FIRST BANCORP /NC/
Form 10-Q
November 09, 2006

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

FORM 10-Q

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

For the quarterly period ended
September 30, 2006

Commission File Number 0-15572

FIRST BANCORP
(Exact Name of Registrant as Specified in its Charter)

North Carolina	56-1421916
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)
341 North Main Street, Troy, North Carolina	27371-0508
(Address of Principal Executive Offices)	(Zip Code)
(Registrant's telephone number, including area code)	(910) 576-6171

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 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. [X] YES [ ] NO

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 number of shares of the registrant's Common Stock outstanding on November 1, 2006 was 14,325,735.

INDEX
FIRST BANCORP AND SUBSIDIARIES

	Page
Part I. Financial Information	
Item 1 - Financial Statements	
Consolidated Balance Sheets - September 30, 2006 and 2005 (With Comparative Amounts at December 31, 2005)	3
Consolidated Statements of Income - For the Periods Ended September 30, 2006 and 2005	4
Consolidated Statements of Comprehensive Income - For the Periods Ended September 30, 2006 and 2005	5
Consolidated Statements of Shareholders' Equity - For the Periods Ended September 30, 2006 and 2005	6
Consolidated Statements of Cash Flows - For the Periods Ended September 30, 2006 and 2005	7
Notes to Consolidated Financial Statements	8
Item 2 - Management's Discussion and Analysis of Consolidated Results of Operations and Financial Condition	18
Item 3 - Quantitative and Qualitative Disclosures About Market Risk	32
Item 4 - Controls and Procedures	33
Part II. Other Information	
Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds	34
Item 6 - Exhibits	34
Signatures	35

Part I. Financial Information
Item 1 - Financial Statements

First Bancorp and Subsidiaries
Consolidated Balance Sheets

September 30,	December 31,	September 30,

($ in thousands-unaudited)	2006	2005 (audited)	2005
ASSETS			
Cash & due from banks, noninterest-bearing	$ 35,931	32,985	21,853
Due from banks, interest-bearing	83,571	41,655	47,402
Federal funds sold	24,212	28,883	28,586
Total cash and cash equivalents	143,714	103,523	97,841
Securities available for sale (costs of $127,353, $114,662, and $115,686)	125,950	113,613	115,622
Securities held to maturity (fair values of $14,326, $14,321, and $12,820)	14,270	14,172	12,799
Presold mortgages in process of settlement	3,145	3,347	3,586
Loans	1,696,835	1,482,611	1,446,185
Less: Allowance for loan losses	(18,465)	(15,716)	(15,879)
Net loans	1,678,370	1,466,895	1,430,306
Premises and equipment	43,207	34,840	33,395
Accrued interest receivable	11,368	8,947	7,779
Goodwill	49,489	47,247	47,247
Other intangible assets	2,229	1,980	2,053
Other	6,716	6,486	7,406
Total assets	$ 2,078,458	1,801,050	1,758,034
LIABILITIES			
Deposits: Demand - noninterest-bearing	$ 212,509	194,051	192,399
Savings, NOW, and money market	497,097	458,221	460,709
Time deposits of $100,000 or more	411,178	356,281	349,620
Other time deposits	544,118	486,024	472,800
Total deposits	1,664,902	1,494,577	1,475,528
Repurchase agreements	32,804	33,530	12,409
Borrowings	200,013	100,239	101,239
Accrued interest payable	5,382	3,835	3,543
Other liabilities	12,268	13,141	14,386
Total liabilities	1,915,369	1,645,322	1,607,105
SHAREHOLDERS' EQUITY			
Common stock, No par value per share Issued and outstanding: 14,310,335, 14,229,148, and 14,196,987 shares	55,394	54,121	53,574
Retained earnings	108,803	102,507	97,655
Accumulated other comprehensive income (loss)	(1,108)	(900)	(300)
Total shareholders' equity	163,089	155,728	150,929
Total liabilities and shareholders' equity	$ 2,078,458	1,801,050	1,758,034

See notes to consolidated financial statements.

First Bancorp and Subsidiaries
Consolidated Statements of Income

($ in thousands, except share data-unaudited)	Three Months Ended September 30, 2006	2005
INTEREST INCOME		
Interest and fees on loans	$ 31,727	24,240
Interest on investment securities:		
Taxable interest income	1,456	1,315
Tax-exempt interest income	140	114
Other, principally overnight investments	584	398
Total interest income	33,907	26,067
INTEREST EXPENSE		
Savings, NOW and money market	1,976	1,042
Time deposits of $100,000 or more	4,668	3,015
Other time deposits	5,646	3,532
Other, primarily borrowings	2,576	1,126
Total interest expense	14,866	8,715
Net interest income	19,041	17,352
Provision for loan losses	1,215	690
Net interest income after provision for loan losses	17,826	16,662
NONINTEREST INCOME		
Service charges on deposit accounts	2,323	2,180
Other service charges, commissions and fees	1,102	961
Fees from presold mortgages	278	328
Commissions from sales of insurance and financial products	357	388
Data processing fees	40	38
Securities gains	--	--
Other gains (losses)	(1,646)	(116)
Total noninterest income	2,454	3,779
NONINTEREST EXPENSES		
Salaries	6,062	5,402
Employee benefits	1,892	1,407
Total personnel expense	7,954	6,809
Net occupancy expense	895	797

Equipment related expenses	877	744
Intangibles amortization	100	71
Other operating expenses	3,709	3,065
Total noninterest expenses	13,535	11,486
Income before income taxes	6,745	8,955
Income taxes	2,373	9,646
NET INCOME (LOSS)	$ 4,372	(691)
Earnings (loss) per share:		
Basic	$ 0.31	(0.05)
Diluted	0.30	(0.05)
Weighted average common shares outstanding:		
Basic	14,294,948	14,186,887
Diluted	14,421,380	14,186,887

See notes to consolidated financial statements.

First Bancorp and Subsidiaries
Consolidated Statements of Comprehensive Income

($ in thousands-unaudited)	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Net income (loss)	$ 4,372	(691)	14,158	8,677
Other comprehensive income (loss):				
Unrealized gains (losses) on securities available for sale:				
Unrealized holding gains (losses) arising during the period, pretax	1,568	(824)	(149)	(1,252)
Tax benefit (expense)	(613)	322	57	491
Reclassification to realized gains	--	--	(205)	(2)
Tax expense	--	--	79	1
Adjustment to minimum pension liability:				
Additional pension charge related to unfunded pension liability	--	--	16	(90)
Tax benefit (expense)	--	--	(6)	35
Other comprehensive income (loss)	955	(502)	(208)	(817)
Comprehensive income (loss)	$ 5,327	(1,193)	13,950	7,860

See notes to consolidated financial statements.

First Bancorp and Subsidiaries
Consolidated Statements of Shareholders' Equity

(In thousands, except per share - unaudited)	Common Stock Shares	Common Stock Amount	Retained Earnings	Accumu Oth Compre Income
Balances, January 1, 2005	14,084	$ 51,614	96,347	
Net income			8,677	
Cash dividends declared ($0.52 per share)			(7,369)	
Common stock issued under stock option plan	58	656		
Common stock issued into dividend reinvestment plan	55	1,204		
Tax benefit realized from exercise of nonqualified stock options	--	100		
Other comprehensive loss				
Balances, September 30, 2005	14,197	$ 53,574	97,655	
Balances, January 1, 2006	14,229	$ 54,121	102,507	
Net income			14,158	
Cash dividends declared ($0.55 per share)			(7,862)	
Common stock issued under stock option plan	77	758		
Common stock issued into dividend reinvestment plan	57	1,219		
Purchases and retirement of common stock	(53)	(1,112)		
Tax benefit realized from exercise of nonqualified stock options	--	94		
Stock-based compensation	--	314		
Other comprehensive loss				
Balances, September 30, 2006	14,310	$ 55,394	108,803	

See notes to consolidated financial statements.

First Bancorp and Subsidiaries

Consolidated Statements of Cash Flows

($ in thousands-unaudited)	Nine Months Ended September 30, 2006	2005
Cash Flows From Operating Activities		
Net income	$ 14,158	8,6
Reconciliation of net income to net cash provided by operating activities:		
Provision for loan losses	3,630	2,1
Net security premium amortization	69	
Gain on sale of securities available for sale	(205)	
Other losses	124	1
Net loan origination fees (costs) deferred	263	(2
Depreciation of premises and equipment	2,118	2,0
Tax benefit from exercise of nonqualified stock options	--	1
Stock-based compensation expense	314	
Amortization of intangible assets	221	2
Deferred income tax benefit	(1,555)	(2
Originations of presold mortgages in process of settlement	(48,413)	(54,8
Proceeds from sales of presold mortgages in process of settlement	48,615	53,0
Increase in accrued interest receivable	(2,386)	(9
Decrease in other assets	2,849	1,9
Increase in accrued interest payable	1,469	8
Increase (decrease) in other liabilities	(1,005)	7,1
Net cash provided by operating activities	20,266	20,0
Cash Flows From Investing Activities		
Purchases of securities available for sale	(45,182)	(47,7
Purchases of securities held to maturity	(3,468)	
Proceeds from maturities/issuer calls of securities available for sale	31,004	19,3
Proceeds from maturities/issuer calls of securities held to maturity	3,192	1,1
Proceeds from sales of securities available for sale	1,575	
Net increase in loans	(210,973)	(82,1
Purchases of premises and equipment	(9,779)	(5,0
Net cash received in purchase of branches	34,915	
Net cash used by investing activities	(198,716)	(114,4
Cash Flows From Financing Activities		
Net increase in deposits and repurchase agreements	125,622	99,1
Proceeds from borrowings, net	99,774	9,0
Cash dividends paid	(7,714)	(7,2
Proceeds from issuance of common stock	1,977	1,8
Purchases and retirement of common stock	(1,112)	
Tax benefit from exercise of nonqualified stock options	94	
Net cash provided by financing activities	218,641	102,8
Increase in Cash and Cash Equivalents	40,191	8,4
Cash and Cash Equivalents, Beginning of Period	103,523	89,4
Cash and Cash Equivalents, End of Period	$ 143,714	97,8

Supplemental Disclosures of Cash Flow Information:

Cash paid during the period for:		
Interest	$ 37,130	22,1
Income taxes	10,915	8,9
Non-cash transactions:		
Unrealized loss on securities available for sale, net of taxes	(218)	(7
Foreclosed loans transferred to other real estate	1,302	2,3

See notes to consolidated financial statements.

Page

First Bancorp and Subsidiaries
Notes to Consolidated Financial Statements

(unaudited) For the Periods Ended September 30, 2006 and 2005

Note 1 - Basis of Presentation

In the opinion of the Company, the accompanying unaudited consolidated financial statements contain all adjustments necessary to present fairly the consolidated financial position of the Company as of September 30, 2006 and 2005 and the consolidated results of operations and consolidated cash flows for the periods ended September 30, 2006 and 2005. All such adjustments were of a normal, recurring nature. Reference is made to the 2005 Annual Report on Form 10-K filed with the SEC for a discussion of accounting policies and other relevant information with respect to the financial statements. The results of operations for the periods ended September 30, 2006 and 2005 are not necessarily indicative of the results to be expected for the full year.

Note 2 - Accounting Policies

Note 1 to the 2005 Annual Report on Form 10-K filed with the SEC contains a description of the accounting policies followed by the Company and discussion of recent accounting pronouncements. The following paragraph updates that information as necessary.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108 (SAB 108). SAB 108 provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The bulletin is effective for the first fiscal year ending after November 15, 2006. The Company does not expect the adoption of SAB 108 to materially impact the Company's consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 (Statement 157), "Fair Value Measurements." Statement 157 provides enhanced guidance for using fair value to measure assets and liabilities. The standard also requires expanded disclosures about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. Statement 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company does not expect the adoption of Statement 157 to materially impact the Company's consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158 (Statement 158), "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans (an amendment of FASB Statements No. 87,

88, 106, and 132R)." Statement 158 requires an employer to: (a) recognize in its statement of financial position an asset for a plan's overfunded status or a liability for a plan's underfunded status (b) measure a plan's assets and its obligations that determine its funded status as of the end of the employer's fiscal year (with limited exceptions) and (c) recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. Those changes will be reported in comprehensive income. The requirement to recognize the funded status of a benefit plan and the disclosure requirements are effective as of the end of the fiscal year ending after December 15, 2006. The Company has not fully assessed the impact of the adoption of Statement 158 at this time. However, if the provisions of Statement 158 had been applied as of December 31, 2005, the Company's shareholders' equity would have been reduced by approximately $6.8 million before tax and approximately $4.1 million after tax.

In July 2006, the Financial Accounting Standards Board (FASB) released FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109" (FIN 48). FIN 48 clarifies the accounting and reporting for uncertainties in income tax law. FIN 48 prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. The Company will adopt FIN 48 in the first quarter of 2007. The cumulative effect of applying the provisions of this interpretation is required to be reported separately as an adjustment to the opening balance of retained earnings in the year of adoption. The Company is in the process of reviewing and evaluating FIN 48, and therefore the ultimate impact of its adoption is not yet known.

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004) (Statement 123(R)), "Share-Based Payment." Statement 123(R) replaces FASB Statement No. 123 (Statement 123), "Accounting for Stock-Based Compensation," and supersedes Accounting Principles Board Opinion No. 25 (Opinion 25), "Accounting for Stock Issued to Employees." Statement 123(R) requires that the compensation cost relating to share-based payment transactions be recognized in the financial statements. Statement 123(R) permits public companies to adopt its requirements using one of two methods. The "modified prospective" method recognizes compensation for all stock options granted after the date of adoption and for all previously granted stock options that become vested after the date of adoption. The "modified retrospective" method includes the requirements of the "modified prospective" method described above, but also permits entities to restate prior period results based on the amounts previously presented under Statement 123 for purposes of pro-forma disclosures. The Company has elected to adopt Statement 123(R) under the "modified prospective" method and accordingly will not restate prior period results. See Note 4 for a more detailed description the Company's adoption of Statement 123(R).

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154 (Statement 154), "Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3." Statement 154 applies to all voluntary changes in accounting principle as well as to changes required by an accounting pronouncement that does not include specific transition provisions. Statement 154 eliminates the previous requirement that the cumulative effect of changes in accounting principle be reflected in the income statement in the period of change. Instead, to enhance the comparability of prior period financial statements, Statement 154 requires that changes in accounting principle be retrospectively applied. Under retrospective application, the new accounting principle is applied as of the beginning of the first period presented, as if that principle had always been used. Statement 154 carries forward the requirement that an error be reported by restating prior

period financial statement as of the beginning of the first period. Statement 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The initial adoption of Statement 154 did not have a material impact on the Company's financial statements; however the adoption of this statement could result in a material change to the way the Company reflects future changes in accounting principles, depending on the nature of future changes in accounting principles and whether specific transition provisions are included.

Note 3 - Reclassifications

Certain amounts reported in the period ended September 30, 2005 have been reclassified to conform with the presentation for September 30, 2006. These reclassifications had no effect on net income (loss) or shareholders' equity for the periods presented, nor did they materially impact trends in financial information.

Note 4 - Equity-Based Compensation Plans

At September 30, 2006, the Company had the following equity-based compensation plans, all of which are stock option plans: the First Bancorp 2004 Stock Option Plan, the First Bancorp 1994 Stock Option Plan, and four plans that were assumed from acquired entities, which are all described below. The Company's shareholders approved all equity-based compensation plans, except for those assumed from acquired companies. As of September 30, 2006, the First Bancorp 2004 Stock Option Plan was the only plan that had shares available for future grants.

The First Bancorp 2004 Stock Option Plan and its predecessor plan, the First Bancorp 1994 Stock Option Plan, were intended to serve as a means of attracting, retaining and motivating key employees and directors and to associate the interests of the plans' participants with those of the Company and its shareholders. Stock option grants to non-employee directors have historically had no vesting requirements, whereas, except as discussed below, stock option grants to employees have generally had five-year vesting schedules (20% vesting each year).

In April 2004, the Company granted 128,000 options to employees with no vesting requirements. These options were granted 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. The Company's options provide for immediate vesting if there is a change in control (as defined in the plans). Under the terms of these two plans, options can have a term of no longer than ten years, and all options granted thus far under these plans have had a term of ten years. 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. As it relates to directors, the Company has historically granted 2,250 stock options to each of the Company's non-employee directors in June of each year, and expects to continue doing so for the foreseeable future. At September 30, 2006, there were 653,658 options outstanding related to these two plans with exercise prices ranging from $7.83 to $22.12. At September 30, 2006, there were 1,186,840 shares remaining available for grant under the First

Bancorp 2004 Stock Option Plan.

The Company also has four stock option plans as a result of assuming plans of acquired companies. At September 30, 2006, there were 38,586 stock options outstanding in connection with these plans, with option prices ranging from $10.22 to $11.49.

The Company issues new shares when options are exercised.

Prior to January 1, 2006, the Company accounted for all of these plans using the intrinsic value method prescribed by Opinion 25 and related interpretations. Because all of the Company's stock options had an exercise price equal to the market value of the underlying common stock on the date of grant, no compensation cost had ever been recognized. On January 1, 2006, the Company adopted Statement 123(R). Statement 123(R) supersedes Opinion 25 (and related interpretations) and requires that the compensation cost relating to share-based payment transactions be recognized in the financial statements. Statement 123(R) permits public companies to adopt its requirements using one of two methods. The "modified prospective" method recognizes compensation expense for all stock options granted after the date of adoption and for all previously granted stock options that become vested after the date of adoption. The "modified retrospective" method includes the requirements of the "modified prospective" method described above, but also permits entities to restate prior period results based on the amounts previously presented under Statement 123 for purposes of pro-forma disclosures. The Company has elected to adopt Statement 123(R) under the "modified prospective" method and accordingly will not restate prior period results.

The Company measures the fair value of each option award on the date of grant using the Black-Scholes option-pricing model. The Company determines the assumptions used in the Black-Scholes option pricing model as follows: the risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of the grant; the dividend yield is based on the Company's dividend yield at the time of the grant (subject to adjustment if the dividend yield on the grant date is not expected to approximate the dividend yield over the expected life of the option); the volatility factor is based on the historical volatility of the Company's stock (subject to adjustment if historical volatility is reasonably expected to differ from the past); the weighted-average expected life is based on the historical behavior of employees related to exercises, forfeitures and cancellations.

As noted above, prior to the adoption of Statement 123(R), the Company applied Opinion 25 to account for its stock options. The following table illustrates the effect on net income and earnings per share had the Company accounted for share-based compensation in accordance with Statement 123(R) for the periods indicated:

(In thousands except per share data)	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Mont Ended September 2006
Net income, as reported	$ 4,372	(691)	14,1
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	22	--	2

Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		(22)	(52)	(2
Pro forma net income		$ 4,372	(743)	14,1
Earnings per share:	Basic-As reported	$ 0.31	(0.05)	0.
	Basic-Pro forma	0.31	(0.05)	0.
	Diluted-As reported	0.30	(0.05)	0.
	Diluted-Pro forma	0.30	(0.05)	0.

For the three and nine month periods ended September 30, 2006, the Company recorded stock-based compensation expense in the income statement of $22,000 and $314,000, respectively, which reduced income before income taxes by those same amounts for the respective periods. The Company recognized no income tax benefits in the income statement related to stock-based compensation for the three month period ended September 30, 2006. The Company recognized $79,000 of income tax benefits in the income statement for the first nine months of 2006. Thus, the impact of stock-based compensation expense on net income for the three months ended September 30, 2006 was to reduce it by $22,000, or less than one cent basic and diluted earnings share. The impact of stock-based compensation expense on net income for the nine months ended September 30, 2006 was to reduce it by $235,000, or approximately 1.6 cents basic and diluted earnings share. The 2006 stock-based compensation expense related to the vesting of several stock option grants made prior to January 1, 2006, as well as a grant of 29,250 options (2,250 options to each non-employee director of the Company) on June 1, 2006 with no vesting requirements. This compensation expense was reflected as an adjustment to cash flows from operating activities on the Company's Consolidated Statement of Cash Flows. At September 30, 2006, the Company had $68,000 of unrecognized compensation costs related to unvested stock options. The cost is expected to be amortized over a weighted-average life of 1.9 years, with $12,000 being expensed in the fourth quarter of 2006, $47,000 being expensed in 2007 equally distributed among each of the four quarters, and $3,000 being expensed in each of 2008, 2009 and 2010, equally distributed among each of the four quarters of each year. In addition, as discussed above, the Company granted 2,250 options, without vesting requirements, to each of its non-employee directors on June 1, 2006 and expects to continue this grant on June 1 of each year thereafter.

As noted above, certain of the Company's stock option grants contain terms that provide for a graded vesting schedule whereby portions of the award vest in increments over the requisite service period. As provided for under Statement 123(R), the Company has elected to recognize compensation expense for awards with graded vesting schedules on a straight-line basis over the requisite service period for the entire award. Statement 123(R) requires companies to recognize compensation expense based on the estimated number of stock options and awards for which service is to be rendered. Over the past five years, there have only been four forfeitures or expirations, totaling 9,600 options, and therefore the Company assumes that all options granted will become vested.

The Company's only option grants for the first nine months of 2006 and 2005 were grants of 29,250 and 31,500 options to non-employee directors on June 1, 2006 and 2005, respectively (2,250 option per director). The per share weighted-average fair value of options granted during the nine months ended

September 30, 2006 and September 30, 2005, was $6.79, and $6.68, respectively, on the date of the grant using the following weighted-average assumptions:

	Nine months ended September 30, 2006	Nine months ended September 30, 2005
Expected dividend yield	3.30%	3.07%
Risk-free interest rate	5.05%	3.84%
Expected life	7 years	7 years
Expected volatility	32.56%	32.99%

The following table presents information regarding the activity during the first nine months of 2006 related to all of the Company's stock options outstanding:

	All Options Outstanding			
Nine months ended September 30, 2006	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Ag Intri (
Outstanding at the beginning of the period	746,882	$ 15.75		
Granted during the period	29,250	21.83		
Exercised during the period	79,388	10.08		
Forfeited or expired during the period	4,500	6.55		
Outstanding at end of period	692,244	$ 16.72	5.5 years	$
Exercisable at September 30, 2006	671,744	$ 16.73	5.4 years	$

The Company received $758,000 and $656,000 as a result of stock option exercises during the nine months ended September 30, 2006 and 2005, respectively. The intrinsic value of the stock options exercised during the nine months ended September 30, 2006 and 2005 was $882,000 and $654,000, respectively. The Company recorded $94,000 and $100,000 in associated tax benefits from the exercise of nonqualified stock options during the nine months ended September 30, 2006 and 2005, respectively. In accordance with Statement 123(R), this benefit is included as a financing activity in the accompanying Statements of Cash Flows for periods subsequent to the adoption of Statement 123(R), but continues to be reported as an operating activity in periods prior to its adoption.

The following table presents information regarding the activity during the first nine months of 2006 related to the Company's stock options outstanding that are nonvested:

	Nonvested Options	
Nine months ended September 30, 2006	Number of Shares	Weighted-Averag Grant-Date Fair Value

Nonvested options outstanding at the beginning of the period	67,999	$	4.75
Granted during the period	--		--
Vested during the period	(47,499)		4.60
Forfeited or expired during the period	--		--
Nonvested options outstanding at end of period	20,500	$	5.05

Note 5 - Earnings Per Share

Basic earnings per share were computed by dividing net income by the weighted average common shares outstanding. Diluted earnings per share includes the potentially dilutive effects of the Company's stock option plan. The following is a reconciliation of the numerators and denominators used in computing basic and diluted earnings per share:

	For the Three Months Ended September 30,				
	2006			2005	
($ in thousands except per share amounts)	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)
Basic EPS					
Net income (loss)	$ 4,372	14,294,948	$ 0.31	$ (691)	14,186,887
Effect of Dilutive Securities	--	126,432		--	--
Diluted EPS	$ 4,372	14,421,380	$ 0.30	$ (691)	14,186,887

	For the Nine Months Ended September 30,				
	2006			2005	
($ in thousands except per share amounts)	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)
Basic EPS					
Net income	$ 14,158	14,281,964	$ 0.99	$ 8,677	14,150,527
Effect of Dilutive Securities	--	143,383		--	202,642
Diluted EPS	$ 14,158	14,425,347	$ 0.98	$ 8,677	14,353,169

For the three and nine months ended September 30, 2006, there were 220,980 options that were antidilutive because the exercise price exceeded the average market price for the period. Because the Company reported a net loss for the three months ended September 30, 2005, all options are considered to be anti-dilutive. If the Company had reported net income for the three months ended September 30, 2005, the "Effect of Dilutive Securities" in the table above would have been 170,840 shares. There were no antidilutive options for the nine months ended September 30, 2005. Antidilutive options have been omitted from the calculation of diluted earnings per share for the respective periods.

Note 6 - Asset Quality Information

Nonperforming assets are defined as nonaccrual loans, loans past due 90 or more days and still accruing interest, restructured loans and other real estate. Nonperforming assets are summarized as follows:

($ in thousands)	September 30, 2006	December 31, 2005	September 30, 2005
Nonperforming loans:			
Nonaccrual loans	$ 5,170	1,640	3,330
Restructured loans	11	13	14
Accruing loans > 90 days past due	--	--	--
Total nonperforming loans	5,181	1,653	3,344
Other real estate	1,799	1,421	2,023
Total nonperforming assets	$ 6,980	3,074	5,367
Nonperforming loans to total loans	0.31%	0.11%	0.23%
Nonperforming assets as a percentage of loans and other real estate	0.41%	0.21%	0.37%
Nonperforming assets to total assets	0.34%	0.17%	0.31%
Allowance for loan losses to total loans	1.09%	1.06%	1.10%

Note 7 - Deferred Loan Fees

Loans are shown on the Consolidated Balance Sheets net of net deferred loan costs (fees) of ($79,000), $184,000, and $75,000 at September 30, 2006, December 31, 2005, and September 30, 2005, respectively.

Note 8 - Goodwill and Other Intangible Assets

The following is a summary of the gross carrying amount and accumulated amortization of amortizable intangible assets as of September 30, 2006, December 31, 2005, and September 30, 2005 and the carrying amount of unamortized intangible assets as of those same dates.

September 30, 2006	December 31, 2005	Septem

($ in thousands)	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization	Gross Carry Amount
Amortizable intangible assets:					
Customer lists	$ 394	139	394	115	3
Noncompete agreements	50	50	50	50	
Core deposit premiums	2,945	1,208	2,441	1,011	2,4
Total	$ 3,389	1,397	2,885	1,176	2,8
Unamortizable intangible assets:					
Goodwill	$ 49,489		47,247		47,2
Pension	$ 237		273		2

Amortization expense totaled $100,000 and $71,000 for the three months ended September 30, 2006 and 2005, respectively. Amortization expense totaled $221,000 and $217,000 for the nine months ended September 30, 2006 and 2005, respectively.

The following table presents the estimated amortization expense for each of the five calendar years ending December 31, 2010 and the estimated amount amortizable thereafter. These estimates are subject to change in future periods to the extent management determines it is necessary to make adjustments to the carrying value or estimated useful lives of amortized intangible assets.

(Dollars in thousands)	Estimated Amortization Expense
2006	$ 323
2007	374
2008	316
2009	279
2010	262
Thereafter	658
Total	$ 2,212

Note 9 - Pension Plans

The Company sponsors two defined benefit pension plans - a qualified retirement plan (the "Pension Plan") which is generally available to all employees, and a Supplemental Executive Retirement Plan (the "SERP Plan"), which is for the benefit of certain senior management executives of the Company.

The Company recorded pension expense totaling $808,000 and $447,000 for the three months ended September 30, 2006 and 2005, respectively, related to the Pension Plan and the SERP Plan. The following table contains the components of the pension expense for the three months ended September 30, 2006 and 2005.

(in thousands)	For the Three Months Ended Sep			
	2006 Pension Plan	2005 Pension Plan	2006 SERP Plan	2005 SERP Pla
Service cost - benefits earned during the period	$ 359	284	217	
Interest cost on projected benefit obligation	222	192	111	
Expected return on plan assets	(242)	(237)	--	
Net amortization and deferral	57	86	84	
Net periodic pension cost	$ 396	325	412	1

The Company recorded pension expense totaling $1,970,000 and $1,341,000 for the nine months ended September 30, 2006 and 2005, respectively, related to the Pension Plan and the SERP Plan. The following table contains the components of the pension expense for the nine months ended September 30, 2006 and 2005.

(in thousands)	For the Nine Months Ended Se			
	2006 Pension Plan	2005 Pension Plan	2006 SERP Plan	2005 SERP Pla
Service cost - benefits earned during the period	$ 1,041	852	375	1
Interest cost on projected benefit obligation	676	576	215	1
Expected return on plan assets	(778)	(711)	--	
Net amortization and deferral	295	258	146	
Net periodic pension cost	$ 1,234	975	736	3

The Company's contributions to the Pension Plan are based on computations by independent actuarial consultants and are intended to ensure that the Pension Plan exceeds minimum funding standards at all times according to standards established by the Internal Revenue Service. The contributions are invested to provide for benefits under the Pension Plan. The Company estimates that its contribution to the Pension Plan will be $1,500,000 during 2006.

The Company's funding policy with respect to the SERP Plan is to fund the related benefits primarily from the operating cash flow of the Company. The Company estimates that its payments to participants in the SERP Plan will be $25,000 in 2006.

Note 2 includes discussion of a newly issued accounting standard that will impact the Company's accounting for its two defined benefit penion plans.

Note 10 - Contingency

The Company recorded a loss amount of $6,320,000, or $0.44 per diluted share, in the third quarter of 2005 to accrue for contingent tax loss exposure involving the North Carolina Department of Revenue. In February 2006, the North Carolina Department of Revenue announced a "Settlement Initiative" that offered

companies with certain transactions that had been challenged by the North Carolina Department of Revenue the opportunity to resolve such matters with reduced penalties by agreeing to participate in the initiative by June 15, 2006. Although the Company believed that its tax returns complied with the relevant statutes, the Board of Directors of the Company decided that it was 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 estimated 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, the Company adjusted its originally reported 2005 earnings to reflect the impact of this subsequent event by reducing originally reported tax expense for the three and twelve months ended December 31, 2005 by $1,982,000, or $0.14 per diluted share. The Company believes it has fully reserved for this liability and does not have any additional state income tax exposure other than the ongoing interest that will continue to accrue ($65,000 per quarter on an after-tax basis) until the Settlement Initiative is completed and the Company pays the amounts due in accordance with the settlement, which is expected to occur in the first quarter of 2007.

Note 11 - Completed Acquisitions

The Company completed two branch acquisitions in the third quarter of 2006 as follows:

(a) On July 7, 2006, the Company completed the purchase of a branch of First Citizens Bank located in Dublin, Virginia. The Company assumed the branch's $21 million in deposits and did not purchase any loans in this transaction. The primary reason for this acquisition was to increase the Company's presence in southwestern Virginia, a market in which the Company already had three branches with a large customer base. The Company paid a deposit premium for the branch of approximately $994,000, all of which is deductible for tax purposes. The identifiable intangible asset associated with the fair value of the core deposit base, as determined by an independent consulting firm, was determined to be $269,000 and is being amortized as expense on an accelerated basis over an eight year period based on an amortization schedule provided by the consulting firm. The remaining intangible asset of $725,000 has been classified as goodwill, and thus is not being systematically amortized, but rather is subject to an annual impairment test. The primary factors that contributed to a purchase price that resulted in recognition of goodwill were the Company's desire to expand its presence in southwestern Virginia with facilities, operations and experienced staff in place. This branch's operations are included in the accompanying Consolidated Statements of Income beginning on the acquisition date of July 7, 2006. Historical pro forma information is not presented due to the immateriality of this transaction to the overall consolidated financial statements of the Company.

(b) On September 1, 2006, the Company completed the purchase of a branch of Bank of the Carolinas in Carthage, North Carolina. The Company assumed the branch's $24 million in deposits and $6 million in loans. The primary reason for this acquisition was to increase the Company's presence in Moore County, a market in which the Company already had ten branches with a large customer base. The Company paid a deposit premium for the branch of approximately $1,754,000, all of which is deductible for tax purposes. The identifiable intangible asset associated with the fair value of the core deposit base, as determined by an independent consulting firm, was determined to be approximately $235,000 and is being amortized as expense on an accelerated basis over a ten year period based on an amortization schedule provided by the consulting firm. The remaining intangible asset of $1,519,000 has been classified as goodwill, and thus is not being systematically amortized, but rather is subject to an annual impairment test. The primary factors that contributed to a purchase price that resulted in recognition of goodwill were the Company's desire to expand in an existing

high-growth market with facilities, operations and

experienced staff in place. This branch's operations are included in the accompanying Consolidated Statements of Income beginning on the acquisition date of September 1, 2006. Historical pro forma information is not presented due to the immateriality of this transaction to the overall consolidated financial statements of the Company.

Item 2 - Management's Discussion and Analysis of Consolidated Results of Operations and Financial Condition

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 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, see "Nonperforming Assets" and "Summary of Loan Loss Experience" below.

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.

See Note 10 to the Consolidated Financial Statements above for information related to a tax loss contingency accrual that was recorded in 2005.

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 higher amount of 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 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 approximately a ten year life, with an accelerated rate of amortization. For insurance agency acquisitions, the identifiable intangible assets related to the customer lists were determined to have a life of ten to fifteen years, 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.

Current Accounting Matters

See Note 2 to the Consolidated Financial Statements above as it relates to accounting standards that have been recently adopted by the Company.

RESULTS OF OPERATIONS

Overview

The Company recorded net income of $4,372,000, or $0.30 per diluted share for the three months ended September 30, 2006, compared to a net loss of $691,000, or $0.05 per diluted share, recorded in the third quarter of 2005. Net income for the nine months ended September 30, 2006 was $14,158,000, or $0.98 per diluted share, a 63.3% increase in diluted earnings per share from the net income of $8,677,000, or $0.60 per diluted share, reported for the nine months ended September 30, 2005.

Results for 2006 include the write-off loss of a merchant credit card receivable amounting to $1,900,000, of which $230,000 was recorded in the second quarter of 2006 and the remaining $1,670,000 was recorded in the third quarter of 2006. The after-tax impact on net income for the second quarter of 2006 was $139,000, or $0.01 per diluted share, and the after-tax impact on net income for the third quarter of 2006 was $1,010,000, or $0.07 per diluted share. Results for 2005 include a loss accrual related to income tax exposure amounting to $6,320,000 (after-tax), or $0.44 per diluted share, which was recorded in the third quarter of 2005. Both of these items are discussed in more detail below.

Growth in loans and deposits was the primary reason for the increases in the Company's net interest income when comparing the three and nine month periods in 2006 to the comparable periods of 2005. Net interest income for the third quarter of 2006 amounted to $19.0 million, a 9.7% increase over the $17.4 million recorded in the third quarter of 2005. Net interest income for the nine months ended September 30, 2006 amounted to $55.3 million, a 9.3% increase over the $50.6 million recorded in the same nine month period in 2005.

The impact of the growth in loans and deposits on the Company's net interest income was partially offset by declines in the Company's net interest margin (tax-equivalent net interest income divided by average earning assets). The Company's net interest margin for the third quarter of 2006 was 4.12% compared to 4.32% for the third quarter of 2005. The Company's net interest margin for the first nine months of 2006 was 4.22% compared to 4.32% for the same nine months of 2005. The 4.12% net interest margin realized in the third quarter of 2006 was a 10 basis point decrease from the second quarter of 2006 net interest margin of 4.22%, and a 21 basis point decrease from the first quarter of 2006 net interest margin of 4.33%. The compressing margin is primarily due to deposit rates paid by the Company rising by more than loan and investment yields, which is associated with the flat interest rate yield curve currently prevailing in the marketplace. The Company has also been negatively impacted by customers shifting their funds from low cost deposits to higher cost deposits as rates have risen.

Page 20

The Company's provision for loan losses amounted to $1,215,000 in the third quarter of 2006, an increase of 76.1% over the $690,000 recorded in the third quarter of 2005. The provision for loan losses for the first nine months of 2006 was $3,630,000, an increase of 71.6% over the $2,115,000 recorded in first nine months of 2005. The higher provisions are a result of the strong loan growth realized in 2006, as asset quality ratios have remained stable and compare favorably to peers. Net internal loan growth was $55 million in the third quarter of 2006 compared to $20 million in the third quarter of 2005, while net internal loan growth was $208 million for the first nine months of 2006 compared to $79 million for the first nine months of 2005. The Company's ratios of annualized net charge-offs to average loans were 11 basis points and 8 basis points for the three and nine month periods in 2006, respectively, compared to 12 basis points and 9 basis points for the three and nine month periods in 2005, respectively. The Company's ratio of nonperforming assets to total assets was

0.34% at September 30, 2006 compared to 0.31% a year earlier.

Noninterest income amounted to $2,454,000 for the third quarter of 2006, a 35.1% decrease from the $3,779,000 recorded in the third quarter of 2005. Noninterest income for the nine months ended September 30, 2006 amounted to $10,252,000, a decrease of 8.5% from the $11,201,000 recorded in the first nine months of 2005. The decreases in 2006 were caused by the write-off loss of a merchant credit card receivable that is discussed in more detail below.

Noninterest expenses amounted to $13.5 million in the third quarter of 2006, a 17.8% increase over the $11.5 million recorded in the third quarter of 2005. Noninterest expenses for the nine months ended September 30, 2006 amounted to $39.3 million, a 10.9% increase from the $35.5 million recorded in the first nine months of 2005. The increase in noninterest expenses is primarily attributable to costs associated with the Company's overall growth in loans, deposits and branch network.

The Company's effective tax rate was approximately 35% and 37% for the three and nine month periods ended September 30, 2006, respectively. The Company recorded a tax benefit of $182,000 in the third quarter of 2006 related to several nonrecurring adjustments that reduced otherwise reported income tax expense. The Company's income tax expense for the three and nine months ended September 30, 2005 included a loss accrual related to income tax exposure amounting to $6,320,000 (after-tax), or $0.44 per diluted share, which was recorded in the third quarter of 2005 and is discussed in more detail below.

The Company's annualized return on average assets for the third quarter of 2006 was 0.88% compared to (0.16%) for the third quarter of 2005. The Company's annualized return on average assets for the nine months ended September 30, 2006 was 1.00% compared to 0.69% for the comparable period of 2005.

The Company's annualized return on average equity for the third quarter of 2006 was 10.54% compared to (1.73%) for the third quarter of 2005. The Company's annualized return on average equity for the nine months ended September 30, 2006 was 11.70% compared to 7.49% for the first nine months of 2005.

Components of Earnings

Net interest income is the largest component of earnings, representing the difference between interest and fees generated from earning assets and the interest costs of deposits and other funds needed to support those assets.

Net interest income for the three month period ended September 30, 2006 amounted to $19,041,000, an increase of $1,689,000, or 9.7%, from the $17,352,000 recorded in the third quarter of 2005. Net interest income on a taxable equivalent basis for the three months ended September 30, 2006, amounted to $19,174,000, an increase of $1,711,000, or 9.8%, from the $17,463,000 recorded in the third quarter of 2005. 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 income amounts in different periods without taking into account the different mix of taxable versus non-taxable investments that may have existed during those periods.

Net interest income for the nine months ended September 30, 2006 amounted to $55,338,000 an increase of

$4,694,000, or 9.3%, from the $50,644,000 recorded in the first nine months of 2005. Net interest income on a taxable equivalent basis for the nine months ended September 30, 2006 amounted to $55,722,000, an increase of $4,743,000, or

9.3%, from the $50,979,000 recorded in the first nine months of 2005.

There are two primary factors that cause changes in the amount of net interest income recorded by the Company - 1) growth in loans and deposits, and 2) the Company's net interest margin. For the three and nine month periods ended September 30, 2006, growth in loans and deposits were the primary causes for the increases in net interest income, as the Company's net interest margins in 2006 were lower than those realized in 2005.

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. The following tables present net interest income analysis on a taxable-equivalent basis.

	For the Three Months Ended September 30,				
	2006			200	
($ in thousands)	Average Volume	Average Rate	Interest Earned or Paid	Average Volume	Aver Ra
Assets					
Loans (1)	$1,669,423	7.54%	$ 31,727	$1,433,874	
Taxable securities	123,168	4.69%	1,456	118,927	
Non-taxable securities (2)	10,668	10.15%	273	10,438	
Short-term investments	41,301	5.61%	584	41,144	
Total interest-earning assets	1,844,560	7.32%	34,040	1,604,383	
Liabilities					
Savings, NOW and money market deposits	$ 491,630	1.59%	$ 1,976	$ 465,089	
Time deposits >$100,000	397,393	4.66%	4,668	347,057	
Other time deposits	529,120	4.23%	5,646	468,170	
Total interest-bearing deposits	1,418,143	3.44%	12,290	1,280,316	
Securities sold under agreements to repurchase	28,712	3.81%	276	6,276	
Borrowings	136,972	6.66%	2,300	79,367	
Total interest-bearing liabilities	1,583,827	3.72%	14,866	1,365,959	
Non-interest-bearing deposits	205,462			186,867	
Net yield on interest-earning assets and net interest income		4.12%	$ 19,174		
Interest rate spread		3.60%			
Average prime rate		8.25%			

(1) Average loans include nonaccruing loans, the effect of which is to lower the average rate shown.

(2) Includes tax-equivalent adjustments of $133,000 and $111,000 in 2006 and 2005, respectively, to reflect the tax benefit that the Company receives

related to its tax-exempt securities, which carry interest rates lower than similar taxable investments due to their tax exempt status. This amount has been computed assuming a 39% tax rate and is reduced by the related nondeductible portion of interest expense.

Page 22

	For the Nine Months Ended September 30,				
	2006			200	
($ in thousands)	Average Volume	Average Rate	Interest Earned or Paid	Average Volume	Aver Ra
Assets					
Loans (1)	$1,592,983	7.36%	$ 87,704	$1,408,736	
Taxable securities	118,750	4.71%	4,187	113,785	
Non-taxable securities (2)	11,516	9.03%	778	10,830	
Short-term investments	40,525	5.45%	1,652	44,780	
Total interest-earning assets	1,763,774	7.15%	94,321	1,578,131	
Liabilities					
Savings, NOW and money market deposits	$ 478,316	1.38%	$ 4,944	$ 472,361	
Time deposits >$100,000	381,029	4.39%	12,519	349,677	
Other time deposits	510,442	3.95%	15,082	446,894	
Total interest-bearing deposits	1,369,787	3.18%	32,545	1,268,932	
Securities sold under agreements to repurchase	29,376	3.69%	811	2,232	
Other, principally borrowings	106,648	6.57%	5,243	77,521	
Total interest-bearing liabilities	1,505,811	3.43%	38,599	1,348,685	
Non-interest-bearing deposits	203,064			180,667	
Net yield on interest-earning assets and net interest income		4.22%	$ 55,722		
Interest rate spread		3.72%			
Average prime rate		7.86%			

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(1) Average loans include nonaccruing loans, the effect of which is to lower the average rate shown.

(2) Includes tax-equivalent adjustments of $384,000 and $335,000 in 2006 and 2005, respectively, to reflect the tax benefit that the Company receives related to its tax-exempt securities, which carry interest rates lower than similar taxable investments due to their tax exempt status. This amount has been computed assuming a 39% tax rate and is reduced by the related nondeductible portion of interest expense.

Average loans outstanding for the third quarter of 2006 were $1.669 billion, which was 16.4% higher than the average loans outstanding for the third quarter of 2005 ($1.434 billion). Average loans outstanding for the nine months ended September 30, 2006 were $1.593 billion, which was 13.1% higher than the average loans outstanding for the nine months ended September 30, 2005 ($1.409 billion).

The mix of the Company's loan portfolio remained substantially the same at September 30, 2006 compared to December 31, 2005, with approximately 87% of the Company's loans being real estate loans, 9% being commercial, financial, and agricultural loans, and the remaining 4% being consumer installment loans. The majority of the Company's real estate loans are personal and commercial loans where real estate provides additional security for the loan.

Average total deposits outstanding for the third quarter of 2006 were $1.624 billion, which was 10.7% higher than the average deposits outstanding for the third quarter of 2005 ($1.467 billion). Average deposits outstanding for the nine months ended September 30, 2006 were $1.573 billion, which was 8.5% higher than the average deposits outstanding for the nine months ended September 30, 2005 ($1.450 billion). Generally, the Company can reinvest funds from deposits at higher yields than the interest rate being paid on those deposits, and therefore increases in deposits typically result in higher amounts of net interest income for the Company.

See additional discussion regarding the nature of the growth in loans and deposits in the section entitled "Financial Condition" below. The effect of the higher amounts of average loans and deposits was to increase net interest income in 2006.

As derived from the tables above, yields on interest earning assets and liabilities are higher for the periods presented in 2006 compared to 2005, which is a result of the rising rate environment that began in the third quarter of 2004. From July 1, 2004 to September 30, 2006, the Federal Reserve raised short-term interest rates 17 times totaling 425 basis points. The tables also indicate that the interest-bearing liability rates paid by the Company have risen by more than yields realized on interest-earning assets. For each of the three and nine month periods ended September 30, 2006, interest-earning asset yields have increased by 85-88 basis points, whereas the average rate paid on interest-bearing liabilities has risen by 115-119 basis points. This narrowing spread was caused by rates paid on most of the Company's categories of interest-bearing liabilities increasing by more than the increases in yields realized on most of the Company's earning assets, which was primarily caused by the flat interest rate yield curve prevailing in the marketplace. The spread has also been negatively impacted by customers shifting their funds from low cost deposits to high cost deposits as rates have risen. As a result of the narrowed interest rate spread, the Company's net interest margin (tax-equivalent net interest income divided by average earning assets) has declined in 2006, with the Company's net interest margin amounting to 4.12% in the third quarter of 2006 compared to 4.32% in the third quarter of 2005, and the Company's net interest margin amounting to 4.22% for the nine months ended September 30, 2006 compared to 4.32% for the same nine months of 2005.

See additional information regarding net interest income in the section entitled "Interest Rate Risk" (Item 3 below).

The provision for loan losses amounted to $1,215,000 in the third quarter of 2006 compared to $690,000 in the third quarter of 2005, and the provision for loan losses for the first nine months of 2006 was $3,630,000 compared to

$2,115,000 for the first nine months of 2005. The higher provisions for loan losses in 2006 compared to 2005 are a result of the strong loan growth realized in 2006, as asset quality ratios have remained stable and compare favorably to peers. Net internal loan growth was $55 million in the third quarter of 2006 compared to $20 million in the third quarter of 2005, while net internal loan growth was $208 million for the first nine months of 2006 compared to $79 million for the first nine months of 2005. The Company's ratios of annualized net charge-offs to average loans were 11 basis points and 8 basis points for the three and nine month periods in 2006, respectively, compared to 12 basis points and 9 basis points for the three and nine month periods in 2005, respectively. The Company's level of nonperforming assets to total assets was 0.34% at September 30, 2006 compared to 0.31% a year earlier

Noninterest income amounted to $2,454,000 for the third quarter of 2006, a 35.1% decrease from $3,779,000 recorded in the third quarter of 2005. Noninterest income for the nine months ended September 30, 2006 amounted to $10,252,000, a decrease of 8.5% from the $11,201,000 recorded in the first nine months of 2005. The decreases in 2006 were caused by the write-off loss of a merchant credit card receivable. During the second quarter of 2006, the Company discovered that it had liability associated with a customer that sold furniture over the internet. The furniture store did not deliver furniture that its customers had ordered and paid for, and was unable to immediately refund their credit card purchases. As the furniture store's credit card processor, the Company became liable for the amounts that were required to be refunded. During the second quarter of 2006, the furniture store changed management, stated its intention to repay the Company for all funds advanced, and began making repayments to the Company. At June 30, 2006, the Company recorded a $230,000 loss to reserve for this situation. During the third quarter of 2006, the furniture store's financial condition deteriorated significantly. Accordingly, the Company determined that it should fully reserve for the entire $1.9 million exposure associated with this situation, which resulted in recording an additional loss of $1,670,000. The owners of the furniture store continue to state their intent to repay the Company, but at this time their ability to do so is uncertain. During the third quarter of 2006, the Company completed a review of all merchant credit card customers and concluded that this situation appears to be an isolated event that is not likely to recur.

Noninterest income was positively impacted in 2006 as a result of higher "other service charges, commissions, and fees." 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, as well as the overall growth in the Company's total customer base. Other service charges, commissions and fees amounted to $1,102,000 in the third quarter of 2006, a

14.7% increase from the $961,000 recorded in the third quarter of 2005. Other service charges, commissions and fees amounted to $3,426,000 for the first nine months of 2006, a 16.1% increase from the $2,950,000 recorded through September 30, 2005.

Noninterest income for the nine months ended September 30, 2006 was negatively impacted by a decrease in data processing income, which declined by $130,000 when comparing the first nine months of 2006 to the comparable period in 2005. At January 1, 2005, the Company had five community bank customers using this service. Three of these customers terminated their contracts with the Company in the latter half of 2005, which resulted in the decrease in data

processing fee income. The Company intends to continue to market this service to area banks, but does not currently have any near-term prospects for additional business.

Also impacting noninterest income were securities gains in the amount of $205,000 in 2006 and $2,000 in 2005, each of which was recorded in the second quarter of the respective year.

Noninterest expenses amounted to $13.5 million in the third quarter of 2006, a 17.8% increase over the $11.5 million recorded in the third quarter of 2005. Noninterest expenses for the nine months ended September 30, 2006 amounted to $39.3 million, a 10.9% increase from the $35.5 million recorded in the first nine months of 2005. The increase in noninterest expenses is primarily attributable to costs associated with the Company's overall growth in loans, deposits and branch network. Since January 1, 2005, the Company's loans and deposits have increased by 24% and 20%, respectively. Additionally, in accordance with the new accounting requirements regarding stock-based compensation (FASB Statement 123(R)) that were effective on January 1, 2006, the Company recorded stock option expense of $22,000 ($22,000 after-tax effect) and $314,000 ($235,000 after-tax effect) for the three and nine month periods ended September 30, 2006, respectively. As permitted by previous accounting standards, no stock option expense was recorded by the Company in 2005, or any prior periods. Noninterest expenses for the nine months ended September 30, 2005 were also impacted by approximately $500,000 in the following miscellaneous expenses, all of which were recorded in the second quarter of 2005: immediately vested post-retirement benefits granted to the Company's CEO totaling $196,000, external Sarbanes-Oxley costs related to the prior year Sarbanes-Oxley certification of $181,000, and public relation expenses of $123,000 associated with the Company's sponsorship of the 2005 U.S. Open Golf Tournament that was held in the Company's largest market - Moore County, North Carolina.

The Company's effective tax rate was approximately 35% and 37% for the three and nine month periods ended September 30, 2006, respectively. The Company recorded a tax benefit of $182,000 in the third quarter of 2006 related to several nonrecurring adjustments that reduced otherwise reported income tax expense. The Company's income tax expense for the three and nine months ended September 30, 2005 includes a loss accrual related to income tax exposure amounting to $6,320,000 (after-tax), or $0.44 per diluted share, which was recorded in the third quarter of 2005. As discussed more fully in the Company's 2005 Form 10-K filed with the Securities and Exchange Commission, during the third quarter of 2005, the Company recorded a $6,320,000 loss accrual to reserve for an audit issue raised by the North Carolina Department of Revenue related to the Company's operating structure that the Department of Revenue deemed to result in improper "income shifting." This reserve was subsequently reduced in the fourth quarter of 2005 by $1,982,000, or $0.14 per diluted share, as a result of a "Settlement Initiative" offered by the North Carolina Department of Revenue that offered companies with certain transactions, including those that applied to the Company, the opportunity to resolve such matters with reduced penalties by agreeing to participate in the initiative. The Company continues to participate in the initiative and expects the matter to be resolved and all amounts paid by March 15, 2007. The aspects of the Company's operating 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).

The Consolidated Statements of Comprehensive Income reflect "Other Comprehensive Income" of $955,000 during the third quarter of 2006 and "Other Comprehensive Loss" of $208,000 for the nine months ended September 30, 2006, compared to "Other Comprehensive Loss" of $502,000 for the third quarter of 2005 and "Other Comprehensive Loss" of $817,000 for the nine months ended September 30, 2005. The primary

component of other comprehensive income/loss for the periods presented relates to changes in unrealized holding gains/losses of the Company's available for sale securities. The Company's available for sale securities portfolio is predominantly comprised of fixed rate bonds that increase in value when market yields for fixed rate bonds decrease and decline in value when market yields for fixed rate bonds increase.

FINANCIAL CONDITION

Total assets at September 30, 2006 amounted to $2.08 billion, 18.2% higher than a year earlier. Total loans at September 30, 2006 amounted to $1.70 billion, a 17.3% increase from a year earlier, and total deposits amounted to $1.66 billion at September 30, 2006, a 12.8% increase from a year earlier.

The following tables present information regarding the nature of the Company's growth since September 30, 2005.

October 1, 2005 to September 30, 2006	Balance at beginning of period	Internal Growth	Growth from Acquisitions	Balance at end of period	T per g
			($ in thousands)		
Loans	$ 1,446,185	244,901	5,749	1,696,835	
Deposits - Noninterest bearing	$ 192,399	15,136	4,974	212,509	
Deposits - Savings, NOW, and Money Market	460,709	24,497	11,891	497,097	
Deposits - Time>$100,000	349,620	56,759	4,799	411,178	
Deposits - Time					