATEMENTS OF INCOME**  
**AND COMPREHENSIVE INCOME**  
(unaudited, dollars in thousands except per share data)

	Nine Months Ended September 30,	
	2008	2007
<b>INTEREST INCOME</b>		
Interest and Fees on Loans	\$ 44,299	\$ 47,498
Interest on Federal Funds Sold and Other Short-term Investments	566	349
Interest and Dividends on Securities:		
Taxable	5,929	5,346
Non-taxable	538	732
<b>TOTAL INTEREST INCOME</b>	<b>51,332</b>	<b>53,925</b>
<b>INTEREST EXPENSE</b>		
Interest on Deposits	16,404	20,581
Interest on FHLB Advances and Other Borrowings	4,298	4,744
<b>TOTAL INTEREST EXPENSE</b>	<b>20,702</b>	<b>25,325</b>
<b>NET INTEREST INCOME</b>	<b>30,630</b>	<b>28,600</b>
Provision for Loan Losses	3,116	3,244
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>27,514</b>	<b>25,356</b>
<b>NON-INTEREST INCOME</b>		
Trust and Investment Product Fees	1,841	1,994
Service Charges on Deposit Accounts	3,721	3,154
Insurance Revenues	4,612	4,394
Other Operating Income	2,438	2,098
Net Gains on Sales of Loans and Related Assets	1,058	545
Net Gain on Securities	179	—
<b>TOTAL NON-INTEREST INCOME</b>	<b>13,849</b>	<b>12,185</b>
<b>NON-INTEREST EXPENSE</b>		
Salaries and Employee Benefits	15,670	16,452
Occupancy Expense	2,467	2,351
Furniture and Equipment Expense	1,811	1,676
Data Processing Fees	1,132	1,037
Professional Fees	1,370	998
Advertising and Promotion	776	619
Supplies	417	449
Other Operating Expenses	3,849	4,486
<b>TOTAL NON-INTEREST EXPENSE</b>	<b>27,492</b>	<b>28,068</b>
Income before Income Taxes	13,871	9,473
Income Tax Expense	4,421	2,843
<b>NET INCOME</b>	<b>\$ 9,450</b>	<b>\$ 6,630</b>



<b>COMPREHENSIVE INCOME</b>	\$	8,866	\$	6,776
Earnings Per Share and Diluted Earnings Per Share	\$	0.85	\$	0.60
Dividends Per Share	\$	0.42	\$	0.42

See accompanying notes to consolidated financial statements.

**GERMAN AMERICAN BANCORP, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(unaudited, dollars in thousands)

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net Income	\$ 9,450	\$ 6,630
Adjustments to Reconcile Net Income to Net Cash from Operating Activities:		
Net Accretion on Securities	(674)	(282)
Depreciation and Amortization	2,526	2,379
Loans Originated for Sale	(83,650)	(48,157)
Proceeds from Sales of Loans Held-for-Sale	85,412	45,741
Loss in Investment in Limited Partnership	150	137
Provision for Loan Losses	3,116	3,244
Gain on Sale of Loans	(1,058)	(545)
Gain on Securities Sales, Net	(529)	—
Loss / (Gain) on Sales of Other Real Estate and Repossessed Assets	16	(57)
Loss / (Gain) on Disposition and Impairment of Premises and Equipment	(17)	69
Other-Than-Temporary-Impairment Write-down on Securities	350	—
Increase in Cash Surrender Value of Company Owned Life Insurance	(611)	(590)
Equity Based Compensation	6	273
Change in Assets and Liabilities:		
Interest Receivable and Other Assets	(17,814)	2,051
Interest Payable and Other Liabilities	23	566
<b>Net Cash from Operating Activities</b>	<b>(3,304)</b>	<b>11,459</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Proceeds from Maturity of Other Short-term Investments	—	100
Proceeds from Maturities of Securities Available-for-Sale	44,993	34,228
Proceeds from Sales of Securities Available-for-Sale	34,788	—
Purchase of Securities Available-for-Sale	(79,563)	—
Proceeds from Maturities of Securities Held-to-Maturity	974	1,673
Purchase of Loans	(22,052)	(19,194)
Proceeds from Sales of Loans	3,150	938
Loans Made to Customers, Net of Payments Received	(4,894)	(56,077)
Proceeds from Sales of Other Real Estate	670	2,890
Property and Equipment Expenditures	(1,984)	(1,162)
Proceeds from Sales of Property and Equipment	58	50
<b>Net Cash from Investing Activities</b>	<b>(23,860)</b>	<b>(36,554)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Change in Deposits	28,986	40,035
Change in Short-term Borrowings	(7,745)	(22,941)
Advances of Long-term Debt	25,000	30,000
Repayments of Long-term Debt	(3,524)	(8,522)
Employee Stock Purchase Plan	(46)	(118)
Dividends Paid	(4,633)	(4,630)

<b>Net Cash from Financing Activities</b>	38,038	33,824
<b>Net Change in Cash and Cash Equivalents</b>	10,874	8,729
Cash and Cash Equivalents at Beginning of Year	27,914	29,695
Cash and Cash Equivalents at End of Period	\$ 38,788	\$ 38,424

See accompanying notes to consolidated financial statements.

**GERMAN AMERICAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2008**  
**(unaudited, dollars in thousands except per share data)**

**Note 1 – Basis of Presentation**

German American Bancorp, Inc. operates primarily in the banking industry. The accounting and reporting policies of German American Bancorp, Inc. and its subsidiaries conform to U.S. generally accepted accounting principles. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted. All adjustments which are, in the opinion of management, necessary for a fair presentation of the results for the periods reported have been included in the accompanying unaudited consolidated financial statements, and all such adjustments are of a normal recurring nature. Certain prior year amounts have been reclassified to conform with current classifications. It is suggested that these consolidated financial statements and notes be read in conjunction with the financial statements and notes thereto in the German American Bancorp, Inc. December 31, 2007 Annual Report on Form 10-K.

**Note 2 – Per Share Data**

The computations of Earnings per Share and Diluted Earnings per Share are as follows:

	<b>Three Months Ended</b>	
	<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Earnings per Share:</b>		
Net Income	\$ 3,319	\$ 2,508
Weighted Average Shares Outstanding	11,029,484	11,008,562
Earnings per Share	\$ 0.30	\$ 0.23
<b>Diluted Earnings per Share:</b>		
Net Income	\$ 3,319	\$ 2,508
Weighted Average Shares Outstanding	11,029,484	11,008,562
Potentially Dilutive Shares, Net	292	17,313
Diluted Weighted Average Shares Outstanding	11,029,776	11,025,875
Diluted Earnings per Share	\$ 0.30	\$ 0.23

Stock options for 248,871 and 268,063 shares of common stock were not considered in computing diluted earnings per share for the quarter ended September 30, 2008 and 2007, respectively, because they were anti-dilutive.

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Earnings per Share:</b>		
Net Income	\$ 9,450	\$ 6,630
Weighted Average Shares Outstanding	11,029,484	11,008,562
Earnings per Share	\$ 0.85	\$ 0.60

<b>Diluted Earnings per Share:</b>			
Net Income	\$	9,450	\$ 6,630
Weighted Average Shares Outstanding		11,029,484	11,008,562
Potentially Dilutive Shares, Net		233	14,131
Diluted Weighted Average Shares Outstanding		11,029,717	11,022,693
Diluted Earnings per Share	\$	0.85	\$ 0.60

Stock options for 248,871 and 257,063 shares of common stock were not considered in computing diluted earnings per share for the nine months ended September 30, 2008 and 2007, respectively, because they were anti-dilutive.

**GERMAN AMERICAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2008**  
**(unaudited, dollars in thousands except per share data)**

**Note 3 – Securities**

The amortized cost, unrealized gross gains and losses recognized in accumulated other comprehensive income (loss), and fair value of Securities Available-for-Sale at September 30, 2008 and December 31, 2007, were as follows:

Securities Available-for-Sale:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>September 30, 2008</b>				
U.S. Treasury and Agency Securities	\$ 499	\$ 2	\$ —	501
Obligations of State and Political Subdivisions	9,708	182	—	9,890
Mortgage-backed Securities	132,772	1,056	(287)	133,541
Equity Securities	4,207	45	(237)	4,015
<b>Total</b>	<b>\$ 147,186</b>	<b>\$ 1,285</b>	<b>\$ (524)</b>	<b>\$ 147,947</b>
<b>December 31, 2007</b>				
U.S. Treasury and Agency Securities	\$ 25,306	\$ 433	\$ —	25,739
Obligations of State and Political Subdivisions	11,387	216	(1)	11,602
Mortgage-backed Securities	105,302	608	(421)	105,489
Equity Securities	4,557	913	—	5,470
<b>Total</b>	<b>\$ 146,552</b>	<b>\$ 2,170</b>	<b>\$ (422)</b>	<b>\$ 148,300</b>

Equity securities that do not have readily determinable fair values are included in the above totals, are carried at historical cost and are evaluated for impairment on a periodic basis.

The carrying amount, unrecognized gains and losses and fair value of Securities Held-to-Maturity at September 30, 2008 and December 31, 2007, were as follows:

Securities Held-to-Maturity:	Carrying Amount	Gross Unrecognized Gains	Gross Unrecognized Losses	Fair Value
<b>September 30, 2008</b>				
Obligations of State and Political Subdivisions	\$ 3,491	\$ 53	\$ —	3,544
<b>December 31, 2007</b>				
Obligations of State and Political Subdivisions	\$ 4,464	\$ 32	\$ —	4,496

Below is a summary of securities with unrealized losses as of September 30, 2008 and December 31, 2007, presented by length of time the securities have been in a continuous unrealized loss position:

<b>At September 30, 2008:</b>	<b>Less than 12 Months</b>		<b>12 Months or More</b>		<b>Total</b>	
	<b>Fair</b>	<b>Unrealized</b>	<b>Fair</b>	<b>Unrealized</b>	<b>Fair</b>	<b>Unrealized</b>
	<b>Value</b>	<b>Loss</b>	<b>Value</b>	<b>Loss</b>	<b>Value</b>	<b>Loss</b>
U.S. Treasury and Agency Securities	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Obligations of State and Political Subdivisions	—	—	—	—	—	—
Mortgage-backed Securities	64,281	(282)	689	(5)	64,970	(287)
Equity Securities	1,786	(237)	—	—	1,786	(237)
<b>Total</b>	<b>\$ 66,067</b>	<b>\$ (519)</b>	<b>\$ 689</b>	<b>\$ (5)</b>	<b>\$ 66,756</b>	<b>\$ (524)</b>

8

**GERMAN AMERICAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2008**  
(unaudited, dollars in thousands except per share data)

**Note 3 – Securities (continued)**

At December 31, 2007:	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Treasury and Agency Securities	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Obligations of State and Political Subdivisions	—	—	230	(1)	230	(1)
Mortgage-backed Securities	1,544	(1)	56,647	(420)	58,191	(421)
Equity Securities	—	—	—	—	—	—
<b>Total</b>	<b>\$ 1,544</b>	<b>\$ (1)</b>	<b>\$ 56,877</b>	<b>\$ (421)</b>	<b>\$ 58,421</b>	<b>\$ (422)</b>

Securities are written down to fair value when a decline in fair value is not considered temporary. In estimating other-than-temporary losses, management considers the length of time and extent that fair value has been less than cost, the financial condition and near term prospects of the issuer, and the Company's ability and intent to hold the security for a period sufficient to allow for any anticipated recovery in fair value. The Company has the intent and ability to hold these securities for the foreseeable future, and the decline in fair value is largely due to changes in market interest rates, therefore, the Company does not consider these securities to be other-than-temporarily impaired. All mortgage-backed securities in the Company's portfolio are guaranteed by government sponsored entities, are investment grade, and are performing as expected.

The Company's equity securities consist of non-controlling investments in other banking organizations. As a result of a valuation of this portfolio during the third quarter of 2008, the Company recognized a \$350 pre-tax charge for an other-than-temporary decline in fair value of this portfolio. As required by SFAS 115, when a decline in fair value below cost is deemed to be other-than-temporary, the unrealized loss must be recognized as a charge to earnings. Accordingly, the other-than-temporary impairment was recognized in the income statement as an investment securities loss during the third quarter of 2008.

**Note 4 – Loans**

Total loans, as presented on the balance sheet, are comprised of the following classifications:

	<b>September 30, 2008</b>	<b>December 31, 2007</b>
Commercial and Industrial Loans	\$ 499,449	\$ 457,033
Residential Mortgage Loans	104,386	116,908
Consumer Loans	128,125	131,110
Agricultural Loans	157,125	165,592
<b>Total Loans</b>	<b>\$ 889,085</b>	<b>\$ 870,643</b>
Less: Unearned Income	(2,278)	(2,922)
Allowance for Loan Losses	(9,358)	(8,044)
<b>Loans, Net</b>	<b>\$ 877,449</b>	<b>\$ 859,677</b>



Information Regarding Impaired Loans:

Impaired Loans with No Allowance for Loan Losses				
Allocated	\$	1,527	\$	1,919
Impaired Loans with Allowance for Loan Losses				
Allocated		3,245		2,384
Amount of Allowance Allocated to Impaired Loans		1,331		399

9

**GERMAN AMERICAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2008**  
**(unaudited, dollars in thousands except per share data)**

**Note 5 – Allowance for Loan Losses**

A summary of the activity in the Allowance for Loan Losses follows:

	September 30, 2008	September 30, 2007
Balance as of January 1	\$ 8,044	\$ 7,129
Provision for Loan Losses	3,116	3,244
Recoveries of Prior Loan Losses	505	330
Loan Losses Charged to the Allowance	(2,307)	(2,648)
Balance as of September 30	\$ 9,358	\$ 8,055

**Note 6 – Segment Information**

The Company's operations include three primary segments: core banking, trust and investment advisory services, and insurance operations. The core banking segment involves attracting deposits from the general public and using such funds to originate consumer, commercial and agricultural, commercial and agricultural real estate, and residential mortgage loans, primarily in the Company's local markets. The core banking segment also involves the sale of residential mortgage loans in the secondary market. The trust and investment advisory services segment involves providing trust, investment advisory, and brokerage services to customers. The insurance segment offers a full range of personal and corporate property and casualty insurance products, primarily in the affiliate banks' local markets.

The core banking segment is comprised by the Company's banking subsidiary, German American Bancorp, which operates through 28 retail banking offices. Net interest income from loans and investments funded by deposits and borrowings is the primary revenue for the core-banking segment. The trust and investment advisory services segment's revenues are comprised primarily of fees generated by German American Financial Advisors & Trust Company ("GAFA"). These fees are derived by providing trust, investment advisory, and brokerage services to its customers. The insurance segment consists of German American Insurance, Inc., which provides a full line of personal and corporate insurance products from seven offices; and German American Reinsurance Company, Ltd. ("GARCL"), which reinsures credit insurance products sold by the Company's affiliate banks. Commissions derived from the sale of insurance products are the primary source of revenue for the insurance segment.

The following segment financial information has been derived from the internal financial statements of German American Bancorp, Inc., which are used by management to monitor and manage the financial performance of the Company. The accounting policies of the three segments are the same as those of the Company. The evaluation process for segments does not include holding company income and expense. Holding company amounts are the primary differences between segment amounts and consolidated totals, and are reflected in the column labeled "Other" below, along with amounts to eliminate transactions between segments.

**Three Months Ended**  
**September 30, 2008**

Core	Trust and Investment Advisory	Consolidated
------	-------------------------------------	--------------

Edgar Filing: GERMAN AMERICAN BANCORP, INC. - Form 10-Q

	<b>Banking</b>	<b>Services</b>	<b>Insurance</b>	<b>Other</b>	<b>Totals</b>
Net Interest Income	\$ 10,603	\$ 8	\$ 17	\$(182)	10,446
Net Gains on Sales of Loans and Related Assets	330	—	—	—	330
Net Gain on Securities	244	—	—	(350)	(106)
Trust and Investment Product Fees	1	618	—	(1)	618
Insurance Revenues	8	36	1,370	(12)	1,402
Noncash Item:					
Provision for Loan Losses	838	—	—	—	838
Depreciation and Amortization	639	7	204	—	850
Income Tax Expense	1,720	66	43	(375)	1,454
Segment Profit / (Loss)	3,482	95	54	(312)	3,319
Segment Assets	1,169,559	2,198	9,817	(2,973)	1,178,601

**GERMAN AMERICAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2008**  
(unaudited, dollars in thousands except per share data)

**Note 6 – Segment Information (continued)****Three Months Ended  
September 30, 2007**

	<b>Core Banking</b>	<b>Trust and Investment Advisory Services</b>	<b>Insurance</b>	<b>Other</b>	<b>Consolidated Totals</b>
Net Interest Income	\$ 10,007	\$ 27	\$ 26	\$ (329)	\$ 9,731
Net Gains on Sales of Loans and Related Assets	212	—	—	—	212
Net Gain on Securities	—	—	—	—	—
Trust and Investment Product Fees	1	677	—	(25)	653
Insurance Revenues	8	3	1,348	(10)	1,349
Noncash Item:					
Provision for Loan Losses	941	—	—	—	941
Depreciation and Amortization	537	6	210	—	753
Income Tax Expense	1,361	74	38	(307)	1,166
Segment Profit / (Loss)	2,641	113	55	(301)	2,508
Segment Assets	1,123,650	2,290	9,700	(48)	1,135,592

**Nine Months Ended  
September 30, 2008**

	<b>Core Banking</b>	<b>Trust and Investment Advisory Services</b>	<b>Insurance</b>	<b>Other</b>	<b>Consolidated Totals</b>
Net Interest Income	\$ 31,203	\$ 59	\$ 55	\$ (687)	\$ 30,630
Net Gains on Sales of Loans and Related Assets	1,058	—	—	—	1,058
Net Gain on Securities	529	—	—	(350)	179
Trust and Investment Product Fees	4	1,864	—	(27)	1,841
Insurance Revenues	48	42	4,570	(48)	4,612
Noncash Item:					
Provision for Loan Losses	3,116	—	—	—	3,116
Depreciation and Amortization	1,893	21	612	—	2,526
Income Tax Expense	4,746	209	340	(874)	4,421

Edgar Filing: GERMAN AMERICAN BANCORP, INC. - Form 10-Q

Segment Profit / (Loss)	9,453	308	548	(859)	9,450
Segment Assets	1,169,559	2,198	9,817	(2,973)	1,178,601

11

---

**GERMAN AMERICAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2008**  
(unaudited, dollars in thousands except per share data)

**Note 6 – Segment Information (continued)**

**Nine Months Ended  
September 30, 2007**

	<b>Core Banking</b>	<b>Trust and Investment Advisory Services</b>	<b>Insurance</b>	<b>Other</b>	<b>Consolidated Totals</b>
Net Interest Income	\$ 29,358	\$ 69	\$ 84	\$ (911)	\$ 28,600
Net Gains on Sales of Loans and Related Assets	545	—	—	—	545
Net Gain on Securities	—	—	—	—	—
Trust and Investment Product Fees	3	2,069	—	(78)	1,994
Insurance Revenues	70	23	4,350	(49)	4,394
Noncash Item:					
Provision for Loan Losses	3,244	—	—	—	3,244
Depreciation and Amortization	1,762	16	601	—	2,379
Income Tax Expense	3,236	240	230	(863)	2,843
Segment Profit / (Loss)	6,923	366	340	(999)	6,630
Segment Assets	1,123,650	2,290	9,700	(48)	1,135,592

**Note 7 – Stock Repurchase Plan**

On April 26, 2001 the Company announced that its Board of Directors approved a stock repurchase program for up to 607,754 (as adjusted for subsequent stock dividends) of the outstanding Common Shares of the Company. Shares may be purchased from time to time in the open market and in large block privately negotiated transactions. The Company is not obligated to purchase any shares under the program, and the program may be discontinued at any time before the maximum number of shares specified by the program are purchased. As of September 30, 2008, the Company had purchased 334,965 (as adjusted for subsequent stock dividends) shares under the program. No shares were purchased under the plan during the nine months ended September 30, 2008.

**Note 8 – Equity Plans and Equity Based Compensation**

The Company maintains two equity incentive plans under which stock options, restricted stock, and other equity incentive awards can be granted. At September 30, 2008, the Company has reserved 620,144 shares of Common Stock (as adjusted for subsequent stock dividends and subject to further customary anti-dilution adjustments) for the purpose of issuance pursuant to outstanding and future grants of options, restricted stock, and other equity awards to officers, directors and other employees of the Company.

For the nine months ended September 30, 2008 and 2007 there were no stock options granted. There was no option expense during the three or nine month periods ended September 30, 2008 and 2007. In addition, there was no

unrecognized option expense as all outstanding options were fully vested prior to September 30, 2008 and 2007.

During the quarter and nine months ended September 30, 2008, the Company granted awards of 385 shares and 804 shares of restricted stock. During the quarter and nine months ended September 30, 2007, the Company granted awards of 397 shares and 21,797 shares of restricted stock. The expense recorded for the restricted stock grants totaled \$4, net of an income tax benefit of \$3, and \$6, net on an income tax benefit of \$4, during the three and nine months ended September 30, 2008, respectively. The expense recorded for the restricted stock grants totaled \$53, net of an income tax benefit of \$34, and \$136, net of an income tax benefit of \$89, during the three and nine months ended September 30, 2007, respectively. Unrecognized expense associated with the restricted stock grants totaled \$4 and \$58 as of September 30, 2008 and 2007, respectively.

The Company maintains an Employee Stock Purchase Plan whereby eligible employees have the option to purchase the Company's common stock at a discount. The plan year for the Employee Stock Purchase Plan runs from August 17 through August 16 of the subsequent year. For years prior to the plan year beginning August 17, 2007, the purchase price of the shares were determined annually and in the range from 85% to 100% of the fair market value of such stock at either the beginning or end of the plan year. For the plan year beginning August 17, 2007 and the plan year beginning August 17, 2008, the purchase price of the shares under this Plan is 95% of the fair market value of the Company's common stock as of the last day of the plan year. The plan provides for the purchase of up to 542,420 shares of common stock, which the Company may obtain by purchases on the open market or from private sources, or by issuing authorized but unissued common shares. Funding for the purchase of common stock is from employee and Company contributions.

**GERMAN AMERICAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2008**  
**(unaudited, dollars in thousands except per share data)**

**Note 8 – Equity Plans and Equity Based Compensation (continued)**

Based on the above referenced setting of the purchase price at 95% of the fair market value of the Company's common stock and elimination of the look-back feature for the 2007/2008 and the 2008/2009 plan years, the Employee Stock Purchase Plan was not and will not be considered compensatory and no expense was or will be recorded during the 2007/2008 and 2008/2009 plan years. The expense recorded for the Employee Stock Purchase Plan totaled \$7 net of an income tax benefit of \$5, and \$29, net of an income tax benefit of \$19, during the three and nine months ended September 30, 2007, respectively. There was no unrecognized compensation expense for the Employee Stock Purchase Plan as of September 30, 2008 and 2007.

**Note 9 – Employee Benefit Plans**

The Company acquired through previous bank mergers a noncontributory defined benefit pension plan with benefits based on years of service and compensation prior to retirement. The benefits under the plan were suspended in 1998. The following tables represent the components of net periodic benefit cost for the periods presented:

	<b>Three Months Ended</b>	
	<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>
Service Cost	\$ —	\$ —
Interest Cost	9	9
Expected Return on Assets	(3)	(3)
Amortization of Transition Amount	(1)	—
Amortization of Prior Service Cost	—	(1)
Recognition of Net (Gain)/Loss	5	7
Net Periodic Benefit Cost	\$ 10	\$ 12
Loss on Settlements and Curtailments	None	None

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>
Service Cost	\$ —	\$ —
Interest Cost	28	28
Expected Return on Assets	(9)	(9)
Amortization of Transition Amount	(1)	(1)
Amortization of Prior Service Cost	(2)	(3)
Recognition of Net (Gain)/Loss	15	21
Net Periodic Benefit Cost	\$ 31	\$ 36
Loss on Settlements and Curtailments	None	45

The Company previously disclosed in its financial statements for the year ended December 31, 2007, that it expected to contribute \$97 to the pension plan during the fiscal year ending December 31, 2008. As of September 30, 2008, the Company had contributed \$81 to the pension plan.



**Note 10 – New Accounting Pronouncements**

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. The standard is effective for fiscal years beginning after November 15, 2007. Statement 157 establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

13

---

**GERMAN AMERICAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2008**  
**(unaudited, dollars in thousands except per share data)**

**Note 10 – New Accounting Pronouncements (continued)**

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs).

Assets and Liabilities Measured on a Recurring Basis

Assets and liabilities measured at fair value on a recurring basis are summarized below:

	Fair Value Measurements at September 30, 2008 Using Quoted Prices in			
	September 30, 2008	Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets:</b>				
Available for Sale Securities	\$ 147,947	\$ 2,272	\$ 143,933	\$ 1,742

Equity securities that do not have readily determinable fair values are carried at cost and are evaluated for impairment on a periodic basis. Equity securities carried at cost and included in the table above totaled \$2,092 at January 1, 2008 and \$1,742 at September 30, 2008. The change in carrying value of these securities was attributable to an other-than-temporary impairment charge of \$350 that was recognized on these securities during the quarter ended September 30, 2008.

Assets and Liabilities Measured on a Non-Recurring Basis

Assets and liabilities measured at fair value on a non-recurring basis are summarized below:

	Fair Value Measurements at September 30, 2008 Using Quoted Prices in			
	September 30, 2008	Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets:</b>				

Impaired Loans	\$	1,783	\$	—	\$	—	\$	1,783
----------------	----	-------	----	---	----	---	----	-------

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of \$2,896, with a valuation allowance of \$1,113, resulting in an additional provision for loan losses of \$346 and \$659 for the three and nine months ended September 30, 2008, respectively. Values for collateral dependent loans are generally based on appraisals obtained from licensed real estate appraisals and in certain circumstances consideration of offers obtained to purchase properties prior to foreclosure or other factors management deems relevant to arrive at a representative fair value. Appraisals for commercial real estate generally use three methods to derive value: cost, sales or market comparison and income approach. The cost method bases value in the cost to replace the current property. Values of market comparison approach evaluates the sales price of similar properties in the same market area. The income approach considers net operating income generated by the property and an investor's required return. The final fair value is based on the reconciliation of these three approaches.

**GERMAN AMERICAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2008**  
**(unaudited, dollars in thousands except per share data)**

**Note 10 – New Accounting Pronouncements (continued)**

In February 2007, the FASB issued Statement No. 159 - *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS No. 159). The standard provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The new standard is effective for the Company on January 1, 2008. The Company did not elect the fair value option for any financial assets or liabilities as of January 1, 2008 or subsequently.

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*. This issue requires that a liability be recorded during the service period when a split-dollar life insurance agreement continues after participants' employment or retirement. The required accrued liability will be based on either the post-employment benefit cost for the continuing life insurance or based on the future death benefit depending on the contractual terms of the underlying agreement. This issue became effective for the Company on January 1, 2008. The impact of adoption of this issue was an adjustment to lower retained earnings of the Company by \$288 effective January 1, 2008.

On November 5, 2007, the SEC issued Staff Accounting Bulletin No. 109, *Written Loan Commitments Recorded at Fair Value through Earnings* ("SAB 109"). Previously, SAB 105, *Application of Accounting Principles to Loan Commitments*, stated that in measuring the fair value of a derivative loan commitment, a company should not incorporate the expected net future cash flows related to the associated servicing of the loan. SAB 109 supersedes SAB 105 and indicates that the expected net future cash flows related to the associated servicing of the loan should be included in measuring fair value for all written loan commitments that are accounted for at fair value through earnings. SAB 105 also indicated that internally-developed intangible assets should not be recorded as part of the fair value of a derivative loan commitment, and SAB 109 retains that view. SAB 109 is effective for derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The impact of adoption of this standard was not material to the Company's financial statements.

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

### **GERMAN AMERICAN BANCORP, INC. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

German American Bancorp, Inc. is a financial services holding company based in Jasper, Indiana. The Company's Common Stock is traded on NASDAQ's Global Select Market, under the symbol GABC. The principal subsidiary of German American Bancorp, Inc. is its banking subsidiary, German American Bancorp, which operates through 28 retail banking offices in the ten contiguous Southern Indiana counties of Daviess, Dubois, Gibson, Knox, Lawrence, Martin, Monroe, Perry, Pike, and Spencer. German American Bancorp owns a trust, brokerage, and financial planning subsidiary, which operates from its banking offices, and a full line property and casualty insurance agency with seven insurance agency offices throughout its market area.

Throughout this Management's Discussion and Analysis, as elsewhere in this report, when we use the term "Company", we will usually be referring to the business and affairs (financial and otherwise) of the Company and its subsidiaries and affiliates as a whole. Occasionally, we will refer to the term "parent company" or "holding company" when we mean to refer to only German American Bancorp, Inc.

This section presents an analysis of the consolidated financial condition of the Company as of September 30, 2008 and December 31, 2007 and the consolidated results of operations for the three and nine months ended September 30, 2008 and 2007. This discussion should be read in conjunction with the consolidated financial statements and other financial data presented elsewhere herein and with the financial statements and other financial data, as well as the Management's Discussion and Analysis of Financial Condition and Results of Operations, included in the Company's December 31, 2007 Annual Report on Form 10-K.

#### **MANAGEMENT OVERVIEW**

This updated discussion should be read in conjunction with the Management Overview that was included in our Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's December 31, 2007 Annual Report on Form 10-K.

During the third quarter of 2008, the Company generated earnings of \$3,319,000 or \$0.30 per share, a 32% increase from the \$2,508,000 or \$0.23 per share in the third quarter of 2007. This level of quarterly earnings represents the fourth successive quarter that the Company has reported the highest level of quarterly earnings in its history. In comparison with prior year results, the Company's performance was enhanced during the third quarter of 2008 in each major category within the income statement reflecting increased revenue from both net interest income and total non-interest income coupled with flat non-interest expense. In addition, the Company's provision for loan loss declined modestly during the third quarter of 2008 compared with 2007. Each of these areas will be discussed in more detail below.

#### **RECENT U.S. TREASURY DEPARTMENT AND FDIC DEVELOPMENTS**

In October 2008, in response to a perceived economic emergency affecting the banking and financial markets, President Bush signed into law the Emergency Economic Stabilization Act of 2008 (the "EESA"). Pursuant to the EESA, the U. S. Department of the Treasury ("the Treasury") has authority to, among other things, purchase up to \$700 billion of mortgages, mortgage-backed securities and certain other financial instruments from financial institutions for the purpose of stabilizing and providing liquidity to the U. S. financial markets.

As part of the EESA, the Treasury announced a program to purchase equity stakes in U. S. financial institutions. Under this program, known as the Troubled Asset Relief Program Capital Purchase Program (the “TARP Capital Purchase Program”), the Treasury will make \$250 billion of capital available to U. S. financial institutions in the form of preferred stock. In conjunction with the purchase of preferred stock, the Treasury will receive warrants to purchase common stock with an aggregate market price equal to 15% of the total amount of the preferred investment. The amount of capital available to each participating financial institution will be not less than one percent, or more than three percent, of that institution's risk weighted assets. Participating financial institutions will be required to adopt the Treasury’s standards for executive compensation and corporate governance for the period during which the Treasury holds equity issued under the TARP Capital Purchase Program and be restricted from increasing dividends to common shareholders or repurchasing common stock for three years without the consent of the Treasury.

Further, after receiving a recommendation from the boards of the Federal Deposit Insurance Corporation (“the FDIC”) and the Federal Reserve System (the “Federal Reserve”), the Treasury in late October 2008 invoked the systemic risk exception to the Federal Deposit Insurance Act, enabling the FDIC to temporarily provide a 100% guarantee of the senior debt of all FDIC-insured institutions and their holding companies, as well as deposits in non-interest bearing transaction deposit accounts, under a Temporary Liquidity Guarantee Program. Coverage under the Temporary Liquidity Guarantee Program is available for 30 days without charge and thereafter at a cost of 75 basis points per annum for senior unsecured debt and 10 basis points per annum for non-interest bearing transaction deposits.

The Company has not yet made a decision to participate in the Temporary Liquidity Guarantee Program or in the TARP Capital Purchase Program, or as to the amount of any capital that the Company may seek under the TARP Capital Purchase Program. The Company must make application by November 14, 2008, to seek to participate in the TARP Capital Purchase Program. Any election by the Company would be subject to approval by the Treasury and appropriate federal bank regulatory agencies. The Company must elect by December 5, 2008 if it intends to opt-out of the Temporary Liquidity Guarantee Program. It is not clear at this time what impact the EESA, the TARP Capital Purchase Program, the Temporary Liquidity Guarantee Program, other liquidity and funding initiatives of the Federal Reserve and other agencies that have been previously announced, and any additional programs that may be initiated in the future will have on the Company and the U. S. and global financial markets.

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The financial condition and results of operations for German American Bancorp, Inc. presented in the Consolidated Financial Statements, accompanying Notes to the Consolidated Financial Statements, and selected financial data appearing elsewhere within this report, are, to a large degree, dependent upon the Company’s accounting policies. The selection of and application of these policies involve estimates, judgments and uncertainties that are subject to change. The critical accounting policies and estimates that the Company has determined to be the most susceptible to change in the near term relate to the determination of the allowance for loan losses, the valuation of securities available for sale, and income tax expense.

### **Allowance for Loan Losses**

The Company maintains an allowance for loan losses to cover probable incurred credit losses at the balance sheet date. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management’s judgment, should be charged-off. A provision for loan losses is charged to operations based on management’s periodic evaluation of the necessary allowance balance. Evaluations are conducted at least quarterly and more often if deemed necessary. The ultimate recovery of all loans is susceptible to future market factors beyond the Company’s control.

The Company has an established process to determine the adequacy of the allowance for loan losses. The determination of the allowance is inherently subjective, as it requires significant estimates, including the amounts and timing of expected future cash flows on impaired loans, estimated losses on other classified loans and pools of homogeneous loans, and consideration of past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors, all of which may be susceptible to significant change. The allowance consists of two components of allocations, specific and general. These two components represent the total allowance for loan losses deemed adequate to cover losses inherent in the loan portfolio.

Commercial and agricultural loans are subject to a standardized grading process administered by an internal loan review function. The need for specific reserves is considered for credits when graded substandard or special mention, or when: (a) the customer’s cash flow or net worth appears insufficient to repay the loan; (b) the loan has been

criticized in a regulatory examination; (c) the loan is on non-accrual; or, (d) other reasons where the ultimate collectibility of the loan is in question, or the loan characteristics require special monitoring. Specific allowances are established in cases where management has identified significant conditions or circumstances related to an individual credit that we believe indicates the loan is impaired. Specific allocations on impaired loans are determined by comparing the loan balance to the present value of expected cash flows or expected collateral proceeds. Allocations are also applied to categories of loans not considered individually impaired but for which the rate of loss is expected to be greater than historical averages, including those graded substandard or special mention and non-performing consumer or residential real estate loans. Such allocations are based on past loss experience and information about specific borrower situations and estimated collateral values.



General allocations are made for other pools of loans, including non-classified loans, homogeneous portfolios of consumer and residential real estate loans, and loans within certain industry categories believed to present unique risk of loss. General allocations of the allowance are primarily made based on a five-year historical average for loan losses for these portfolios, judgmentally adjusted for economic factors and portfolio trends.

Due to the imprecise nature of estimating the allowance for loan losses, the Company's allowance for loan losses may include a minor unallocated component. The unallocated component of the allowance for loan losses incorporates the Company's judgmental determination of inherent losses that may not be fully reflected in other allocations, including factors such as economic uncertainties, lending staff quality, industry trends impacting specific portfolio segments, and broad portfolio quality trends. Therefore, the ratio of allocated to unallocated components within the total allowance may fluctuate from period to period.

### **Securities Valuation**

Securities available-for-sale are carried at fair value, with unrealized holding gains and losses reported separately in accumulated other comprehensive income (loss), net of tax. The Company obtains market values from a third party on a monthly basis in order to adjust the securities to fair value. Equity securities that do not have readily determinable fair values are carried at cost. Additionally, all securities are required to be written down to fair value when a decline in fair value is other than temporary; therefore, future changes in the fair value of securities could have a significant impact on the Company's operating results. In determining whether a market value decline is other than temporary, management considers the reason for the decline, the extent of the decline and the duration of the decline. As of September 30, 2008, gross unrealized losses on the securities available-for-sale portfolio totaled approximately \$524,000.

### **Income Tax Expense**

Income tax expense involves estimates related to the valuation allowance on deferred tax assets and loss contingencies related to exposure from tax examinations.

A valuation allowance reduces deferred tax assets to the amount management believes is more likely than not to be realized. In evaluating the realization of deferred tax assets, management considers the likelihood that sufficient taxable income of appropriate character will be generated within carryback and carryforward periods, including consideration of available tax planning strategies. As of December 31, 2007, the Company had a deferred tax asset of \$649,000 which includes tax credit carryforwards of \$403,000. Based on the long carryforward periods available, management has assessed it more likely than not that these credits will be realized and no valuation allowance has been established on this asset.

Tax-related loss contingencies, including assessments arising from tax examinations and tax strategies, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. In considering the likelihood of loss, management considers the nature of the contingency, the progress of any examination or related protest or appeal, the views of legal counsel and other advisors, experience of the Company or other enterprises in similar matters, if any, and management's intended response to any assessment.

## **RESULTS OF OPERATIONS**

### **Net Income:**

Net income increased \$811,000 or 32% to \$3,319,000 or \$0.30 per share for the quarter ended September 30, 2008, compared to \$2,508,000 or \$0.23 per share for the third quarter of 2007. The increase in net income during the third quarter 2008 compared with same quarter of 2007 was due to improvement across the major categories of the income

statement including net interest income, non-interest income, lower provision for loan losses combined with relatively stable non-interest expense.

Net income for the first nine months of 2008 totaled 9,450,000 or \$0.85 per share representing an increase of \$2,820,000 or 43% over the \$6,630,000 or \$0.60 per share recorded in the nine months ended September 30, 2007. The increase in net income during the nine months ended September 30, 2008 compared with the same period of 2007 was attributable to improvement in net interest income, non-interest income and expense, and a modestly lower provision for loan losses.

**Net Interest Income:**

Net interest income is the Company's single largest source of earnings, and represents the difference between interest and fees realized on earning assets, less interest paid on deposits and borrowed funds. The following table summarizes the Company's net interest income (on a tax-equivalent basis, at an effective tax rate of 34%) for each of the periods presented herein (dollars in thousands):

18

---

	Three Months Ended September 30,		Change from Prior Period	
	2008	2007	Amount	Percent
Interest Income (T/E)	\$ 16,879	\$ 18,770	\$ (1,891)	(10.1)%
Interest Expense	6,283	8,907	(2,624)	(29.5)%
Net Interest Income (T/E)	\$ 10,596	\$ 9,863	733	7.4%

Net interest income increased \$715,000 or 7% (an increase of \$733,000 or 7% on a tax-equivalent basis) for the quarter ended September 30, 2008 compared with the same quarter of 2007. The net interest margin represents tax-equivalent net interest income expressed as a percentage of average earning assets. The tax equivalent net interest margin for the third quarter 2008 was 3.89% compared to 3.78% for the third quarter of 2007. The yield on earning assets totaled 6.19% during the quarter ended September 30, 2008 compared to 7.18% in the same period of 2007 while the cost of funds (expressed as a percentage of average earning assets) totaled 2.30% during 2008 compared to 3.40% in 2007.

Average earning assets totaled approximately \$1.086 billion for the quarter ended September 30, 2008 compared with \$1.038 billion for the quarter ended September 30, 2007. During the third quarter of 2008, average loans outstanding totaled \$889.2 million, an increase of \$25.8 million or 3%, compared to the \$863.4 million in average loans outstanding during the third quarter of 2007. Average commercial and agricultural loans totaled \$651.4 million, an increase of \$42.6 million or 7% during the quarter ended September 30, 2008 compared with the same quarter of the prior year. Average residential mortgage loans and consumer loans totaled \$237.8 million during the quarter ended September 30, 2008 representing a decline of \$16.8 million or 7% over 2007.

	Nine Months Ended September 30,		Change from Prior Period	
	2008	2007	Amount	Percent
Interest Income (T/E)	\$ 51,741	\$ 54,386	\$ (2,645)	(4.9)%
Interest Expense	20,702	25,325	(4,623)	(18.3)%
Net Interest Income (T/E)	\$ 31,039	\$ 29,061	\$ 1,978	6.8%

Net interest income increased \$2,030,000 or 7% (an increase of \$1,978,000 or 7% on a tax-equivalent basis) for the nine months ended September 30, 2008 compared with the nine months ended September 30, 2007. The tax equivalent net interest margin for the nine months ended September 30, 2008 was 3.84% compared to 3.81% for the same period of 2007. The yield on earning assets totaled 6.41% during the nine months ended September 30, 2008 compared to 7.13% in the same period of 2007 while the cost of funds (expressed as a percentage of average earning assets) totaled 2.57% during 2008 compared to 3.32% in 2007.

Average earning assets totaled approximately \$1.077 billion for the nine months ended September 30, 2008 compared with \$1.019 billion for the nine months ended September 30, 2007. During the first nine months of 2008, average loans outstanding totaled \$876.7 million, an increase of \$44.1 million or 5%, compared to the \$832.6 million in average loans outstanding during the first nine months of 2007. Average commercial and agricultural loans totaled \$633.1 million, an increase of \$51.4 million or 9% during the nine months ended September 30, 2008 compared with the same period of the prior year. Average residential mortgage loans and consumer loans totaled \$243.6 million during the nine months ended September 30, 2008 representing a decrease of \$7.3 million or 3% over the same period of 2007.

#### Provision for Loan Losses:

The Company provides for loan losses through regular provisions to the allowance for loan losses. The provision is affected by net charge-offs on loans and changes in specific and general allocations of the allowance. The provision

for loan loss totaled \$838,000 during the quarter ended September 30, 2008, representing a decrease of \$103,000 from the third quarter 2007 provision of \$941,000. During the third quarter of 2008, the annualized provision for loan loss represented 0.38% of average loans outstanding compared with 0.44% on an annualized basis of average loans outstanding during the third quarter of 2007.

The provision for loan loss totaled \$3,116,000 during the nine months ended September 30, 2008, representing a decline of \$128,000 from the nine months ended September 30, 2007 provision of \$3,244,000. During the nine months ended September 30, 2008, the annualized provision for loan loss represented 0.47% of average loans outstanding compared with 0.52% on an annualized basis of average loans outstanding during the nine months ended September 30, 2007.

Net charge-offs totaled \$1,333,000 or 0.60% on an annualized basis of average loans outstanding during the three months ended September 30, 2008 compared with \$662,000 or 0.31% on an annualized basis of average loans outstanding during the same period of 2007. During the third quarter of 2008, one single commercial credit charge-off totaled \$1.2 million and represented 54 basis points of average loans for the quarter ended September 30, 2008. The charge-off amount for this credit was fully provided for in prior periods. In addition, this commercial credit was moved to other real estate owned during the third quarter 2008 and has subsequently been sold in the fourth quarter 2008 with no additional loss associated with the property.

Net charge-offs totaled \$1,802,000 or 0.27% on an annualized basis of average loans outstanding during the nine months ended September 30, 2008 compared with \$2,318,000 or 0.37% on an annualized basis of average loans outstanding during the same period of 2007. The higher level of net charge-offs during the nine months ended September 30, 2007, was primarily attributable to the charge-off related to a single large commercial credit facility that occurred during the first half of 2007.

The provisions for loan losses made during the quarter ended September 30, 2008 were made at a level deemed necessary by management to absorb estimated, probable incurred losses in the loan portfolio. A detailed evaluation of the adequacy of the allowance for loan losses is completed quarterly by management, the results of which are used to determine provisions for loan losses. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors.

#### **Non-interest Income:**

During the third quarter of 2008, non-interest income totaled \$4,324,000 representing an increase of \$316,000 or 8% over the third quarter of 2007. During the nine months ended September 30, 2008, non-interest income totaled \$13,849,000 representing an increase of \$1,664,000 or 14% over the same period of 2007.

Deposit service charges and fees totaled \$1,293,000 during the quarter ended September 30, 2008 representing an increase of \$171,000 or 15% over the same period of 2007. Deposit service charges and fees totaled \$3,721,000 during the nine months ended September 30, 2008 representing an increase of \$567,000 or 18% over the same period of 2007. The increase was attributable to a combination of increased gross fees and a reduced level of refunded and waived fees.

During the third quarter of 2008, insurance commission and fees totaled \$1,402,000 which is an increase of \$53,000 or 4% compared to the third quarter of 2007. During the nine month period ended September 30, 2008, insurance commission and fees totaled \$4,612,000 which is an increase of \$218,000 or 5% compared to 2007. The increase was attributable to an increase of \$316,000 in contingency revenue during the first half of 2008 compared with the first half of 2007.

During the quarter ended September 30, 2008, the net gain on sale of residential loans totaled \$330,000, an increase of \$118,000 or 56% over the gain recognized in the quarter ended September 30, 2007. The increase was attributable to higher levels of residential loan sales which totaled \$23.7 million in the third quarter of 2008, compared to \$17.6 million in the same period of 2007 combined with a higher margin on the loans sold. During the nine months ended September 30, 2008, the net gain on sale of residential loans totaled \$1,058,000, an increase of \$513,000 or 94% over the gain of \$545,000 recognized in the nine months ended September 30, 2007. The increase was attributable to higher levels of residential loan sales which totaled \$84.4 million in the first nine months of 2008, compared to \$45.2 million in the same period of 2007.

The Company recognized a net loss on securities of \$106,000 in the third quarter of 2008. The Company sold approximately \$18 million of agency mortgage related securities at a gain of \$244,000 during the third quarter 2008. Also, during the quarter ended September 30, 2008, the Company recognized an other-than-temporary impairment expense of \$350,000 on its portfolio of non-controlling investments in other banking organizations. The Company has no investments in agency preferred securities.

The Company recognized a net gain on securities of \$179,000 in the nine months ended September 30, 2008. The Company sold approximately \$34 million of agency mortgage related securities at a gain of \$433,000 during the nine months ended 2008. In addition, the Company recognized a gain of \$96,000 on the mandatory redemption on a portion of VISA stock acquired as part of the initial public offering of VISA, Inc. These gains were partially offset by

the other-than-temporary impairment expense of \$350,000 on its portfolio of non-controlling investments in other banking organizations recognized during the third quarter of 2008.

**Non-interest Expense:**

During the quarter ended September 30, 2008, non-interest expense totaled \$9,159,000, an increase of \$35,000 or less than 1% from the same period of 2007. During the nine months ended September 30, 2008, non-interest expense totaled \$27,492,000, a decline of \$576,000 or 2% from the same period of 2007.

Salaries and benefits totaled \$5,225,000 in the quarter ended September 30, 2008 representing a decline of \$170,000 or 3% from the same quarter of 2007. Salaries and benefits totaled \$15,670,000 in the nine months ended September 30, 2008 representing a decline of \$782,000 or 5% from the same period of 2007. The decline was largely attributable to a decrease of approximately 24 full time equivalent employees (“FTE”), or 6% of total FTEs, and 29 full-time equivalent employees, or 7% of total FTEs, during the three and nine months ended September 30, 2008 compared with the same periods of 2007. The decline in salaries and benefits was also achieved while the company recognized \$196,000 and \$662,000 for post-retirement benefits for employees that were accrued as part of the Company’s formal review of effectiveness and efficiency during the three and nine months ended September 30, 2008.

In the quarter ended September 30, 2008, occupancy and furniture and equipment expense totaled \$1,408,000, an increase of \$79,000 or 6% compared to the quarter ended September 30, 2007. During the nine months ended September 30, 2008, occupancy and furniture and equipment expense totaled \$4,278,000, an increase of \$251,000 or 6% compared to the nine months ended September 30, 2007. The increases were largely attributable to higher levels of furniture, fixtures and equipment depreciation.

Professional fees increased \$108,000 or 42% during the third quarter of 2008 and \$372,000 or 37% during the nine months ended September 30, 2008, compared with the same periods of 2007. The increases were due primarily to professional fees associated with the Company's formal review of effectiveness and efficiency.

Other operating expenses increased \$18,000 or 1% during the third quarter of 2008 and declined \$637,000 or 14% during the nine months ended September 30, 2008, compared with the same periods of 2007. During the nine months ended September 30, 2008, collection costs declined by \$225,000, respectively, as compared with the same periods of 2007. The decline was largely due to an elevated level in 2007 related to the resolution of a single large non-performing commercial credit facility during the first half of 2007. During the nine months ended September 30, 2008, losses related to fraudulent ATM/debit card transactions decreased by \$90,000 compared with the same period of 2007; however, during the third quarter of 2008 these types of losses increased by \$79,000 over the same period of 2007.

#### **Income Taxes:**

The Company's effective income tax rate approximated 30.5% during the three months ended September 30, 2008 compared with 31.7% during the same period of 2007. The Company's effective income tax rate approximated 31.9% during the nine months ended September 30, 2008 compared with 30.0% during the same period of 2007. The effective tax rate in both 2008 and 2007 was lower than the blended statutory rate of 39.6% resulting primarily from the Company's tax-exempt investment income on securities and loans, income tax credits generated from investments in affordable housing projects, and income generated by subsidiaries domiciled in a state with no state or local income tax.

#### **FINANCIAL CONDITION**

Total assets at September 30, 2008 increased \$46.9 million to \$1.179 billion compared with \$1.132 billion in total assets at December 31, 2007. Cash and cash equivalents increased \$10.9 million to \$38.8 million at September 30, 2008 compared with \$27.9 million at year-end 2007. This increase was largely attributable to an increase in deposits during 2008. Securities available-for-sale and held-to-maturity remained relatively stable declining \$1.4 million to \$151.4 million at September 30, 2008 compared with \$152.8 million at year-end 2007. Accrued interest receivable and other assets increased \$18.1 million to \$32.6 million at September 30, 2008 compared with \$14.5 million at year-end 2007. This increase, along with the stable comparison of securities, was attributable to the sale of and subsequent reclassification to accounts receivable from securities available-for-sale of approximately \$18 million of agency mortgage related securities that settled early in the fourth quarter of 2008. The proceeds from the sale settlement have been subsequently reinvested back into the securities available-for-sale portfolio during the fourth quarter of 2008.

Loans, net of unearned income, increased \$19.1 million to \$886.8 million at September 30, 2008 compared to \$867.7 million at December 31, 2007. Commercial and industrial loans increased \$42.4 million or 9%, agricultural based loans decreased \$8.5 million or 5%, consumer loans decreased \$3.0 million or 2% and residential mortgage loans declined \$12.5 million or 11% during the nine months ended September 30, 2008.

Total Deposits at September 30, 2008, increased \$29.0 million to \$906.4 million compared with \$877.4 million in total deposits at December 31, 2007. Demand, savings, and money market accounts increased \$78.2 million while

time deposits decreased \$49.2 million. FHLB Advances and other borrowings increased \$13.7 million to \$157.9 million at September 30, 2008 compared to \$144.2 million at year-end 2007.



**Non-performing Assets:**

The following is an analysis of the Company's non-performing assets at September 30, 2008 and December 31, 2007 (dollars in thousands):

	<b>September 30, 2008</b>	<b>December 31, 2007</b>
Non-accrual Loans	\$ 7,385	\$ 4,356
Past Due Loans (90 days or more)	34	8
Restructured Loans	—	—
Total Non-performing Loans	7,419	4,364
Other Real Estate	3,757	1,517
Total Non-performing Assets	\$ 11,176	\$ 5,881
Non-performing Loans to Total Loans	0.84%	.50%
Allowance for Loan Loss to Non-performing Loans	126.14%	184.33%

The Company's level of overall non-performing assets increased by approximately \$5.3 million and non-performing loans increased by approximately \$3.1 million during the nine months ended September 30, 2008. Other real estate increased \$2.2 million during the nine months ended September 30, 2008 with the majority of the increase in other real estate related to a single commercial real estate property which was originally a participation loan in which the Company was a 53% participant in a newly constructed apartment complex. This property was acquired through foreclosure in the third quarter of 2008. The Company's balance at September 30, 2008 in other real estate related to this property was \$1.7 million after a partial charge-off of \$1.2 million. The property has been subsequently sold in fourth quarter of 2008 with no additional loss associated with the property.

The Company's level of non-performing loans increased by approximately \$3.1 million to \$7.4 million during the nine months ended September 30, 2008. This level of non-performing loans represents 0.84% of total loans outstanding at September 30, 2008, an increase from 0.50% as of year-end 2007. The increase in non-performing loans was primarily related to commercial credits that each totaled less than \$1.0 million.

**Capital Resources:**

Federal banking regulations provide guidelines for determining the capital adequacy of bank holding companies and banks. These guidelines provide for a more narrow definition of core capital and assign a measure of risk to the various categories of assets. The Company is required to maintain minimum levels of capital in proportion to total risk-weighted assets and off-balance sheet exposures such as loan commitments and standby letters of credit.

Tier 1, or core capital, consists of shareholders' equity less goodwill, core deposit intangibles, other identifiable intangibles and certain deferred tax assets defined by bank regulations. Tier 2 capital currently consists of the amount of the allowance for loan losses which does not exceed a defined maximum allowance limit of 1.25 percent of gross risk adjusted assets and subordinated debenture obligations. Total capital is the sum of Tier 1 and Tier 2 capital.

The minimum requirements under these standards are generally at least a 4.0 percent leverage ratio, which is Tier 1 capital divided by defined "total assets"; 4.0 percent Tier 1 capital to risk-adjusted assets; and, an 8.0 percent total capital to risk-adjusted assets ratios. Under these guidelines, the Company, on a consolidated basis, and its subsidiary bank, have capital ratios that exceed the regulatory minimums.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requires federal regulatory agencies to define capital tiers. These are: well-capitalized, adequately-capitalized, under-capitalized, significantly

under-capitalized, and critically under-capitalized. Under these regulations, a “well-capitalized” entity must achieve a Tier 1 risk-based capital ratio of at least 6.0 percent; a total capital ratio of at least 10.0 percent; and, a leverage ratio of at least 5.0 percent, and not be under a capital directive. The Company’s subsidiary bank was categorized as well-capitalized as of September 30, 2008.

At September 30, 2008, management was not under such a capital directive, nor was it aware of any current recommendations by banking regulatory authorities which, if they were to be implemented, would have or are reasonably likely to have, a material effect on the Company's liquidity, capital resources or operations.

The table below presents the Company's consolidated capital ratios under regulatory guidelines:

	<b>Minimum for Capital Adequacy Purposes</b>	<b>At September 30, 2008</b>	<b>At December 31, 2007</b>
Leverage Ratio	4.00%	7.52%	7.41%
Tier 1 Capital to Risk-adjusted Assets	4.00%	9.10%	