## SECOND BANCORP INC

## Form 10-Q

May 15, 2001

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SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
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FORM 10-Q

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[X] QUARTERLY REPORT UNDER SECTION 13 OR 15(d) THE SECURITIES EXCHANGE ACT OF
    1934
    For quarter ended March 31, 2001
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    OR
    [ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934.
For the transition period ..... to .....
Commission file number: 0-15624
SECOND BANCORP INCORPORATED
(exact name of registrant as specified in its charter)
Ohio 34-1547453

(State or other jurisdiction of (I.R.S. Employer
in Company or organization) Identification No.)
108 Main Ave. Warren, Ohio 44482-1311

(Address of principal executive (Zip Code)
offices)
330.841 .0123
-------------
Registrant's telephone number, including area code
Not applicable
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Former name, former address and former fiscal year, if changed since last
report.
Indicate by check mark whether the registrant (1) has filed all reports required
to be filed by Section 13 or $15(d)$ of the Securities Exchange Act of 1934 during
the preceding 12 months (or for such shorter periods that the registrant was
required to file such reports), and (2) has been subject to such filing
requirements for the past 90 days.
Yes .x. No ...

Indicate the number of shares outstanding of each of the issuer's classes of
common stock, as of the latest practical date.
Common Stock, without par value - 10,003,260 shares outstanding as of April 30,
2001.
SECOND BANCORP INCORPORATED AND SUBSIDIARY
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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
Second Bancorp Incorporated and Subsidiary
Consolidated Balance Sheets

|  | March 31 | December 31 |
| :---: | :---: | :---: |
| (Dollars in thousands) | 2001 | 2000 |
| ASSETS |  |  |
| Cash and due from banks | \$36,937 | \$35,272 |
| Federal funds sold and temporary investments | 25,451 | 0 |
| Trading account | 238 | 328 |
| Securities: |  |  |
| Available-for-sale (at market value) | 377,323 | 382,098 |
| Loans | 1,076,284 | 1,070,089 |
| Less reserve for loan losses | 15,778 | 15,217 |
| Net loans | 1,060,506 | 1,054,872 |
| Premises and equipment | 17,533 | 18,039 |
| Accrued interest receivable | 10,118 | 11,181 |
| Goodwill and intangible assets | 6,157 | 6,038 |
| Other assets | 37,568 | 38,462 |
| Total assets | \$1,571,831 | \$1,546,290 |

## LIABILITIES AND SHAREHOLDERS' EQUITY

| Deposits: |  |  |
| :---: | :---: | :---: |
| Demand - non-interest bearing | \$105,920 | \$110,045 |
| Demand - interest bearing | 86,124 | 87,268 |
| Savings | 239,661 | 246,056 |
| Time deposits | 629,851 | 592,766 |
| Total deposits | 1,061,556 | 1,036,135 |
| Federal funds purchased and securities sold under agreements to repurchase | 119,684 | 129,895 |
| Note Payable | 1,000 | 1,000 |
| Other borrowed funds | 46 | 2,163 |
| Federal Home Loan Bank advances | 256,591 | 251,733 |
| Accrued expenses and other liabilities | 10,986 | 8,167 |
| Total liabilities | 1,449,863 | 1,429,093 |
| Shareholders' equity: |  |  |
| Common stock, no par value; $30,000,000$ shares authorized; 10,785,760; 10,787,310 and 10,776,470 |  |  |
| shares issued, respectively | 36,953 | 36,935 |

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    393,100 shares, respectively
Net unrealized holding losses on
    available-for-sale securities, net of tax
Retained earnings
Total shareholders' equity
Total liabilities and shareholders' equity
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See notes to consolidated financial statements.

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Second Bancorp Incorporated and Subsidiary Consolidated Statements of Income

| $(14,740)$ | $(13,947)$ |
| :---: | :---: |
| 3,440 | 281 |
| 96,315 | 93,928 |
| 121,968 | 117,197 |
| \$1,571,831 | \$1,546,290 |

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| (Dollars in thousands, | For the Three Months Ended March 31 |
| :---: | :---: |
| except per share data) | 20012000 |

## INTEREST INCOME

| Loans (including fees) : |  |  |
| :---: | :---: | :---: |
| Taxable | \$22,101 | \$21,536 |
| Exempt from federal income taxes | 288 | 215 |
| Securities: |  |  |
| Taxable | 5,125 | 4,709 |
| Exempt from federal income taxes | 773 | 882 |
| Federal funds sold and other interest income | 191 | 93 |
| Total interest income | 28,478 | 27,435 |
| INTEREST EXPENSE |  |  |
| Deposits | 11,469 | 10,879 |
| Federal funds purchased and securities sold under agreements to repurchase | 1,187 | 1,184 |
| Note Payable | 18 | 19 |
| Other borrowed funds | 37 | 43 |
| Federal Home Loan Bank advances | 3,851 | 2,892 |
| Total interest expense | 16,562 | 15,017 |
| Net interest income | 11,916 | 12,418 |
| Provision for loan losses | 761 | 687 |

Net interest income after provision for loan losses 11,155
11,731

NON-INTEREST INCOME

| Service charges on deposit accounts | 1,261 | 1,054 |
| :---: | :---: | :---: |
| Trust fees | 756 | 1,004 |
| (Losses) gains on sale of loans | 783 | 391 |
| Trading account losses | 58 | 114 |
| Security (losses) gains | 529 | 99 |
| Other operating income | 1,172 | 1,141 |
| Total non-interest income | 4,559 | 3,803 |
| NON-INTEREST EXPENSE |  |  |
| Salaries and employee benefits | 5,194 | 5,316 |
| Net occupancy | 1,116 | 1,052 |
| Equipment | 1,049 | 987 |
| Professional services | 343 | 477 |
| Assessment on deposits and other taxes | 401 | 413 |
| Amortization of goodwill and other intangibles | 81 | 116 |
| Other operating expenses | 1,867 | 1,936 |
| Total non-interest expense | 10,051 | 10,297 |
| Income before federal income taxes | 5,663 | 5,237 |
| Income tax expense | 1,475 | 1,301 |
| Net income before cumulative effect of accounting change | \$4,188 | \$3,936 |
| Cumulative effect of accounting change - SFAS 133 | (101) | 0 |
| Net income | \$4,087 | \$3,936 |
| NET INCOME PER COMMON SHARE: |  |  |
| Basic - before cumulative effect of accounting change | \$ 0.42 | \$0.38 |
| Dilutive - before cumulative effect of |  |  |
| Basic | \$0.41 | \$0.38 |
| Diluted | \$0.41 | \$0.38 |
| Weighted average common shares outstanding: |  |  |
| Basic | 10,020,097 | 10,406,020 |
| Diluted | 10,046,562 | 10,436,890 |

See notes to financial statements.

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Second Bancorp Incorporated and Subsidiary
Consolidated Statements of Shareholders' Equity


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Net income
Adjustments to reconcile net income to net
Adjustments to reconcile net income to net
        Provision for loan losses 761 
        Provision for depreciation 850
        Provision for amortization of goodwill and core deposit intangibles 81
        Provision for allowance for mortgage servicing rights 30
        Net gain / amortization on servicing rights
    (Accretion) amortization of investment discount and premium
    Deferred income taxes
    Securities gains (529)
    Other gains, net
    Net decrease in trading account securities
    Decrease (Increase) in interest receivable 1,063
    Increase (Decrease) in interest payable 52
    Originations of loans held-for-sale
    Proceeds from sale of loans held-for-sale
    Net change in other assets & other liabilities
    Net cash provided by operating activities
Investing Activities
    Proceeds from maturities of securities - available-for-sale
    Proceeds from sales of securities - available-for-sale
Purchases of securities - available-for-sale
    Net increase in loans
Net increase in premises and equipment
Net cash provided by (used by) investing activities
Financing Activities
    Net (decrease) increase in demand deposits, interest bearing
        demand and savings deposits
        (11,664)
        37,085
        9,
    Net increase (decrease) in time deposits
    Net (decrease) increase in federal funds purchased and
        securities sold under agreements to repurchase
    Decrease in note payable
        (10, 211)
        30
        0
        (2,117)
        26,503
        32,862
            7,
            (230)
        (33)
        0
        (841)
        148
        (59,912)
        60,695
        $ 4,087
        $
        3,
        30
        (529)
        1,063
            5 2
        (14,
    (14,
        2,714
        14,
        \prime
        8,936
        6,
\(\$ \quad 4,087\)
761
850
81
30
\((230)\)
\((33)\)
0
\((529)\)
\((841)\)
148
1,063
52
\((59,912)\)
60,695
2,714
8,936
        6
    (49,922)
    (6,395)
            (344)
2,704
                                    (314)
                            3,
            '
                    *
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                    *
                    *
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See notes to financial statements.

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Notes to Consolidated Financial Statements (unaudited)
Second Bancorp Incorporated and Subsidiary
March 31, 2001
(Dollars in thousands)

## NOTE 1 - BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation $S-X$. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three-month period ended March 31, 2001 are not necessarily indicative of the results that may be expected for the year ended December 31, 2001. Certain reclassifications have been made to amounts previously reported in order to conform to current period presentations. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2000 .

NOTE 2 - COMPREHENSIVE INCOME
During the first three months of 2001 and 2000 , total comprehensive income amounted to $\$ 6,046$ and $\$ 4,730$, respectively. The components of comprehensive income, net of tax, for the and three month periods ended March 31, 2001 and 2000 are as follows:

Net income
Change in other comprehensive income -SFAS 133
Unrealized losses on available-for-sale securities

| 2001 | 2000 |
| :---: | :---: |
| \$4,087 | \$3,936 |
| 490 | 0 |
| 2,669 | (806) |
| \$7,246 | \$3,130 |

Accumulated other comprehensive loss, net of related tax, at March 31, 2001 totaled $\$ 3,440$ and were comprised of accumulated changes in unrealized market value adjustments on securities available-for-sale, net of tax, and other comprehensive income from SFAS 133 derivative holdings. Accumulated other comprehensive loss, net of related tax, at December 31, 2000 and March 31, 2000 totaled $\$ 281$ and $\$(8,597)$, respectively, and were comprised entirely of accumulated changes in unrealized market value adjustments on securities available-for-sale, net of tax. Disclosure of reclassification amounts:


NOTE 3 - RECENT ACCOUNTING PRONOUNCEMENTS
In June 1998, the Financial Accounting standard Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activity" as amended in June, 1999 by SFAS No. 137, "Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133," and in June 2000, by SFAS 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities, " (collectively SFAS No. 133). SFAS No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments imbedded in other contracts, and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as a hedge. The accounting for changes in the fair value of derivative (gains and losses) depends on the intended use of the derivative and resulting designation. On January 1, 2001, the Corporation adopted SFAS No. 133 resulting in a cumulative effect of accounting change transition adjustment of $\$(101,000)$, after tax.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations. Management's Discussion and Analysis of Financial Condition and Results of Operations
Second Bancorp Incorporated and Subsidiary

## General

Second Bancorp Incorporated (the "Company") is a one-bank holding company which owns The Second National Bank of Warren (the "Bank"), a Warren, Ohio based commercial bank. Operating through thirty-four branches the Bank offers a wide range of commercial and consumer banking and trust services primarily to business and individual customers in various communities in a nine county area in northeastern Ohio. The Bank focuses its marketing efforts primarily on local independent and professional firms and individuals that are the owners and principals of such firms.

## Financial Condition

At March 31, 2001, the Company had consolidated total assets of $\$ 1.57$ billion, deposits of $\$ 1.06$ billion and shareholders' equity of $\$ 122$ million. Since March 31, 2000, total assets have decreased by $\$ 21$ million or $1.3 \%$ primarily as a result of the sale of $\$ 130$ million in mortgage loans during the third quarter of 2000. The sale resulted in a smaller balance sheet and lower exposure to long-term fixed rate assets. Gross loans have decreased by $\$ 23$ million to total $\$ 1.076$ billion. Consumer lending activities have resulted in a strong increase in outstanding balances, while the sale of residential real estate loan balances has reduced from a $42 \%$ concentration of total loans as of March 31,2000 to $31 \%$ at the most recent quarter end. Consumer loans represented $29 \%$ of loans at the end of the first quarter of 2001 versus $21 \%$ for the first quarter of 2000 . Cash, federal funds sold and other liquid assets increased by $\$ 18$ million over the past year.

Funding growth has primarily been generated through advances from the Federal Home Loan Bank ("FHLB"). FHLB advances have increased by $\$ 23$ million over the past year.

Results of Operations
General.

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The Company reported net operating income of $\$ 4,188,000$, exclusive of the $\$ 101,000$ cumulative effect of accounting change from the transition to SFAS 133. Net operating income for the first quarter represented a diluted forty-two cents (\$.42) per share. Operating return on average assets (ROA) and return on average total shareholders' equity (ROE) were $1.08 \%$ and $14.09 \%$ respectively for the first quarter of 2001 compared to $1.02 \%$ and $13.70 \%$ for last year's first quarter. A reduced net interest margin caused by a shift in funding from core deposits to more expensive large time deposits. The decline in net interest margin was offset by an increase in non-interest income coupled with a decline in non-interest expenses.

Asset Quality. The reserve for loan losses increased to $1.47 \%$ of loans through an addition of $\$ 761,000$ in provision coupled with lower than normal net charge-offs of $.07 \%$. Loan losses are expected to resume their more historical level of $.25 \%$ to $.30 \%$ of loans for the remainder of the year. The reserve was 1.03\% of total loans at March 31, 2000. Non-accrual loans have increased over the past year and total $\$ 5,163,000$ as of March 31, 2001 versus $\$ 3,068,000$ as of the same date last year. Similarly, loans past due over 90 days and still accruing totaled $\$ 3,849,000$ as of March 31, 2001 versus $\$ 2,082,000$ as of the same date last year

Net Interest Income. Net interest income for the first quarter of 2001 decreased by $\$ 502,000$ from the same period last year to $\$ 11,916,000$. The decrease was primarily due to a lower net interest margin that is being influenced by a decline in low-cost core deposits and an increase in higher cost large time deposits. The net interest margin declined to $3.43 \%$ for the first quarter of 2001 versus $3.61 \%$ for the same period in 2000. Average interest earning assets increased by . $7 \%$ during the past year, influenced strongly by the sale of mortgage loans in the third quarter of 2000.

Non-interest Income. Non-interest income totaled $\$ 4,559,000$, or $20 \%$ higher than the first quarter of 2000. The increase came from a variety of sources including 1) an increase in $20 \%$ in service charges on deposit

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accounts attributable to a revised deposit account structure, fee schedule and collection procedures, 2) a doubling of gains on sale of loans from $\$ 391,000$ to $\$ 783,000$ primarily due to lower mortgage rates and the resulting increase in refinancing activity and 3) a $\$ 430,000$ increase in gains on the sale of securities. The gains on the sale of securities were generated and proceeds reinvested in higher yielding securities improving future income streams. Trust income decreased by $\$ 248,000$, or $20 \%$, from a year ago primarily to a reduction in assets under management.

Non-interest Expense. Expenses for the first quarter of 2001 were $2.4 \%$ lower than for the same period in 2000. Reductions in salaries and benefits, professional services, assessments on deposits and other taxes, amortization of goodwill and other intangibles and other operating expenses were realized.

Capital resources. Shareholders' equity has increased by $\$ 6$ million from a year ago due primarily to the increase in accumulated other comprehensive income ("OCI"), which increased by over $\$ 11$ million since a year earlier. The company repurchased 54,800 shares of common stock into Treasury during the first quarter of 2001, which partially offset the increase in OCI. The Company has slightly more than 65,000 shares remaining under the present repurchase authorization. Repurchases under this authorization are expected to be completed through open market transactions at prevailing market prices and are discretionary, based upon management's periodic assessment of market conditions and financial benefit to the Company. This continuing repurchase authorization will remain in effect until amended or withdrawn by subsequent board action. As of March 31, 2001, the Company had repurchased 785,000 of the authorized shares of common stock.

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Liquidity. Management of the Company's liquidity position is necessary to ensure that funds are available to meet the cash flow needs of depositors and borrowers as well as the operating cash needs of the Company. Funds are available from a number of sources including maturing securities, payments made on loans, the acquisition of new deposits, the sale of packaged loans, borrowing from the FHLB and overnight lines of credit of over $\$ 37$ million through correspondent banks. The parent company has three major sources of funding including dividends from the Bank, $\$ 20$ million in unsecured lines of credit with correspondent banks, which are renewable annually, and access to the capital markets. One million of the unsecured line of credit is in use as of March 31, 2001.

Forward-looking statements:
The section that follows contains certain forward-looking statements (as defined in the Private Securities Litigation Reform Act of 1995). These forward-looking statements may involve significant risks and uncertainties. Although the Company believes that the expectations reflected in such forward-looking statements are reasonable, actual results may differ materially from the expectations discussed in these forward-looking statements.

Market Risk Management:
Market risk is the risk of economic loss from adverse changes in the fair value of financial instruments due to changes in (a) interest rates, (b) foreign exchange rates, or (c) other factors that relate to market volatility of the rate, index, or price underlying the financial instrument. The Company's market risk is composed primarily of interest rate risk. The Company's Asset/Liability Committee (ALCO) is responsible for reviewing the interest rate sensitivity position of the Company and establishing policies to monitor and limit the exposure to interest rate risk. Since nearly the Company's entire interest rate risk exposure relates to the financial instrument activity of the Bank, the Bank's Board of Directors review the policies and guidelines established by ALCO.

The primary objective of asset/liability management is to provide an optimum and stable net interest margin, after-tax return on assets and return on equity capital, as well as adequate liquidity and capital. Interest rate risk is monitored through the use of two complementary measures: dynamic gap analysis and earnings simulation models. While each of the measurement techniques has limitations, taken together they represent a reasonably comprehensive tool for measuring the magnitude of interest rate risk inherent in the Company.

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The earnings simulation model forecasts earnings for a one-year horizon frame under a variety of interest rate scenarios; including interest rate shocks, stepped rates and yield curve shifts. Management evaluates the impact of the various rate simulations against earnings in a stable interest rate environment. The most recent model projects net income would increase by $0.5 \%$ if interest rates would immediately rise by 200 basis points. It projects a decrease in net income of $2.0 \%$ if interest rates would immediately fall by 200 basis points. Management believes this reflects an appropriate level of risk from interest rate movements. The earnings simulation model includes assumptions about how the various components of the balance sheet and rate structure are likely to react through time in different interest rate environments. These assumptions are derived from historical analysis and management's outlook. Management expects interest rates to have a neutral to downward bias for the remainder of 2001.

Interest rate sensitivity is managed through the use of security portfolio management techniques, the use of fixed rate long-term borrowings from the FHLB, the establishment of rate and term structures for time deposits and loans and the sale of long-term fixed rate mortgages through the secondary mortgage
market. Although the Company also uses off-balance sheet swaps, caps and floors to manage interest rate risk.

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PART II. OTHER INFORMATION
Item 1. Legal Proceedings -

The Company is subject to various pending and threatened lawsuits in which claims for monetary damages are asserted in the ordinary course of business. While any litigation involves an element of uncertainty, in the opinion of management, liabilities, if any, arising from such litigation or threat thereof will not have a material impact on the financial position or results of operations of the Company.

Item 2. Changes in Securities - Not Applicable

Item 3. Defaults upon Senior Securities - Not Applicable

Item 4. Submission of Matters to a Vote of Security Holders -
(a) - (d) Second Bancorp Incorporated's Annual Meeting of Shareholders was held on March 8, 2001. The results of the votes on the matters presented to shareholders are as follows: Of the $10,000,760$ issued and outstanding shares eligible to vote, $8,757,523$ were represented at the meeting. The shareholders approved Proposal 1 to set the number of directors at eleven with $8,172,381$ votes "FOR", 500,052 votes "AGAINST" and 85,085 "ABSTAINED". Elected to serve as directors of the Company in Class I until the 2003 Annual Meeting of Shareholders under Proposal 2 were:

| Share voted "FOR" Dr. David A. Allen, Jr. | $8,233,274$ |
| :--- | :--- |
| Share voted "FOR" R. L. (Rick) Blossom | $8,620,125$ |
| Share voted "FOR" Norman C. Harbert | $8,232,063$ |
| Share voted "FOR" Phyllis J. Izant | $8,070,691$ |
| Share voted "FOR" John L. Pogue | $8,227,509$ |
| Share voted "FOR" Raymond John Wean, III | $8,177,177$ |

The shareholders approved Proposal 3 to ratify the appointment of Ernst \& Young
LLP as the independent Certified Public Accountants of the Company with votes "FOR" of $8,653,157$, votes "AGAINST" of 22,280 and votes "ABSTAINED" of 82,082 .

Item 5. Other Information - Not Applicable
Item 6. Exhibits and Reports on Form 8-K:

The following exhibits are included herein:
(11) Statement re: computation of earnings per share

The Company filed a report on Form 8-K on March 27, 2001 to announce an increase in the common stock dividend to $\$ .17$ per share. The Company filed a report on Form 8-K on March 27, 2001 regarding earnings for the fourth quarter of 2000 . The Company filed a report on Form 8-K on April 25, 2001 to announce earnings for the first quarter of 2001. The Company filed a report on Form 8-K on May 11, 2001 to announce the election of Rick L. Blossom as Chairman of Second Bancorp Incorporated and The Second National Bank of Warren.

## SIGNATURES

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

SECOND BANCORP INCORPORATED

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Date: May 14, 2001 /s/ David L. Kellerman
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David L. Kellerman, Treasurer
Signing on behalf of the registrant and as principal accounting officer and principal financial officer.

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