SOUTHERN MICHIGAN BANCORP INC
Form 10-Q
May 14, 2001

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarter ended March 31, 2001    Commission file number 2-78178

Southern Michigan Bancorp, Inc.

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Michigan | 38-2407501 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification Number) |
| 51 West Pearl Street, Coldwater, Michigan | 49036 |
| (Address of principal executive offices) | (Zip Code) |

Registrant's telephone number, including area code -- (517) 279-5500

Indicate by check mark whether registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No.

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

Common Stock, $2.50 Par Value - 1,940,469 shares at April 30, 2001 (including shares held by ESOP)

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CONDENSED CONSOLIDATED BALANCE SHEETS

SOUTHERN MICHIGAN BANCORP, INC AND SUBSIDIARY

March 31
2001
(Unaudited)
(In

| | | |
|---|---|---|
| ASSETS | | |
| Cash and due from banks | $ | 20,013 |
| Securities available for sale | | 54,340 |
| Loans, net of allowance for loan losses of $1,523 (2000 - $2,096) | | 206,146 |
| Federal funds loaned | | 500 |
| Premises and equipment | | 8,503 |
| Other assets | | 12,583 |
| TOTAL ASSETS | $ | 302,085 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Deposits: | | |
| Non-interest bearing | $ | 35,995 |
| Interest bearing | | 213,485 |
| | | 249,480 |
| Federal funds purchased | | - |
| Accounts payable and other liabilities | | 3,088 |
| Other long-term borrowings | | 23,000 |
| TOTAL LIABILITIES | | 275,568 |
| Common stock subject to repurchase obligation in ESOP | | 1,732 |
| Shareholders' equity: | | |
| Preferred stock, 100,000 shares authorized | | |
| Common stock, $2.50 par value: | | |
| Authorized--4,000,000 shares | | |
| Issued--1,940,469 shares (2000 - 1,940,502) | | |
| Outstanding--1,828,728 shares (2000 - 1,831,064) | | 4,572 |
| Capital surplus | | 9,823 |
| Retained earnings | | 10,348 |
| Net unrealized appreciation on available for sale securities | | 630 |
| Unearned Employee Stock Ownership Plan shares | | (588) |
| TOTAL SHAREHOLDERS' EQUITY | | 24,785 |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | $ | 302,085 |

(A) The balance sheet at December 31, 2000 has been derived from the audited consolidated financial statements at that date.

See notes to condensed consolidated financial statements.





CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

SOUTHERN MICHIGAN BANCORP, INC. AND SUBSIDIARY

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2001

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|---|---|
| Interest income: | |
| Loans, including fees | $ |
| Securities: | |
| Taxable | |
| Tax exempt | |
| Other | |
| Total interest income | |
| Interest expense: | |
| Deposits | |
| Other | |
| Total interest expense | |
| NET INTEREST INCOME | |
| Provision for loan losses | |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | |
| Non-interest income: | |
| Service charges on deposit accounts | |
| Trust fees | |
| Gain on sales of securities | |
| Gain on sales of loans | |
| Earnings on life insurance policies | |
| Other | |
| Non-interest expense: | |
| Salaries and benefits | |
| Occupancy | |
| Equipment | |
| Other | |
| INCOME BEFORE INCOME TAXES | |
| Federal income taxes | |
| NET INCOME | |
| Other comprehensive income/(loss), net of tax: | |
| COMPREHENSIVE INCOME | $ |
| Basic and Diluted Earnings Per Share | |
| Dividends Declared Per Share | |

See notes to condensed consolidated financial statements.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

SOUTHERN MICHIGAN BANCORP, INC. AND SUBSIDIARY

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|---|---|
| | 2001 |
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| **OPERATING ACTIVITIES** | |
| Net income | $ 674 |
| Adjustments to reconcile net income to net cash provided by operating activities: | |
| Provision for loan losses | 375 |
| Provision for depreciation | 178 |
| Net realized gain on sales of securities | (6) |
| Net change in: | |
| Other assets | 934 |
| Accrued expenses and other liabilities | (392) |
| Net cash provided by operating activities | 1,763 |
| **INVESTING ACTIVITIES** | |
| Proceeds from sales of securities | 2,125 |
| Proceeds from maturity of securities | 5,732 |
| Purchases of securities | (10,041) |
| Increase in federal funds sold | (500) |
| Net (increase) decrease in loans | 5,788 |
| Net increase in premises and equipment | (1,062) |
| Net cash provided by (used in) investing activities | 2,042 |
| **FINANCING ACTIVITIES** | |
| Net increase (decrease) in deposits | 4,050 |
| Increase (decrease) in federal funds purchased | (4,000) |
| Decrease in long term borrowings | (2,000) |
| Common stock repurchased and retired | (1) |
| Cash dividends | (330) |
| Net cash provided by (used in) financing activities | (2,281) |
| Increase in cash and cash equivalents | 1,524 |
| Cash and cash equivalents at beginning of period | 18,489 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | $ 20,013 |

See notes to condensed consolidated financial statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

SOUTHERN MICHIGAN BANCORP, INC. AND SUBSIDIARY

March 31, 2001

NOTE A -- BASIS OF PRESENTATION

The accompanying year-end balance sheet data was derived from audited consolidated financial statements, but does not include all disclosures required by generally accepted accounting principles.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2000.

Basic earnings per common share is net income divided by the weighted average number of common shares outstanding during the period. ESOP shares are considered outstanding for this calculation unless unearned. Diluted earnings per common share includes the dilutive effect of additional potential common shares issuable under stock options. Earnings and dividends per share are restated for all stock splits and dividends through the date of issue of the financial statements. The weighted average common shares outstanding for the quarters ended March 31, 2001 and 2000 were 1,925,094 and 1,946,047 respectively.





ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

FINANCIAL CONDITION

Total deposits increased by 1.7% during the first quarter of 2001. The Company has traditionally experienced a decline in deposits in the first quarter of the year, however, with the stock market decline, the Company has experienced an influx of money into the certificate of deposit portfolio.

Loans have decreased by 2.9% in the first three months of 2001. The decrease has occurred in the consumer and real estate mortgage portfolios. The largest decrease occurred in the real estate mortgage portfolio. Due to lower interest rates, many existing customers have rewritten their adjustable rate loans into fixed rate loans which were then sold to the secondary market. There were $228,000 in loans held for sale as of March 31, 2001.

Investment securities increased by 5.6% during the first quarter of 2001. Funds received from increased deposits were used to purchase additional securities.

There were no significant fixed asset commitments as of March 31, 2001.

On April 17, 2001, 10,191 options to purchase shares of stock were granted by the Board of Directors under the 2000 Stock Option plan.

CAPITAL RESOURCES

The Federal Reserve Board (FRB) has adopted risk-based capital guidelines applicable to the Company. These guidelines require that bank holding companies maintain capital commensurate with both on and off balance sheet credit risks of their operations. Under the guidelines, a bank holding company must have a minimum ratio of total capital to risk-weighted assets of 8.0 percent. In addition, a bank holding company must maintain a minimum ratio of Tier 1 capital equal to 4.0 percent of risk-weighted assets. Tier 1 capital includes common shareholders' equity, qualifying perpetual preferred stock and minority interest in equity accounts of consolidated subsidiaries less goodwill.

As a supplement to the risk-based capital requirements, the FRB has also adopted leverage capital ratio requirements. The leverage ratio requirements establish a minimum ratio of Tier 1 capital to total assets less goodwill of 3 percent for the most highly rated bank holding companies. All other bank holding companies are required to maintain additional Tier 1 capital yielding a leverage ratio of 4 percent to 5 percent, depending on the particular circumstances and risk profile of the institution.





The following table summarizes the Company's capital ratios as of March 31, 2001:

| | |
|---|---|
| Tier 1 risk-based capital ratio | 11.12% |
| Total risk-based capital ratio | 11.80% |
| Leverage ratio | 8.31% |

The above table indicates that the Company's capital ratios are above the regulatory minimum requirements.

RESULTS OF OPERATIONS

Net Interest Income

Net interest income declined by $114,000 for the three month period ended March 31, 2001 compared to the same period in 2000. This decrease is the result of a slight decrease in the Company's margin due to competitive pressures on loan rates and higher costs associated with cost of funds, such as interest bearing deposits and FHLB borrowings.

Provision for Loan Losses

The provision for loan losses is based on an analysis of outstanding loans. In assessing the adequacy of the allowance, management reviews the characteristics of the loan portfolio in order to determine the overall quality and risk profile. Some factors considered by management in determining the level at which the allowance is maintained include a continuing evaluation of those loans identified as being subject to possible problems in collection, results of examinations by regulatory agencies, current economic conditions and historical loan loss experience.

The first quarter 2001 provision for loan losses was $225,000 higher than 2000 levels. The increase was the result of the charge-off of one commercial loan of $673,000 for which $526,000 had previously been reserved in the allowance for loan loss. The allowance for loan losses is being maintained at a level, which in management's opinion, is adequate to absorb probable loan losses in the loan portfolio as of March 31, 2001.

Non-interest Income

Non-interest income, which includes service charges on deposit accounts, gain on sale of loans, trust fee income, security gains and losses and other miscellaneous charges and fees, increased by $168,000 during the first quarter





of 2001 compared to the same period in 2000. The increase was primarily due to gains recognized on the sale of real estate mortgage loans to the secondary market. In order to reduce the risk associated with changing interest rates, the Company regularly sells fixed rate real estate mortgage loans on the secondary market.

The Company recognizes a profit at the time of sale. During a period of relatively low interest rates, the Company has generated large volumes of fixed rate mortgage loans.

Non-interest Expense

Non-interest expenses decreased by $43,000 for the three month period ended March 31, 2001 compared to the same period in 2000, reflecting management's continued efforts toward improving operating efficiencies.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company's primary market risk exposure is interest rate risk and to a lesser extent, liquidity risk. Interest rate risk arises when the maturity or repricing characteristics of assets differ significantly from the maturity or the repricing characteristics of liabilities. Accepting this risk can be an important source of profitability and shareholder value, however, excessive levels of interest rate risk could pose a significant threat to the Company's earnings and capital base. Accordingly, effective risk management that maintains interest rate risk at prudent levels is essential to the Company's safety and soundness.

The Company measures the impact of changes in interest rates on net interest income through a comprehensive analysis of the Bank's interest rate sensitive assets and liabilities. Interest rate sensitivity varies with different types of interest-earning assets and interest-bearing liabilities. Overnight federal funds and mutual funds on which rates change daily and loans which are tied to the prime rate or a comparable index differ considerably from long-term investment securities and fixed-rate loans. Similarly, certificates of deposit and money market investment accounts are much more interest sensitive than passbook savings accounts. The shorter term interest rate sensitivities are key to measuring the interest sensitivity gap, or excess interest-earning assets over interest-bearing liabilities. In addition to reviewing the interest sensitivity gap, the Company also analyzes projected changes in market interest rates and the resulting effect on net interest income.





Liquidity management involves the ability to meet the cash flow requirements of customers who may be either depositors wanting to withdraw funds or borrowers needing assurance that sufficient funds will be available to meet their credit needs. Certain portions of the Bank's liabilities may be short-term or due on demand, while most of its assets may be invested in long-term loans or investments. Accordingly, the Company seeks to have in place sources of cash to meet short-term demands. These funds can be obtained by increasing deposits, borrowing or selling assets. Also, Federal Home Loan Bank advances and short-term borrowings provide additional sources of liquidity for the Company.

There have been no significant changes in the distribution of the Company's financial instruments that are sensitive to changes in interest rates during the first quarter of 2001.

PART II - OTHER INFORMATION

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

None.

ITEM 6. Exhibits and Reports on Form 8-K

a. Form 8-K was filed during the first quarter of 2001 announcing the Registrant's adoption of a Stock Repurchase Program.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Southern Michigan Bancorp, Inc.
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(Registrant)

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| MAY 12, 2001 | JAMES T. GROHALSKI |
| Date | James T. Grohalski, President<br>and Chief Executive Officer<br>(Principal Financial and<br>Accounting Officer) |