FIRST BANCORP /NC/
Form 10-K
March 14, 2008

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

FORM 10-K

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

For the fiscal year ended December 31, 2007

Commission File Number 0-15572

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

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

Securities Registered Pursuant to Section 12(b) of the Act:
COMMON STOCK, NO PAR VALUE
(Title of each class)

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the

Exchange Act during the preceding twelve months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. ý YES o NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-K or any amendment to the Form 10-K. ý

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one)

o Large Accelerated Filer	ý Accelerated Filer	o Non-Accelerated Filer (Do not check if a smaller reporting company)	o Smaller Reporting Company

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

The aggregate market value of the Common Stock, no par value, held by non-affiliates of the registrant, based on the closing price of the Common Stock as of June 30, 2007 as reported by The NASDAQ Global Select Market, was approximately $225,809,891.

The number of shares of the registrant's Common Stock outstanding on February 29, 2008 was 14,377,980.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement to be filed pursuant to Regulation 14A are incorporated herein by reference into Part III.

CROSS REFERENCE INDEX

		Begins on Page (s)
	PART I	
Item 1	Business	4
Item 1A	Risk Factors	13
Item 1B	Unresolved Staff Comments	15
Item 2	Properties	15
Item 3	Legal Proceedings	15
Item 4	Submission of Matters to a Vote of Shareholders	15
	PART II	
Item 5	Market for the Registrant's Common Stock, Related Shareholder Matters, and Issuer Purchases of Equity Securities	16
Item 6	Selected Consolidated Financial Data	18, 50
Item 7	Management's Discussion and Analysis of Financial Condition	
	and Results of Operations	18
	Critical Accounting Policies	18
	Merger and Acquisition Activity	20
	Overview Comparison of 2007 to 2006	21
	Overview Comparison of 2006 to 2005	23
	Statistical Information	
	Net Interest Income	25, 51
	Provision for Loan Losses	28, 57
	Noninterest Income	28, 52
	Noninterest Expenses	30, 52
	Income Taxes	30, 53
	Stock-Based Compensation	31
	Distribution of Assets and Liabilities	34, 53
	Securities	35, 53
	Loans	36, 55
	Nonperforming Assets	37, 56
	Allowance for Loan Losses and Loan Loss Experience	39, 56
	Deposits and Securities Sold Under Agreements to Repurchase	40, 57
	Borrowings	41
	Liquidity, Commitments, and Contingencies	43, 59
	Off-Balance Sheet Arrangements and Derivative Financial Instruments	44
	Interest Rate Risk (Including Quantitative and Qualitative Disclosures About Market Risk)	44, 58
	Return on Assets and Equity	47, 60
	Capital Resources and Shareholders' Equity	47, 61
	Inflation	49
	Current Accounting and Regulatory Matters	49
Item 7A	Quantitative and Qualitative Disclosures About Market Risk	49

Forward-Looking Statements		49
Item 8	Financial Statements and Supplementary Data:	
	Consolidated Balance Sheets as of December 31, 2007 and 2006	63
	Consolidated Statements of Income for each of the years in the three-year period ended December 31, 2007	64

		Begins on Page (s)
	Consolidated Statements of Comprehensive Income for each of the years in the three-year period ended December 31, 2007	65
	Consolidated Statements of Shareholders' Equity for each of the years in the three-year period ended December 31, 2007	66
	Consolidated Statements of Cash Flows for each of the years in the three-year period ended December 31, 2007	67
	Notes to Consolidated Financial Statements	68
	Reports of Independent Registered Public Accounting Firm	102
	Selected Consolidated Financial Data	50
	Quarterly Financial Summary	62
Item 9	Changes in and Disagreements with Accountants on Accounting and Financial Disclosures	104
Item 9A	Controls and Procedures	104
Item 9B	Other Information	105
	PART III	
Item 10	Directors, Executive Officers and Corporate Governance	106*
Item 11	Executive Compensation	106*
Item 12	Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters	106*
Item 13	Certain Relationships and Related Transactions, and Director Independence	106*
Item 14	Principal Accountant Fees and Services	106*
	PART IV	
Item 15	Exhibits and Financial Statement Schedules	106
	SIGNATURES	109

* Information called for by Part III (Items 10 through 14) is incorporated herein by reference to the Registrant's definitive Proxy Statement for the 2008 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission on or before April 29, 2008.

Index

PART I

Item 1. Business

General Description

The Company

First Bancorp (the "Company") is a bank holding company. The principal activity of the Company is the ownership and operation of First Bank (the "Bank"), a state-chartered bank with its main office in Troy, North Carolina. The Company also owns and operates a nonbank subsidiary, Montgomery Data Services, Inc. ("Montgomery Data"), a data processing company. This subsidiary is fully consolidated for financial reporting purposes. The Company is also the parent to a series of statutory business trusts organized under the laws of the State of Delaware that were created for the purpose of issuing trust preferred debt securities. The Company's outstanding debt associated with these trusts was $46.4 million and $67.0 million at December 31, 2007 and 2006, respectively.

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

The Bank was organized in 1934 and began banking operations in 1935 as the Bank of Montgomery, named for the county in which it operated. As of December 31, 2007, the Bank operated in a 26-county area centered in Troy, North Carolina. Troy, population 3,500, is located in the center of Montgomery County, approximately 60 miles east of Charlotte, 50 miles south of Greensboro, and 80 miles southwest of Raleigh. The Bank conducts business from 70 branches located within a 120-mile radius of Troy, covering principally a geographical area from Latta, South Carolina to the southeast, to Wilmington, North Carolina to the east, to Radford, Virginia to the north, to Wytheville, Virginia to the northwest, and to Harmony, North Carolina to the west. The Bank also has a loan production office in Blacksburg, which is located in southwestern Virginia and represents the Bank's furthest location to the north of Troy. Of the Bank's 70 branches, 63 are in North Carolina, with three branches in South Carolina and four braches in Virginia (where the Bank operates under the name "First Bank of Virginia"). Ranked by assets, the Bank was the 7th largest bank headquartered in North Carolina as of December 31, 2007.

As of December 31, 2007, the Bank had one wholly owned subsidiary, First Bank Insurance Services, Inc. ("First Bank Insurance"). First Bank Insurance was acquired as an active insurance agency in 1994 in connection with the Company's acquisition of a bank that had an insurance subsidiary. On December 29, 1995, the insurance agency operations of First Bank Insurance were divested. From December 1995 until October 1999, First Bank Insurance was inactive. In October 1999, First Bank Insurance began operations again as a provider of non-FDIC insured investments and insurance products. Currently, First Bank Insurance's primary business activity is the placement of property and casualty insurance coverage.

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

General Business

The Bank engages in a full range of banking activities, with the acceptance of deposits and the making of loans being its most basic activities. The Bank offers deposit products such as checking, savings, NOW and money market

accounts, as well as time deposits, including various types of certificates of deposits (CDs) and individual retirement accounts (IRAs).

Index

The Bank provides loans for a wide range of consumer and commercial purposes, including loans for business, agriculture, real estate, personal uses, home improvement and automobiles. The Bank also offers credit cards, debit cards, letters of credit, safe deposit box rentals, bank money orders and electronic funds transfer services, including wire transfers. In addition, the Bank offers internet banking, cash management and bank-by-phone capabilities to its customers, and is affiliated with ATM networks that give Bank customers access to 50,000 ATMs, with no surcharge fee. In 2005, the Bank began offering repurchase agreements (also called securities sold under agreement to repurchase), which are similar to interest-bearing deposits and allow the Bank to pay interest to business customers without statutory limitations on the number of withdrawals that these customers can make. In 2007, the Bank introduced remote capture, which allows business customers with a method to electronically transmit checks received from customers into their bank account without having to visit a branch. Also in 2007, the Bank began an initiative to grow its Hispanic customer base by opening two uniquely Hispanic branches under the trade name "Primer Banco," which means First Bank in Spanish. The Hispanic population is the fastest growing segment in the Bank's market area.

Because the majority of the Bank's customers are individuals and small to medium-sized businesses located in the counties it serves, management does not believe that the loss of a single customer or group of customers would have a material adverse impact on the Bank. There are no seasonal factors that tend to have any material effect on the Bank's business, and the Bank does not rely on foreign sources of funds or income. Because the Bank operates primarily within the central Piedmont region of North Carolina, the economic conditions within that area could have a material impact on the Company. See additional discussion below in the section entitled "Territory Served and Competition."

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

Montgomery Data's primary business is to provide electronic data processing services for the Bank. Ownership and operation of Montgomery Data allows the Company to do all of its electronic data processing without paying fees for such services to an independent provider. Maintaining its own data processing system also allows the Company to adapt the system to its individual needs and to the services and products it offers. Although not a significant source of income, Montgomery Data has historically made its excess data processing capabilities available to area financial institutions for a fee. For the years ended December 31, 2007, 2006 and 2005, external customers provided gross revenues of $204,000, $162,000 and $279,000, respectively. During 2005, two of the five customers terminated their services with Montgomery Data and switched to another provider. During 2006, one other customer terminated its service, which left Montgomery Data with two outside customers as of December 31, 2006 and 2007. Montgomery Data intends to continue to market its services to area banks, but does not currently have any near-term prospects for additional business.

Until December 31, 2007, the Company had another subsidiary, First Bancorp Financial Services. First Bancorp Financial was originally organized under the name of First Recovery in September of 1988 for the purpose of providing a back-up data processing site for Montgomery Data and other financial and non-financial clients. First Recovery's back-up data processing operations were divested in 1994. Since that time, First Bancorp Financial had been occasionally used to purchase and dispose of parcels of real estate that had been acquired by the Bank through foreclosure or from branch closings. First Bancorp Financial Services had been substantially inactive for most of the last decade, and the Company elected to dissolve this subsidiary effective December 31, 2007.

Index

First Bancorp Capital Trust I was organized in October 2002 for the purpose of issuing $20.6 million in debt securities. These debt securities were called by the Company at par on November 7, 2007 and First Bancorp Capital Trust I was dissolved.

First Bancorp Capital Trust II and First Bancorp Capital Trust III were organized in December 2003 for the purpose of issuing $20.6 million in debt securities ($10.3 million were issued from each trust). These borrowings are due on December 19, 2033 and are also structured as trust preferred capital securities in order to qualify as regulatory capital. These debt securities are callable by the Company at par on any quarterly interest payment date beginning on January 23, 2009. The interest rate on these debt securities adjusts on a quarterly basis at a weighted average rate of three-month LIBOR plus 2.70%.

First Bancorp Capital Trust IV was organized in April 2006 for the purpose of issuing $25.8 million in debt securities. These borrowings are due on June 15, 2036 and are structured as trust preferred capital securities, which qualify as capital for regulatory capital adequacy requirements. These debt securities are callable by the Company at par on any quarterly interest payment date beginning on June 15, 2011. The interest rate on these debt securities adjusts on a quarterly basis at a rate of three-month LIBOR plus 1.39%.

Territory Served and Competition

The Company’s headquarters are located in Troy, Montgomery County, North Carolina. The Company serves primarily the south central area of the Piedmont region of North Carolina. The following table presents, for each county where the Company operates, the number of bank branches operated by the Company within the county at December 31, 2007, the approximate amount of deposits with the Company in the county as of December 31, 2007, the Company’s approximate market share at June 30, 2007, and the number of bank competitors located in the county at June 30, 2007.

County	No. of Branches	Deposits (in millions)	Market Share	Number of Competitors
Anson, NC	1	$ 11	4.1%	5
Brunswick, NC	3	22	1.2%	12
Cabarrus, NC	2	36	2.0%	11
Chatham, NC	2	45	8.6%	10
Davidson, NC	3	117	5.7%	10
Dillon, SC	3	70	26.0%	2
Duplin, NC	3	67	13.8%	7
Guilford, NC	1	32	0.4%	25
Harnett, NC	3	117	12.5%	8
Iredell, NC	2	30	1.4%	17
Lee, NC	4	189	23.0%	8
Montgomery, NC	5	92	36.0%	4
Montgomery, VA	1	20	1.3%	10
Moore, NC	11	394	26.8%	10
New Hanover, NC	2	18	0.3%	16
Pulaski, VA	1	21	5.6%	8

Randolph, NC	5	62	3.8%	15
Richmond, NC	1	33	5.9%	6
Robeson, NC	5	159	16.2%	10
Rockingham, NC	1	25	2.17%	10
Rowan, NC	2	44	3.1%	12
Scotland, NC	2	51	15.3%	6
Stanly, NC	4	96	10.9%	6
Wake, NC	1	18	0.1%	28
Washington, VA	1	21	2.2%	15
Wythe, VA	1	48	10.4%	10
Total	70	$ 1,838		

Index

The Company's 70 branches and facilities are primarily located in small communities whose economies are based primarily on services, manufacturing and light industry. Although the Company's market is predominantly small communities and rural areas, the market area is not dependent on agriculture. Textiles, furniture, mobile homes, electronics, plastic and metal fabrication, forest products, food products, chicken hatcheries, and cigarettes are among the leading manufacturing industries in the trade area. Leading producers of lumber and rugs are located in Montgomery County. The Pinehurst area within Moore County is a widely known golf resort and retirement area. The High Point area is widely known for its furniture market. New Hanover and Brunswick Counties are in the southeastern coastal region of North Carolina, which are popular with tourists and have significant retirement populations. Additionally, several of the communities served by the Company are "bedroom" communities of large cities like Charlotte, Raleigh and Greensboro, while several branches are located in medium-sized cities such as Albemarle, Asheboro, High Point, Southern Pines and Sanford. The Company also has branches in small communities such as Bennett, Polkton, Vass, and Harmony.

Approximately 21% of the Company's deposit base is in Moore County, and approximately 10% is in Lee County. Accordingly, material changes in competition, the economy or population of Moore or Lee counties could materially impact the Company. No other county comprises more than 10% of the Company's deposit base.

The Company competes in its various market areas with, among others, several large interstate bank holding companies that are headquartered in North Carolina. These large competitors have substantially greater resources than the Company, including broader geographic markets, higher lending limits and the ability to make greater use of large-scale advertising and promotions. A significant number of interstate banking acquisitions have taken place in the past decade, thus further increasing the size and financial resources of some of the Company's competitors, three of which are among the largest bank holding companies in the nation. In many of the Company's markets, the Company also competes against banks that have been organized within the past ten years. These new banks often focus on loan and deposit balance sheet growth, and not necessarily on earnings profitability. This strategy often allows them to offer more attractive terms on loans and deposits than the Company is able to offer because the Company must achieve an acceptable level of profitability. Moore County, which as noted above comprises a disproportionate share of the Company's deposits, is a particularly competitive market, with at least ten other financial institutions having a physical presence. See "Supervision and Regulation" below for a further discussion of regulations in the Company's industry that affect competition.

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

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

Lending Policy and Procedures

Conservative lending policies and procedures and appropriate underwriting standards are high priorities of the Bank. Loans are approved under the Bank's written loan policy, which provides that lending officers, principally branch managers, have authority to approve loans of various amounts up to $350,000. Each of the Bank's regional senior lending officers has discretion to approve secured loans of various principal amounts up to $500,000 and together can approve loans up to $3,000,000. Lending limits may vary depending upon whether the loan is secured or unsecured.

Index

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

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

The Bank also contracts with an independent consulting firm to review new loan originations meeting certain criteria, as well as to assign risk grades to existing credits meeting certain thresholds. The consulting firm's observations, comments, and risk grades, including variances with the Bank's risk grades, are shared with the audit committee of the Company's board of directors, and are considered by management in setting Bank policy, as well as in evaluating the adequacy of the allowance for loan losses. The consulting firm also provides training on a periodic basis to the Company's loan officers to keep them updated on current developments in the marketplace. For additional information, see "Allowance for Loan Losses and Loan Loss Experience" under Item 7 below.

Investment Policy and Procedures

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

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

Mergers and Acquisitions

As part of its operations, the Company has pursued an acquisition strategy over the years to augment its internal growth. The Company regularly evaluates the potential acquisition of, or merger with, various financial institutions.

8

Index

The Company's acquisitions to date have generally fallen into one of three categories - 1) an acquisition of a financial institution or branch thereof within a market in which the Company operates, 2) an acquisition of a financial institution or branch thereof in a market contiguous or nearly contiguous to a market in which the Company operates, or 3) an acquisition of a company that has products or services that the Company does not currently offer.

The Company believes that it can enhance its earnings by pursuing these types of acquisition opportunities through any combination or all of the following: 1) achieving cost efficiencies, 2) enhancing the acquiree's earnings or gaining new customers by introducing a more successful banking model with more products and services to the acquiree's market base, 3) increasing customer satisfaction or gaining new customers by providing more locations for the convenience of customers, and 4) leveraging the Company's customer base by offering new products and services.

Since 2000, the Company has completed acquisitions in all three categories described above. During that time, the Company has 1) completed three whole-bank acquisitions, with one being in the existing market area and the other two being in contiguous markets, with assets totaling approximately $500 million, 2) purchased ten bank branches from other banks (both in the existing market area and in contiguous/nearly contiguous markets) with total assets of approximately $250 million, and 3) acquired two insurance agencies, which provided the Company with the ability to offer property and casualty insurance coverage. The Company also currently has a pending acquisition of a savings bank with approximately $220 million in assets that operates in markets contiguous to ones in which the Company already operates. The Company anticipates that the completion of this acquisition will occur in April 2008.

There are many factors that the Company considers when evaluating how much to offer for potential acquisition candidates - in the form of a purchase price comprised of cash and/or stock for a whole company purchase or a deposit premium in a branch purchase. Most significantly, the Company compares expectations of future earnings per share on a stand-alone basis with projected future earnings per share assuming completion of the acquisition under various pricing scenarios. Significant assumptions that affect this analysis include the estimated future earnings stream of the acquisition candidate, the amount of cost efficiencies that can be realized, and the interest rate earned/lost on the cash received/paid. In addition to the earnings per share comparison, the Company also considers other factors including (but not limited to): marketplace acquisition statistics, location of the candidate in relation to the Company's expansion strategy, market growth potential, management of the candidate, potential integration issues (including corporate culture), and the size of the acquisition candidate.

The Company plans to continue to evaluate acquisition opportunities that could potentially benefit the Company and its shareholders. These opportunities may include acquisitions that do not fit the categories discussed above.

For a further discussion of recent acquisition activity, see "Merger and Acquisition Activity" under Item 7 below.

Employees

As of December 31, 2007, the Company had 574 full-time and 81 part-time employees. The Company is not a party to any collective bargaining agreements and considers its employee relations to be good.

Supervision and Regulation

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

Index

Supervision and Regulation of the Company

The Company is a bank holding company within the meaning of the Bank Holding Company Act of 1956, as amended. The Company is also regulated by the Commissioner under the North Carolina Bank Holding Company Act of 1984.

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

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

The United States Congress and the North Carolina General Assembly have periodically considered and adopted legislation that has resulted in, and could result in further, deregulation of both banks and other financial institutions. Such legislation could modify or eliminate geographic restrictions on banks and bank holding companies and current restrictions on the ability of banks to engage in certain nonbanking activities. For example, in 1999, the U.S. enacted legislation that allowed bank holding companies to engage in a wider range of non-banking activities, including greater authority to engage in securities and insurance activities. Under the Gramm-Leach-Bliley Act (the “Act”), a bank holding company that elects to become a financial holding company may engage in any activity that the Federal Reserve Board, in consultation with the Secretary of the Treasury, determines by regulation or order is (i) financial in nature, (ii) incidental to any such financial activity, or (iii) complementary to any such financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally. The Act made significant changes in U.S. banking law, principally by repealing certain restrictive provisions of the 1933 Glass-Steagall Act. The Act lists certain activities that are deemed to be financial in nature, including lending, exchanging, transferring, investing for others, or safeguarding money or securities; underwriting and selling insurance; providing financial, investment, or economic advisory services; underwriting, dealing in or making a market in, securities; and any activity currently permitted for bank holding companies by the Federal Reserve Board under Section 4(c)(8) of the Bank Holding Company Act. The Act does not authorize banks or their affiliates to engage in commercial activities that are not financial in nature. A bank holding company may elect to be treated as a financial holding company only if all depository institution subsidiaries of the holding company are well-capitalized, well-managed and have at least a satisfactory rating under the Community Reinvestment Act. At the present time, the Company does not anticipate applying for status as a financial holding company under the Act. This and other legislative and regulatory changes have increased the ability of financial institutions to expand the scope of their operations, both in terms of services offered and geographic coverage. Such legislative changes have placed the Company in more direct competition with other financial institutions, including mutual funds, securities brokerage firms, insurance companies, investment banking firms, and internet banks. The Company cannot predict what other legislation might be enacted or what other regulations might be adopted or, if enacted or adopted, the effect thereof on the Company’s business.

After the September 11, 2001 terrorist attacks in New York and Washington, D.C., the United States government acted in several ways to tighten control on activities perceived to be connected to money laundering and terrorist funding. A series of orders were issued that identify terrorists and terrorist organizations and require the blocking of

property and assets of, as well as prohibiting all transactions or dealings with, such terrorists, terrorist organizations and those that assist or sponsor them.

Index

The USA Patriot Act substantially broadened existing anti-money laundering legislation and the extraterritorial jurisdiction of the United States, imposed new compliance and due diligence obligations, created new crimes and penalties, compelled the production of documents located both inside and outside the United States, including those of foreign institutions that have a correspondent relationship in the United States, and clarified the safe harbor from civil liability to customers. In addition, the United States Treasury Department issued regulations in cooperation with the federal banking agencies, the Securities and Exchange Commission, the Commodity Futures Trading Commission and the Department of Justice to require customer identification and verification, expand the money-laundering program requirement to the major financial services sectors, including insurance and unregistered investment companies, such as hedge funds, and facilitate and permit the sharing of information between law enforcement and financial institutions, as well as among financial institutions themselves. The United States Treasury Department also has created the Treasury USA Patriot Act Task Force to work with other financial regulators, the regulated community, law enforcement and consumers to continually improve the regulations. The Company has established policies and procedures to ensure compliance with the USA Patriot Act.

In 2002, the Sarbanes-Oxley Act was signed into law. The Sarbanes-Oxley Act represents a comprehensive revision of laws affecting corporate governance, accounting obligations and corporate reporting. The Sarbanes-Oxley Act is applicable to all companies with equity or debt securities registered under the Securities Exchange Act of 1934, as amended. In particular, the Sarbanes-Oxley Act established: (i) new requirements for audit committees, including independence, expertise, and responsibilities; (ii) additional responsibilities regarding financial statements for the Chief Executive Officer and Chief Financial Officer of the reporting company; (iii) new standards for auditors and regulation of audits; (iv) increased disclosure and reporting obligations for the reporting company and its directors and executive officers; and (v) new and increased civil and criminal penalties for violation of the securities laws. The most significant expense associated with compliance with the Sarbanes-Oxley Act has been the internal control documentation and attestation requirements of Section 404 of the Act. The Company’s incremental external costs associated with complying with Section 404 of the Sarbanes-Oxley Act amounted to approximately $832,000 in 2005, the initial year of required compliance, with the external cost declining to approximately $200,000-$300,000 in each subsequent year as the Company gained efficiencies. The incremental costs relate to higher external audit fees and outside consultant fees. These amounts do not include the value of the significant internal resources devoted to compliance.

Supervision and Regulation of the Bank

Federal banking regulations applicable to all depository financial institutions, among other things: (i) provide federal bank regulatory agencies with powers to prevent unsafe and unsound banking practices; (ii) restrict preferential loans by banks to “insiders” of banks; (iii) require banks to keep information on loans to major shareholders and executive officers and (iv) bar certain director and officer interlocks between financial institutions.

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

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

paid to the Company by the Bank.

Index

The Bank is a member of the FDIC, which currently insures the deposits of member banks. For this protection, each member bank pays a quarterly statutory assessment, based on its level of deposits, and is subject to the rules and regulations of the FDIC. For 2005 and 2006, due to the funded status of the insurance fund, the FDIC did not assess the Bank any insurance premiums. However, in late 2006 the FDIC adopted new regulations that resulted in all financial institutions, including the Bank, being assessed deposit insurance premiums ranging from 5 cents to 43 cents per $100 of assessable deposits beginning in 2007. The amount of the assessment within that range is based on risk factors that have been established by the FDIC. Based on the specified risk factors, for 2007, the Bank was assigned an assessment rate of 5.1 cents per $100 of assessable deposits, which resulted in annual insurance premium expense to the Bank of approximately $932,000. However, as part of the 2006 legislation that created the new assessment schedule, the rules provide credits to certain institutions that paid deposit insurance premiums in years prior to 1996. As a result, the Bank received a one-time credit of $832,000 that was used to offset FDIC insurance premiums in 2007, which left the Bank with an actual expense of $100,000 in 2007. The Company will have no remaining credit in 2008, and therefore, the Company expects that its deposit insurance premium expense will be approximately $1 million in 2008.

In addition to deposit insurance assessments, the FDIC is authorized to collect assessments against insured deposits to be paid to the Finance Corporation (FICO) to service FICO debt incurred in connection with the resolution of the thrift industry crisis the 1980s. The FICO assessment rate is adjusted quarterly. The average annual assessment rate in 2007 was 1.16 cents per $100 for insured deposits, which resulted in approximately $205,000 in expense for the Bank for 2007. For the first quarter of 2008, the FICO assessment rate for such deposits will decrease to 1.14 cents per $100 of assessable deposits.

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

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

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

Available Information

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

12

Item 1A. Risk Factors

We are subject to interest rate risk, which could negatively impact earnings.

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

From mid-2004 through mid-2007, interest rates were generally increasing, although short-term interest rates rose faster than long-term interest rates. In 2006, this resulted in short-term interest rates reaching the same level as long-term interest rates, which is referred to as a "flat yield curve." A flat yield curve is unfavorable for us and many other financial institutions because our funding costs are generally tied to short-term interest rates, while our investment rates, in the form of securities and loans, are more closely correlated to long-term interest rates. Largely as a result of the flat yield curve, our net interest margin declined throughout 2006. The flat yield curve prevailed for most of 2007, which resulted in our net interest margin remaining at levels lower than our historical average. However, the strong growth that we achieved in loans and deposits in 2006 and 2007 more than offset the negative impact of the flat yield curve, resulting in an increase in net interest income in 2006 and 2007 in comparison to the immediately preceding year.

Beginning in late 2007 and continuing into early 2008, the Federal Reserve began reducing interest rates in response to unfavorable economic conditions in the United States economy. From September 2007 through February 2008, the Federal Reserve reduced interest rates by 225 basis points. When interest rates decline, most of our adjustable rate loans, which comprise approximately 46% of all of our loans, reprice downwards immediately by the full amount of the rate cut. However, most of our interest expense relates to customer certificates of deposit, which cannot be repriced at lower interest rates until they mature. As a result, interest rate cuts negatively impact our profitability, particularly in the short-term. Additionally, given the sharp decline in interest rates, the interest rates we pay on our deposit accounts either cannot be repriced downwards by the full amount of the rate cut due to competitive pressures or because the rate is so close to zero already.

For the reasons noted above and based on prevailing economic forecasts that the Federal Reserve will reduce interest rates further, we expect our profitability to be negatively impacted during 2008 as a result of the declines in interest rates.

We face strong competition, which could hurt our business.

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

Index

We compete in our market areas with several large interstate bank holding companies, including three of the largest in the nation, which are headquartered in North Carolina. These large competitors have substantially greater resources than we have, including broader geographic markets, more banking locations, higher lending limits and the ability to make greater use of large-scale advertising and promotions. Also, these institutions, particularly to the extent they are more diversified than we are, may be able to offer the same products and services that we offer at more competitive rates and prices.

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

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

Our allowance for loan losses may not be adequate to cover actual losses.

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

We establish the amount of the allowance for loan losses based on historical loss rates, as well as estimates and assumptions about future events. Because of the extensive use of estimates and assumptions, our actual loan losses could differ, possibly significantly, from our estimate. We believe that our allowance for loan losses is adequate to provide for probable losses, but it is possible that the allowance for loan losses will need to be increased for credit reasons or that regulators will require us to increase this allowance. Either of these occurrences could materially and adversely affect our earnings and profitability.

We are vulnerable to the economic conditions within the fairly small geographic region in which we operate.

Like many businesses, our overall success is partially dependent on the economic conditions in the marketplace where we operate. Our marketplace is predominately concentrated in the central Piedmont region of North Carolina. An economic downturn in this fairly small geographic region that negatively impacted our customers would likely also have an adverse impact on us. For example, an economic downturn could result in higher loan default rates and reduce the value of real estate securing those loans, which would likely increase our loan losses. At December 31, 2007, approximately 86% of our loans were secured by real estate collateral, and thus a decrease in real estate values could have an adverse impact on our operations.

We are subject to extensive regulation, which could have an adverse effect on our operations.

We are subject to extensive regulation and supervision from the North Carolina Commissioner of Banks, the FDIC, and the Federal Reserve Board. This regulation and supervision is intended primarily for the protection of the FDIC insurance fund and our depositors and borrowers, rather than for holders of our common stock. Regulatory authorities have extensive discretion in their supervisory and enforcement activities, including the imposition of restrictions on operations, the classification of our assets and determination of the level of the allowance for loan losses. Changes in the regulations that apply to us, or changes in our compliance with regulations, could have a material impact on our

operations.

Index

In the normal course of business, we process large volumes of transactions involving millions of dollars. If internal controls fail to work as expected, if systems are used in an unauthorized manner, or if employees subvert our internal controls, we could experience significant losses.

We process large volumes of transactions on a daily basis and are exposed to numerous types of operational risk. Operational risk includes the risk of fraud by persons inside or outside the company, the execution of unauthorized transactions by employees, errors relating to transaction processing and systems and breaches of the internal control system and compliance requirements. This risk of loss also includes potential legal actions that could arise as a result of an operational deficiency or as a result of noncompliance with applicable regulatory standards.

We establish and maintain systems of internal operational controls that provide us with timely and accurate information about our level of operational risk. Although not foolproof, these systems have been designed to manage operational risk at appropriate, cost-effective levels. Procedures exist that are designed to ensure that policies relating to conduct, ethics, and business practices are followed. From time to time, losses from operational risk may occur, including the effects of operational errors. We continually monitor and improve our internal controls, data processing systems, and corporate-wide processes and procedures, but there can be no assurance that future losses will not occur.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

The main offices of the Company and the Bank are owned by the Bank and are located in a three-story building in the central business district of Troy, North Carolina. The building houses administrative and bank teller facilities. The Bank’s Operations Division, including customer accounting functions, offices and operations of Montgomery Data, and offices for loan operations, are housed in two one-story steel frame buildings approximately one-half mile west of the main office. Both of these buildings are owned by the Bank. The Company operates 70 bank branches. The Company owns all its bank branch premises except 10 branch offices for which the land and buildings are leased and two branch offices for which the land is leased but the building is owned. In addition, the Company leases one loan production office. There are no options to purchase or lease additional properties. The Company considers its facilities adequate to meet current needs and believes that lease renewals or replacement properties can be acquired as necessary to meet future needs.

Item 3. Legal Proceedings

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

There were no tax shelter penalties assessed by the Internal Revenue Service against the Company during the year ended December 31, 2007.

Item 4. Submission of Matters to a Vote of Shareholders

No matters were submitted to a vote of shareholders during the fourth quarter of 2007.

15

Index

PART II

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

The Company's common stock trades on The NASDAQ Global Select Market under the symbol FBNC. Table 22, included in "Management's Discussion and Analysis" below, set forth the high and low market prices of the Company's common stock as traded by the brokerage firms that maintain a market in the Company's common stock and the dividends declared for the periods indicated. It is the Company's current intention to continue to pay cash dividends in the future comparable to those in the recent past. See "Business - Supervision and Regulation" above and Note 15 to the consolidated financial statements for a discussion of regulatory restrictions on the Company's payment of dividends. As of December 31, 2007, there were approximately 2,605 shareholders of record and another 3,600 shareholders whose stock is held in "street name." There were no sales of unregistered securities during the year ended December 31, 2007.

Additional Information Regarding the Registrant's Equity Compensation Plans

At December 31, 2007, the Company had seven equity compensation plans. Each of these plans is a stock option plan. Four of the seven plans were assumed in corporate acquisitions. The Company's 2007 Equity Plan is the only one of the seven plans for which new grants of stock options are possible.

The following table presents information as of December 31, 2007 regarding shares of the Company's stock that may be issued pursuant to the Company's stock options plans. The table does not include information with respect to shares subject to outstanding options granted under stock incentive plans assumed by the Company in connection with mergers and acquisitions of companies that originally granted those options. Footnote (2) to the table indicates the total number of shares of common stock issuable upon the exercise of options under the assumed plans as of December 31, 2007, and the weighted average exercise price of those options. No additional options may be granted under those assumed plans. The Company has no warrants or stock appreciation rights outstanding.

	As of December 31, 2007		
Plan category	(a) Number of securities to be issued upon exercise of outstanding options	(b) Weighted-average exercise price of outstanding options	(c) Number of securities available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders (1)	576,061	$ 17.74	1,155,500
Equity compensation plans not approved by security holders			

Total	576,061	$	17.74	1,155,500

(1) Consists of (A) the Company's 2007 Equity Plan, which is currently in effect; (B) the Company's 2004 Stock Option Plan; and (C) the Company's 1994 Stock Option Plan, each of which was approved by shareholders.

The table does not include information for stock incentive plans that the Company assumed in connection with mergers and acquisitions of the companies that originally established those plans. As of December 31, 2007, a total of 31,921 shares of common stock were issuable upon exercise under those assumed plans. The weighted average exercise price of those outstanding options is $10.91 per share. No additional options may be granted under those assumed plans.

Index

Performance Graph

The performance graph shown below compares the Company's cumulative total return to shareholders for the five-year period commencing December 31, 2002 and ending December 31, 2007, with the cumulative total return of the Russell 2000 Index (reflecting overall stock market performance of small-capitalization companies), and an index of banks with between $1 billion and $5 billion in assets, as constructed by SNL Securities, LP (reflecting changes in banking industry stocks). The graph and table assume that $100 was invested on December 31, 2002 in each of the Company's common stock, the Russell 2000 Index, and the SNL Bank Index, and that all dividends were reinvested.

First Bancorp
Comparison of Five-Year Total Return Performances (1)
Five Years Ending December 31, 2007

	Total Return Index Values (1) December 31,					
	2002	2003	2004	2005	2006	2007
First Bancorp	$ 100.00	137.25	184.43	141.42	158.53	142.33
Russell 2000	100.00	147.25	174.24	182.18	215.64	212.26
SNL Index-Banks between $1 billion and $5 billion	100.00	135.99	167.83	164.97	190.90	139.06

Notes:

(1) Total return indices were provided from an independent source, SNL Securities LP, Charlottesville, Virginia, and assume initial investment of $100 on December 31, 2002, reinvestment of dividends, and changes in market values. Total return index numerical values used in this example are for illustrative purposes only.

Index

Issuer Purchases of Equity Securities

Pursuant to authorizations by the Company's board of directors, the Company has from time to time repurchased shares of common stock in private transactions and in open-market purchases. The most recent board authorization was announced on July 30, 2004 and authorized the repurchase of 375,000 shares of the Company's stock. During 2007, the Company repurchased a total of 27,348 shares of its own stock at an average price of $19.41 per share. As shown below, the Company did not repurchase any shares of its common stock during the three months ended December 31, 2007.

Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased (2)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (1)
Month #1 (October 1, 2007 to October 31, 2007)				234,667
Month #2 (November 1, 2007 to November 30, 2007)				234,667
Month #3 (December 1, 2007 to December 31, 2007)				234,667
Total				234,667

Footnotes to the Above Table

(1) All shares available for repurchase are pursuant to publicly announced share repurchase authorizations. On July 30, 2004, the Company announced that its Board of Directors had approved the repurchase of 375,000 shares of the Company's common stock. The repurchase authorization does not have an expiration date. There are no plans or programs the Company has determined to terminate prior to expiration, or under which the Company does not intend to make further purchases.

(2) The above table above does not include shares that were used by option holders to satisfy the exercise price of the call options issued by the Company to its employees and directors pursuant to the Company's stock option plans. There were no such exercises during the three months ended December 31, 2007.

Item 6. Selected Consolidated Financial Data

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

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

Management's Discussion and Analysis is intended to assist readers in understanding the Company's results of operations and changes in financial position for the past three years. This review should be read in conjunction with the consolidated financial statements and accompanying notes beginning on page 63 of this report and the supplemental financial data contained in Tables 1 through 22 included with this discussion and analysis. All share data for periods prior to November 15, 2004 has been adjusted from originally reported amounts to reflect the 3-for-2 stock split paid on November 15, 2004.

CRITICAL ACCOUNTING POLICIES

The accounting principles followed by the Company and the methods of applying these principles conform with accounting principles generally accepted in the United States of America and with general practices followed by the banking industry.

Index

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 two 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 and 2) 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 the estimation of 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 "Allowance for Loan Losses and Loan Loss Experience" below.

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.

Index

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 intangibles have generally been estimated to have a life ranging from seven to ten years, 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.

MERGER AND ACQUISITION ACTIVITY

The Company did not complete any acquisitions in 2005 or 2007. The Company completed two branch purchases in 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.

Index

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 weighted average amortization period is approximately 2.2 years. 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 factor that contributed to a purchase price that resulted in recognition of goodwill was 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 $1,768,000, 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 thirteen year period based on an amortization schedule provided by the consulting firm. The weighted-average amortization period is approximately 3.2 years. The remaining intangible asset of $1,533,000 has been classified as goodwill, and thus is not being systematically amortized, but rather is subject to an annual impairment test. The primary factor that contributed to a purchase price that resulted in recognition of goodwill was 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.

At December 31, 2007, the Company had one pending acquisition. On July 12, 2007, the Company announced that it had reached an agreement to acquire Great Pee Dee Bancorp, Inc. ("Great Pee Dee"), the holding company for a community bank headquartered in Cheraw, South Carolina with three branches and total assets of $222 million. Under the terms of the agreement and subject to possible adjustment, each share of Great Pee Dee common stock issued and outstanding on the merger date will be converted into and exchanged for the right to receive 1.15 shares of the Company's common stock. Additional information is available in the registration statement, which includes a proxy statement/prospectus, concerning the proposed merger that was filed with the SEC on February 5, 2008. The Company anticipates the completion of this merger to occur in April 2008.

See Note 2 and Note 6 to the consolidated financial statements for additional information regarding intangible assets.

ANALYSIS OF RESULTS OF OPERATIONS

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

2007 Compared to 2006

Overview - Net income was 13% higher in 2007 than in 2006. In 2006, a merchant credit card loss totaling $1.9 million, or $0.08 per diluted share (after-tax) negatively impacted earnings.

Index

The positive impact on earnings due to high growth in loans and deposits during 2007 was partially offset by a lower net interest margin and higher expenses that were associated with the Company's growth.

Financial Highlights ($ in thousands except per share data)		2007	2006	Change
Earnings				
Net interest income	$	79,284	74,536	6.4%
Provision for loan losses		5,217	4,923	6.0%
Noninterest income		18,473	14,310	29.1%
Noninterest expenses		57,580	53,198	8.2%
Income before income taxes		34,960	30,725	13.8%
Income tax expense		13,150	11,423	15.1%
Net income	$	21,810	19,302	13.0%
Net income per share				
Basic	$	1.52	1.35	12.6%
Diluted		1.51	1.34	12.7%
At Year End				
Assets	$	2,317,249	2,136,624	8.5%
Loans		1,894,295	1,740,396	8.8%
Deposits		1,838,277	1,695,679	8.4%
Ratios				
Return on average assets		1.02%	1.00%	
Return on average equity		12.77%	11.83%	
Net interest margin (taxable-equivalent)		4.00%	4.18%	

The following is a more detailed discussion of the Company's results for 2007 compared to 2006:

Net income for the year ended December 31, 2007 amounted to $21,810,000, or $1.51 per diluted share, compared to net income of $19,302,000, or $1.34 per diluted share, reported for 2006. Results for 2006 include the write-off loss during the second and third quarters of a merchant credit card receivable amounting to $1,900,000, which had an after-tax impact of $1,149,000, or $0.08 per diluted share, on the Company's earnings for 2006.

The Company experienced strong balance sheet growth in 2007. Total assets at December 31, 2007 amounted to $2.32 billion, 8.5% higher than a year earlier. Total loans at December 31, 2007 amounted to $1.89 billion, an increase of $154 million, or 8.8%, from a year earlier. Total deposits amounted to $1.84 billion at December 31, 2007, an increase of $143 million, or 8.4%. All of the loan and deposit growth was internally-generated, as there were no acquisitions that were completed during the year. Total shareholders' equity amounted to $174.1 million at

December 31, 2007, a 7.0% increase from a year earlier.

The growth in loans and deposits was the primary reason for the increase in the Company's net interest income when comparing 2007 to 2006. Net interest income for the year ended December 31, 2007 amounted to $79.3 million, a 6.4% increase over the $74.5 million recorded in 2006.

The impact of the growth in loans and deposits on the Company's net interest income was partially offset by a decline 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 year ended December 31, 2007 was 4.00% compared to 4.18% for 2006.

For the first three quarters of 2007, the lower net interest margins realized in 2007 compared to 2006 were caused primarily by deposit rates paid by the Company rising by more than loan and investment yields, which

Index

was associated with the flat interest rate yield curve that was prevailing in the marketplace. The Company was also negatively impacted during that period by customers shifting their funds from low cost deposits to higher cost deposits as rates rose. In the fourth quarter of 2007, the Company's net interest margin was negatively impacted by the Federal Reserve lowering interest rates by a total of 100 basis points during the last four months of the year. When interest rates are lowered, the Company's net interest margin declines, at least temporarily, as most of the Company's adjustable rate loans reprice downward immediately, while rates on the Company's customer time deposits are fixed, and thus do not adjust downward until they mature.

The Company's provision for loan losses did not vary significantly when comparing 2007 to 2006. The provision for loan losses for the year ended December 31, 2007 was $5,217,000 compared to $4,923,000 for 2006. Asset quality changes and loan growth are the most significant factors that impact the Company's provision for loan losses. Generally in 2007, the impact of unfavorable asset quality trends on the Company's provision for loan losses was largely offset by lower loan growth experienced during the year compared to 2006. The Company's net charge-offs to average loans ratio was 0.16% for the year ended December 31, 2007 compared to 0.11% in 2006, while the ratio of nonperforming assets to total assets was 0.47% at December 31, 2007 compared to 0.39% a year earlier. Net internal loan growth for 2007 was $154 million compared to $252 million for 2006.

Noninterest income for the year ended December 31, 2007 amounted to $18,473,000, an increase of 29.1% from the $14,310,000 recorded in 2006. The positive variance in noninterest income for 2007 compared to 2006 was significantly impacted by a $1.9 million merchant credit card loss that the Company reserved for in the second and third quarters of 2006. Another reason for the increase in 2007 compared to 2006 was the Company's expansion of its overdraft protection program in the fourth quarter of 2007 to include overdraft protection for debit card purchases and ATM withdrawals. Previously the overdraft protection program, in which the Company charges a fee for honoring payments on overdrawn accounts, only applied to written checks. This change resulted in an increase in service charges on deposit accounts.

Noninterest expenses for 2007 amounted to $57.6 million, an 8.2% increase from the $53.2 million recorded in 2006. The increase in noninterest expenses is primarily attributable to costs associated with the Company's overall growth in loans, deposits and branch network. Since October 1, 2006, the Company has opened six full service bank branches. Although noninterest expenses rose in 2007, the lower rate of increase compared to 2006 was partially due to the implementation of cost control recommendations that arose from a performance improvement consulting project that was completed in the first quarter of 2007. In addition, since the completion of the consulting project, the Company has taken further measures to contain costs and improve efficiency. As a result, the Company's number of full-time equivalent employees decreased by six during 2007. For the first time in many years, the Company began to again record FDIC insurance expense in the fourth quarter of 2007. This was as a result of the FDIC recently beginning to charge for FDIC insurance again in order to replenish its reserves. The Company recorded $100,000 in FDIC insurance expense in the fourth quarter of 2007.

The Company's efficiency ratio (noninterest expense divided by the sum of tax-equivalent net interest income plus noninterest income – for this measure, a lower ratio is more favorable) was 58.57% for the year ended December 31, 2007 compared to 59.54% for 2006.

During both 2006 and 2007, the Company's effective tax rate was approximately 37%.

2006 Compared to 2005

Overview - Net income was 20.0% higher in 2006 than in 2005. Both years had unusual items of expense that negatively impacted earnings. In 2006, a merchant credit card loss totaling $1.9 million, or $0.08 per diluted share (after-tax) negatively impacted earnings, while in 2005, the Company recorded a tax loss related to an unfavorable

state tax audit amounting to $4.3 million, or $0.30 per diluted share. Excluding those items, net income would have been essentially unchanged in 2006 compared to 2005. The positive impact on earnings of high growth in loans and deposits during 2006 was offset by a lower net interest margin and higher expenses that were associated with the Company’s growth.

Index

Financial Highlights ($ in thousands except per share data)		2006	2005	Change
Earnings				
Net interest income	$	74,536	68,591	8.7%
Provision for loan losses		4,923	3,040	61.9%
Noninterest income		14,310	15,004	– 4.6%
Noninterest expenses		53,198	47,636	11.7%
Income before income taxes		30,725	32,919	– 6.7%
Income tax expense		11,423	16,829	– 32.1%
Net income	$	19,302	16,090	20.0%
Net income per share				
Basic	$	1.35	1.14	18.4%
Diluted		1.34	1.12	19.6%
At Year End				
Assets	$	2,136,624	1,801,050	18.6%
Loans		1,740,396	1,482,611	17.4%
Deposits		1,695,679	1,494,577	13.5%
Ratios				
Return on average assets		1.00%	0.94%	
Return on average equity		11.83%	10.39%	
Net interest margin (taxable-equivalent)		4.18%	4.33%	

The following is a more detailed discussion of the Company's results for 2006 compared to 2005:

Net income for the year ended December 31, 2006 amounted to $19,302,000, or $1.34 per diluted share, compared to net income of $16,090,000, or $1.12 per diluted share, reported for 2005. Results for 2006 include the write-off loss during the second and third quarters of a merchant credit card receivable amounting to $1,900,000, which had an after-tax impact of $1,149,000, or $0.08 per diluted share, on the Company's earnings for 2006. Results for 2005 include a loss accrual related to income tax exposure amounting to $4,338,000, or $0.30 per diluted share. See additional discussion in the section entitled "Income Taxes" below.

The Company experienced strong balance sheet growth in 2006. Total assets at December 31, 2006 amounted to $2.14 billion, 18.6% higher than a year earlier. Total loans at December 31, 2006 amounted to $1.74 billion, an increase of $258 million, or 17.4%, from a year earlier. Total deposits amounted to $1.70 billion at December 31, 2006, an increase of $201 million, or 13.5%, from a year earlier. Virtually all of the loan growth was

internally-generated, whereas approximately $44 million of the deposit growth was the result of two branch acquisitions that were completed in the third quarter of 2006. Total shareholders' equity amounted to $162.7 million at December 31, 2006, a 4.5% increase from a year earlier. Shareholders' equity was negatively impacted at December 31, 2006 by the Company's adoption of new pension plan accounting rules (FASB Statement 158) that resulted in an increase in pension liabilities of $6.0 million, an increase in assets (primarily deferred tax assets) in the amount of $2.2 million, and a reduction to shareholders' equity of $3.8 million.

The growth in loans and deposits was the primary reason for increases in the Company's net interest income when comparing 2006 to 2005. Net interest income for the year ended December 31, 2006 amounted to $74.5 million, an 8.7% increase over the $68.6 million recorded 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 year ended December 31, 2006 was 4.18% compared to 4.33% for 2005.

Index

The compressing margin was primarily due to 1) deposit rates paid by the Company rising by more than loan and investment yields, which was largely associated with the flat interest rate yield curve prevailing in the marketplace, and 2) the negative impact of the Company having more of its overall funding occurring in its highest cost funding sources, which is a result of a need to fund high loan growth, as well as customers shifting their funds from low cost deposits to higher cost deposits as interest rates have risen.

The Company’s provision for loan losses for 2006 was $4,923,000, an increase of 61.9% over the $3,040,000 recorded in 2005. The higher loss provision was primarily the result of higher loan growth realized in 2006 compared to 2005, and to a lesser extent an increase in the level of the Company’s nonperforming assets. Net internal loan growth was $252 million for 2006 compared to $116 million for 2005.

The Company’s ratio of net charge-offs to average loans was 11 basis points in 2006 compared to 14 basis points in 2005. The Company’s level of nonperforming assets amounted to $8.4 million at December 31, 2006 compared to $3.1 million at December 31, 2005. This increase was primarily the result of the December 31, 2005 level of nonperforming assets being unusually low. The low level of nonperforming assets was the result of several of the Company's largest nonaccrual loan relationships being reduced to zero in the fourth quarter of 2005, either as a result of cash received or the loan being charged-off. This resulted in the amount of the Company's nonperforming loans at December 31, 2005 reaching its lowest level in over five years. In 2006, the Company experienced more typical activity within its nonaccrual loan category, and the amount of nonaccrual loans increased to a more normal level. The Company’s nonperforming assets to total assets ratio was 0.39% at December 31, 2006 compared to 0.17% at December 31, 2005. This ratio averaged 0.34% for each of the five year ends from 2000-2004.

Noninterest income for 2006 amounted to $14.3 million, a decrease of 4.6% from the $15.0 million recorded in 2005. The decrease in the 2006 amount was caused by a $1.9 million write-off loss of a merchant credit card receivable. See the section entitled “Noninterest Income” below for a discussion of this matter.

Noninterest expenses for 2006 amounted to $53.2 million, an 11.7% increase from the $47.6 million recorded in 2005. The increase in noninterest expenses is primarily attributable to costs associated with the Company’s overall growth in loans, deposits and branch network. From January 1, 2005 to December 31, 2006, the Company’s loans and deposits increased by 27% and 22%, respectively, and the Company’s branch network increased from 59 branches to 68 branches. 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 $325,000 ($246,000 after-tax effect) for the year ended December 31, 2006. As permitted by previous accounting standards, no stock option expense was recorded by the Company in 2005, or any prior periods.

The Company’s effective tax rate was 37% for the year ended December 31, 2006. As noted above, the Company’s income tax expense in 2005 was significantly impacted by a tax loss accrual recorded in the third quarter of 2005 and a partial reversal of this accrual recorded in the fourth quarter of 2005. See additional discussion in the section entitled “Income Taxes” below.

Net Interest Income

Net interest income on a reported basis amounted to $79,284,000 in 2007, $74,536,000 in 2006, and $68,591,000 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. Net interest income on a tax-equivalent basis amounted to $79,838,000 in 2007, $75,037,000 in 2006, and $69,039,000 in 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 amounts in different periods without taking into account the different mix of taxable versus non-taxable investments that may have existed during those periods. The following is a

reconciliation of reported net interest income to tax-equivalent net interest income.

Index

	Year ended December 31,		
($ in thousands)	2007	2006	2005
Net interest income, as reported	$ 79,284	74,536	68,591
Tax-equivalent adjustment	554	501	448
Net interest income, tax-equivalent	$ 79,838	75,037	69,039

Table 2 analyzes net interest income on a tax-equivalent basis. The Company's net interest income on a taxable-equivalent basis increased by 6.4% in 2007 and 8.7% in 2006. 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 (tax-equivalent net interest income divided by average interest-earning assets). In 2006 and 2007, growth in loans and deposits increased net interest income, the positive effects of which were partially offset by lower net interest margins realized in each year.

The Company's loans outstanding grew by 8.8% and 17.4% in 2007 and 2006, respectively, while deposits increased 8.4% in 2007 and 13.5% in 2006. As illustrated in Table 3, in both 2007 and 2006, this growth positively impacted net interest income. In both years, the positive impact on net interest income of growth in interest-earning assets, primarily loans, more than offset the higher interest expense associated with funding the asset growth. In 2007, growth in interest-earning asset volumes resulted in an increase in interest income of $15.1 million, while growth in interest-bearing liabilities only resulted in $8.0 million in higher interest expense. In 2006, growth in interest-earning asset volumes resulted in an increase in interest income of $14.1 million, while growth in interest-bearing liabilities only resulted in $7.2 million in higher interest expense. As a result, balance sheet growth resulted in an increase in tax-equivalent net interest income of $7.0 million in 2007 and $6.9 million in 2006. For analysis regarding the nature of the Company's loan and deposit growth, see "Analysis of Financial Condition and Changes in Financial Condition" below.

Table 3 also illustrates the impact that changes in the rates that the Company earned/paid had on the Company's net interest income in 2006 and 2007. During each of 2006 and 2007, the prevailing interest rate environment was, on average, generally higher than that of the immediately preceding year. In 2006, the higher interest rates resulted in an increase in interest expense of $14.6 million compared to an increase in interest income of only $13.7 million, which resulted in a reduction in net interest income of $0.9 million. In 2007, the higher interest rates resulted in an increase in interest expense of $6.9 million compared to an increase in interest income of only $4.7 million, which resulted in a reduction in net interest income of $2.2 million.

The Company measures the spread between the yield on its earning assets and the cost of its funding primarily in terms of the ratio entitled "net interest margin" which is defined as tax-equivalent net interest income divided by average earning assets. The Company's net interest margin decreased in both 2007 and 2006, amounting to 4.00% in 2007, 4.18% in 2006, and 4.33% in 2005.

For 2006 and most of 2007, the Company's net interest margin was negatively impacted by the effects of short-term interest rates prevailing in the market place rising by more than long-term interest rates following the series of Federal Reserve interest rate increases that occurred throughout 2005 and the first half of 2006 - with short-term interest rates being approximately the same as long-term interest rates for much of 2006 and 2007 (commonly referred to as a "flat yield curve"). A flat yield curve is unfavorable for the Company because the Company's funding costs are generally tied to short-term interest rates, while its investment rates, in the form of securities and loans, are more closely

correlated to longer-term interest rates. When short-term and long-term interest rates converge, the interest rate spread the Company is able to earn is reduced and the Company's net interest margin and profitability are unfavorably impacted. Due largely to the progressive flattening of the yield curve that occurred throughout 2006, the Company's net interest margin decreased throughout 2006 before stabilizing at the lower levels in 2007 as a result of the relatively stable interest rate environment in effect for most of 2007.

Index

In addition to the effects of the flat yield curve, the Company's net interest margin has been negatively impacted by its deposit growth being concentrated in deposit account types that carry high interest rates. Specifically, the Company has experienced disproportionately high growth rates in its premium money market account and its time deposits greater than $100,000, two of the Company's highest rate funding sources. The disproportionate growth in these accounts has been due to the Company offering high promotional rates in order to help fund loan growth, as well as customers shifting funds from low rate deposit accounts to higher rate deposit accounts as interest rates generally rose in 2006 and during most of 2007.

The Company's net interest margin has also been negatively impacted by the intense competition in the markets in which it operates. Competition for deposits, in particular, is particularly fierce, and requires the Company to pay relatively higher interest rates on deposit accounts than it historically has.

For these reasons, the yields the Company realized on its interest-earning assets increased by a smaller amount than did the rates the Company paid on its interest-bearing liabilities during both 2006 and 2007. As derived from Table 2, in comparing 2007 to 2006, the yield realized on average earning assets increased by only 25 basis points (from 7.23% to 7.48%) while the average rate paid on interest-bearing liabilities, increased by 48 basis points (from 3.56% to 4.04%). In 2006, the yield realized on average earning assets, increased by only 84 basis points (from 6.39% to 7.23%) while the average rate paid on interest-bearing liabilities, increased by 114 basis points (from 2.42% to 3.56%). The differences in these increases in each year negatively impacted the Company's net interest margin.

Also, as can be derived from Table 2, during 2007, the Company's highest cost funding sources (time deposits, borrowings and securities sold under agreements to repurchase) comprised 60.9% of its total funding (total interest-bearing liabilities plus non-interest bearing deposits), a slight increase from 60.5% in 2006, which in turn was an increase from 57.6% in 2005. As noted above, this shift to higher cost funding sources has been partially a result of the need to fund high loan growth, as well as the fact that some customers have shifted their funds from low cost deposits to higher cost deposits as interest rates have risen. In addition to the increases in balances experienced in high cost funding sources, the largest category of "low-cost" interest-bearing deposits – Money Market deposits – has recently experienced more growth and rate sensitivity than it has historically. The average balance of Money Market deposits grew 20% in 2006 and 30% in 2007, while the increase in the average interest rate paid on this category of deposits rose more than any other funding source during both years - 60 basis points in 2007 (from 2.71% to 3.31%) and 131 basis points in 2006 (from 1.40% to 2.71%). These increases are almost entirely due to the Company's introduction in late 2005 of a high interest rate money market account (4.25% for most of 2006 and 2007) that was created to compete with area competitors. Average balances in the other lower cost deposit categories experienced decreases of $1 million in 2007 and $17 million in 2006. The Company believes that a large portion of the decreases in the lower cost accounts in 2006 and 2007 was the result of shifts to higher rate accounts.

From 2002 to 2004, the Company gradually positioned itself to be protected in a rising interest rate environment by originating more variable rate loans than fixed rate loans – a rising interest rate environment was forecasted by most economists after the steeply declining interest rate environment that began in 2001 and concluded with interest rates being at their lowest levels in 40 years during 2004. This initiative resulted in the Company's loan mix changing from 57% fixed rate and 43% variable rate at December 31, 2001 to 60% variable rate and 40% fixed rate at December 31, 2004. When considered with the rest of the Company's assets and liabilities however, this 60% variable / 40% fixed mix of loans contributed to heightened interest rate risk exposure in the event of a declining interest rate environment. Accordingly, beginning in 2005 the Company began originating more fixed rate loans than variable rate loans to lessen this risk, which resulted in the Company's fixed/variable mix shifting to 51% variable rate and 49% fixed rate at December 31, 2006 and 46% variable rate and 54% fixed rate at December 31, 2007.

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

Provision for Loan Losses

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

The provision for loan losses recorded by the Company amounted to $5,217,000 in 2007, compared to $4,923,000 in 2006 and $3,040,000 in 2005. Asset quality changes and loan growth are the most significant factors that impact the Company’s provision for loan losses. Generally in 2007, the impact of unfavorable asset quality trends on the Company’s provision for loan losses was largely offset by lower loan growth experienced during the year compared to 2006. The Company’s net charge-offs to average loans ratio was 0.16% for the year ended December 31, 2007 compared to 0.11% in 2006, while the ratio of nonperforming assets to total assets was 0.47% at December 31, 2007 compared to 0.39% a year earlier. Net internal loan growth was lower in 2007 than it was 2006, amounting to $154 million in 2007 compared to $252 million in 2006. The increase in the provision for loan losses in 2006 from 2005 was primarily the result of higher loan growth realized in 2006 compared to 2005, and to a lesser extent an increase in the level of the Company’s nonperforming assets. The Company’s net internal loan growth was $252 million in 2006 compared to $116 million in 2005, while total nonperforming assets amounted to $8.4 million at December 31, 2006, compared to $3.1 million at December 31, 2005.

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

Noninterest Income

Noninterest income recorded by the Company amounted to $18,473,000 in 2007, $14,310,000 in 2006, and $15,004,000 in 2005.

As shown in Table 4, core noninterest income, which excludes gains and losses from sales of securities, loans, and other assets, amounted to $17,996,000 in 2007, an 11.1% increase from $16,204,000 in 2006. The 2006 core noninterest income of $16,204,000 was 6.2% higher than the $15,262,000 recorded in 2005.

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

Service charges on deposit accounts in 2007 amounted to $9,988,000, an 11.4% increase compared to $8,968,000 recorded in 2006. The $8,968,000 recorded in 2006 was 5.0% more than the 2005 amount of $8,537,000. The primary reason for the increase in 2007 compared to 2006 was the Company’s expansion of its overdraft protection program in the fourth quarter of 2007 to include overdraft protection for debit card purchases and ATM withdrawals. Previously the overdraft protection program, in which the Company charges a fee for honoring payments on overdrawn accounts, only applied to written checks. The 5.0% increase in service charges on deposit accounts in 2006 was primarily associated with the Company’s overall growth.

Other service charges, commissions and fees amounted to $5,158,000 in 2007, a 12.7% increase from the $4,578,000 earned in 2006. The 2006 amount of $4,578,000 was 15.5% higher than the $3,963,000 recorded in 2005. This category of noninterest income includes items such as electronic payment processing revenue (which includes fees

related to credit card transactions by merchants and customers and fees earned from debit card transactions), ATM charges, safety deposit box rentals, fees from sales of personalized checks, and check cashing fees. This category of income grew in 2006 and 2007 primarily because of increases in these activity-related fee

Index

services resulting from the increased acceptance and popularity of debit cards, special credit and debit card promotions that increased their use, and the overall growth in the Company's total customer base, including growth achieved from corporate acquisitions. The gross fees that the Company earned from electronic payment processing revenue amounted to $3,514,000 in 2007, a $544,000, or 18.3%, increase from the $2,970,000 earned in 2006. The 2006 amount was $745,000, or 33.5%, higher than the $2,225,000 earned in 2005.

Fees from presold mortgages amounted to $1,135,000 in 2007, $1,062,000 in 2006, and $1,176,000 in 2005. Fees from presold mortgages peaked in 2003 ($2,327,000 recorded in 2003) as a result of a high level of mortgage loan refinancings brought on by low mortgage interest rates. Since that time, the absence of the initial wave of refinancing activity and higher adjustable rate mortgage rates have resulted in the Company's fees from presold mortgages decreasing from the 2003 level and averaging approximately $200,000-$300,000 per quarter over each of the past three years.

Commissions from sales of insurance and financial products have grown steadily over the past three years – amounting to $1,511,000 in 2007, $1,434,000 in 2006, and $1,307,000 in 2005. This line item includes commissions the Company receives from three sources - 1) sales of credit life insurance associated with new loans, 2) commissions from the sales of investment, annuity, and long-term care insurance products, and 3) commissions from the sale of property and casualty insurance. The following table presents the contribution of each of the three sources to the total amount recognized in this line item:

($ in thousands)	2007	2006	2005
Commissions earned from:			
Sales of credit life insurance	$ 304	337	308
Sales of investments, annuities, and long term care insurance	387	266	193
Sales of property and casualty insurance	820	831	806
Total	$ 1,511	1,434	1,307

Data processing fees amounted to $204,000 in 2007, $162,000 in 2006, and $279,000 in 2005. As noted earlier, Montgomery Data makes its excess data processing capabilities available to area financial institutions for a fee. The decline in this revenue in 2006 was the result of the loss of a customer, which left Montgomery Data with two outside customers as of December 31, 2006 and 2007. Montgomery Data intends to continue to market this service to area banks, but does not currently have any near-term prospects for additional business.

Noninterest income not considered to be "core" amounted to a net gain of $477,000 in 2007, a net loss of $1,894,000 in 2006, and a net loss of $258,000 in 2005. In Table 4, the line item entitled "other gains (losses), net" totaling $2,099,000 in 2006 includes a loss of $1,900,000 related to the write-off loss of a merchant credit card receivable. During 2006, the Company discovered that it had liability associated with a commercial merchant client 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 contractually 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 in estimated exposure associated with this situation, which resulted in recording an additional loss of $1,670,000. During the third quarter of 2006, the Company completed a review of all merchant credit card customers and concluded that this situation appeared to be an isolated event that was not likely to recur. During 2007, the Company determined that its ultimate exposure to this loss was approximately $190,000 less than the original estimated total loss of $1.9 million that had been reserved for in 2006. Accordingly, the Company reversed $190,000 of this loss during 2007, which is included in "other gains (losses), net."

Index

Partially as a result of the aforementioned loss, the Company terminated its contract with its previous credit card processor in 2007 and entered into a new contract with a different processor. The new contract shifts the risk of losses similar to the one described above from the Company to the third-party processor. The previous processor agreed to continue processing payments for the Company's merchant credit card clients until each of them can be systematically converted to the new processor. At December 31, 2007, approximately 30% of the Company's merchant credit card clients had been converted from the old processor to the new processor and the remaining clients are expected to be converted in the first quarter of 2008. Although the Company retains the risk of loss related to each merchant until they are converted, the Company does not expect any losses to occur prior to the rest of the conversions taking place.

Also included in "other gains (losses), net" are normal write-downs of tax credit partnership investments amounting to $308,000, $295,000 and $189,000 in 2007, 2006, and 2005, respectively. The Company projects $320,000 of tax credit investment write-downs in 2008. The Company's total investment in tax credit partnerships amounted to $1.4 million, $1.6 million and $1.1 million at December 31, 2007, 2006, and 2005, respectively. To date, all tax credit write-downs have been exceeded, and are projected to continue to be exceeded, by the amount of tax credits realized and recorded as a reduction of income tax expense.

The Company realized net securities gains of $487,000, $205,000, and $5,000 in 2007, 2006, and 2005, respectively. These sales were initiated primarily to realize current income.

Noninterest Expenses

Noninterest expenses for 2007 were $57,580,000, compared to $53,198,000 in 2006 and $47,636,000 in 2005. Table 5 presents the components of the Company's noninterest expense during the past three years.

Based on the amounts noted above, noninterest expenses increased 8.2% in 2007 and 11.7% in 2006. The increases in noninterest expenses over the past three years have occurred in nearly every line item of expense and have been primarily a result of the significant growth experienced by the Company. Over the past three years, the number of the Company's branches has increased from 59 to 70, and the number of full time equivalent employees has increased from 563 at December 31, 2004 to 614 at December 31, 2007. Additionally, from December 31, 2004 to December 31, 2007, the amount of loans outstanding increased 38.6% and deposits increased 32.4%. Although noninterest expenses rose in 2007, the lower rate of increase compared to 2006 was partially due to the implementation of cost control recommendations that arose from a performance improvement consulting project that was completed in the first quarter of 2007. In addition, since the completion of the consulting project, the Company has taken further measures to contain costs and improve efficiency. Partially as a result of this initiative, the Company's number of full-time equivalent employees decreased by six during 2007.

From 2004 through 2006, the Company was not required to pay any FDIC deposit insurance premiums. As discussed above in "Supervision and Regulation of the Bank," in 2006 the FDIC modified its rules relating to the assessment of deposit insurance premiums. In 2007, the Company incurred approximately $100,000 in FDIC deposit insurance premium expense compared to none in 2006. In 2008, the Company estimates its FDIC insurance expense will be approximately $1 million.

Income Taxes

The provision for income taxes was $13,150,000 in 2007, $11,423,000 in 2006, and $16,829,000 in 2005.

Table 6 presents the components of tax expense and the related effective tax rates. The effective tax rate for 2007 was 37.6% compared to 37.2% in 2006 and 51.1% in 2005. The high effective tax rate of 51.1% in 2005 is primarily a

result of the contingency loss accrual discussed in the following paragraph. During periods in 2005 that did not include contingency loss accrual matters, the Company's effective tax rate was approximately 38%-39%.

Index

The Company recorded nonrecurring adjustments in the third quarter of 2006 amounting to $182,000 that reduced otherwise reported income tax expense. The Company expects its effective tax rate to be in the 37%-38% range for the foreseeable future.

In 1999, in consultation with the Company's tax advisors, the Company established an operating structure involving a real estate investment trust (REIT) that resulted in a reduction in the Company's state tax liability to the state of North Carolina. In late 2004, the North Carolina Department of Revenue indicated that it would challenge taxpayers engaged in activities deemed to be "income-shifting," and they indicated that they believed certain REIT operating structures were a type of "income-shifting." During 2005, the North Carolina Department of Revenue began an audit of the Company's tax returns for 2001-2004, which represented all years eligible for audit. In the third quarter of 2005, based on consultations with the Company's external auditor and legal counsel, the Company determined that it should record a $6.3 million loss accrual to reserve for this issue, which was comprised of $8.6 million in estimated liability related to taxes due, interest and penalty, less $2.3 million in related federal tax benefit. In February 2006, the North Carolina Department of Revenue announced a "Settlement Initiative" that offered companies with certain transactions, including those with a REIT operating structure, the opportunity to resolve such matters with reduced penalties by agreeing to participate in the initiative by June 15, 2006. Although the Company believes that its tax returns complied with the relevant statutes, the board of directors of the Company decided that it was in the best interest 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 would be approximately $6.4 million, or $4.3 million net of the federal tax benefit, which was $2.0 million less than the amount that was originally accrued. Accordingly, in March 2006, the Company retroactively recorded an adjustment to its fourth quarter of 2005 earnings to reverse $2.0 million of tax expense. The aspects of the REIT structure that gave rise to this issue were discontinued effective January 1, 2005. In March 2007, the Company completed its participation in the North Carolina Department of Revenue's Settlement Initiative by paying the state $6.9 million to settle the matter, which represented the $6.4 million accrued as of December 31, 2005 plus interest of $0.5 million that accrued from December 31, 2005 until the date of the payment.

Stock-Based Compensation

Until the approval by shareholders of the First Bancorp 2007 Equity Plan ("2007 Equity Plan") on May 2, 2007, the Company's stock-based compensation plans only permitted the issuance of stock options, whereas the 2007 Equity Plan, in addition to providing for grants of stock options, also allows for grants of other types of equity-based compensation including stock appreciation rights, restricted stock, restricted performance stock, unrestricted stock, and performance units.

Although the Company's only grant under the 2007 Equity Plan thus far has been the grant of 2,250 stock options to each non-employee director on June 1, 2007, in 2008 the Company expects to grant a combination of performance units and stock options to approximately twenty employees. It is expected that these grants will have both performance (earnings per share targets) and service conditions that must be met in order for the grants to vest, whereas previously stock option grants to employees only had service conditions (typically five year vesting).

For all years prior to 2006, the Company was not required to record any expense for the value of stock options granted to employees or directors. As discussed in more detail in Note 1(s) to the consolidated financial statements, a new accounting standard ("Statement 123(R)", as defined below) required the Company to record the value of stock options as an expense in the income statement beginning January 1, 2006. Based on the requirement of Statement 123(R), the Company recorded compensation expense of $190,000, or $134,000 net of taxes, in 2007 related to stock option grants. In 2006, the Company recorded compensation expense of $325,000, or $246,000 net of taxes, related to stock option grants. Note 14 to the consolidated financial statements contains pro forma net income and earnings per share information for 2005, as if the Company applied the fair value recognition provisions required by the new

standard. Note 14 indicates that the Company's stock-based employee compensation expense would have been $335,000, net of taxes, for the year ended December 31, 2005.

Index

In 2008, 2009, and 2010 the Company's stock-based compensation expense related to options currently outstanding will be approximately $3,300, $3,300, and $3,000 respectively. There is no tax benefit related to any of those expenses. Any new stock-based awards that are granted and vest after January 1, 2008 will increase the amount of stock-based compensation expense recorded by the Company. In addition to the annual grant of 2,250 stock options to each of the Company's non-employee directors which resulted in the Company recording an expense of $144,000 ($88,000 after-tax) in 2007, as noted above, the Company expects to grant a combination of performance units and stock options to certain employees in 2008. It is expected that these grants will have both performance (earnings per share targets) and service conditions in order to vest. The Company currently expects that the incremental pre-tax expense associated with these grants will be in a range of zero to $250,000 for each of the next three years depending on the number of stock options and performance units that vest.

Index

ANALYSIS OF FINANCIAL CONDITION AND CHANGES IN FINANCIAL CONDITION

Overview

Over the past two years, the Company has achieved steady increases in its levels of loans and deposits, which has resulted in an increase in assets from $1.8 billion at December 31, 2005 to $2.3 billion at December 31, 2007. This growth has been both internally generated and acquired. During the third quarter of 2006, the Company completed the acquisition of two branches, while the Company did not complete any acquisitions in 2007. The following table presents detailed information regarding the nature of the Company's growth in 2006 and 2007:

(in thousands)	Balance at beginning of period	Internal growth	Growth from Acquisitions	Balance at end of period	Total percentage growth	Internal growth (1)
2007						
Loans	$ 1,740,396	153,899		1,894,295	8.8%	8.8%
Deposits - Noninterest bearing	217,291	14,850		232,141	6.8%	6.8%
Deposits - NOW	193,435	(650)		192,785	-0.3%	-0.3%
Deposits - Money Market	205,994	58,659		264,653	28.5%	28.5%
Deposits - Savings	103,346	(2,391)		100,955	-2.3%	-2.3%
Deposits - Time>$100,000	422,772	56,404		479,176	13.3%	13.3%
Deposits - Time<$100,000	552,841	15,726		568,567	2.8%	2.8%
Total deposits	$ 1,695,679	142,598		1,838,277	8.4%	8.4%
2006						
Loans	$ 1,482,611	252,036	5,749	1,740,396	17.4%	17.0%
Deposits - Noninterest bearing	194,051	18,266	4,974	217,291	12.0%	9.4%
Deposits - NOW	188,828	(1,245)	5,852	193,435	2.4%	-0.7%
Deposits - Money Market	155,964	47,935	2,095	205,994	32.1%	30.7%
Deposits - Savings	113,429	(14,027)	3,944	103,346	-8.9%	-12.4%
Deposits - Time>$100,000	356,281	61,692	4,799	422,772	18.7%	17.3%
Deposits - Time<$100,000	486,024	44,504	22,313	552,841	13.7%	9.2%
Total deposits	$ 1,494,577	157,125	43,977	1,695,679	13.5%	10.5%

(1) Excludes the impact of acquisitions.

As shown in the table above, the Company experienced internal loan growth of 8.8% and 17.0%, in 2007 and 2006, respectively. The strong growth experienced in 2006 and 2007 was partially due to the Company's recent expansion into Mooresville, North Carolina, a high growth market near Charlotte, and the Company's expansion into the coastal North Carolina counties of New Hanover County and Brunswick County. Loan growth in these markets amounted to $89 million in 2007 and $75 million in 2006.

Total deposits increased 8.4% in 2007 and 13.5% in 2006. The Company had no brokered deposits outstanding at December 31, 2006 or 2007. In both 2006 and 2007, the Company achieved its highest growth in time deposits, particularly time deposits in denominations greater than $100,000. Time deposits, especially time deposits greater than $100,000, are generally the easiest type of deposit to achieve growth in through the use of promotional interest rates. The Company offered promotional interest rates in 2006 and 2007 in order to help fund the strong loan growth experienced both years.

In addition to the increases in time deposits, the Company experienced high growth in its Money Market deposit accounts, which increased by approximately 30% in both 2006 and 2007. These increases are almost entirely due to the Company's introduction in late 2005 of a high interest rate money market account (4.25% for most of 2006 and 2007) that was created to compete with area competitors. The Company believes that a large portion of the decreases in NOW and Savings accounts in 2006 and 2007 was the result of customers shifting funds to the high rate money market account.

Index

Over the past few years, including 2006 and 2007, the Company's loan growth has exceeded its deposit growth and to a greater extent exceeded its retail deposit growth (which excludes time deposits greater than $100,000). The Company believes the higher internal growth rates for loans compared to retail deposits over the past two years is largely attributable to the type of customers the Company has been able to attract. Most of the Company's loan growth has come from small-business customers that need loans in order to expand their business, and have few deposits. Additionally, the Company has found it difficult to compete for retail deposits in recent years. The Company frequently competes against banks in the marketplace that either 1) are so large that they enjoy better economies of scale over the Company and can thus offer higher rates, or 2) are recently started banks that are focused on building market share, and not necessarily on positive earnings, by offering high deposit rates. The Company believes it enjoys advantages in the loan marketplace because of its seasoned lenders who have the experience necessary to oversee the completion of a loan and are afforded the autonomy to be able to make timely decisions.

The Company's liquidity did not change significantly during 2006 or 2007. Higher loan growth as compared to deposit growth in recent years has resulted in the Company's loan to deposit ratio increasing from 99% in 2005 to 103% in both 2006 and 2007. The negative impact on the Company's liquidity due to the imbalance in loan and deposit growth has been offset by a higher level of securities sold under agreements to repurchase and borrowings. The level of the Company's liquid assets (consisting of cash, due from banks, federal funds sold, presold mortgages in process of settlement and securities) as a percentage of deposits, securities sold under agreements to repurchase and borrowings has remained stable, amounting to approximately 15% at each of the past three year ends.

In both 2006 and 2007, the Company's balance sheet growth exceeded internal capital growth resulting from earnings. In order to maintain its regulatory capital ratios at internal targets in 2006, the Company issued an additional $25.8 million in trust preferred debt securities, which are includable as regulatory capital. The increases to the Company's capital ratios resulting from this issuance were mostly offset in 2007 by the redemption of $20.6 million in trust preferred securities that had been originally issued in 2002. All of the Company's capital ratios have significantly exceeded the minimum regulatory thresholds for all periods covered by this report.

Although the Company's largest market area, the central Piedmont region of North Carolina, has experienced economic difficulties in the past few years as a result of manufacturing job losses, the Company's asset quality ratios have remained fairly stable over the past three years, with ratios of net charge-offs to average loans ranging from 11 basis points to 16 basis points and nonperforming assets to total assets ranging from 17 basis points to 47 basis points. Consistent with current economic conditions, the Company has noted modest increases in its trends in delinquencies and classified assets. However, the Company does not believe these trends will materially impact its financial condition in the foreseeable future.

Distribution of Assets and Liabilities

Table 7 sets forth the percentage relationships of significant components of the Company's balance sheet at December 31, 2007, 2006, and 2005.

The relative size of the components of the balance sheet has not varied significantly over the past two years, with loans comprising 80%-81% of total assets and deposits comprising 79%-83%. The most significant variance in Table 7 is the 2006 increase in the percentage of borrowings, which increased from 5% at December 31, 2005, to 10% at December 31, 2006. The Company has increasingly relied on borrowings in order to help fund the strong loan growth that has exceeded deposit growth.

Index

Securities

Information regarding the Company's securities portfolio as of December 31, 2007, 2006, and 2005 is presented in Tables 8 and 9.

The composition of the investment securities portfolio reflects the Company's investment strategy of maintaining an appropriate level of liquidity while providing a relatively stable source of income. The investment portfolio also provides a balance to interest rate risk and credit risk in other categories of the balance sheet while providing a vehicle for the investment of available funds, furnishing liquidity, and supplying securities to pledge as required collateral for certain deposits.

Total securities amounted to $151.8 million, $143.1 million, and $125.1 million at December 31, 2007, 2006, and 2005, respectively. The increase in securities over the past two years was primarily due to securities purchases that have been necessary to collateralize higher levels of repurchase agreements and pledged deposits, as well as to help maintain the Company's liquidity at targeted levels. Over the past two years, the Company has elected to primarily purchase securities issued by the Federal Home Loan Bank, a government-sponsored enterprise, which, due to their non-amortizing nature, are easier to pledge than mortgage-backed securities and can be more easily purchased in shorter maturity terms than mortgage-backed securities. In general, the Company prefers to invest in short-term investments in order to provide liquidity and manage interest rate risk.

The majority of the Company's "government-sponsored enterprise" securities are issued by the Federal Home Loan Bank and carry one maturity date, often with an issuer call feature. The Company's mortgage-backed securities have been primarily issued by Freddie Mac and Fannie Mae, which are government-sponsored corporations, and vary in their repayment in correlation with the underlying pools of home mortgage loans. The Company's investment in corporate bonds is primarily comprised of trust preferred securities issued by other North Carolina bank holding companies.

Included in mortgage-backed securities at December 31, 2007 were collateralized mortgage obligations ("CMOs") with an amortized cost of $9,551,000 and a fair value of $9,373,000. Included in mortgage-backed securities at December 31, 2006 were CMOs with an amortized cost of $11,898,000 and a fair value of $11,517,000. Included in mortgage-backed securities at December 31, 2005 were CMOs with an amortized cost of $15,810,000 and a fair value of $15,399,000. The CMOs that the Company has invested in are substantially all "early tranche" portions of the CMOs, which minimizes long-term interest rate risk to the Company.

At December 31, 2007, a net unrealized gain of $86,000 was included in the carrying value of securities classified as available for sale, compared to net unrealized losses of $860,000 and $1,049,000 at December 31, 2006 and 2005, respectively. In 2006 and 2005, a steadily rising interest rate environment caused a decline in fair market value of securities. In 2007, declines in interest rates late in the year resulted in a small unrealized gain at December 31, 2007. Higher interest rates negatively impact the value of fixed income securities and conversely, lower interest rates have a positive impact on the value of fixed income securities. Management evaluated any unrealized losses on individual securities at each year end and determined them to be of a temporary nature and caused by fluctuations in market interest rates, not by concerns about the ability of the issuers to meet their obligations. Net unrealized gains (losses), net of applicable deferred income taxes, of $52,000, ($524,000), and ($639,000) have been reported as part of a separate component of shareholders' equity (accumulated other comprehensive income (loss)) as of December 31, 2007, 2006, and 2005, respectively.

The fair value of securities held to maturity, which the Company carries at amortized cost, was more than the carrying value at December 31, 2007 and 2006 by $9,000 and $46,000, respectively. Management evaluated any unrealized losses on individual securities at each year end and determined them to be of a temporary nature and caused by fluctuations in market interest rates, not by concerns about the ability of the issuers to meet their obligations.

Table 9 provides detail as to scheduled contractual maturities and book yields on securities available for sale and securities held to maturity at December 31, 2007. Mortgage-backed and other amortizing securities are shown maturing in the time periods consistent with their estimated lives based on expected prepayment speeds.

Index

The weighted average taxable-equivalent yield for the securities available for sale portfolio was 5.14% at December 31, 2007. The expected weighted average life of the available for sale portfolio using the call date for above-market callable bonds, the maturity date for all other non-mortgage-backed securities, and the expected life for mortgage-backed securities, was 3.9 years.

The weighted average taxable-equivalent yield for the securities held to maturity portfolio was 6.61% at December 31, 2007. The expected weighted average life of the held to maturity portfolio using the call date for above-market callable bonds and the maturity date for all other securities, was 6.0 years.

As of December 31, 2007 and 2006, the Company held no investment securities of any one issuer, other than government-sponsored enterprises or corporations, in which aggregate book values and market values exceeded 10% of shareholders' equity.

Loans

Table 10 provides a summary of the loan portfolio composition at each of the past five year ends.

The loan portfolio is the largest category of the Company's earning assets and is comprised of commercial loans, real estate mortgage loans, real estate construction loans, and consumer loans. The Company restricts virtually all of its lending to its 26 county market area, which is located in central and southeastern North Carolina, three counties in southern Virginia and Dillon County, South Carolina. The diversity of the region's economic base has historically provided a stable lending environment.

In 2007, loans outstanding increased $153.9 million, or 8.8%, to $1.89 billion. In 2006, loans outstanding increased $257.8 million, or 17.4%, to $1.74 billion. All of the loan growth in 2007 was internally generated, as the Company did not complete any acquisitions during that year. The majority of the loan growth in 2006 was internally generated, as the Company only acquired a total of $6 million in loans from the acquisitions of two bank branches completed in 2006. The majority of the 2007 and 2006 loan growth occurred in loans secured by real estate, with approximately $136.8 million, or 88.9%, in 2007, and $224.8 million, or 87.2%, in 2006, of the net loan growth occurring in real estate mortgage or real estate construction loans.

Within the growth in real estate loans in 2006 and 2007, the Company has experienced the highest growth in the following two categories – i) construction and land development loans – growth of $58 million in 2007 and $30 million in 2006, and ii) unimproved land (primarily vacant residential lots) – growth of $55 million in 2007 and $75 million in 2006. These two categories combined totaled $384.0 million at December 31, 2007, or 20.2% of all loans, and totaled $271.7 million at December 31, 2006, or 15.6% of all loans. The Company has not noted any significant changes in credit quality trends among these types of loans in the last twelve months.

Over the years, the Company's loan mix has remained fairly consistent, with real estate loans (mortgage and construction) comprising approximately 86% of the loan portfolio, commercial, financial, and agricultural loans not secured by real estate comprising 9-10%, and consumer installment loans comprising 4-5% of the portfolio. The majority of the Company's "real estate" loans are primarily various personal and commercial loans where real estate provides additional security for the loan.

Index

At December 31, 2007, $1.637 billion, or 86.4%, of the Company's loan portfolio was secured by liens on real property. Included in this total are $724.2 million, or 38.2% of total loans, in loans secured by liens on 1-4 family residential properties and $912.5 million, or 48.2% of total loans, in loans secured by liens on other types of real estate. At December 31, 2006, $1.500 billion, or 86.2%, of the Company's loan portfolio was secured by liens on real property. Included in this total are $718.4 million, or 41.3% of total loans, in loans secured by liens on 1-4 family residential properties and $781.6 million, or 44.9% of total loans, in loans secured by liens on other types of real estate. The Company's $1.637 billion in real estate mortgage loans at December 31, 2007 can be further classified as follows – for comparison purposes, the classification of the Company's $1.500 billion real estate loan portfolio at December 31, 2006 is shown in parenthesis:

- $514.3 million, or 27.2% of total loans (vs. $513.1 million, or 29.5% of total loans), are secured by first liens on residential homes, in which the borrower's personal income is generally the primary repayment source.
- $496.0 million, or 26.2% of total loans (vs. $474.6 million, or 27.3% of total loans), are primarily dependent on cash flow from a commercial business for repayment.
- $212.9 million, or 11.2% of total loans (vs. $155.4 million, or 8.9% of total loans), are real estate construction and land development loans.
- $209.9 million, or 11.1% of total loans (vs. $205.3 million, or 11.8% of total loans), are home equity loans (lines-of-credit and term loans) obtained by consumers for various purposes.
- $171.1 million, or 9.0% of total loans (vs. $116.3 million, or 6.7% of total loans), are tracts of unimproved land.
- $32.6 million, or 1.7% of total loans (vs. $35.3 million, or 2.0% of total loans), are primarily dependent on cash flow from agricultural crop sales.

Table 11 provides a summary of scheduled loan maturities over certain time periods, with fixed rate loans and adjustable rate loans shown separately. Approximately 31% of the Company's loans outstanding at December 31, 2007 mature within one year and 81% of total loans mature within five years. The percentages of variable rate loans and fixed rate loans as compared to total performing loans were 46.3% and 53.7%, respectively, as of December 31, 2007. The Company intentionally makes a blend of fixed and variable rate loans so as to reduce interest rate risk. See discussion regarding fluctuations in the Company's ratio of fixed rate loans to variable rate loans in the section above entitled "Net Interest Income."

Nonperforming Assets

Nonperforming assets include nonaccrual loans, loans past due 90 or more days and still accruing interest, restructured loans and other real estate. As a matter of policy the Company places all loans that are past due 90 or more days on nonaccrual basis, and thus there were no loans at any of the past five year ends that were 90 days past due and still accruing interest. Table 12 summarizes the Company's nonperforming assets at the dates indicated.

Nonaccrual loans are loans on which interest income is no longer being recognized or accrued because management has determined that the collection of interest is doubtful. Placing loans on nonaccrual status negatively impacts earnings because (i) interest accrued but unpaid as of the date a loan is placed on nonaccrual status is reversed and deducted from interest income, (ii) future accruals of interest income are not recognized until it becomes probable that both principal and interest will be paid and (iii) principal charged-off, if appropriate, may necessitate additional provisions for loan losses that are charged against earnings. In some cases, where borrowers are experiencing financial difficulties, loans may be restructured to provide terms significantly different from the originally contracted terms.

Nonperforming loans (which includes nonaccrual loans and restructured loans) as of December 31, 2007, 2006, and 2005 totaled $7,813,000, $6,862,000, and $1,653,000, respectively. Nonperforming loans as a percentage of total

loans amounted to 0.41%, 0.39%, and 0.11%, at December 31, 2007, 2006, and 2005, respectively.

37

Index

The variances in the dollar amount of nonperforming loans among the periods have been primarily due to changes in nonaccrual loans, as restructured loans have not changed significantly. In the fourth quarter of 2005, the collection process for several of the Company's largest nonaccrual loan relationships reached a conclusion and their principal balances were reduced to zero either as a result of cash received or the loan being charged-off. This resulted in the amount of the Company's nonperforming loans at December 31, 2005 reaching its lowest level in over five years. In 2006 and 2007, the Company experienced more typical activity within its nonaccrual loan category, and the amount of nonaccrual loans increased to more normal levels as a percentage of the total loan portfolio. The Company’s largest nonaccrual relationships at December 31, 2007 and 2006 amounted to $530,000 and $585,000, respectively.

If the nonaccrual loans and restructured loans as of December 31, 2007, 2006 and 2005 had been current in accordance with their original terms and had been outstanding throughout the period (or since origination if held for part of the period), gross interest income in the amounts of approximately $610,000, $510,000 and $123,000 for nonaccrual loans and $1,000, $1,000 and $2,000 for restructured loans would have been recorded for 2007, 2006, and 2005, respectively. Interest income on such loans that was actually collected and included in net income in 2007, 2006, and 2005 amounted to approximately $252,000, $179,000 and $67,000 for nonaccrual loans (prior to their being placed on nonaccrual status) and $1,000, $1,000 and $2,000 for restructured loans, respectively. At December 31, 2007 and 2006, the Company had no commitments to lend additional funds to debtors whose loans were nonperforming.

Management routinely monitors the status of certain large loans that, in management’s opinion, have credit weaknesses that could cause them to become nonperforming loans. In addition to the nonperforming loan amounts discussed above, management believes that an estimated $5.5-$6.0 million of loans that were performing in accordance with their contractual terms at December 31, 2007 have the potential to develop problems depending upon the particular financial situations of the borrowers and economic conditions in general. Management has taken these potential problem loans into consideration when evaluating the adequacy of the allowance for loan losses at December 31, 2007 (see discussion below).

Loans classified for regulatory purposes as loss, doubtful, substandard, or special mention that have not been disclosed in the problem loan amounts and the potential problem loan amounts discussed above do not represent or result from trends or uncertainties that management reasonably expects will materially impact future operating results, liquidity, or capital resources, or represent material credits about which management is aware of any information that causes management to have serious doubts as to the ability of such borrowers to comply with the loan repayment terms.

Other real estate includes foreclosed, repossessed, and idled properties. Other real estate has increased over the past three years, amounting to $3,042,000 at December 31, 2007, $1,539,000 at December 31, 2006, and $1,421,000 at December 31, 2005. Other real estate represented approximately 0.07%-0.13% of total assets at each of the past three year ends. The increases in other real estate are due to increased foreclosure activity. At December 31, 2007, the largest balance related to any single piece of other real estate was $425,000. The Company’s management believes that the fair values of the items of other real estate, less estimated costs to sell, equal or exceed their respective carrying values at the dates presented.

Index

Allowance for Loan Losses and Loan Loss Experience

The allowance for loan losses is created by direct charges to operations (known as a "provision for loan losses" for the period in which the charge is taken). Losses on loans are charged against the allowance in the period in which such loans, in management's opinion, become uncollectible. The recoveries realized during the period are credited to this allowance. The Company considers its procedures for recording the amount of the allowance for loan losses and the related provision for loan losses to be a critical accounting policy. See the heading "Critical Accounting Policies" above for further discussion.

The factors that influence management's judgment in determining the amount charged to operating expense include past loan loss experience, composition of the loan portfolio, evaluation of probable inherent losses and current economic conditions.

The Company uses a loan analysis and grading program to facilitate its evaluation of probable inherent loan losses and the adequacy of its allowance for loan losses. In this program, risk grades are assigned by management and tested by an independent third party consulting firm. The testing program includes an evaluation of a sample of new loans, loans that management identifies as having potential credit weaknesses, loans past due 90 days or more, loans originated by new loan officers, nonaccrual loans and any other loans identified during previous regulatory and other examinations.

The Company strives to maintain its loan portfolio in accordance with what management believes are conservative loan underwriting policies that result in loans specifically tailored to the needs of the Company's market areas. Every effort is made to identify and minimize the credit risks associated with such lending strategies. The Company has no foreign loans, few agricultural loans and does not engage in significant lease financing or highly leveraged transactions. Commercial loans are diversified among a variety of industries. The majority of loans captioned in the tables discussed below as "real estate" loans are primarily various personal and commercial loans where real estate provides additional security for the loan. Collateral for virtually all of these loans is located within the Company's principal market area.

Although the Company's largest market area, the central Piedmont region of North Carolina, has experienced economic difficulties in the past few years as a result of manufacturing job losses, the Company's asset quality ratios have remained fairly stable over the past three years with net charge-offs to average loans ranging from 11 basis points to 16 basis points and nonperforming assets to total assets ranging from 17 basis points to 47 basis points. Consistent with current economic conditions, the Company has noted modest increases in its trends in delinquencies and classified assets. However, the Company does not believe that these trends will materially impact its financial condition in the foreseeable future. The Company does not originate "subprime" loans.

The allowance for loan losses amounted to $21,324,000 at December 31, 2007 compared to $18,947,000 at December 31, 2006 and $15,716,000 at December 31, 2005. This represented 1.13%, 1.09%, and 1.06%, of loans outstanding as of December 31, 2007, 2006, and 2005, respectively. The higher percentages in 2006 and 2007 are primarily associated with slightly higher levels of classified assets in each year. As noted in Table 12, the Company's allowance for loan losses as a percentage of nonperforming loans ("coverage ratio") amounted to 273% at December 31, 2007 compared to 276% at December 31, 2006 and 951% at December 31, 2005. Due to the secured nature of virtually all of the Company's loans that are on nonaccrual status, the variance in the coverage ratio is not necessarily indicative of the relative adequacy of the allowance for loan losses. As noted above in "Nonperforming Assets", the level of nonaccrual loans at December 31, 2005 was at an unusually low level, thus resulting in the higher coverage ratio for the 2005 year end.

Table 13 sets forth the allocation of the allowance for loan losses at the dates indicated. The portion of these reserves that was allocated to specific loan types in the loan portfolio increased to $21,306,000 at December 31, 2007 from $18,942,000 at December 31, 2006 and $15,692,000 at December 31, 2005. The 12.5% increase in the amount of the allocated allowance during 2007 is relatively consistent with the 8.8% increase in total loans outstanding during the year.

Index

Similarly, the 20.7% increase in the amount of the allocated allowance during 2006 is consistent with the 17.4% increase in total loans outstanding during the year. In addition to the allocated portion of the allowance for loan losses, the Company maintains an unallocated portion that is not assigned to any specific category of loans, but rather is intended to reserve for the inherent risk in the overall portfolio and the intrinsic inaccuracies associated with the estimation of the allowance for loan losses and its allocation to specific loan categories. The amount of the unallocated portion of the allowance for loan losses did not vary materially at any of the past three year ends. The allowance for loan losses is available to absorb losses in all categories.

Management considers the allowance for loan losses adequate to cover probable loan losses on the loans outstanding as of each reporting date. It must be emphasized, however, that the determination of the allowance using the Company's procedures and methods rests upon various judgments and assumptions about economic conditions and other factors affecting loans. No assurance can be given that the Company will not in any particular period sustain loan losses that are sizable in relation to the amount reserved or that subsequent evaluations of the loan portfolio, in light of conditions and factors then prevailing, will not require significant changes in the allowance for loan losses or future charges to earnings.

In addition, various regulatory agencies, as an integral part of their examination process, periodically review the allowances for loan losses and losses on foreclosed real estate. Such agencies may require the Company to recognize additions to the allowances based on the examiners' judgments about information available to them at the time of their examinations.

For the years indicated, Table 14 summarizes the Company's balances of loans outstanding, average loans outstanding, and a detailed rollforward of the allowance for loan losses. In addition to the increases to the allowance for loan losses related to normal provisions, the increases in the dollar amounts of the allowance for loan losses in 2006 was also affected by amounts recorded to provide for loans assumed in corporate acquisitions. In 2006, the Company added $52,000 to the allowance for loan losses related to approximately $6 million in loans assumed in a branch acquisition.

Table 14 also provides a breakout of loans charged-off and recoveries of loans previously charged-off based on the loan type. In years prior to 2006, the Company's policy was to record net charge-offs related to deposit overdrafts as a reduction to service charges on deposits accounts. Based on regulatory requirements, on July 1, 2006, the Company began recording charge-offs and recoveries related to deposit overdrafts to the allowance for loan losses. Total net charge-offs related to overdrafts that were recorded as a reduction to service charges on deposit accounts instead of a reduction to the allowance for loan losses amounted to $81,000 for the six months ended June 30, 2006 and $248,000, $258,000, and $272,000, for the years ended December 31, 2005, 2004, and 2003, respectively.

The Company's net loan charge-offs amounted to $2,840,000 in 2007, $1,744,000 in 2006, and $2,041,000 in 2005. This represents 0.16%, 0.11%, and 0.14% of average loans during 2007, 2006, and 2005 respectively. In each of the past five years, the Company's net charge-off ratio has been in the range of 0.10%-0.16%.

Deposits and Securities Sold Under Agreements to Repurchase

At December 31, 2007, deposits outstanding amounted to $1.838 billion, an increase of $142 million, or 8.4%, from December 31, 2006. There were no deposits assumed in acquisitions in 2007. In 2006, deposits grew from $1.495 billion to $1.696 billion, an increase of $201 million, or 13.5% from December 31, 2005. Approximately $157 million, or 78%, of the deposit growth in 2006 was internally generated, while the remaining $44 million, or 22%, resulted from the acquisitions of two bank branches completed in 2006.

The nature of the Company's deposit growth is illustrated in the table on page 33. The following table reflects the mix of the Company's deposits at each of the past three year ends:

	2007	2006	2005
Noninterest-bearing deposits	13%	13%	13%
NOW deposits	10%	11%	13%
Money market deposits	14%	12%	10%
Savings deposits	6%	6%	8%
Time deposits > $100,000	26%	25%	24%
Time deposits < $100,000	31%	33%	32%
Total deposits	100%	100%	100%
Securities sold under agreements to repurchase as a percent of total deposits	2%	3%	2%

The deposit mix remained relatively consistent from 2005 to 2007, with the largest variances being a decrease in NOW and Savings deposits and an increase in Money Market deposits. The Company believes this has been due to the introduction of a high interest rate money market account that was created to compete with area competitors. The Company believes that a large portion of the decreases in NOW deposit accounts and Savings deposit accounts in 2006 and 2007 was the result of a shift to the high rate money market account.

The Company routinely engages in activities designed to grow and retain deposits, such as (1) emphasizing relationship banking to new and existing customers, where borrowers are encouraged and normally expected to maintain deposit accounts with the Company, (2) pricing deposits at rate levels that will attract and/or retain a level of deposits, and (3) continually working to identify and introduce new products that will attract customers or enhance the Company's appeal as a primary provider of financial services.

Table 15 presents the average amounts of deposits of the Company and the average yield paid for those deposits for the years ended December 31, 2007, 2006, and 2005.

As of December 31, 2007, the Company held approximately $479.2 million in time deposits of $100,000 or more. Table 16 is a maturity schedule of time deposits of $100,000 or more as of December 31, 2007. This table shows that 90% of the Company's time deposits greater than $100,000 mature within one year.

At each of the past three year ends, the Company had no deposits issued through foreign offices, nor did the Company believe that it held any deposits by foreign depositors.

Borrowings

The Company had borrowings outstanding of $242.4 million at December 31, 2007 compared to $210.0 million at December 31, 2006. As shown in Table 2, average borrowings have steadily increased over the past three years, amounting to $77.1 million in 2005, increasing by $36 million in 2006 to $113.4 million, and increasing by $17 million to $130.4 million in 2007. The increase in borrowings in 2006 and 2007 has been primarily a result of needing to fund the loan growth that has exceeded deposit growth. In 2006, average loans outstanding were $201 million higher than in 2005, whereas average deposits increased by only $139 million. In 2007, average loans increased by $185 million compared to average deposit growth of $181 million.

At December 31, 2007, the Company had three sources of readily available borrowing capacity - 1) an approximately $321 million line of credit with the Federal Home Loan Bank of Atlanta (FHLB), of which $176 million was outstanding at December 31, 2007 and $143 million was outstanding at December 31, 2006, 2) a $70 million overnight federal funds line of credit with a correspondent bank, none of which was outstanding at December 31, 2007 or 2006, and 3) an approximately $81 million line of credit through the Federal Reserve Bank of Richmond's (FRB) discount window, none of which was outstanding at December 31, 2007 or 2006.

Index

The Company's line of credit with the FHLB can be structured as either short-term or long-term borrowings, depending on the particular funding or liquidity need, and is secured by the Company's FHLB stock and a blanket lien on most of its real estate loan portfolio. As of December 31, 2007, $171 million of the $176 million outstanding with the FHLB was structured as short-term borrowings and had a weighted-average interest rate of 4.41%, with the remaining $5 million outstanding having an interest rate of 5.26% and a maturity date in April 2009. For the year ended December 31, 2007, the average amount of short-term FHLB borrowings outstanding was approximately $58 million and had a weighted average interest rate for the year of 5.26%. The maximum amount of short-term FHLB borrowings outstanding at any month-end during 2007 was the year end amount of $171 million.

In addition to the outstanding borrowings from the FHLB that reduce the available borrowing capacity of the line of credit, the borrowing capacity was further reduced by $40 million at December 31, 2007 and 2006 as a result of the Company pledging letters of credit backed by the FHLB for public deposits at each of those dates.

The Company's correspondent bank relationship allows the Company to purchase up to $70 million in federal funds on an overnight, unsecured basis (federal funds purchased). The Company had no borrowings outstanding under this line at December 31, 2007 or 2006. This line of credit was not drawn upon during any of the past three years.

The Company also has a line of credit with the FRB discount window. This line is secured by a blanket lien on a portion of the Company's commercial and consumer loan portfolio (excluding real estate loans). Based on the collateral owned by the Company as of December 31, 2007, the available line of credit is approximately $81 million. This line of credit was established primarily in connection with the Company's Y2K liquidity contingency plan and has not been drawn on since inception. The FRB has indicated that it would not expect lines of credit that have been granted to financial institutions to be a primary borrowing source. The Company plans to maintain this line of credit, although it is not expected that it will be drawn upon except in unusual circumstances.

In addition to the lines of credit described above, in which the Company had $176 million and $143 million outstanding as of December 31, 2007, and 2006, respectively, the Company also had a total of $46.4 million in trust preferred security debt outstanding at December 31, 2007 and $67.0 million outstanding as of December 31, 2006. The Company has initiated three trust preferred security issuances since 2002 totaling $67.0 million, with one of those issuances for $20.6 million being redeemed in 2007. These borrowings each have 30 year final maturities and were structured in a manner that allow them to qualify as capital for regulatory capital adequacy requirements. These debt securities are callable by the Company at par on any quarterly interest payment date five years after their issue date. The Company issued $20.6 million of this debt on October 29, 2002, an additional $20.6 million on December 19, 2003, and $25.8 million on April 13, 2006. The interest rate on these debt securities adjusts on a quarterly basis at a rate of three-month LIBOR plus 3.45% for the securities issued in 2002, three-month LIBOR plus 2.70% for the securities issued in 2003, and three-month LIBOR plus 1.39% for the securities issued in 2006.

The $20.6 million in trust preferred securities that were issued in 2002 at a rate of LIBOR plus 3.45% were called and redeemed by the Company at par in November 2007. The Company's original intent was to replace the called securities with a new issuance at a lower interest rate that would also qualify as regulatory capital. However, the Company's ability to issue new trust preferred securities into the marketplace was negatively impacted by the liquidity and credit concerns experienced in the United States economy beginning in the fall of 2007. The Company observed that very few trust preferred securities were being issued in the marketplace in the fall of 2007, and those that were issued carried a significantly higher interest rate than those issued in recent years. It was the Company's general belief that this period of low demand and high interest rates in the marketplace was a temporary phenomenon and that the opportunity to issue new trust preferred securities at more favorable rates would return in the near future. Accordingly, the Company elected to fund the redemption of the trust preferred securities issued in 2002 with a $20 million line of credit that the Company obtained from a third-party commercial bank. This line of credit has a maturity date of October 30, 2009 and carries an interest rate of either i) prime minus 1.00% or ii) LIBOR plus

1.50%, at the discretion of the Company. Although this line of credit does not qualify as regulatory capital, the Company's capital ratios continued to significantly exceed minimum regulatory thresholds following the redemption. It is the Company's continued intent to replace the line of credit in the near future with debt that qualifies as regulatory capital.

Index

The Company incurred approximately $1,195,000 in debt issuance costs related to the 2002 and 2003 trust preferred security issuances that were recorded as prepaid expenses that are being amortized to the earliest call dates and are included in the "Other Assets" line item of the consolidated balance sheet. No debt issuance costs were incurred with the 2006 issuance.

Liquidity, Commitments, and Contingencies

The Company's liquidity is determined by its ability to convert assets to cash or to acquire alternative sources of funds to meet the needs of its customers who are withdrawing or borrowing funds, and its ability to maintain required reserve levels, pay expenses and operate the Company on an ongoing basis. The Company's primary liquidity sources are net income from operations, cash and due from banks, federal funds sold and other short-term investments. The Company's securities portfolio is comprised almost entirely of readily marketable securities which could also be sold to provide cash.

As noted above, in addition to internally generated liquidity sources, the Company has the ability to obtain borrowings from the following three sources – 1) an approximately $321 million line of credit with the FHLB, 2) a $70 million overnight federal funds line of credit with a correspondent bank, and 3) an approximately $81 million line of credit through the FRB's discount window.

The Company's liquidity did not change significantly during 2006 or 2007. Higher loan growth as compared to deposit growth in recent years has resulted in the Company's loan to deposit ratio increasing from 99% in 2005 to 103% in both 2006 and 2007. The negative impact on the Company's liquidity due to the imbalance in loan and deposit growth has been offset by a higher level of securities sold under agreements to repurchase and borrowings. The level of the Company's liquid assets (consisting of cash, due from banks, federal funds sold, presold mortgages in process of settlement and securities) as a percentage of deposits, securities sold under agreements to repurchase and borrowings has grown slightly over the past two years, with this ratio increasing from 14.2% in 2005 to 15.1% in both 2006 and 2007.

The Company's management believes its liquidity sources, including unused lines of credit, are at an acceptable level and remain adequate to meet its operating needs in the foreseeable future. The Company will continue to monitor its liquidity position carefully and will explore and implement strategies to increase liquidity if deemed appropriate.

In the normal course of business there are various outstanding contractual obligations of the Company that will require future cash outflows. In addition, there are commitments and contingent liabilities, such as commitments to extend credit, that may or may not require future cash outflows.

Table 18 reflects the contractual obligations and other commercial commitments of the Company outstanding as of December 31, 2007. Any of the Company's $176 million in outstanding borrowings with the FHLB may be accelerated immediately by the FHLB in certain circumstances, including material adverse changes in the condition of the Company or if the Company's qualifying collateral is less than the amount required under the terms of the borrowing agreement.

In the normal course of business there are various outstanding commitments and contingent liabilities such as commitments to extend credit, which are not reflected in the financial statements. As of December 31, 2007, the Company had outstanding unfunded loan and credit card commitments of $340,160,000, of which $281,999,000 were at variable rates and $58,161,000 were at fixed rates. Included in outstanding loan commitments were unfunded commitments of $197,777,000 on revolving credit plans, of which $171,871,000 were at variable rates and $25,906,000 were at fixed rates.

At December 31, 2007 and 2006, the Company had $6,176,000 and $4,459,000, respectively, in standby letters of credit outstanding. The Company had no carrying amount for these standby letters of credit at either of those dates. The nature of the standby letters of credit is that of a guarantee made on behalf of the Company's customers to suppliers of the customers to guarantee payments owed to the supplier by the customer.

Index

The standby letters of credit are generally for terms of one year, at which time they may be renewed for another year if both parties agree. The payment of the guarantees would generally be triggered by a continued nonpayment of an obligation owed by the customer to the supplier. The maximum potential amount of future payments (undiscounted) the Company could be required to make under the guarantees in the event of nonperformance by the parties to whom credit or financial guarantees have been extended is represented by the contractual amount of the financial instruments discussed above. In the event that the Company is required to honor a standby letter of credit, a note, already executed by the customer, becomes effective providing repayment terms and any collateral. Over the past ten years, the Company has had to honor one standby letter of credit, which was repaid by the borrower without any loss to the Company. Management expects any draws under existing commitments to be funded through normal operations.

It has been the experience of the Company that deposit withdrawals are generally replaced with new deposits, thus not requiring any net cash outflow. Based on that assumption, management believes that it can meet its contractual cash obligations and existing commitments from normal operations.

The Company is not involved in any legal proceedings that, in management's opinion, could have a material effect on the consolidated financial position of the Company; however, see "Income Taxes" above for discussion of a tax loss contingency.

Off-Balance Sheet Arrangements and Derivative Financial Instruments

Off-balance sheet arrangements include transactions, agreements, or other contractual arrangements pursuant to which the Company has obligations or provides guarantees on behalf of an unconsolidated entity. The Company has no off-balance sheet arrangements of this kind other than repayment guarantees associated with its trust preferred securities.

Derivative financial instruments include futures, forwards, interest rate swaps, options contracts, and other financial instruments with similar characteristics. The Company has not engaged in derivatives activities through December 31, 2007 and has no current plans to do so.

Interest Rate Risk (Including Quantitative and Qualitative Disclosures About Market Risk – Item 7A.)

Net interest income is the Company's most significant component of earnings. Notwithstanding changes in volumes of loans and deposits, the Company's level of net interest income is continually at risk due to the effect that changes in general market interest rate trends have on interest yields earned and paid with respect to the various categories of earning assets and interest-bearing liabilities. It is the Company's policy to maintain portfolios of earning assets and interest-bearing liabilities with maturities and repricing opportunities that will afford protection, to the extent practical, against wide interest rate fluctuations. The Company's exposure to interest rate risk is analyzed on a regular basis by management using standard GAP reports, maturity reports, and an asset/liability software model that simulates future levels of interest income and expense based on current interest rates, expected future interest rates, and various intervals of "shock" interest rates. Over the years, the Company has been able to maintain a fairly consistent yield on average earning assets (net interest margin). Over the past five calendar years, the Company's net interest margin has ranged from a low of 4.00% (realized in 2007) to a high of 4.52% (realized in 2003). During that five year period, the prime rate of interest has ranged from a low of 4.00% to a high of 8.25%. The consistency of the net interest margin is aided by the relatively low level of long-term interest rate exposure that the Company maintains. At December 31, 2007, approximately 95% of the Company's interest-earning assets are subject to repricing within five years (because they are either adjustable rate assets or they are fixed rate assets that mature) and substantially all of its interest-bearing liabilities reprice with five years.

44

Table 17 sets forth the Company's interest rate sensitivity analysis as of December 31, 2007, using stated maturities for all instruments except mortgage-backed securities (which are allocated in the periods of their expected payback) and securities and borrowings with call features that are expected to be called (which are shown in the period of their expected call). As illustrated by this table, at December 31, 2007, the Company had $503 million more in interest-bearing liabilities that are subject to interest rate changes within one year than earning assets. This generally would indicate that net interest income would experience downward pressure in a rising interest rate environment and would benefit from a declining interest rate environment. However, this method of analyzing interest sensitivity only measures the magnitude of the timing differences and does not address earnings, market value, or management actions. Also, interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. In addition to the effects of "when" various rate-sensitive products reprice, market rate changes may not result in uniform changes in rates among all products. For example, included in interest-bearing liabilities subject to interest rate changes within one year at December 31, 2007 are deposits totaling $558 million comprised of NOW, savings, and certain types of money market deposits with interest rates set by management. These types of deposits historically have not repriced with or in the same proportion as general market indicators.

Overall, the Company believes that in the near term (twelve months), net interest income would not likely experience significant downward pressure from rising interest rates. Similarly, management would not expect a significant increase in near term net interest income from falling interest rates. Generally, when rates change, the Company's interest-sensitive assets that are subject to adjustment reprice immediately at the full amount of the change, while the Company's interest-sensitive liabilities that are subject to adjustment reprice at a lag to the rate change and typically not to the full extent of the rate change. In the short-term (less than six months), this results in the Company being asset-sensitive, meaning that the Company's net interest income benefits from an increase in interest rates and is negatively impacted by a decrease in interest rates. However, in the twelve-month horizon, the impact of having a higher level of interest-sensitive liabilities lessens the short-term effects of changes in interest rates just discussed. The general discussion in this paragraph applies most directly in a "normal" interest rate environment in which longer term maturity instruments carry higher interest rates than short term maturity instruments, and is less applicable in periods in which there is a "flat" interest rate curve, as discussed in the following paragraph.

Prior to the interest rate decrease that occurred in September 2007, the Federal Reserve had increased the discount rate 17 times totaling 425 basis points beginning on July 1, 2004 and regularly thereafter until June 29, 2006. However, the impact of these rate increases did not have an equal effect on short-term interest rates and long-term interest rates in the marketplace. In the marketplace, short-term rates rose by a significantly higher amount than have longer-term interest rates. For example, from June 30, 2004 to December 31, 2006, the interest rate on three-month treasury bills rose by 369 basis points, whereas the interest rate for seven-year treasury notes increased by only 46 basis points. This resulted in what economists refer to as a "flat yield curve", which means that short-term interest rates were substantially the same as long-term interest rates. This is an unfavorable interest rate environment for many banks, including the Company, as short-term interest rates generally drive the Company's deposit pricing and longer-term interest rates generally drive loan pricing. When these rates converge, which they did, the profit spread the Company realizes between loan yields and deposit rates narrows, which reduces the Company's net interest margin. Due largely to the progressive flattening of the yield curve that occurred throughout 2006, the Company's net interest margin decreased throughout 2006 before stabilizing at the lower levels in 2007 as a result of the relatively stable interest rate environment in effect for most of 2007. The Company's net interest margin was 4.37% in the fourth quarter of 2005 and steadily declined to 4.05% by the fourth quarter of 2006. The Company's net interest margin was 4.18% for the full year 2006, compared to 4.33% in 2005. In 2007, the Company's net interest margin for each quarter of the year was within 3 basis points of its average for the year of 4.00%.

In addition to the impact of the interest rate environment discussed above, the Company's net interest margin was also negatively impacted by the Company having more of its overall funding occurring in its highest cost funding

sources. This trend was caused by aggressive pricing to attract funds to fund high loan growth, and by customers shifting their funds from low cost deposits to higher cost deposits.

Interest rates were reduced by the Federal Reserve by a total of 100 basis points in late 2007. However, because these reductions occurred late in the year, with 50 basis points of cuts occurring in the last 61 days of the year, the Company's net interest margin was only marginally impacted by these cuts in 2007. As noted above, the Company's net interest margin is negatively impacted, at least in the short-term, by reductions in interest rates. Accordingly, in 2008 the Company expects its net interest margin to be negatively impacted by the interest rate cuts that occurred in late 2007 and even more significantly by the additional rate cuts that have already occurred in 2008. In January 2008, the Federal Reserve responded to continued weakness in the US economy by reducing interest rates by another 125 basis points, and many economists are forecasting an additional 75-100 basis points in rate cuts by June 2008. In addition to the initial normal decline in net interest margin that the Company experiences when interest rates are reduced (as discussed above), the cumulative impact of the magnitude of the approximately 300 basis points in interest rate cuts (those already made plus those forecasted) is expected to amplify and lengthen the negative impact on the Company's net interest margin in 2008 and possibly beyond. This is primarily due to the Company's inability to cut a significant portion of its interest-bearing deposits by any significant amount due to their already near-zero interest rate. Based on its most recent interest rate modeling, which assumes an additional 75 basis points in interest rate cuts (federal funds rate = 2.25%, prime = 5.25%), the Company projects its net interest margin will be approximately 3.70% for the full year of 2008. In addition to the assumption regarding interest rates, the aforementioned modeling is dependent on many other assumptions that could vary significantly from expectations, including, but not limited to: prepayment assumptions on fixed rate loans, loan growth, mix of loan growth, deposit growth, mix of deposit growth, and the ability of the Company to manage changes in rates earned on loans and paid on deposits, which will depend largely on actions taken by the Company's competitors.

The Company has no market risk sensitive instruments held for trading purposes, nor does it maintain any foreign currency positions. Table 19 presents the expected maturities of the Company's other than trading market risk sensitive financial instruments. Table 19 also presents the estimated fair values of market risk sensitive instruments as estimated in accordance with Statement of Financial Accounting Standards No. 107, "Disclosures About Fair Value of Financial Instruments." The Company's assets and liabilities have estimated fair values that are do not materially differ from their carrying amounts.

See additional discussion regarding net interest income, as well as discussion of the changes in the annual net interest margin, in the section entitled "Net Interest Income" above.

Index

Return on Assets and Equity

Table 20 shows return on assets (net income divided by average total assets), return on equity (net income divided by average shareholders' equity), dividend payout ratio (dividends per share divided by net income per share) and shareholders' equity to assets ratio (average shareholders' equity divided by average total assets) for each of the years in the three-year period ended December 31, 2007.

Capital Resources and Shareholders' Equity

Shareholders' equity at December 31, 2007 amounted to $174.1 million compared to $162.7 million at December 31, 2006. The two basic components that typically have the largest impact on the Company's shareholders' equity are net income, which increases shareholders' equity, and dividends declared, which decreases shareholders' equity.

In 2007, net income of $21,810,000 increased equity, while dividends declared of $10,928,000 reduced equity. Other significant items affecting shareholders' equity in 2007 were 1) proceeds of $568,000 received from common stock issued as a result of stock option exercises, 2) repurchases of 27,000 shares of the Company's common stock at an average price of $19.41, which reduced shareholders' equity by $532,000, and 3) other comprehensive gain of $216,000, which was primarily comprised of a $576,000 increase in the net unrealized gain, net of taxes, of the Company's available for sale securities and a $360,000 negative adjustment to equity related to the funded status of the Company's two defined benefit plans in accordance with Statement of Financial Accounting Standards No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" (Statement 158). See Notes 1(s) and 11 to the Company's consolidated financial statements for additional discussion of Statement 158.

In 2006, net income of $19,302,000 increased equity, while dividends declared of $10,589,000 reduced equity. Other significant items affecting shareholders' equity in 2006 were 1) proceeds of $1,027,000 received from common stock issued as a result of stock option exercises, 2) proceeds of $1,557,000 received from the issuance of stock into the Company's dividend reinvestment plan, 3) repurchases of 53,000 shares of the Company's common stock at an average price of $20.97, which reduced shareholders' equity by $1,112,000, and 4) a $3,775,000 negative adjustment to equity related to the Company's December 31, 2006 adoption of Statement 158.

In 2005, net income of $16,090,000 increased equity, while dividends declared of $9,930,000 reduced equity. Other significant items affecting shareholders' equity in 2005 were 1) proceeds of $785,000 received from common stock issued as a result of stock option exercises, 2) proceeds of $1,604,000 received from the issuance of stock into the Company's dividend reinvestment plan, and 3) other comprehensive loss of $1,417,000, which was primarily comprised of a $1,362,000 decrease in the net unrealized gain, net of taxes, of the Company's available for sale securities.

The Company is not aware of any recommendations of regulatory authorities or otherwise which, if they were to be implemented, would have a material effect on its liquidity, capital resources, or operations.

The Company and the Bank must comply with regulatory capital requirements established by the FRB and the FDIC. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. These capital standards require the Company and the Bank to maintain minimum ratios of "Tier 1" capital to total risk-weighted assets ("Tier I Capital Ratio") and total capital to

risk-weighted assets (“Total Capital Ratio”) of 4.00% and 8.00%, respectively.

Index

Tier 1 capital is comprised of total shareholders' equity, excluding unrealized gains or losses from the securities available for sale, less intangible assets, and total capital is comprised of Tier 1 capital plus certain adjustments, the largest of which for the Company and the Bank is the allowance for loan losses. Risk-weighted assets refer to the on- and off-balance sheet exposures of the Company and the Bank, adjusted for their related risk levels using formulas set forth in FRB and FDIC regulations.

In addition to the risk-based capital requirements described above, the Company and the Bank are subject to a leverage capital requirement, which calls for a minimum ratio of Tier 1 capital (as defined above) to quarterly average total assets ("Leverage Ratio) of 3.00% to 5.00%, depending upon the institution's composite ratings as determined by its regulators. The FRB has not advised the Company of any requirement specifically applicable to it.

Table 21 presents the Company's regulatory capital ratios as of December 31, 2007, 2006, and 2005. All of the Company's capital ratios have significantly exceeded the minimum regulatory thresholds for all periods covered by this report.

In addition to shareholders' equity, the Company has supplemented its capital in recent years with trust preferred security debt issuances, which because of their structure qualify as regulatory capital. This has generally been necessary because the Company's balance sheet growth has outpaced the growth rate of its capital. Additionally, the Company has purchased several bank branches over the years that resulted in the Company recording intangible assets, which negatively impacted regulatory capital ratios. As discussed in "Borrowings" above, the Company has issued a total of $67.0 million in trust preferred securities since 2002, with the most recent issuance being a $25.8 million issuance that occurred in April 2006. Also as discussed above, in November 2007 the Company elected to redeem $20.6 million of these trust preferred securities due to their high interest rate. Due to unfavorable market conditions, the Company elected to fund the redemption not with new trust preferred securities, which was the Company's intent, but rather with a third-party line of credit, which does not quality as regulatory capital. This redemption reduced the Company's regulatory capital by $20 million and reduced each of its regulatory capital ratios by approximately 100 basis points. It is the Company's intent to replace the line of credit with an instrument that qualifies as regulatory capital in the near future.

In addition to the minimum capital requirements described above, the regulatory framework for prompt corrective action also contains specific capital guidelines for a bank's classification as "well capitalized." The specific guidelines are as follows – Tier I Capital Ratio of at least 6.00%, Total Capital Ratio of at least 10.00%, and a Leverage Ratio of at least 5.00%. The Bank's regulatory ratios exceeded the threshold for "well-capitalized" status at December 31, 2007, 2006, and 2005.

The Company's goal is to maintain its capital ratios at levels no less than the "well-capitalized" thresholds set for banks. At December 31, 2007, the Company's total risk-based capital ratio was 10.30% compared to the 10.00% "well-capitalized" threshold. The Company believes it has readily accessible options to increase capital should the need arise, including perpetual preferred stock, a secondary common stock offering, or the issuance of additional trust preferred securities.

See "Supervision and Regulation" under "Business" above and Note 15 to the consolidated financial statements for discussion of other matters that may affect the Company's capital resources.

Index

Inflation

Because the assets and liabilities of a bank are primarily monetary in nature (payable in fixed determinable amounts), the performance of a bank is affected more by changes in interest rates than by inflation. Interest rates generally increase as the rate of inflation increases, but the magnitude of the change in rates may not be the same. The effect of inflation on banks is normally not as significant as its influence on those businesses that have large investments in plant and inventories. During periods of high inflation, there are normally corresponding increases in the money supply, and banks will normally experience above average growth in assets, loans and deposits. Also, general increases in the price of goods and services will result in increased operating expenses.

Current Accounting and Regulatory Matters

The Company prepares its consolidated financial statements and related disclosures in conformity with standards established by, among others, the Financial Accounting Standards Board (the “FASB”). Because the information needed by users of financial reports is dynamic, the FASB frequently issues new rules and proposes new rules for companies to apply in reporting their activities. See Note 1(s) to the Company’s consolidated financial statements for a discussion of recent rule proposals and changes.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

The information responsive to this Item is found in Item 7 under the caption “Interest Rate Risk.”

FORWARD-LOOKING STATEMENTS

Part I of this report contains statements that could be deemed forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and the Private Securities Litigation Reform Act, which statements are inherently subject to risks and uncertainties. Forward-looking statements are statements that include projections, predictions, expectations or beliefs about future events or results or otherwise are not statements of historical fact. Such statements are often characterized by the use of qualifying words (and their derivatives) such as “expect,” “believe,” “estimate,” “plan,” “project,” or other statements concerning opinions or judgment of the Company and its management about future events. Factors that could influence the accuracy of such forward-looking statements include, but are not limited to, the financial success or changing strategies of the Company’s customers, the Company’s level of success in integrating acquisitions, actions of government regulators, the level of market interest rates, and general economic conditions. For additional information that could affect the matters discussed in this paragraph, see the “Risk Factors” section in Item 1A of this report.

Index

Table 1 Selected Consolidated Financial Data

($ in thousands, except per share and nonfinancial data)	Year Ended December 31, 2007	2006	2005	2004	2003
Income Statement Data					
Interest income	$ 148,942	129,207	101,429	81,593	74,667
Interest expense	69,658	54,671	32,838	20,303	18,907
Net interest income	79,284	74,536	68,591	61,290	55,760
Provision for loan losses	5,217	4,923	3,040	2,905	2,680
Net interest income after provision	74,067	69,613	65,551	58,385	53,080
Noninterest income	18,473	14,310	15,004	15,864	14,918
Noninterest expense	57,580	53,198	47,636	43,717	37,964
Income before income taxes	34,960	30,725	32,919	30,532	30,034
Income taxes	13,150	11,423	16,829	10,418	10,617
Net income	21,810	19,302	16,090	20,114	19,417
Earnings per share – basic	1.52	1.35	1.14	1.42	1.38
Earnings per share – diluted	1.51	1.34	1.12	1.40	1.35
Per Share Data					
Cash dividends declared	$ 0.76	0.74	0.70	0.66	0.63
Market Price					
High	26.72	23.90	27.88	29.73	21.49
Low	16.40	19.47	19.32	18.47	15.30
Close	18.89	21.84	20.16	27.17	20.80
Book value - stated	12.11	11.34	10.94	10.54	10.02
Tangible book value	8.56	7.76	7.48	7.04	6.44
Selected Balance Sheet Data (at year end)					
Total assets	$ 2,317,249	2,136,624	1,801,050	1,638,913	1,475,769
Loans	1,894,295	1,740,396	1,482,611	1,367,053	1,218,895
Allowance for loan losses	21,324	18,947	15,716	14,717	13,569
Intangible assets	51,020	51,394	49,227	49,330	50,701
Deposits	1,838,277	1,695,679	1,494,577	1,388,768	1,249,364
Borrowings	242,394	210,013	100,239	92,239	76,000
Total shareholders' equity	174,070	162,705	155,728	148,478	141,856
Selected Average Balances					
Assets	$ 2,139,576	1,922,510	1,709,380	1,545,332	1,339,823
Loans	1,808,219	1,623,188	1,422,419	1,295,682	1,113,426
Earning assets	1,998,428	1,793,811	1,593,554	1,434,425	1,245,679
Deposits	1,780,265	1,599,575	1,460,620	1,306,404	1,153,385
Interest-bearing liabilities	1,726,002	1,537,385	1,359,744	1,232,130	1,065,950
Shareholders' equity	170,857	163,193	154,871	146,683	137,293

Ratios					
Return on average assets	1.02%	1.00%	0.94%	1.30%	1.45%
Return on average equity	12.77%	11.83%	10.39%	13.71%	14.14%
Net interest margin (taxable-equivalent basis)	4.00%	4.18%	4.33%	4.31%	4.52%
Shareholders' equity to assets at year end	7.51%	7.62%	8.65%	9.06%	9.61%
Loans to deposits at year end	103.05%	102.64%	99.20%	98.44%	97.56%
Allowance for loan losses to total loans	1.13%	1.09%	1.06%	1.08%	1.11%
Nonperforming assets to total assets at year end	0.47%	0.39%	0.17%	0.32%	0.39%
Net charge-offs to average loans	0.16%	0.11%	0.14%	0.14%	0.10%
Efficiency ratio	58.57%	59.54%	56.68%	56.32%	53.32%
Nonfinancial Data					
Number of branches	70	68	61	59	57
Number of employees – Full time equivalents	614	620	578	563	550

Per share amounts for 2003 have been restated from their originally reported amounts to reflect the 3-for-2 stock split paid on November 15, 2004.

Index

Table 2 Average Balances and Net Interest Income Analysis

	Year Ended December 31,								
	2007			2006			2005		
($ in thousands)	Average Volume	Avg. Rate	Interest Earned or Paid	Average Volume	Avg. Rate	Interest Earned or Paid	Average Volume	Avg. Rate	Interest Earned or Paid
Assets									
Loans (1)	$ 1,808,219	7.70%	$ 139,323	$ 1,623,188	7.44%	$ 120,694	$ 1,422,419	6.62%	$ 94,097
Taxable securities	131,035	4.92%	6,453	118,032	4.84%	5,718	114,223	4.54%	5,184
Non-taxable securities (2)	13,786	8.09%	1,115	11,466	8.84%	1,014	10,782	8.57%	924
Short-term investments, primarily federal funds	45,388	5.74%	2,605	41,125	5.55%	2,282	46,130	3.62%	1,672
Total interest-earning assets	1,998,428	7.48%	149,496	1,793,811	7.23%	129,708	1,593,554	6.39%	101,877
Cash and due from banks	38,906			37,872			34,574		
Bank premises and equipment, net	45,398			38,592			32,179		
Other assets	56,844			52,235			49,073		
Total assets	$ 2,139,576			$ 1,922,510			$ 1,709,380		
Liabilities and Equity									
NOW accounts	$ 192,407	0.37%	$ 712	$ 187,888	0.36%	$ 679	$ 187,721	0.32%	$ 602
Money market accounts	239,258	3.31%	7,929	183,751	2.71%	4,972	153,649	1.40%	2,148
Savings accounts	106,357	1.62%	1,727	111,909	1.29%	1,443	129,278	1.00%	1,298
Time deposits >$100,000	450,801	5.03%	22,687	390,246	4.53%	17,662	350,240	3.26%	11,425
Other time deposits	567,572	4.67%	26,498	520,140	4.09%	21,276	455,557	2.86%	13,043
Total interest-bearing deposits	1,556,395	3.83%	59,553	1,393,934	3.30%	46,032	1,276,445	2.23%	28,516
Securities sold under agreements to repurchase	39,220	3.76%	1,476	30,036	3.72%	1,116	6,219	2.88%	179
Borrowings	130,387	6.62%	8,629	113,415	6.63%	7,523	77,080	5.37%	4,143
	1,726,002	4.04%	69,658	1,537,385	3.56%	54,671	1,359,744	2.42%	32,838

Total interest-bearing liabilities									
Non-interest-bearing deposits	223,870			205,641			184,175		
Other liabilities	18,847			16,291			10,590		
Shareholders' equity	170,857			163,193			154,871		
Total liabilities and shareholders' equity	$ 2,139,576			$ 1,922,510			$ 1,709,380		
Net yield on interest-earning assets and net interest income		4.00%	$ 79,838		4.18%	$ 75,037		4.33%	$ 69,039
Interest rate spread		3.44%			3.67%			3.97%	
Average prime rate		8.05%			7.96%			6.19%	

(1) Average loans include nonaccruing loans, the effect of which is to lower the average rate shown. Interest earned includes recognized loan fees in the amounts of $836,000, $696,000, and $1,037,000 for 2007, 2006, and 2005, respectively.

(2) Includes tax-equivalent adjustments of $554,000, $501,000, and $448,000 in 2007, 2006, and 2005, respectively, to reflect the federal and state benefit of the tax-exempt securities (using a 39% combined tax rate), reduced by the related nondeductible portion of interest expense.

Index

Table 3 Volume and Rate Variance Analysis

(In thousands)	Year Ended December 31, 2007 Change Attributable to Changes in Volumes	Year Ended December 31, 2007 Change Attributable to Changes in Rates	Year Ended December 31, 2007 Total Increase (Decrease)	Year Ended December 31, 2006 Change Attributable to Changes in Volumes	Year Ended December 31, 2006 Change Attributable to Changes in Rates	Year Ended December 31, 2006 Total Increase (Decrease)
Interest income (tax-equivalent):						
Loans	$ 14,007	4,622	18,629	14,105	12,492	26,597
Taxable securities	635	100	735	179	355	534
Non-taxable securities	196	(95)	101	60	30	90
Short-term investments, principally federal funds sold	241	82	323	(230)	840	610
Total interest income	15,079	4,709	19,788	14,114	13,717	27,831
Interest expense:						
NOW accounts	17	16	33	1	76	77
Money Market accounts	1,671	1,286	2,957	618	2,206	2,824
Savings accounts	(81)	365	284	(199)	344	145
Time deposits>$100,000	2,894	2,131	5,025	1,558	4,679	6,237
Other time deposits	2,077	3,145	5,222	2,245	5,988	8,233
Total interest-bearing deposits	6,578	6,943	13,521	4,223	13,293	17,516
Securities sold under agreements to repurchase	343	17	360	785	152	937
Borrowings	1,124	(18)	1,106	2,182	1,198	3,380
Total interest expense	8,045	6,942	14,987	7,190	14,643	21,833
Net interest income (tax-equivalent)	$ 7,034	(2,233)	4,801	6,924	(926)	5,998

Changes attributable to both volume and rate are allocated equally between rate and volume variances.

Table 4 Noninterest Income

(In thousands)	Year Ended December 31, 2007	2006	2005
Service charges on deposit accounts	$ 9,988	8,968	8,537
Other service charges, commissions, and fees	5,158	4,578	3,963
Fees from presold mortgages	1,135	1,062	1,176
Commissions from sales of insurance and financial products	1,511	1,434	1,307
Data processing fees	204	162	279
Total core noninterest income	17,996	16,204	15,262
Loan sale gains	-	-	9
Securities gains, net	487	205	5
Other gains (losses), net	(10)	(2,099)	(272)
Total	$ 18,473	14,310	15,004

Table 5 Noninterest Expenses

Year Ended December 31,

(In thousands)	2007	2006	2005
Salaries	$ 26,227	23,867	21,921
Employee benefits	7,443	6,811	6,054
Total personnel expense	33,670	30,678	27,975
Occupancy expense	3,795	3,447	3,037
Equipment related expenses	3,809	3,419	2,965
Amortization of intangible assets	374	322	290
Stationery and supplies	1,593	1,675	1,590
Telephone	1,246	1,273	1,260
Non-credit losses	204	165	110
Other operating expenses	12,889	12,219	10,409
Total	$ 57,580	53,198	47,636

Index

Table 6 Income Taxes

(In thousands)		2007	2006	2005
Current	- Federal	$ 11,625	10,809	8,285
	- State	1,938	1,927	8,700
Deferred	- Federal	(348)	(1,112)	(124)
	- State	(65)	(201)	(32)
Total		$ 13,150	11,423	16,829
Effective tax rate		37.6%	37.2%	51.1%

Table 7 Distribution of Assets and Liabilities

	As of December 31,		
	2007	2006	2005
Assets			
Interest-earning assets			
Net loans	81%	80%	81%
Securities available for sale	6	6	6
Securities held to maturity	1	1	1
Short term investments	6	5	4
Total interest-earning assets	94	92	92
Noninterest-earning assets			
Cash and due from banks	1	2	2
Premises and equipment	2	2	2
Other assets	3	4	4
Total assets	100%	100%	100%
Liabilities and shareholders' equity			
Demand deposits – noninterest bearing	10%	10%	11%
NOW deposits	8	9	10
Money market deposits	11	9	9
Savings deposits	4	5	6
Time deposits of $100,000 or more	21	20	20
Other time deposits	25	26	27
Total deposits	79	79	83
Securities sold under agreements to repurchase	2	2	2
Borrowings	10	10	5
Accrued expenses and other liabilities	1	1	1
Total liabilities	92	92	91
Shareholders' equity	8	8	9
Total liabilities and shareholders' equity	100%	100%	100%

Table 8 Securities Portfolio Composition

	As of December 31,		
(In thousands)	2007	2006	2005

Securities available for sale:			
Government-sponsored enterprise securities	$ 69,893	62,456	44,481
Mortgage-backed securities	39,296	43,442	47,928
Corporate bonds	13,855	13,580	14,912
Equity securities	12,070	10,486	6,292
Total securities available for sale	135,114	129,964	113,613
Securities held to maturity:			
State and local governments	16,611	13,089	11,382
Other	29	33	66
Total securities held to maturity	16,640	13,122	11,448
Total securities	$ 151,754	143,086	125,061
Average total securities during year	$ 144,821	129,498	125,005

Index

Table 9 Securities Portfolio Maturity Schedule

	As of December 31, 2007		
($ in thousands)	Book Value	Fair Value	Book Yield (1)
Securities available for sale:			
Government-sponsored enterprise securities			
Due within one year	$ 17,707	17,697	3.92%
Due after one but within five years	51,756	52,196	5.18%
Total	69,463	69,893	4.86%
Mortgage-backed securities (2)			
Due within one year	170	167	4.21%
Due after one but within five years	22,169	21,930	4.52%
Due after five but within ten years	9,191	9,028	4.71%
Due after ten years	8,176	8,171	5.45%
Total	39,706	39,296	4.75%
Corporate debt securities			
Due after five but within ten years	6,092	5,885	5.91%
Due after ten years	7,727	7,970	7.92%
Total	13,819	13,855	7.03%
Equity securities	12,040	12,070	5.91%
Total securities available for sale			
Due within one year	17,877	17,864	3.92%
Due after one but within five years	73,925	74,126	4.98%
Due after five but within ten years	15,283	14,913	5.19%
Due after ten years	15,903	16,141	6.65%
Equity securities	12,040	12,070	5.91%
Total	$ 135,028	135,114	5.14%
Securities held to maturity:			
State and local governments			
Due within one year	$ 2,264	2,275	7.46%
Due after one but within five years	3,466	3,496	6.95%
Due after five but within ten years	4,608	4,649	6.33%
Due after ten years	6,273	6,200	6.31%
Total	16,611	16,620	6.61%
Other			
Due after one but within five years	29	29	6.57%
Total	29	29	6.57%
Total securities held to maturity			

Due within one year	2,264	2,275	7.46%
Due after one but within five years	3,495	3,525	6.95%
Due after five but within ten years	4,608	4,649	6.33%
Due after ten years	6,273	6,200	6.31%
Total	$ 16,640	16,649	6.61%

(1) Yields on tax-exempt investments have been adjusted to a taxable equivalent basis using a 39% tax rate.

(2) Mortgage-backed securities are shown maturing in the periods consistent with their estimated lives based on expected prepayment speeds.

Index

Table 10 Loan Portfolio Composition

	As of December 31,									
	2007		2006		2005		2004		2003	
($ in thousands)	Amount	% of Total Loans	Amount	% of Total Loans	Amount	% of Total Loans	Amount	% of Total Loans	Amount	% of Total Loans
Commercial, financial, & agricultural	$ 172,530	9.11%	$ 165,214	9.49%	$ 135,942	9.17%	$ 122,501	8.96%	$ 117,287	9.62%
Real estate -construction	212,902	11.24%	155,440	8.93%	125,158	8.44%	117,158	8.57%	98,189	8.05%
Real estate -mortgage(1)	1,423,842	75.17%	1,344,553	77.26%	1,150,068	77.58%	1,063,694	77.80%	939,578	77.05%
Installment loans to individuals	84,875	4.48%	75,162	4.32%	71,259	4.81%	63,913	4.67%	64,444	5.28%
Loans, gross	1,894,149	100.0%	1,740,369	100.0%	1,482,427	100.0%				