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FIRST BANCORP /NC/  
Form 10-K  
March 15, 2006

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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FORM 10-K

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

For the fiscal year ended December 31, 2005

Commission File Number 0-15572

FIRST BANCORP

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(Exact Name of Registrant as Specified in its Charter)

North Carolina

56-1421916

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(State of Incorporation)

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(I.R.S. Employer Identification Number)

341 North Main Street, Troy, North Carolina

27371-0508

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(Address of Principal Executive Offices)

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(Zip Code)

Registrant's telephone number, including area code

(910) 576-6171

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Securities Registered Pursuant to Section 12(b) of the Act: None  
Securities Registered Pursuant to Section 12(g) of the Act:

COMMON STOCK, NO PAR VALUE  
(Title of each class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act of 1933.  YES  NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1934.  YES  NO

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding twelve 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-K or any

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amendment to the Form 10-K. [ X ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. [ ] Large Accelerated Filer [ X ] Accelerated Filer [ ] Non-Accelerated Filer

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

The aggregate market value of the Common Stock, no par value, held by non-affiliates of the registrant, based on the closing price of the Common Stock as of June 30, 2005 as reported on the NASDAQ National Market System, was approximately \$252,329,000.

The number of shares of the registrant's Common Stock outstanding on February 27, 2006 was 14,255,043.

### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement to be filed pursuant to Regulation 14A are incorporated herein by reference into Part III.  
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\* Information called for by Part III (Items 10 through 14) is incorporated herein by reference to the Registrant's definitive Proxy Statement for the 2006 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission.

PART I

Item 1. Business

General Description

The Company

First Bancorp (the "Company") is a bank holding company. The principal activity of the Company is the ownership and operation of First Bank (the "Bank"), a state chartered bank with its main office in Troy, North Carolina. The Company also owns and operates two nonbank subsidiaries: Montgomery Data Services, Inc. ("Montgomery Data"), a data processing company, and First Bancorp Financial Services, Inc. ("First Bancorp Financial"), which owns and operates various real estate. Each of these subsidiaries is fully consolidated for financial reporting purposes. The Company is also the parent to three statutory business trusts created under the laws of the State of Delaware, which have issued a total of \$41.2 million in trust preferred debt securities. Under current accounting requirements, these three statutory business trusts are not consolidated for financial reporting purposes - see discussion of FIN 46 in "Current Accounting and Regulatory Matters" under Item 7 below.

The Company was incorporated in North Carolina on December 8, 1983, as Montgomery Bancorp, for the purpose of acquiring 100% of the outstanding common stock of the Bank through stock-for-stock exchanges. On December 31, 1986, the Company changed its name to First Bancorp to conform its name to the name of the Bank, which had changed its name from Bank of Montgomery to First Bank in 1985.

The Bank was organized in 1934 and began banking operations in 1935 as the Bank of Montgomery, named for the county in which it operated. As of December 31, 2005, the Bank operated in a 24-county area centered in Troy, North Carolina. Troy, population 3,500, is located in the center of Montgomery County, approximately 60 miles east of Charlotte, 50 miles south of Greensboro, and 80 miles southwest of Raleigh. The Bank conducts business from 61 branches located within a 120-mile radius of Troy, covering principally a geographical area from Latta, South Carolina to the southeast, to Wallace, North Carolina to the east, to Radford, Virginia to the north, to Wytheville, Virginia to the northwest, and to Harmony, North Carolina to the west. The Bank also has a loan production office in Wilmington, which is on the coast of North Carolina and represents the Bank's furthest location to the east of Troy. Of the Bank's 61 full-service branches, 55 are in North Carolina, with three branches each in South Carolina and Virginia (where the Bank operates under the name "First Bank of Virginia"). Ranked by assets, the Bank was the 7th largest bank in North Carolina as of December 31, 2005.

The Bank has two wholly owned subsidiaries, First Bank Insurance Services, Inc. ("First Bank Insurance") and First Montgomery Financial Services Corporation ("First Montgomery"). First Bank Insurance was acquired as an active insurance agency in 1994 in connection with the Company's acquisition of a bank that had an insurance subsidiary. On December 29, 1995, the insurance agency operations of First Bank Insurance were divested. From December 1995 until October 1999, First Bank Insurance was inactive. In October 1999, First Bank Insurance began operations again as a provider of non-FDIC insured investments and insurance products. Currently, First Bank Insurance's primary business activity is the placement of property and casualty insurance coverage. First Montgomery, a Virginia corporation incorporated on November 2, 2001, was formed to acquire real estate in Virginia and lease the property to the Bank. First Troy Realty Corporation ("First Troy") was incorporated on May 12, 1999 and is a

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subsidiary of First Montgomery. First Troy was formed for the purpose of allowing the Bank to centrally manage a portion of its residential, mortgage, and commercial real estate loan portfolio. The assets of First Montgomery and First Troy were liquidated during 2005, and these entities are no longer active.

The Company's principal executive offices are located at 341 North Main Street, Troy, North Carolina 27371-0508, and its telephone number is (910) 576-6171. Unless the context requires otherwise, references to the "Company" in this annual report on Form 10-K shall mean collectively First Bancorp and its consolidated

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subsidiaries.

### General Business

The Bank engages in a full range of banking activities, providing such services as checking, savings, NOW and money market accounts and other time deposits of various types including certificates of deposits (CDs) and individual retirement accounts (IRAs); loans for business, agriculture, real estate, personal uses, home improvement and automobiles; credit cards; debit cards; letters of credit; safe deposit box rentals; bank money orders; and electronic funds transfer services, including wire transfers, automated teller machines, and bank-by-phone capabilities. In December 2004, the Bank also began offering its internet banking product, with on-line bill-pay and cash management features. Because the majority of the Bank's customers are individuals and small to medium-sized businesses located in the counties it serves, management does not believe that the loss of a single customer or group of customers would have a material adverse impact on the Bank. There are no seasonal factors that tend to have any material effect on the Bank's business, and the Bank does not rely on foreign sources of funds or income. Because the Bank operates primarily within the central Piedmont region of North Carolina, the economic conditions within that area could have a material impact on the Company. See additional discussion below in the section entitled "Territory Served and Competition."

Beginning in 1999, First Bank Insurance began offering non-FDIC insured investment and insurance products, including mutual funds, annuities, long-term care insurance, life insurance, and company retirement plans, as well as financial planning services (the "investments division"). In May 2001, First Bank Insurance added to its product line when it acquired two insurance agencies that specialized in the placement of property and casualty insurance. In October 2003, the "investment division" of First Bank Insurance became a part the Bank. The primary activity of First Bank Insurance is now the placement of property and casualty insurance products.

Montgomery Data's primary business is to provide electronic data processing services for the Bank. Ownership and operation of Montgomery Data allows the Company to do all of its electronic data processing without paying fees for such services to an independent provider. Maintaining its own data processing system also allows the Company to adapt the system to its individual needs and to the services and products it offers. Although not a significant source of income, Montgomery Data has historically made its excess data processing capabilities available to area financial institutions for a fee. For the years ended December 31, 2005, 2004 and 2003, external customers provided gross revenues of \$279,000, \$416,000 and \$333,000, respectively. During 2005, three of the five customers terminated their services with Montgomery Data and switched to another provider, which left Montgomery Data with two outside customers as of December 31, 2005. Montgomery Data intends to continue to market this service to area banks, but does not currently have any near-term prospects for additional business.

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First Bancorp Financial was organized under the name of First Recovery in September of 1988 for the purpose of providing a back-up data processing site for Montgomery Data and other financial and non-financial clients. First Recovery's back-up data processing operations were divested in 1994. First Bancorp Financial now periodically purchases parcels of real estate from the Bank that were acquired through foreclosure or from branch closings. First Bancorp Financial actively pursues the sale of these properties.

First Bancorp Capital Trust I was organized in October 2002 for the purpose of issuing \$20.6 million in debt securities. These borrowings are due on November 7, 2032 and were structured as trust preferred capital securities, which qualify as capital for regulatory capital adequacy requirements. These debt securities are callable by the Company at par on any quarterly interest payment date beginning on November 7, 2007. The interest rate on these debt securities adjusts on a quarterly basis at a rate of three-month LIBOR plus 3.45%. This rate may not exceed 12.50% through November 2007.

First Bancorp Capital Trust II and First Bancorp Capital Trust III were organized in December 2003 for

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the purpose of issuing \$20.6 million in debt securities (\$10.3 million were issued from each trust). These borrowings are due on December 19, 2033 and were also structured as trust preferred capital securities in order to qualify as regulatory capital. These debt securities are callable by the Company at par on any quarterly interest payment date beginning on January 23, 2009. The interest rate on these debt securities adjusts on a quarterly basis at a weighted average rate of three-month LIBOR plus 2.70%.

First Montgomery was incorporated on November 2, 2001. First Montgomery was formed for the purpose of selecting and acquiring real estate in Virginia, which would then be leased to the Bank for use as bank branches. First Troy was incorporated on May 12, 1999 as a subsidiary of the Bank. Upon the formation of First Montgomery as a subsidiary of the Bank, the Bank contributed its interest in First Troy to First Montgomery, resulting in First Troy becoming a subsidiary of First Montgomery. First Troy was formed for the purpose of allowing the Bank to centrally manage a portion of its residential, mortgage, and commercial real estate loan portfolio. For tax years through December 31, 2004, First Troy elected to be treated as a real estate investment trust for tax purposes. During 2005, in response to evolving taxing authority developments (discussed in more detail in "Liquidity, Commitments, and Contingencies" under Item 7 below), the Company liquidated First Montgomery and First Troy by transferring the assets and liabilities of each of these subsidiaries to the Bank. It is the Company's intent to dissolve First Montgomery and First Troy in 2006.

### Territory Served and Competition

The Company's headquarters are located in Troy, Montgomery County, North Carolina. The Company serves primarily the south central area of the Piedmont region of North Carolina. The following table presents, for each county where the Company operates, the number of bank branches operated by the Company within the county, the approximate amount of deposits with the Company in the county as of December 31, 2005, the Company's approximate market share, and the number of bank competitors located in the county.

| County       | No. of<br>Branches | Deposits<br>(in millions) | Market<br>Share | Number<br>Competitors |
|--------------|--------------------|---------------------------|-----------------|-----------------------|
| Anson, NC    | 1                  | \$ 11                     | 4.9%            | 4                     |
| Cabarrus, NC | 2                  | 28                        | 1.3%            | 9                     |

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|                |       |          |       |    |
|----------------|-------|----------|-------|----|
| Chatham, NC    | 2     | 52       | 9.6%  | 9  |
| Davidson, NC   | 3     | 114      | 6.3%  | 9  |
| Dillon, SC     | 3     | 62       | 24.7% | 2  |
| Duplin, NC     | 3     | 47       | 10.7% | 7  |
| Guilford, NC   | 1     | 30       | 0.6%  | 24 |
| Harnett, NC    | 3     | 93       | 10.0% | 7  |
| Iredell, NC    | 1     | 21       | 1.2%  | 15 |
| Lee, NC        | 4     | 136      | 19.2% | 7  |
| Montgomery, NC | 5     | 87       | 39.2% | 4  |
| Montgomery, VA | 1     | 11       | 0.1%  | 9  |
| Moore, NC      | 10    | 337      | 25.0% | 10 |
| Randolph, NC   | 4     | 53       | 3.7%  | 14 |
| Richmond, NC   | 1     | 30       | 6.1%  | 5  |
| Robeson, NC    | 5     | 126      | 15.4% | 9  |
| Rockingham, NC | 1     | 14       | 1.2%  | 9  |
| Rowan, NC      | 2     | 42       | 3.5%  | 11 |
| Scotland, NC   | 2     | 46       | 14.7% | 5  |
| Stanly, NC     | 4     | 82       | 10.1% | 5  |
| Wake, NC       | 1     | 15       | 0.1%  | 21 |
| Washington, VA | 1     | 25       | 2.6%  | 12 |
| Wythe, VA      | 1     | 33       | 7.3%  | 9  |
|                | ----- | -----    |       |    |
| Total          | 61    | \$ 1,495 |       |    |
|                | ===== | =====    |       |    |

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The Company's 61 branches and facilities are primarily located in small communities whose economies are based primarily on services, manufacturing and light industry. Although the Company's market is predominantly small communities and rural areas, the area is not dependent on agriculture. Textiles, furniture, mobile homes,

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electronics, plastic and metal fabrication, forest products, food products and cigarettes are among the leading manufacturing industries in the trade area. Leading producers of lumber, socks, hosiery and area rugs are located in Montgomery County. The Pinehurst area within Moore County is a widely known golf resort and retirement area. The High Point area is widely known for its furniture market. Additionally, several of the communities served by the Company are "bedroom" communities serving large cities like Charlotte, Raleigh and Greensboro, while several branches serve medium-sized cities such as Albemarle, Asheboro, High Point, Southern Pines and Sanford. The Company also has branches in small communities such as Bennett, Polkton, Vass, and Harmony.

Approximately 23% of the Company's deposit base is in Moore County, and, accordingly, material changes in competition, the economy or population of Moore County could materially impact the Company. No other county comprises more than 10% of the Company's deposit base.

The Company competes in its various market areas with, among others, several large interstate bank holding companies that are headquartered in North Carolina. These large competitors have substantially greater resources than the Company, including broader geographic markets, higher lending limits and the ability to make greater use of large-scale advertising and promotions. A significant number of interstate banking acquisitions have taken place in the past decade, thus further increasing the size and financial resources of some of the Company's competitors, three of which are among the largest bank holding companies in the nation. In many of the Company's markets, the Company also competes against banks that have been organized within the past ten years. These

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new banks often focus on loan and deposit balance sheet growth, and not necessarily on earnings profitability. This strategy often allows them to offer more attractive terms on loans and deposits than the Company is able to offer because the Company must achieve an acceptable level of profitability. Moore County, which as noted above comprises a disproportionate share of the Company's deposits, is a particularly competitive market, with at least ten other financial institutions having a physical presence. See "Supervision and Regulation" below for a further discussion of regulations in the Company's industry that affect competition.

The Company competes not only against banking organizations, but also against a wide range of financial service providers, including federally and state chartered savings and loan institutions, credit unions, investment and brokerage firms and small-loan or consumer finance companies. Competition among financial institutions of all types is virtually unlimited with respect to legal ability and authority to provide most financial services. The Company also experiences competition from internet banks, particularly in the area of time deposits.

However, the Company believes it has certain advantages over its competition in the areas it serves. The Company seeks to maintain a distinct local identity in each of the communities it serves and actively sponsors and participates in local civic affairs. Most lending and other customer-related business decisions can be made without delays often associated with larger systems. Additionally, employment of local managers and personnel in various offices and low turnover of personnel enable the Company to establish and maintain long-term relationships with individual and corporate customers.

### Lending Policy and Procedures

Conservative lending policies and procedures and appropriate underwriting standards are high priorities of the Bank. Loans are approved under the Bank's written loan policy, which provides that lending officers, principally branch managers, have authority to approve loans of various amounts up to \$100,000. Each of the Bank's regional senior lending officers has discretion to approve secured loans in principal amounts up to \$350,000 and together can approve loans up to \$3,000,000. Lending limits may vary depending upon whether the loan is secured or unsecured.

The Bank's board of directors reviews and approves loans that exceed management's lending authority, loans to executive officers, directors, and their affiliates and, in certain instances, other types of loans. New credit extensions are reviewed daily by the Bank's senior management and at least monthly by its board of directors.

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The Bank continually monitors its loan portfolio to identify areas of concern and to enable management to take corrective action. Lending officers and the board of directors meet periodically to review past due loans and portfolio quality, while assuring that the Bank is appropriately meeting the credit needs of the communities it serves. Individual lending officers are responsible for pursuing collection of past-due amounts and monitoring any changes in the financial status of borrowers.

The Bank also contracts with an independent consulting firm to review new loan originations meeting certain criteria, as well as to assign risk grades to existing credits meeting certain thresholds. The consulting firm's observations, comments, and risk grades, including variances with the Bank's risk grades, are shared with the audit committee of the Company's board of directors, and are considered by management in setting Bank policy, as well as in evaluating the



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adequacy of the allowance for loan losses. The consulting firm also provides on-going training on a periodic basis to the Company's loan officers to keep them updated on current developments in the marketplace. For additional information, see "Allowance for Loan Losses and Loan Loss Experience" under Item 7 below.

### Investment Policy and Procedures

The Company has adopted an investment policy designed to optimize the Company's income from funds not needed to meet loan demand in a manner consistent with appropriate liquidity and risk objectives. Pursuant to this policy, the Company may invest in federal, state and municipal obligations, federal agency obligations, public housing authority bonds, industrial development revenue bonds, Fannie Mae, Government National Mortgage Association, Freddie Mac, and Student Loan Marketing Association securities, and, to a limited extent, corporate bonds. Except for corporate bonds, the Company's investments must be rated at least Baa by Moody's or BBB by Standard and Poor's. Securities rated below A are periodically reviewed for creditworthiness. The Company may purchase non-rated municipal bonds only if such bonds are in the Company's general market area and determined by the Company to have a credit risk no greater than the minimum ratings referred to above. Industrial development authority bonds, which normally are not rated, are purchased only if they are judged to possess a high degree of credit soundness to assure reasonably prompt sale at a fair value. The Company is also authorized by its board of directors to invest a portion of its security portfolio in high quality corporate bonds, with the amount of bonds related to any one issuer not to exceed the Company's legal lending limit. Prior to purchasing a corporate bond, the Company's management performs due diligence on the issuer of the bond, and the purchase is not made unless the Company believes that the purchase of the bond bears no more risk to the Company than would an unsecured loan to the same company.

The Company's investment officer implements the investment policy, monitors the investment portfolio, recommends portfolio strategies and reports to the Company's investment committee. Reports of all purchases, sales, issuer calls, net profits or losses and market appreciation or depreciation of the bond portfolio are reviewed by the Company's board of directors each month. Once a quarter, the Company's interest rate risk exposure is evaluated by its board of directors. Once a year, the written investment policy is reviewed by the board of directors, and the Company's portfolio is compared with the portfolios of other companies of comparable size.

### Mergers and Acquisitions

As part of its operations, the Company has pursued an acquisition strategy over the years to augment its internal growth. The Company regularly evaluates the potential acquisition of or merger with various financial institutions. The Company's acquisitions to date have generally fallen into one of three categories - 1) an acquisition of a financial institution or branch thereof within a market in which the Company operates, 2) an acquisition of a financial institution or branch thereof in a market contiguous to a market in which the Company operates, or 3) an acquisition of a company that has products or services that the Company does not currently offer.

The Company believes that it can enhance its earnings by pursuing these types of acquisition opportunities

through any combination or all of the following: 1) achieving cost efficiencies, 2) enhancing the acquiree's earnings or gaining new customers by introducing a

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more successful banking model with more products and services to the acquiree's market base, 3) increasing customer satisfaction or gaining new customers by providing more locations for the convenience of customers, and 4) leveraging the Company's customer base by offering new products and services.

In the last five years, the Company has made acquisitions in all three categories described above. In 2001, acquisitions resulted in the Company adding \$116.2 million in loans and \$204.6 million in deposits, expanding into four contiguous markets (Lumberton, Pembroke, St. Pauls, and Thomasville), providing another branch for customers in one of the Company's newer markets (Salisbury), and giving the Company the ability to offer property and casualty insurance coverage. In 2002, the Company completed the acquisition of a branch within its market area (Broadway, located in Lee County) with approximately \$8.4 million in deposits and \$3.1 million in loans. In 2003, the Company completed acquisitions that added approximately \$72.5 million in loans and \$160.8 million in deposits that were in the nearby markets of Dillon County SC, Duplin County NC, Harmony NC, and Fairmont NC. In 2003, the Company also purchased another property and casualty insurance agency that provided efficiencies of scale when combined with the agency purchased in 2001. The Company did not complete any acquisitions during 2004 or 2005, but in 2006 has agreed to purchase a branch in Dublin, Virginia (a contiguous market) with \$20 million in deposits.

The Company plans to continue to evaluate acquisition opportunities that could potentially benefit the Company and its shareholders. These opportunities may include acquisitions that do not fit the categories discussed above. For a further discussion of recent acquisition activity, see "Merger and Acquisition Activity" under Item 7 below.

### Employees

As of December 31, 2005, the Company had 540 full-time and 76 part-time employees. The Company is not a party to any collective bargaining agreements and considers its employee relations to be good.

### Supervision and Regulation

As a bank holding company, the Company is subject to supervision, examination and regulation by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board") and the North Carolina Office of the Commissioner of Banks (the "Commissioner"). The Bank is subject to supervision and examination by the Federal Deposit Insurance Corporation (the "FDIC") and the Commissioner. For additional information, see also Note 15 to the consolidated financial statements.

### Supervision and Regulation of the Company

The Company is a bank holding company within the meaning of the Bank Holding Company Act of 1956, as amended, and is required to register as such with the Federal Reserve Board. The Company is also regulated by the Commissioner under the Bank Holding Company Act of 1984.

A bank holding company is required to file quarterly reports and other information regarding its business operations and those of its subsidiaries with the Federal Reserve Board. It is also subject to examination by the Federal Reserve Board and is required to obtain Federal Reserve Board approval prior to making certain acquisitions of other institutions or voting securities. The Commissioner is empowered to regulate certain acquisitions of North Carolina banks and bank holding companies, issue cease and desist orders for violations of North Carolina banking laws, and promulgate rules necessary to effectuate the purposes of the Bank Holding Company Act of 1984.

Regulatory authorities have cease and desist powers over bank holding

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companies and their nonbank

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subsidiaries where their actions would constitute a serious threat to the safety, soundness or stability of a subsidiary bank. Those authorities may compel holding companies to invest additional capital into banking subsidiaries upon acquisitions or in the event of significant loan losses or rapid growth of loans or deposits.

In 1999, the U.S. enacted legislation that allowed bank holding companies to engage in a wider range of non-banking activities, including greater authority to engage in securities and insurance activities. Under the Gramm-Leach-Bliley Act (the "Act"), a bank holding company that elects to become a financial holding company may engage in any activity that the Federal Reserve Board, in consultation with the Secretary of the Treasury, determines by regulation or order is (i) financial in nature, (ii) incidental to any such financial activity, or (iii) complementary to any such financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally. The Act made significant changes in U.S. banking law, principally by repealing certain restrictive provisions of the 1933 Glass-Steagall Act. The Act lists certain activities that are deemed to be financial in nature, including lending, exchanging, transferring, investing for others, or safeguarding money or securities; underwriting and selling insurance; providing financial, investment, or economic advisory services; underwriting, dealing in or making a market in, securities; and any activity currently permitted for bank holding companies by the Federal Reserve Board under Section 4(c)(8) of the Bank Holding Company Act. The Act does not authorize banks or their affiliates to engage in commercial activities that are not financial in nature. A bank holding company may elect to be treated as a financial holding company only if all depository institution subsidiaries of the holding company are well-capitalized, well-managed and have at least a satisfactory rating under the Community Reinvestment Act. At the present time, the Company does not anticipate applying for status as a financial holding company under the Act.

National and state banks are also authorized by the Act to engage, through "financial subsidiaries," in any activity that is permissible for a financial holding company (as described above) and any activity that the Secretary of the Treasury, in consultation with the Federal Reserve Board, determines is financial in nature or incidental to any such financial activity, except (i) insurance underwriting, (ii) real estate development or real estate investment activities (unless otherwise permitted by law), (iii) insurance company portfolio investments and (iv) merchant banking. The authority of a national or state bank to invest in a financial subsidiary is subject to a number of conditions, including, among other things, requirements that the bank be well-managed and well-capitalized (after deducting from the bank's capital outstanding investments in financial subsidiaries).

The United States Congress and the North Carolina General Assembly have periodically considered and adopted legislation that has resulted in, and could result in further, deregulation of both banks and other financial institutions. Such legislation could modify or eliminate geographic restrictions on banks and bank holding companies and current restrictions on the ability of banks to engage in certain nonbanking activities. For example, the Riegle-Neal Interstate Banking Act, which was enacted several years ago, allows expansion of interstate acquisitions by bank holding companies and banks. This and other legislative and regulatory changes have increased the ability of financial institutions to expand the scope of their operations, both in terms of services offered and geographic coverage. Such legislative changes have placed the Company in more direct competition with other financial institutions, including mutual funds,

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securities brokerage firms, insurance companies, investment banking firms, and internet banks. The Company cannot predict what other legislation might be enacted or what other regulations might be adopted or, if enacted or adopted, the effect thereof on the Company's business.

After the September 11, 2001 terrorist attacks in New York and Washington, D.C., the United States government acted in several ways to tighten control on activities perceived to be connected to money laundering and terrorist funding. A series of orders were issued that identify terrorists and terrorist organizations and require the blocking of property and assets of, as well as prohibiting all transactions or dealings with, such terrorists, terrorist organizations and those that assist or sponsor them. The USA Patriot Act substantially broadened existing anti-money laundering legislation and the extraterritorial jurisdiction of the United States, imposed new compliance and due diligence obligations, created new crimes and penalties, compelled the production of documents located both inside and outside the United States, including those of foreign institutions that have a

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correspondent relationship in the United States, and clarified the safe harbor from civil liability to customers. In addition, the United States Treasury Department issued regulations in cooperation with the federal banking agencies, the Securities and Exchange Commission, the Commodity Futures Trading Commission and the Department of Justice to require customer identification and verification, expand the money-laundering program requirement to the major financial services sectors, including insurance and unregistered investment companies, such as hedge funds, and facilitate and permit the sharing of information between law enforcement and financial institutions, as well as among financial institutions themselves. The United States Treasury Department also has created the Treasury USA Patriot Act Task Force to work with other financial regulators, the regulated community, law enforcement and consumers to continually improve the regulations. The Company has established policies and procedures to ensure compliance with the USA Patriot Act.

In 2002, the Sarbanes-Oxley Act was signed into law. The Sarbanes-Oxley Act represents a comprehensive revision of laws affecting corporate governance, accounting obligations and corporate reporting. The Sarbanes-Oxley Act is applicable to all companies with equity or debt securities registered under the Securities Exchange Act of 1934, as amended. In particular, the Sarbanes-Oxley Act established: (i) new requirements for audit committees, including independence, expertise, and responsibilities; (ii) additional responsibilities regarding financial statements for the Chief Executive Officer and Chief Financial Officer of the reporting company; (iii) new standards for auditors and regulation of audits; (iv) increased disclosure and reporting obligations for the reporting company and their directors and executive officers; and (v) new and increased civil and criminal penalties for violation of the securities laws. The most significant expense associated with compliance with the Sarbanes-Oxley Act has been the internal control documentation and attestation requirements of Section 404 of the Act. In 2004 and 2005, the Company's incremental external costs associated with complying with Section 404 of the Sarbanes-Oxley Act amounted to approximately \$193,000 and \$832,000, respectively. The incremental costs relate to higher external audit fees and outside consultant fees. These amounts do not include the value of the significant internal resources devoted to compliance.

### Supervision and Regulation of the Bank

Federal banking regulations applicable to all depository financial institutions, among other things: (i) provide federal bank regulatory agencies with powers to prevent unsafe and unsound banking practices; (ii) restrict

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preferential loans by banks to "insiders" of banks; (iii) require banks to keep information on loans to major shareholders and executive officers; and (iv) bar certain director and officer interlocks between financial institutions.

As a state chartered bank, the Bank is subject to the provisions of the North Carolina banking statutes and to regulation by the Commissioner. The Commissioner has a wide range of regulatory authority over the activities and operations of the Bank, and the Commissioner's staff conducts periodic examinations of the Bank and its affiliates to ensure compliance with state banking regulations. Among other things, the Commissioner regulates the merger and consolidation of state-chartered banks, the payment of dividends, loans to officers and directors, recordkeeping, types and amounts of loans and investments, and the establishment of branches. The Commissioner also has cease and desist powers over state-chartered banks for violations of state banking laws or regulations and for unsafe or unsound conduct that is likely to jeopardize the interest of depositors.

The dividends that may be paid by the Bank to the Company are subject to legal limitations under North Carolina law. In addition, regulatory authorities may restrict dividends that may be paid by the Bank or the Company's other subsidiaries. The ability of the Company to pay dividends to its shareholders is largely dependent on the dividends paid to the Company by its subsidiaries.

The Bank is a member of the FDIC, which currently insures the deposits of member banks. For this protection, each bank pays a quarterly statutory assessment, based on its level of deposits, and is subject to the rules and regulations of the FDIC. The FDIC also is authorized to approve conversions, mergers, consolidations and assumptions of deposit liability transactions between insured banks and uninsured banks or institutions, and

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to prevent capital or surplus diminution in such transactions where the resulting, continuing, or assumed bank is an insured nonmember bank. In addition, the FDIC monitors the Bank's compliance with several banking statutes, such as the Depository Institution Management Interlocks Act and the Community Reinvestment Act of 1977. The FDIC also conducts periodic examinations of the Bank to assess its compliance with banking laws and regulations, and it has the power to implement changes in or restrictions on a bank's operations if it finds that a violation is occurring or is threatened.

Neither the Company nor the Bank can predict what other legislation might be enacted or what other regulations might be adopted, or if enacted or adopted, the effect thereof on the Bank's operations.

See "Capital Resources and Shareholders' Equity" under Item 7 below for a discussion of regulatory capital requirements.

### Available Information

The Company maintains a corporate Internet site at [www.firstbancorp.com](http://www.firstbancorp.com), which contains a link within the "Investor Relations" section of the site to each of its filings with the Securities and Exchange Commission, including its annual reports on Form 10-K, its quarterly reports on Form 10-Q, its current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934. These filings are available, free of charge, as soon as reasonably practicable after the Company electronically files such material with, or furnishes it to, the Securities and Exchange Commission. These filings can also be accessed at the Securities and Exchange Commission's website located at [www.sec.gov](http://www.sec.gov). Information included on the Company's Internet site is not incorporated by reference into

this annual report.

Item 1A. Risk Factors

I. The Company is subject to interest rate risk, which could negatively impact earnings.

Net interest income is the Company's most significant component of earnings. The Company's net interest income results from the difference between the yields the Company earns on its interest-earning assets, primarily loans and investments, and the rates that the Company pays on its interest-bearing liabilities, primarily deposits and borrowings. When interest rates change, the yields the Company earns on its interest-earning assets and the rates the Company pays on its interest-bearing liabilities do not necessarily move in tandem with each other because of the difference between their maturities and repricing characteristics. This mismatch can negatively impact net interest income if the margin between yields earned and rates paid narrows. Interest rate environment changes can occur at any time and are affected by many factors that are outside the control of the Company, including inflation, recession, unemployment trends, the Federal Reserve's monetary policy, domestic and international disorder and instability in domestic and foreign financial markets.

As of December 31, 2005, interest rates in general have been steadily increasing for the past 18 months. During that period, the Company's interest-earning asset yields have increased by approximately the same amount as the Company's interest-bearing liability rates. However, our net interest income has benefited from the fact that the Company's interest-earnings assets generally reprice sooner upon a change in interest rates than do the Company's interest-bearing liabilities. Therefore, if interest rates do not change in 2006, the Company will likely have more interest-bearing liabilities than interest-earning assets that will reprice at higher rates. This will likely negatively impact the Company's net interest income. If interest rates were to decrease in 2006, the negative impact to the Company's net interest margin would be exacerbated as a result of the Company's interest-earning assets repricing downwards faster and by a greater amount than the Company's interest bearing liabilities. Growth that the Company expects to generate in loans and deposits would be expected to increase net interest income, and thus would lessen the negative impact of compressing spreads in a "no change" or declining interest rate environment.

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II. The Company faces strong competition, which could hurt the Company's business.

The Company's business operations are centered primarily in North Carolina, southwestern Virginia and northeastern South Carolina. Increased competition within this region may result in reduced loan originations and deposits. Ultimately, the Company may not be able to compete successfully against current and future competitors. Many competitors offer the types of loans and banking services that the Company offers. These competitors include savings associations, national banks, regional banks and other community banks. The Company also faces competition from many other types of financial institutions, including finance companies, internet banks, brokerage firms, insurance companies, credit unions, mortgage banks and other financial intermediaries.

The Company competes in its market areas with several large interstate bank holding companies, including three of the largest in the nation that are headquartered in North Carolina. These large competitors have substantially greater resources than the Company, including broader geographic markets, more

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banking locations, higher lending limits and the ability to make greater use of large-scale advertising and promotions. Also, these institutions, particularly to the extent they are more diversified than the Company, may be able to offer the same products and services that the Company offers at more competitive rates and prices.

The Company also competes in some of its market areas with many banks that have been organized within the past ten years. These new banks often focus on loan and deposit balance sheet growth, and not necessarily on earnings profitability. This strategy often allows them to offer more attractive terms on loans and deposits than the Company is able to offer because the Company must achieve an acceptable level of profitability.

Moore County, which comprises a disproportionate share of the Company's deposits, is a particularly competitive market, with at least ten other financial institutions having a physical presence, including large interstate bank holding companies and recently organized banks.

III. The Company's allowance for loan losses may not be adequate to cover actual losses.

Like all financial institutions, the Company maintains an allowance for loan losses to provide for probable losses caused by customer loan defaults. The allowance for loan losses may not be adequate to cover actual loan losses, and in this case additional and larger provisions for loan losses would be required to replenish the allowance. Provisions for loan losses are a direct charge against income.

The level of the allowance for loan losses set by the Company is dependent on the use of historical loss rates, as well as estimates and assumptions of future events. Because of the extensive use of estimates and assumptions, there is the possibility that they could be wrong and that the Company's actual loan losses could differ (and possibly significantly) from the Company's estimate. The Company believes that its allowance for loan losses is adequate to provide for probable losses, but it is possible that the allowance for loan losses will need to be increased for credit reasons or that regulators will require the Company to increase this allowance. Either of these occurrences could materially and adversely affect the Company's earnings and profitability.

IV. The Company is vulnerable to the economic conditions within the fairly small geographic region in which it operates.

Like most businesses, the Company's overall success is partially dependent on the economic conditions in the marketplace where it operates. The Company's marketplace is concentrated in the central Piedmont region of North Carolina and is therefore not particularly diversified. An economic downturn in this fairly small geographic region that negatively impacted the Company's customers would likely also have an adverse impact on the Company. For example, an economic downturn may result in higher loan default rates and reduce the value of real estate securing those loans, which would likely increase the Company's loan losses. At December 31, 2005, approximately 86% of the Company's loans were secured by real estate collateral, and thus the

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Company could be adversely impacted if real estate values decreased.

V. The Company is subject to extensive regulation, which could have an adverse effect.

The Company is subject to extensive regulation and supervision from the

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North Carolina Commissioner of Banks, the FDIC, and the Federal Reserve Board. This regulation and supervision is intended primarily for the protection of the FDIC insurance fund and the Company's depositors and borrowers, and not for holders of the Company's common stock. Regulatory authorities have extensive discretion in their supervisory and enforcement activities, including the imposition of restrictions on operations, the classification of the Company's assets and determination of the level of the allowance for loan losses. Changes in the regulations that apply to the Company, or changes in the Company's compliance with regulations, could have a material impact on our operations.

### Item 1B. Unresolved Staff Comments

None

### Item 2. Properties

The main offices of the Company, the Bank and First Bancorp Financial are owned by the Bank and are located in a three-story building in the central business district of Troy, North Carolina. The building houses administrative and bank teller facilities. The Bank's Operations Division, including customer accounting functions, offices and operations of Montgomery Data, and offices for loan operations, are housed in two one-story steel frame buildings approximately one-half mile west of the main office. Both of these buildings are owned by the Bank. The Company operates 61 bank branches. The Company owns all its bank branch premises except nine branch offices for which the land and buildings are leased and four branch offices for which the land is leased but the building is owned. In addition, the Company leases three loan production offices. There are no other options to purchase or lease additional properties. The Company considers its facilities adequate to meet current needs and believes that lease renewals or replacement properties can be acquired as necessary to meet future needs.

### Item 3. Legal Proceedings

Various legal proceedings may arise in the ordinary course of business and may be pending or threatened against the Company and/or its subsidiaries. However, neither the Company nor any of its subsidiaries is involved in any pending legal proceedings that management believes could have a material effect on the consolidated financial position of the Company.

There were no tax shelter penalties assessed by the Internal Revenue Service against the Company during the year ended December 31, 2005.

### Item 4. Submission of Matters to a Vote of Shareholders

No matters were submitted to a vote of shareholders during the fourth quarter of 2005.

## PART II

### Item 5. Market for the Registrant's Common Stock, Related Shareholder Matters, and Issuer Purchases of Equity Securities

The Company's common stock trades on the NASDAQ National Market System of the NASDAQ Stock Market under the symbol FBNC. Table 22, included in "Management's Discussion and Analysis" below, set

forth the high and low market prices of the Company's common stock as traded by the brokerage firms that maintain a market in the Company's common stock and the



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dividends declared for the periods indicated. See "Business - Supervision and Regulation" above and Note 15 to the consolidated financial statements for a discussion of regulatory restrictions on the payment of dividends. As of December 31, 2005, there were approximately 2,700 shareholders of record and another 3,250 shareholders whose stock is held in "street name." There were no sales of unregistered securities during the year ended December 31, 2005. It is the Company's current intention to continue to pay cash dividends in the future comparable to those in the recent past.

### Issuer Purchases of Equity Securities

Pursuant to authorizations by the Company's board of directors, the Company has from time to time repurchased shares of common stock in private transactions and in open-market purchases. The most recent board of director authorization was announced on July 30, 2004 and authorized the repurchase of 375,000 shares of the Company's stock. During 2005, the Company did not repurchase any shares of its own stock. The following table sets forth information about the Company's stock repurchase plan for the three months ended December 31, 2005.

### Issuer Purchases of Equity Securities

| Period  | Total Number of<br>Shares Purchased (2) | Average Price Paid per<br>Share | Total Number of Shares<br>Purchased as Part<br>of Publicly Announced<br>Plans or Programs |
|---|---|---------------------------------|---|
| Month #1 (October 1, 2005 to<br>October 31, 2005)   | --                                      | --                              | --  |
| Month #2 (November 1, 2005<br>to November 30, 2005) | --                                      | --                              | --  |
| Month #3 (December 1, 2005<br>to December 31, 2005) | --                                      | --                              | --  |
| <b>Total</b>  | <b>--</b>                               | <b>--</b>                       | <b>--</b>   |

### Footnotes to the Above Table

- (1) Any shares repurchased would be pursuant to publicly announced share repurchase authorizations. On July 30, 2004, the Company announced that its Board of Directors had approved the repurchase of 375,000 shares of the Company's common stock. The repurchase authorization does not have an expiration date. There are no plans or programs the issuer has determined to terminate prior to expiration, or under which the issuer does not intend to make further purchases.
- (2) The above table above does not include shares that were used by option holders to satisfy the exercise price of the Company's call options issued by the Company to its employees and directors pursuant to the Company's stock option plans. In November 2005, 522 shares of the Company's common stock with a weighted average price of \$22.00 were used to satisfy the exercise price of employee option exercises. In December 2005, 1,383 shares of the Company's common stock, with a weighted average market price of \$22.07 were used to satisfy such exercises.

### Item 6. Selected Consolidated Financial Data

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Table 1 sets forth selected consolidated financial data for the Company.

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### Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Management's Discussion and Analysis is intended to assist readers in understanding the Company's results of operations and changes in financial position for the past three years. This review should be read in conjunction with the consolidated financial statements and accompanying notes beginning on page 60 of this report and the supplemental financial data contained in Tables 1 through 22 included with this discussion and analysis. All share data for periods prior to November 15, 2004 has been adjusted from its originally reported amounts to reflect the 3-for-2 stock split paid on November 15, 2004.

#### CRITICAL ACCOUNTING POLICIES

The accounting principles followed by the Company and the methods of applying these principles conform with accounting principles generally accepted in the United States of America and with general practices followed by the banking industry. Certain of these principles involve a significant amount of judgment and/or use of estimates based on the Company's best assumptions at the time of the estimation. The Company has identified three policies as being more sensitive in terms of judgments and estimates, taking into account their overall potential impact to the Company's consolidated financial statements - 1) the allowance for loan losses, 2) tax uncertainties, and 3) intangible assets.

#### Allowance for Loan Losses

Due to the estimation process and the potential materiality of the amounts involved, the Company has identified the accounting for the allowance for loan losses and the related provision for loan losses as an accounting policy critical to the Company's consolidated financial statements. The provision for loan losses charged to operations is an amount sufficient to bring the allowance for loan losses to an estimated balance considered adequate to absorb losses inherent in the portfolio.

Management's determination of the adequacy of the allowance is based primarily on a mathematical model that estimates the appropriate allowance for loan losses. This model has two components. The first component involves the estimation of losses on loans defined as "impaired loans." A loan is considered to be impaired when, based on current information and events, it is probable the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. The estimated valuation allowance is the difference, if any, between the loan balance outstanding and the value of the impaired loan as determined by either 1) an estimate of the cash flows that the Company expects to receive from the borrower discounted at the loan's effective rate, or 2) in the case of a collateral-dependent loan, the fair value of the collateral.

The second component of the allowance model is to estimate losses for all loans not considered to be impaired loans. First, loans that have been risk graded by the Company as having more than "standard" risk but are not considered to be impaired are assigned estimated loss percentages generally accepted in the banking industry. Loans that are classified by the Company as having normal credit risk are segregated by loan type, and estimated loss percentages are assigned to each loan type, based on the historical losses, current economic conditions, and operational conditions specific to each loan type.

The reserve estimated for impaired loans is then added to the reserve

estimated for all other loans. This becomes the Company's "allocated allowance." In addition to the allocated allowance derived from the model, management also evaluates other data such as the ratio of the allowance for loan losses to total loans, net loan growth information, nonperforming asset levels and trends in such data. Based on this additional analysis, the Company may determine that an additional amount of allowance for loan losses is necessary to reserve for probable losses. This additional amount, if any, is the Company's "unallocated allowance." The sum of the allocated allowance and the unallocated allowance is compared to the actual allowance for loan losses recorded on the books of the Company and any adjustment necessary for the recorded allowance to equal the computed allowance is recorded as a provision for loan losses. The provision for loan losses is a direct charge to earnings

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in the period recorded.

Although management uses the best information available to make evaluations, future adjustments may be necessary if economic, operational, or other conditions change. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize additions to the allowance based on the examiners' judgment about information available to them at the time of their examinations.

For further discussion including a review of the range of provisions for loan losses and its impact on reported results in recent periods, see "Nonperforming Assets" and "Allowance for Loan Losses and Loan Loss Experience" under "Analysis of Financial Condition and Changes in Financial Condition."

#### Tax Uncertainties

The Company reserves for tax uncertainties in instances when it has taken a position on a tax return that may differ from the opinion of the applicable taxing authority. In accounting for tax contingencies, the Company assesses the relative merits and risks of certain tax transactions, taking into account statutory, judicial and regulatory guidance in the context of the Company's tax position. For those matters where it is probable that the Company will have to pay additional taxes, interest or penalties and a loss or range of losses can be reasonably estimated, the Company records reserves in the consolidated financial statements. For those matters where it is reasonably possible but not probable that the Company will have to pay additional taxes, interest or penalties and the loss or range of losses can be reasonably estimated, the Company only makes disclosures in the notes and does not record reserves in the consolidated financial statements. The process of concluding that a loss is reasonably possible or probable and estimating the amount of loss or range of losses and related tax reserves is inherently subjective, and future changes to the reserve may be necessary based on changes in management's intent, tax law or related interpretations, or other functions.

The sections below entitled "Income Taxes" and "Liquidity, Commitments, and Contingencies" and Notes 12 and 18 to the consolidated financial statements include information related to a tax loss contingency accrual that was recorded in 2005. For 2004, the Company had determined that this same tax uncertainty required disclosure, but not loss accrual.

#### Intangible Assets

Due to the estimation process and the potential materiality of the amounts involved, the Company has also identified the accounting for intangible assets as an accounting policy critical to the Company's consolidated financial

statements.

When the Company completes an acquisition transaction, the excess of the purchase price over the amount by which the fair market value of assets acquired exceeds the fair market value of liabilities assumed represents an intangible asset. The Company must then determine the identifiable portions of the intangible asset, with any remaining amount classified as goodwill. Identifiable intangible assets associated with these acquisitions are generally amortized over the estimated life of the related asset, whereas goodwill is tested annually for impairment, but not systematically amortized. Assuming no goodwill impairment, it is beneficial to the Company's future earnings to have a lower amount assigned to identifiable intangible assets and a higher amount to goodwill as opposed to having a higher amount considered to be identifiable intangible assets and a lower amount classified as goodwill.

For the Company, the primary identifiable intangible asset typically recorded in connection with a whole bank or bank branch acquisition is the value of the core deposit intangible, whereas when the Company acquires an insurance agency, the primary identifiable intangible asset is the value of the acquired customer list. Determining the amount of identifiable intangible assets and their average lives involves multiple assumptions

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and estimates and is typically determined by performing a discounted cash flow analysis, which involves a combination of any or all of the following assumptions: customer attrition/runoff, alternative funding costs, deposit servicing costs, and discount rates. The Company typically engages a third party consultant to assist in each analysis. For the whole bank and bank branch transactions recorded to date, the core deposit intangible in each case has been estimated to have a ten year life, with an accelerated rate of amortization. For the 2003 insurance agency acquisition, the identifiable intangible asset related to the customer list was determined to have a ten year life, with amortization occurring on a straight-line basis.

Subsequent to the initial recording of the identifiable intangible assets and goodwill, the Company amortizes the identifiable intangible assets over their estimated average lives, as discussed above. In addition, on at least an annual basis, goodwill is evaluated for impairment by comparing the fair value of the Company's reporting units to their related carrying value, including goodwill (the Company's community banking operation is its only material reporting unit). At its last evaluation, the fair value of the Company's community banking operation exceeded its carrying value, including goodwill. If the carrying value of a reporting unit were ever to exceed its fair value, the Company would determine whether the implied fair value of the goodwill, using a discounted cash flow analysis, exceeded the carrying value of the goodwill. If the carrying value of the goodwill exceeded the implied fair value of the goodwill, an impairment loss would be recorded in an amount equal to that excess. Performing such a discounted cash flow analysis would involve the significant use of estimates and assumptions.

The Company reviews identifiable intangible assets for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. The Company's policy is that an impairment loss is recognized, equal to the difference between the asset's carrying amount and its fair value, if the sum of the expected undiscounted future cash flows is less than the carrying amount of the asset. Estimating future cash flows involves the use of multiple estimates and assumptions, such as those listed above.

The foregoing accounting policy was adopted by the Company effective on January 1, 2002 in accordance with newly issued accounting standards for

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goodwill and other intangible assets. For acquisitions occurring prior to January 1, 2002, the Company generally did not separately identify its identifiable intangible assets from its goodwill, as all intangible assets were amortized under accounting standards then in effect. According to the transition provisions of the accounting standards that changed the Company's accounting policy to that described above, the entire amount of those combined intangible assets was accounted for entirely as non-amortizable goodwill.

### MERGER AND ACQUISITION ACTIVITY

Over the past three fiscal years, the Company has completed several acquisitions, which have resulted in significant amounts of intangible assets being recorded by the Company, as detailed below. As noted above, the accounting for intangible assets changed significantly in 2002 with the Company being required under new accounting standards to cease the amortization of goodwill. See Note 2 and Note 6 to the consolidated financial statements for additional information regarding intangible assets.

The Company did not announce or complete any acquisitions in 2004 or 2005. In January 2006, the Company announced an agreement to purchase a bank branch in Dublin, Virginia with approximately \$20 million in deposits from another financial institution. The Company completed the following acquisitions during 2003:

(a) On January 2, 2003, the Company completed the acquisition of Uwharrie Insurance Group, Inc. ("Uwharrie"), a Montgomery County based property and casualty insurance agency. Uwharrie was subsequently merged into First Bank Insurance. With eight employees, Uwharrie served approximately 5,000 customers, primarily from its Troy-based headquarters, and had annual commissions of approximately \$500,000. The primary reason for the acquisition was to gain efficiencies of scale with the Company's existing property and casualty insurance business. The acquisition resulted in the Company recording an intangible asset of approximately \$544,000. Based on an independent appraisal, \$50,000 of the intangible asset recorded was

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determined to be attributable to the value of the noncompete agreement signed as part of the transaction and is being amortized over its two year life, \$151,000 was determined to be attributable to the value of the customer list and is being amortized on a straight-line basis over ten years, and the remaining \$343,000 was determined to be goodwill and thus is not being systematically amortized, but rather is subject to an annual impairment test.

(b) On January 15, 2003, the Company completed the acquisition of Carolina Community Bancshares, Inc. ("CCB"), the parent company of Carolina Community Bank, a South Carolina community bank with three branches in Dillon County, South Carolina. This represented the Company's first entry into South Carolina. Dillon County, South Carolina is contiguous to Robeson County, North Carolina, a county where the Company already operated four branches. The Company's primary reason for the acquisition was to expand into a contiguous market with facilities, operations and experienced staff in place. In this transaction, the shareholders of CCB received 1.2 shares of the Company's stock and \$20.00 in cash for each share of CCB stock they owned at the time of closing. The transaction was completed on January 15, 2003, with the Company paying cash of \$8.3 million, issuing 499,332 shares of common stock that were valued at approximately \$8.4 million, and assuming employee stock options with an intrinsic value of approximately \$0.9 million. As of the date of the acquisition, CCB had approximately \$48 million in loans, \$59 million in deposits and \$70 million in total assets. In connection with the acquisition of CCB, the Company recorded total intangible assets of \$10.2 million, of which \$771,000 was

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determined to be the value of the core deposit base and is being amortized on an accelerated basis over ten years, and \$9.4 million was determined to be goodwill and thus is not being systematically amortized, but rather is subject to an annual impairment test.

(c) On October 24, 2003, the Company completed the acquisition of four branches of RBC Centura Bank located in Fairmont, Harmony, Kenansville, and Wallace, all in North Carolina. As of the date of the acquisition, the branches had a total of approximately \$102 million in deposits and \$25 million in loans. The primary reason for the acquisition was to expand into new markets and increase the Company's customer base. Subject to certain limitations, the Company paid a deposit premium of 14.1% for the branches, which resulted in the Company recording intangible assets relating to this purchase of \$14.2 million. The identifiable intangible asset associated with the fair value of the core deposit base, as determined by an independent consulting firm, was valued at approximately \$1.3 million and is being amortized as expense on an accelerated basis over a ten year period. The remaining intangible asset of \$12.9 million has been classified as goodwill, and thus is not being systematically amortized, but rather is subject to an annual impairment test.

The following table contains a condensed balance sheet that indicates the amount assigned to each major asset and liability as of the respective acquisition dates for the 2003 acquisitions described above.

| Assets acquired   | Uwharrie<br>Insurance<br>Group | Carolina<br>Community<br>Bank | RBC<br>Centura<br>Branches | Total |
|---|--------------------------------|-------------------------------|----------------------------|-------|
| (in millions)   |                                |                               |                            |       |
| Cash  | \$ --                          | 7.0                           | 62.4                       | 69.4  |
| Securities  | --                             | 13.1                          | --                         | 13.1  |
| Loans, gross  | --                             | 47.7                          | 24.8                       | 72.5  |
| Allowance for loan losses   | --                             | (0.8)                         | (0.3)                      | (1.1) |
| Premises and equipment  | --                             | 0.8                           | 1.0                        | 1.8   |
| Other   | --                             | 2.5                           | 0.2                        | 2.7   |
| Total assets acquired   | --                             | 70.3                          | 88.1                       | 158.4 |
| Liabilities assumed   |                                |                               |                            |       |
| Deposits  | --                             | 58.9                          | 102.0                      | 160.9 |
| Borrowings  | --                             | 2.1                           | --                         | 2.1   |
| Other   | --                             | 0.6                           | 0.3                        | 0.9   |
| Total liabilities assumed   | --                             | 61.6                          | 102.3                      | 163.9 |
| Value of cash paid and/or<br>stock issued to<br>stock-holders of acquiree | 0.5                            | 18.9                          | n/a                        | 19.4  |
| Intangible assets recorded  | \$ 0.5                         | 10.2                          | 14.2                       | 24.9  |

There are many factors that the Company considers when evaluating how much to offer for potential acquisition candidates - in the form of a purchase price comprised of cash and/or stock for a whole company purchase or a deposit premium in a branch purchase. Most significantly, the Company compares expectations of future earnings per share on a stand-alone basis with projected future earnings

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per share assuming completion of the acquisition under various pricing scenarios. Significant assumptions that affect this analysis include the estimated future earnings stream of the acquisition candidate, the amount of cost efficiencies that can be realized, and the interest rate earned/lost on the cash received/paid. In addition to the earnings per share comparison, the Company also considers other factors including (but not limited to): marketplace acquisition statistics, location of the candidate in relation to the Company's expansion strategy, market growth potential, management of the candidate, potential integration issues (including corporate culture), and the size of the acquisition candidate.

### ANALYSIS OF RESULTS OF OPERATIONS

Net interest income, the "spread" between earnings on interest-earning assets and the interest paid on interest-bearing liabilities, constitutes the largest source of the Company's earnings. Other factors that significantly affect operating results are the provision for loan losses, noninterest income such as service fees and noninterest expenses such as salaries, occupancy expense, equipment expense and other overhead costs, as well as the effects of income taxes.

#### Overview - 2005 Compared to 2004

Net income for the year ended December 31, 2005 amounted to \$16,090,000, or \$1.12 per diluted share, a 20.0% decrease from the net income of \$20,114,000, or \$1.40 per diluted share, reported for 2004. The annual earnings for 2005 were significantly impacted by a contingency loss accrual related to income tax exposure amounting to \$4,338,000 (after-tax), or \$0.30 per diluted share. The Company originally accrued \$6,320,000, or \$0.44 per diluted share, related to this loss exposure in the third quarter of 2005. In March 2006, prior to filing its financial statements, the Company reversed \$1,982,000, or \$0.14 per diluted share, of this accrual, effective for the fourth quarter of 2005, as a result of a change in the loss estimate. See additional discussion in the section entitled "Income Taxes" below.

Total assets at December 31, 2005 amounted to \$1.80 billion, 9.9% higher than a year earlier. Total loans at December 31, 2005 amounted to \$1.48 billion, an increase of \$116 million, or 8.5%, from a year earlier. Total deposits amounted to \$1.49 billion at December 31, 2005, an increase of \$106 million, or 7.6%, from a year earlier. Deposit growth would have been higher had the Company not paid off, without renewing, \$50 million in brokered deposits that were outstanding at December 31, 2004 and matured during 2005. The Company had no brokered deposits outstanding at December 31, 2005.

The growth in loans and deposits was the primary reason for the increase in the Company's net interest income when comparing 2004 to 2005. Net interest income for the year ended December 31, 2005 amounted to \$68.6 million, an 11.9% increase over the \$61.3 million recorded in 2004. The Company's net interest margin (tax-equivalent net interest income divided by average earning assets) realized for 2005 was 4.33% compared to 4.31% for 2004. The rising interest rate environment had a positive effect on the Company's net interest margin, but the positive effects were largely offset by the mix of the Company's deposit growth being more concentrated in the categories of time deposits and time deposits greater than \$100,000. Time deposits are generally a high cost category of funds for the Company. However, their increased usage has been necessary in order to fund loan growth.

The Company's provision for loan losses did not vary significantly in 2005 compared to 2004, amounting to \$3,040,000 in 2005 compared to \$2,905,000 in 2004. The ratio of net-charge offs to average loans for 2005 was 0.14%, which is the same as it was for 2004. At December 31, 2005, the Company's nonperforming assets to total assets ratio was 0.17% compared to 0.32% at the prior year end,

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and was the lowest it has been at any year

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end since the Company became publicly held in 1985.

Noninterest income for 2005 amounted to \$15.0 million, a decrease of 5.4% from the \$15.9 million recorded in 2004. The decrease in 2005 is partly a result of lower service charges on deposit accounts. Service charges on deposit accounts have decreased primarily as a result of the negative impact that higher short term interest rates have on the service charges that the Company earns from its commercial depositors - in the Company's commercial account service charge rate structure, commercial depositors are given "earnings credits" (negatively impacting service charges) on their average deposit balances that are tied to short term interest rates. Also, in 2005 the Company recorded significantly lower "securities gains" and "other gains" compared to 2004. In 2005, the Company recorded a combined net loss of \$258,000 for these two line items compared to a net gain of \$648,000 in 2004, a negative change of \$906,000.

Noninterest expenses in 2005 amounted to \$47.6 million, a 9.0% increase from the \$43.7 million recorded in 2004. The increase in noninterest expenses is primarily attributable to costs associated with the Company's overall growth in loans, deposits and branch network. Also, the Company's Sarbanes-Oxley compliance costs amounted to \$832,000 in 2005 compared to \$193,000 in 2004.

The Company's income tax expense for 2005 of \$16.8 million includes the previously discussed contingency tax loss accrual of \$4.3 million. During periods that did not include this accrual, the Company's effective tax rate in 2005 was approximately 38%-39% compared to approximately 34%-35% in 2004. The higher effective tax rate in 2005 compared to 2004 is the result of the Company discontinuing, effective January 1, 2005, the operating structure involving a real estate investment trust (REIT) that gave rise to the 2005 contingency tax loss accrual. The Company expects its effective tax rate to continue to be in the 38%-39% range for the foreseeable future. See additional discussion in the section entitled "Income Taxes" below.

### Overview - 2004 Compared to 2003

Net income for the year ended December 31, 2004 amounted to \$20,114,000, or \$1.40 per diluted share, a 3.6% increase in net income and a 3.7% increase in diluted earnings per share over the net income of \$19,417,000, or \$1.35 per diluted share, reported for 2003. All per share amounts originally reported for periods prior to November 15, 2004 have been adjusted to reflect the 3-for-2 stock split paid on November 15, 2004.

Total assets at December 31, 2004 amounted to \$1.64 billion, 11.1% higher than a year earlier. Total loans at December 31, 2004 amounted to \$1.37 billion, a 12.2% increase from a year earlier, and total deposits amounted to \$1.39 billion at December 31, 2004, an 11.2% increase from a year earlier. Approximately \$50 million of the total 2004 deposit increase of \$139 million related to wholesale brokered deposits that the Company gathered in order to help fund the high loan growth experienced during 2004.

The increase in loans and deposits during 2004 resulted in an increase in the Company's net interest income from 2003 to 2004. Net interest income for the year ended December 31, 2004 amounted to \$61.3 million, a 9.9% increase over the \$55.8 million recorded in 2003. The positive impact on net interest income from the increases in loans and deposits more than offset a lower net interest margin realized in 2004 compared to 2003. The Company's net interest margin (tax-equivalent net interest income divided by average earning assets) for 2004 was 4.31% compared to the 4.52% in 2003. The Company's net interest margin was



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negatively impacted by the thirteen interest rate cuts initiated by the Federal Reserve from 2001 to 2003 and the Company's shift toward originating more adjustable rate loans compared to fixed rate loans to protect the Company from anticipated increases in interest rates. The Federal Reserve increased interest rates by 125 basis points in the second half of 2004 which was responsible for the Company's net interest margin increasing during the third and fourth quarters of 2004 after having decreased for the immediately preceding five consecutive quarters.

The Company's provision for loan losses did not vary significantly in 2004 compared to 2003, amounting to \$2,905,000 in 2004 compared to \$2,680,000 in 2003. The Company's asset quality ratios remained sound in

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2004, with a net-charge off ratio (net charge-offs divided by average loans) of 0.14% in 2004 compared to 0.10% in 2003, and a December 31, 2004 nonperforming asset to total asset ratio of 0.32%, compared to 0.39% at the prior year end.

For the year ended 2004, noninterest income amounted to \$15.9 million, a 6.3% increase from \$14.9 million in 2003. Except for fees from presold mortgages, most components of noninterest income increased for the year ended 2004 compared to 2003 as a result of the Company's overall growth, particularly the Company's October 2003 acquisition of four bank branches with \$102 million in deposits, which impacted the Company's noninterest income for all twelve months of 2004 compared to only three months in 2003. Fees from presold mortgages decreased significantly in 2004 as a result of a decline in mortgage refinancing activity caused by higher mortgage interest rates. Fees from presold mortgages decreased from \$2.3 million in 2003 to \$1.0 million in 2004. The Company realized securities gains and other gains of \$648,000 in 2004 compared to \$306,000 in 2003.

Noninterest expenses for 2004 amounted to \$43.7 million, a 15.2% increase from the \$38.0 million recorded in 2003. The increase in noninterest expenses was primarily attributable to growth in the Company's branch network, which increased by eight branches from October 2003 through the end of 2004.

The Company's effective tax rates were slightly lower for 2004 compared to 2003, amounting to 34.1% in 2004 compared to 35.3% for 2003. The lower effective tax rate in 2004 was caused by several factors including higher amounts of state tax exempt income, higher amounts of low income housing investment tax credits, and the reversal of an \$89,000 tax liability that was recorded in connection with a previous corporate acquisition.

### Net Interest Income

Net interest income on a reported basis amounted to \$68,591,000 in 2005, \$61,290,000 in 2004, and \$55,760,000 in 2003. For internal purposes and in the discussion that follows, the Company evaluates its net interest income on a tax-equivalent basis by adding the tax benefit realized from tax-exempt securities to reported interest income. Net interest income on a tax-equivalent basis amounted to \$69,039,000 in 2005, \$61,765,000 in 2004, and \$56,278,000 in 2003. Management believes that analysis of net interest income on a tax-equivalent basis is useful and appropriate because it allows a comparison of net interest amounts in different periods without taking into account the different mix of taxable versus non-taxable investments that may have existed during those periods.

Table 2 analyzes net interest income on a tax-equivalent basis. The Company's net interest income on a taxable-equivalent basis increased by 11.8% in 2005 and 9.7% in 2004. There are two primary factors that cause changes in

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the amount of net interest income recorded by the Company - 1) growth in loans and deposits, and 2) the Company's net interest margin (tax-equivalent net interest income divided by average interest-earning assets).

As illustrated in Table 3, in both 2005 and 2004, net interest income was positively impacted by both higher amounts of average loans and deposits outstanding. In 2005, the average amount of loans outstanding increased 9.8%, and the average amount of deposits outstanding increased 11.8%. In 2004, the average amount of loans outstanding increased 16.4%, and the average amount of deposits outstanding increased 13.3%. The growth in the volume of loans and deposits increased net interest income by \$5.8 million in 2005 and \$7.8 million in 2004. The higher amounts of average loans and deposits outstanding in 2005 were entirely a result of internal growth, as the Company did not complete any acquisitions in 2004 or 2005. The higher amounts of average loans and deposits outstanding in 2004 were a result of both internal growth, as well as growth achieved in corporate acquisitions. Although the Company did not complete any acquisitions in 2004, the increases in the Company's average loan and deposit amounts in 2004 compared to 2003 were impacted by acquisitions completed in 2003, as the loans and deposits assumed in the 2003 acquisitions were outstanding for the full year in 2004 compared to only a partial year in 2003 (from the date of the respective acquisitions). For analysis regarding the nature of the Company's loan and deposit growth, see "Analysis of Financial Condition and Changes in Financial Condition" below.

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Table 3 also illustrates the impact that changes in the rates that the Company earned/paid had on the Company's net interest income in 2004 and 2005. In 2005, the Federal Reserve increased interest rates eight times totaling 200 basis points, which followed five rate increases totaling 125 basis points that occurred in the second half of 2004. This rising interest rate environment resulted in higher amounts of interest income earned and interest expense paid in 2005, with the net effect being a \$1.5 million increase in net interest income. In 2004, although the average prime rate was slightly higher than in 2003, the average yields realized on earning assets and the average rates paid on interest-bearing liabilities for the year were both lower than in 2003. The average yield on earning assets was lower in 2004 than in 2003 due to a growing percentage of adjustable rate loans, which carry lower initial rates than fixed rate loans (see below for additional discussion), and lower renewal/reinvestment rates earned on fixed rate earning assets that matured during 2004 that had been originated during periods of higher interest rates. The average rate paid on interest-bearing liabilities was lower in 2004 than in 2003 due to the interest rates on deposits that are set by management not being increased at the same time, or by the full amount, as increases in the prime rate of interest that occurred in 2004. Also, interest expense on time deposits was otherwise lower as a result of time deposits that were originated prior to the increases in interest rates, with maturities subsequent to the dates of the rate changes. The reduction in interest income for 2004 was \$2.4 million more than the reduction in interest expense, and thus changes in interest rates negatively impacted the Company's net interest income for 2004.

The Company measures the spread between the yield on its earning assets and the cost of its funding primarily in terms of the ratio entitled "net interest margin" which is defined as tax-equivalent net interest income divided by average earning assets. The Company's net interest margin increased slightly in 2005 after decreasing in 2004, amounting to 4.33% in 2005, 4.31% in 2004, and 4.52% in 2003.

In 2005, the Company's net interest margin was positively impacted by the rising interest rate environment, but the positive effects were largely offset by the mix of the Company's deposit growth being more concentrated in the

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categories of time deposits and time deposits greater than \$100,000. As derived from Table 2, in 2005, the yield earned on loans, the Company's primary earning asset, increased by 75 basis points, from 5.87% to 6.62%, while the average rate paid on savings, NOW and money market accounts, the Company's largest deposit category, increased by only 32 basis points (from 0.54% to 0.86%). The difference in these increases positively impacted the Company's net interest margin. However, 82% of the Company's average deposit growth in 2005 was comprised of time deposits, which are a high cost category of funds for the Company and incrementally result in lower net interest margins for the Company. In addition to being a high cost of funds for the Company, this category of deposits is typically more price-sensitive than the Company's other deposit categories, repricing upward by a greater amount in a rising rate environment than the Company's other deposits. In 2005, the average rate paid on time deposits greater than \$100,000 increased by 92 basis points in 2005, from 2.34% to 3.26%, while the average rate paid for all other time deposits increased by 82 basis points, from 2.04% to 2.86%. The higher growth in time deposits was necessary in order to fund the Company's loan growth. The positive and negative factors discussed above mostly offset each other, resulting in a two basis point increase in net interest margin for 2005 - from 4.31% in 2004 to 4.33% in 2005.

In 2004, the Company's net interest margin was negatively impacted by the interest rate environment and a shift towards originating more adjustable rate loans compared to fixed rate loans to protect the Company from an expected rise in interest rates. The mostly declining interest rate environment in effect from 2001 until June 30, 2004, and the level to which interest rates dropped, resulted in the Company being unable to reset deposit rates by an amount that would offset the negative impact of the lower yields earned on the Company's interest earning assets. In the declining rate environment, the Company's interest-sensitive assets repriced sooner (most on the day following the interest rate cut) and by a larger percentage (generally by the same number of basis points that the Federal Reserve discount rate was decreased) than did the Company's interest-sensitive liabilities that were subject to repricing. Additionally, as fixed rate earning assets originated during periods of higher interest rates matured, they were generally replaced with lower yielding earning assets. The Company was unable to reset deposit rates by the full amount of the interest rate cuts because of their already near-zero rates and because of

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competitive pricing pressures. Also, interest rates paid on time deposits are generally fixed and are not subject to automatic adjustment. When time deposits mature, the Company has the opportunity, at the customers' discretion, to renew the time deposit at a rate set by the Company. Because time deposits that are interest-sensitive in a twelve month horizon mature throughout the twelve month period, any change in the renewal rate will affect only a portion of the twelve month period. In addition, although changes in interest rates on renewing time deposits generally track rate changes in the interest rate environment, the Company found it especially difficult to decrease rates on renewing time deposits by the corresponding decreases in the Federal Reserve discount rate because of competitive pressures in the Company's market areas. Finally, in 2004 the Company increased its reliance on time deposits greater than \$100,000 and borrowings in order to fund high loan growth that exceeded core retail deposit growth. The ratio of the average amount of time deposits greater than \$100,000 and borrowings to total funding (total deposits plus borrowings) increased from 22.7% in 2003 to 25.6% in 2004. The impact of the factors just discussed resulted in a 21 basis point decrease in net interest margin for 2004 - from 4.52% in 2003 to 4.31% in 2004.

As discussed above, from 2002 to 2004, the Company gradually positioned itself to be protected in a rising interest rate environment by originating more variable rate loans than fixed rate loans - a rising interest rate environment

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was forecasted by most economists after the steeply declining interest rate environment that began in 2001 and concluded with interest rates being at their lowest levels in 40 years during 2004. This initiative resulted in the Company's loan mix changing from 57% fixed rate and 43% variable rate at December 31, 2001 to 60% variable rate and 40% fixed rate at December 31, 2004. In 2005, most economists began to forecast that the steadily increasing interest rate environment in effect since mid-2004 would end in 2006. As a result, in 2005 the Company began originating a more even mix of fixed rate loans and variable rate loans, which resulted in the Company's fixed/variable mix shifting slightly to 58% variable rate and 42% fixed rate at December 31, 2005.

See additional information regarding net interest income in the section entitled "Interest Rate Risk."

### Provision for Loan Losses

The provision for loan losses charged to operations is an amount sufficient to bring the allowance for loan losses to an estimated balance considered appropriate to absorb probable losses inherent in the portfolio. Management's determination of the adequacy of the allowance is based on the level of loan growth, an evaluation of the portfolio, current economic conditions, historical loan loss experience and other risk factors.

The provision for loan losses recorded by the Company did not vary significantly over the past three years, amounting to \$3,040,000 in 2005, compared to \$2,905,000 in 2004 and \$2,680,000 in 2003. Net internal loan growth was strong for each of those years, amounting to \$116 million in 2005 and \$148 million in both 2004 and 2003. There was no external/acquired loan growth in 2004 or 2005. In 2003, there was acquired growth of \$72.5 million, for which a preexisting allocation for loan losses was already in place. Asset quality ratios were stable during each of the three years in the period ended December 31, 2005.

See the section entitled "Allowance for Loan Losses and Loan Loss Experience" below for a more detailed discussion of the allowance for loan losses. The allowance is monitored and analyzed regularly in conjunction with the Company's loan analysis and grading program, and adjustments are made to maintain an adequate allowance for loan losses.

### Noninterest Income

Noninterest income recorded by the Company amounted to \$15,004,000 in 2005, \$15,864,000 in 2004, and \$14,918,000 in 2003.

As shown in Table 4, core noninterest income, which excludes gains and losses from sales of securities, loans, and other assets, amounted to \$15,262,000 in 2005, a 0.3% increase from \$15,216,000 in 2004. The 2004

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core noninterest income of \$15,216,000 was 4.1% higher than the \$14,612,000 recorded in 2003.

See Table 4 and the following discussion for an understanding of the components of noninterest income.

Service charges on deposit accounts in 2005 amounted to \$8,537,000, a 5.8% decrease compared to \$9,064,000 recorded in 2004. Service charges on deposit accounts have decreased primarily as a result of the negative impact that higher short term interest rates have on the service charges that the Company earns from its commercial depositors - in the Company's commercial account service

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charge rate structure, commercial depositors are given "earnings credits" (negatively impacting service charges) on their average deposit balances that are tied to short term interest rates. Beginning in February 2006, the Company changed the index that the earnings "credit rate" is tied to. The new index is based on a money market rate that is currently lower than the previous rate and is less susceptible to volatile changes, while still being competitive in the marketplace. The Company expects the new index to result in an increase in income earned from service charges on deposit accounts in 2006 as compared to the service charge income that would have been received using the old index. The 2004 amount of \$9,064,000 in service charges on deposit accounts was 14.2% higher than the 2003 amount of \$7,938,000. This increase can be attributed to the following primary factors: 1) periodic rate increases, 2) service charges earned from internally generated deposit growth, and 3) service charges earned from acquired deposits. Deposit service charge rates are generally increased 2%-4% per year, while internal growth among deposit transaction accounts was 4%-5% in both 2004 and 2003. The deposits assumed in the acquisition of four RBC Centura branches on October 24, 2003 generated approximately \$720,000 in service charges for the full year of 2004 compared to \$125,000 realized during the partial period in 2003 subsequent to the acquisition. This incremental income of \$595,000 accounted for approximately half of the 14.2% increase in service charges on deposit accounts. The Company's income from service charges on deposit accounts in the fourth quarter of 2004 was essentially flat when compared to the fourth quarter of 2003, which was a result of a higher customer deposit base, the positive effects of which were offset by the negative impact that higher short term interest rates in the second half of 2004 had on service charges from commercial depositors - see discussion above.

Other service charges, commissions and fees amounted to \$3,963,000 in 2005, a 17.9% increase from the \$3,361,000 earned in 2004. The 2004 amount of \$3,361,000 was 24.0% higher than the \$2,710,000 recorded in 2003. This category of noninterest income includes items such as credit card interchange income related to merchants and customers, debit card interchange income, ATM charges, safety deposit box rentals, fees from sales of personalized checks, and check cashing fees. This category of income grew primarily because of increases in these activity-related fee services as a result of the increased acceptance and popularity of debit cards, special credit and debit card promotions that increased their use, and the overall growth in the Company's total customer base, including growth achieved from corporate acquisitions.

Fees from presold mortgages amounted to \$1,176,000 in 2005, a 21.4% increase from the 2004 amount of \$969,000. The 2004 amount was a 58.4% decrease from the \$2,327,000 recorded in 2003. Fees from presold mortgages peaked in 2003 as a result of a high level of mortgage loan refinancings brought on by low mortgage interest rates. Since that time, the absence of the initial wave of refinancing activity and higher adjustable rate mortgage rates have resulted in the Company's fees from presold mortgages decreasing from the 2003 level and averaging approximately \$200,000-\$300,000 per quarter.

Commissions from sales of insurance and financial products amounted to \$1,307,000 in 2005, \$1,406,000 in 2004, and \$1,304,000 in 2003. This line item includes commissions the Company receives from three sources - 1) sales of credit insurance associated with new loans, 2) commissions from the sales of investment, annuity, and long-term care insurance products, and 3) commissions from the sale of property and casualty insurance. The following table presents the contribution of each of the three sources to the total amount recognized in this line item:

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| (\$ in thousands) | 2005  | 2004  | 2003  |
|-------------------|-------|-------|-------|
|                   | ----- | ----- | ----- |

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Commissions earned from:

|  |         |       |       |
|--|---------|-------|-------|
| Sales of credit insurance  | \$ 308  | 291   | 300   |
| Sales of investments, annuities,<br>and long term care insurance | 193     | 291   | 299   |
| Sales of property and casualty<br>insurance                      | 806     | 824   | 705   |
|  | -----   | ----- | ----- |
| Total  | \$1,307 | 1,406 | 1,304 |
|  | =====   | ===== | ===== |

As shown in the table above, lower "sales of investments, annuities, and long-term care insurance" is the primary cause for the decrease in recorded insurance and financial product commissions from 2004 to 2005. The decrease in this component is primarily due to two employees in this area being transferred to another division of the Company and not yet being replaced.

Data processing fees amounted to \$279,000 in 2005, \$416,000 in 2004, and \$333,000 in 2003. As noted earlier, Montgomery Data makes its excess data processing capabilities available to area financial institutions for a fee. The decrease in data processing fees in 2005 is a result of three of the five customers of Montgomery Data terminating their service and switching to another provider. Montgomery Data intends to continue to market this service to area banks, but does not currently have any near-term prospects for additional business.

Noninterest income not considered to be "core" amounted to a net loss of \$258,000 in 2005, a net gain of \$648,000 in 2004, and a net gain of \$306,000 in 2003. The 2005 net loss of \$258,000 included \$189,000 in losses due to normal write-downs of tax credit investments, and \$83,000 in losses related to a change in the Company's methodology for reserving for overdrafts and overdraft loans. The 2004 net gain of \$648,000 included securities gains of \$299,000, which were effected primarily in order to realize current income. Also in 2004, the Company sold a former bank branch building that resulted in a gain of approximately \$350,000. The 2003 net gain of \$306,000 primarily related to securities gains of \$218,000 effected primarily to realize current income and an \$82,000 gain from a sale of vacant land located beside one of the Company's existing branches. The Company projects \$196,000 of tax credit investment write-downs in 2006. Tax credit write-downs experienced in 2005 and projected for 2006 have increased from the \$70,000 amounts recorded in 2004 and 2003 as a result of additional investments made in tax credit partnerships during 2005. To date, all tax credit write-downs have been exceeded, and are projected to continue to be exceeded, by the amount of tax credits realized and recorded as a reduction of income tax expense.

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### Noninterest Expenses

Noninterest expenses for 2005 were \$47,636,000, compared to \$43,717,000 in 2004 and \$37,964,000 in 2003. Table 5 presents the components of the Company's noninterest expense during the past three years.

Based on the recorded amounts noted above, noninterest expenses increased 9.0% in 2005 and 15.2% in 2004. The increases in noninterest expenses over the past three years have occurred in nearly every line item of expense and have been primarily as a result of the significant growth experienced by the Company, both internally and by acquisition. Over the past three years, the number of the Company's branches has increased from 48 to 61, and the number of full time equivalent employees has increased from 447 at December 31, 2002 to 578 at

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December 31, 2005. Additionally, from December 31, 2002 to December 31, 2005, the amount of loans outstanding increased 48.5% and deposits increased 41.5%. The incremental expense associated with the acquisition of the four RBC Centura branches in October 2003 was approximately \$380,000 in 2003 and \$1,900,000 on an annual basis thereafter. The Company's noninterest expenses were also impacted by external costs associated with complying Section 404 of the Sarbanes-Oxley Act. These expenses amounted to approximately \$193,000 in 2004 and increased to \$832,000 in 2005. These amounts do not include the value of the significant internal resources devoted to compliance. The Company expects its Sarbanes-Oxley compliance costs to decline modestly in 2006 from the expense recorded in 2005.

### Income Taxes

The provision for income taxes was \$16,829,000 in 2005, \$10,418,000 in 2004, and \$10,617,000 in 2003.

The Company's income tax expense for 2005 of \$16.8 million includes a contingency accrual of \$4.3 million. In 1999, in consultation with the Company's tax advisors, the Company established an operating structure involving a real estate investment trust ("REIT") that resulted in a reduction in the Company's state tax liability to the state of North Carolina. In late 2004, the North Carolina Department of Revenue indicated that it would challenge taxpayers engaged in activities deemed to be "income-shifting," and they indicated that they believed certain REIT operating structures were a type of "income-shifting." During 2005, the North Carolina Department of Revenue began an audit of the Company's tax returns for 2001-2004, which represented all years eligible for audit. In the third quarter of 2005, based on consultations with the Company's external auditor and legal counsel, the Company determined that it should record a \$6.3 million loss accrual to reserve for this issue. In February 2006, the North Carolina Department of Revenue announced a "Settlement Initiative" that offered companies with certain transactions, including those with a REIT operating structure, the opportunity to resolve such matters with reduced penalties by agreeing to participate in the initiative by June 15, 2006. Although the Company continues to believe that its tax returns complied with the relevant statutes, the board of directors of the Company has tentatively decided that it is in the best interests of the Company to settle this matter by participating in the initiative. Based on the terms of the initiative, the Company estimates that its total liability to settle the matter will be approximately \$4.3 million, net of the federal tax benefit, or \$2.0 million less than the amount that was originally accrued. Accordingly, in March 2006, prior to the filing of its financial statements, the Company retroactively recorded an adjustment to its fourth quarter of 2005 earnings to reverse \$2.0 million of tax expense, as required by relevant accounting standards. The aspects of the REIT structure that gave rise to this issue were discontinued effective January 1, 2005, and thus the Company does not believe it has any additional exposure related to this item beyond the amount of the accrual other than ongoing interest on the unpaid taxes amounting to \$65,000 per quarter (after-tax).

Table 6 presents the components of tax expense and the related effective tax rates. The high effective tax rate of 55.1% in 2005 is primarily a result of the contingency loss accrual discussed above. During periods in 2005 that did not include contingency loss accrual matters, the Company's effective tax rate was approximately 38%-39% compared to approximately 34%-35% in 2004 and 2003. The higher effective tax rate in 2005 compared to 2004 is the result of the Company discontinuing, effective January 1, 2005, the operating structure involving a real estate investment trust (REIT) that gave rise to the contingency tax accrual. The Company

expects its effective tax rate to continue to be in the 38%-39% range for the

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foreseeable future. In 2004, the Company's effective tax rate of 34.1% was slightly lower than the 2003 effective tax rate of 35.3%. The lower effective tax rate in 2004 was caused by several factors including higher amounts of state tax exempt income, higher amounts of low income housing investment tax credits, and the reversal of an \$89,000 tax liability that was recorded in connection with a previous corporate acquisition.

### Stock-Based Compensation

For the three years ended December 31, 2005, the Company was not required to record any expense for the value of stock options granted to employees. As discussed in more detail below in the next to last paragraph of the section entitled "Current Accounting and Regulatory Matters," a new accounting standard ("Statement 123(R)", as defined below) will require the Company to record the value of stock options as an expense in the income statement beginning January 1, 2006. Note 1(k) to the consolidated financial statements contains pro forma net income and earnings per share information as if the Company applied the fair value recognition provisions required by the new standard. Note 1(k) indicates that the Company's stock-based employee compensation expense would have been \$335,000, \$1,291,000 and \$319,000, for the three years ended December 31, 2005, 2004, and 2003, respectively. The significant increase in expense in 2004 compared to 2003 and 2005 is primarily due to the Company granting 128,000 employee options in April 2004 with immediate vesting (under the new standard, expense related to the fair market value of options is recognized when the options vest). Prior to that grant, all previous employee option grants had five year vesting periods (20% vesting each year), and thus the amount of expense related to options was generally spread over the five year vesting period. The Compensation Committee of the Board of Directors of the Company granted the April 2004 options without any vesting requirements for two reasons - 1) the options were granted primarily as a reward for past performance and therefore had already been "earned" in the view of the Committee, and 2) to potentially minimize the impact that any change in accounting standards for stock options could have on future years' reported net income. Employee stock option grants since the April 2004 grant have reverted to having five year vesting periods.

As noted above, beginning on January 1, 2006, the Company will be required to expense, within its income statement, the value of stock option grants that vest from that date forward. In 2006, 2007, and 2008 the Company's stock-based compensation expense related to options currently outstanding will be approximately \$126,000, \$47,000, and \$3,000 respectively. New stock option grants that are granted and vest after January 1, 2006 will increase the amount of stock-based compensation expense recorded by the Company. Except for grants to directors (see below), the Company cannot estimate the amount of future stock option grants at this time. In the past, stock option grants to employees have been irregular, generally falling into three categories - 1) to attract and retain new employees, 2) to recognize changes in responsibilities of existing employees, and 3) to periodically reward exemplary performance. The Company expects to continue to grant 2,250 stock options to each of the Company's non-employee directors in June of each year until the 2014 expiration of the current stock option plan. In 2005, the amount of pro forma expense associated with the June director grants was \$127,000.

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## ANALYSIS OF FINANCIAL CONDITION AND CHANGES IN FINANCIAL CONDITION

### Overview

Over the past two years, the Company has achieved steady increases in its levels of loans and deposits. All of this growth has been internally generated, as the Company did not complete any acquisitions in 2004 or 2005. The following



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table presents detailed information regarding the nature of the Company's growth in 2004 and 2005:

| (in thousands)                               | Balance at<br>beginning<br>of period<br>----- | Internal<br>growth<br>----- | Change in<br>brokered<br>deposits<br>----- | Balance at<br>end of<br>period<br>----- | Total<br>percentage<br>growth<br>----- |
|--|---|-----------------------------|--|---|--|
| 2005<br>-----                                |   |                             |  |   |  |
| Loans  | \$1,367,053<br>=====                          | 115,558<br>=====            | --<br>=====                                | 1,482,611<br>=====                      | 8.5<br>=====                           |
| Deposits - Noninterest bearing               | 165,778                                       | 28,273                      | --   | 194,051                                 | 17.1                                   |
| Deposits - Savings, NOW, and<br>Money Market | 472,811                                       | (14,590)                    | --   | 458,221                                 | (3.1)                                  |
| Deposits - Time>\$100,000                    | 334,756                                       | 71,398                      | (49,873)                                   | 356,281                                 | 6.4                                    |
| Deposits - Time                              |   |                             |  |   |  |