

FIRST COMMUNITY CORP /SC/
Form 10-Q
November 12, 2008
[Table of Contents](#)

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

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

For the Quarterly Period ended September 30, 2008

or

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

For the Transition Period from to

FIRST COMMUNITY CORPORATION

(Exact name of registrant as specified in its charter)

South Carolina

(State or other jurisdiction of incorporation or organization)

57-1010751

(I.R.S. Employer Identification No.)

5455 Sunset Boulevard, Lexington, South Carolina 29072

(Address of principal executive offices) (Zip Code)

(803) 951-2265

(Registrant's telephone number, including area code)

(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 period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark 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.

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: On October 31, 2008, 3,221,199 shares of the issuer's common stock, par value \$1.00 per share, were issued and outstanding.

Table of Contents

TABLE OF CONTENTS

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements.

Consolidated Balance Sheets

Consolidated Statements of Income (Loss)

Consolidated Statements of Changes in Shareholders' Equity and Comprehensive Income (Loss)

Consolidated Statements of Cash Flows

Notes to Consolidated Financial Statements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Item 4. Controls and Procedures.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

Item 3. Defaults Upon Senior Securities.

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

Item 5. Other Information.

Item 6. Exhibits.

INDEX TO EXHIBITS

SIGNATURES

EX-31.1 RULE 13A-14(A) CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER

EX-31.2 RULE 13A-14(A) CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER

EX-32 SECTION 1350 CERTIFICATIONS

Table of Contents

PART I
FINANCIAL INFORMATION

Item 1. Financial Statements.

FIRST COMMUNITY CORPORATION
CONSOLIDATED BALANCE SHEETS

| | September 30, 2008 (Unaudited) | December 31, 2007 |
|---|--------------------------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$ 9,594,427 | \$ 9,439,159 |
| Interest-bearing bank balances | 5,981,546 | 48,196 |
| Federal funds sold and securities purchased under agreements to resell | 2,011,500 | 4,194,276 |
| Investment securities - available for sale | 140,517,912 | 160,908,253 |
| Investment securities - held to maturity (market value of \$68,887,402 and \$6,360,733 at September 30, 2008 and December 31, 2007) | 71,679,191 | 6,316,570 |
| Trading securities | 2,545,284 | 2,876,086 |
| Other investments, at cost | 7,111,194 | 5,156,595 |
| Loans | 324,333,357 | 310,028,490 |
| Less, allowance for loan losses | 3,663,694 | 3,530,328 |
| Net loans | 320,669,663 | 306,498,162 |
| Property, furniture and equipment - net | 19,484,999 | 19,701,466 |
| Bank owned life insurance | 10,184,268 | 9,919,728 |
| Goodwill | 27,761,219 | 27,761,219 |
| Intangible assets | 2,226,741 | 1,983,280 |
| Other assets | 13,901,747 | 10,809,810 |
| Total assets | \$ 633,669,691 | \$ 565,612,800 |
| LIABILITIES | | |
| Deposits: | | |
| Non-interest bearing demand | \$ 72,788,876 | \$ 79,508,510 |
| NOW and money market accounts | 99,039,568 | 88,038,360 |
| Savings | 23,013,391 | 24,272,030 |
| Time deposits less than \$100,000 | 154,361,651 | 122,435,709 |
| Time deposits \$100,000 and over | 84,114,687 | 91,599,759 |
| Total deposits | 433,318,173 | 405,854,368 |
| Securities sold under agreements to repurchase | 27,351,800 | 23,334,200 |
| Federal Home Loan Bank Advances | 92,689,279 | 49,299,478 |
| Federal Home Loan Bank Advances, at fair value | 2,493,787 | 1,532,541 |
| Junior subordinated debentures | 15,464,000 | 15,464,000 |
| Other borrowed money | 137,168 | 190,386 |
| Other liabilities | 5,395,858 | 5,942,207 |
| Total liabilities | 576,850,065 | 501,617,180 |
| SHAREHOLDERS EQUITY | | |
| Preferred stock, par value \$1.00 per share; 10,000,000 shares authorized; none issued and outstanding | | |

Edgar Filing: FIRST COMMUNITY CORP /SC/ - Form 10-Q

| | | |
|--|----------------|----------------|
| Common stock, par value \$1.00 per share; 10,000,000 shares authorized; issued and outstanding 3,221,199 and 3,211,011 at September 30, 2008 and December 31, 2007, respectively | 3,221,199 | 3,211,011 |
| Nonvested restricted stock | (195,000) | |
| Additional paid in capital | 48,687,061 | 48,616,512 |
| Retained earnings | 7,079,704 | 14,564,054 |
| Accumulated other comprehensive income (loss) | (1,973,338) | (2,395,957) |
| Total shareholders' equity | 56,819,626 | 63,995,620 |
| Total liabilities and shareholders' equity | \$ 633,669,691 | \$ 565,612,800 |

Table of Contents

FIRST COMMUNITY CORPORATION
CONSOLIDATED STATEMENTS OF INCOME (LOSS)

| | Nine Months Ended September 30, 2008 (Unaudited) | Nine Months Ended September 30, 2007 (Unaudited) |
|---|--|--|
| Interest income: | | |
| Loans, including fees | \$ 16,263,431 | \$ 16,493,118 |
| Taxable securities | 7,902,663 | 5,695,640 |
| Non-taxable securities | 305,725 | 325,252 |
| Federal funds sold and securities purchased under resale agreements | 182,697 | 290,251 |
| Other | 109,839 | 31,706 |
| Total interest income | 24,764,355 | 22,835,967 |
| Interest expense: | | |
| Deposits | 8,530,103 | 8,773,646 |
| Federal funds purchased and securities sold under agreement to repurchase | 298,920 | 853,140 |
| Other borrowed money | 3,025,251 | 1,923,836 |
| Total interest expense | 11,854,274 | 11,550,622 |
| Net interest income | 12,910,081 | 11,285,345 |
| Provision for loan losses | 722,600 | 359,975 |
| Net interest income after provision for loan losses | 12,187,481 | 10,925,370 |
| Non-interest income: | | |
| Deposit service charges | 2,070,878 | 1,971,559 |
| Mortgage origination fees | 459,926 | 258,193 |
| Commission on sale of non deposit products | 243,549 | 218,699 |
| Gain (loss) on sale of securities | (28,582) | 73,694 |
| Other-than-temporary-impairment write-down on securities | (14,325,235) | |
| Fair value gain adjustments | 165,082 | 45,793 |
| Other | 1,097,792 | 1,038,090 |
| Total non-interest income (loss) | (10,316,590) | 3,606,028 |
| Non-interest expense: | | |
| Salaries and employee benefits | 5,894,143 | 5,448,125 |
| Occupancy | 858,025 | 911,578 |
| Equipment | 955,804 | 949,280 |
| Marketing and public relations | 395,461 | 375,643 |
| Amortization of intangibles | 383,941 | 502,228 |
| Other | 2,811,128 | 2,425,930 |
| Total non-interest expense | 11,298,502 | 10,612,784 |
| Income (loss) before taxes | (9,427,611) | 3,918,614 |
| Income tax expense (benefit) | (3,122,800) | 1,151,852 |
| Net income (loss) | \$ (6,304,811) | \$ 2,766,762 |
| Basic earnings (loss) per common share | \$ (1.97) | \$ 0.85 |
| Diluted earnings (loss) per common share | \$ (1.97) | \$ 0.84 |

Table of Contents

FIRST COMMUNITY CORPORATION
CONSOLIDATED STATEMENTS OF INCOME (LOSS)

| | Three Months Ended September 30, 2008 (Unaudited) | Three Months Ended September 30, 2007 (Unaudited) |
|---|---|---|
| Interest income: | | |
| Loans, including fees | \$ 5,336,553 | \$ 5,754,554 |
| Taxable securities | 2,866,898 | 2,000,203 |
| Non-taxable securities | 98,781 | 107,948 |
| Federal funds sold and securities purchased under resale agreements | 31,977 | 119,862 |
| Other | 92,321 | 14,014 |
| Total interest income | 8,426,530 | 7,996,581 |
| Interest expense: | | |
| Deposits | 2,788,846 | 3,090,112 |
| Federal funds purchased and securities sold under agreement to repurchase | 73,346 | 290,817 |
| Other borrowed money | 1,128,286 | 706,658 |
| Total interest expense | 3,990,478 | 4,087,587 |
| Net interest income | 4,436,052 | 3,908,994 |
| Provision for loan losses | 358,500 | 134,475 |
| Net interest income after provision for loan losses | 4,077,552 | 3,774,519 |
| Non-interest income: | | |
| Deposit service charges | 749,608 | 714,242 |
| Mortgage origination fees | 129,585 | 76,955 |
| Commission on sale of non deposit products | 85,312 | 75,266 |
| Other-than-temporary-impairment write-down on securities | (8,162,852) | |
| Fair value gain (loss) adjustments | (7,848) | 138,161 |
| Other | 368,397 | 358,658 |
| Total non-interest income (loss) | (6,837,798) | 1,363,282 |
| Non-interest expense: | | |
| Salaries and employee benefits | 1,986,821 | 1,838,619 |
| Occupancy | 298,221 | 340,246 |
| Equipment | 313,561 | 316,610 |
| Marketing and public relations | 94,875 | 96,817 |
| Amortization of intangibles | 122,881 | 167,409 |
| Other | 1,054,882 | 713,416 |
| Total non-interest expense | 3,871,241 | 3,473,117 |
| Income (loss) before tax | (6,631,487) | 1,664,684 |
| Income tax expense (benefit) | (2,685,711) | 516,588 |
| Net income (loss) | \$ (3,945,776) | \$ 1,148,096 |
| Basic earnings (loss) per common share | \$ (1.23) | \$ 0.35 |
| Diluted earnings (loss) per common share | \$ (1.23) | \$ 0.35 |

Table of Contents**FIRST COMMUNITY CORPORATION****Statement of Changes in Shareholders' Equity and Comprehensive Income (Loss)****Nine Months ended September 30, 2008 and September 30, 2007**

| | Shares Issued | Common Stock | Nonvested Restricted Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (loss) | Total |
|--|------------------|-----------------|----------------------------------|----------------------------------|----------------------|--|---------------|
| Balance, December 31, 2006 | 3,264,608 | \$ 3,264,608 | \$ | \$ 49,695,346 | \$ 12,033,065 | \$ (1,785,368) | \$ 63,207,651 |
| Comprehensive Income: | | | | | | | |
| Net income | | | | | 2,766,762 | | 2,766,762 |
| Cumulative adjustment to initially apply FASB Statement No. 159 | | | | | (559,678) | 559,678 | |
| Accumulated other comprehensive loss net of income tax benefit of \$89,300 | | | | | | (165,920) | |
| Less: reclassification adjustment for gains included in net income, net of tax net of tax of \$25,793 | | | | | | (47,901) | |
| Other comprehensive loss | | | | | | (213,821) | (213,821) |
| Total comprehensive income | | | | | | | 2,552,941 |
| Dividends paid (\$0.20 per share) | | | | | (648,316) | | (648,316) |
| Common stock repurchased | (104,513) | (104,513) | | (1,686,948) | | | (1,791,461) |
| Options exercised | 54,230 | 54,230 | | 660,692 | | | 714,922 |
| Dividend reinvestment plan | 8,598 | 8,598 | | 127,328 | | | 135,926 |
| Balance, September 30, 2007 | 3,222,923 | \$ 3,222,923 | \$ | \$ 48,796,418 | \$ 13,591,833 | \$ (1,439,511) | \$ 64,171,663 |
| Balance, December 31, 2007 | 3,211,011 | \$ 3,211,011 | \$ | \$ 48,616,512 | \$ 14,564,054 | \$ (2,395,957) | \$ 63,995,620 |
| Comprehensive Income: | | | | | | | |
| Net income (loss) | | | | | (6,304,811) | | (6,304,811) |
| Accumulated other comprehensive loss net of income tax benefit of \$\$4,878,794 | | | | | | (9,060,618) | |
| Less: reclassification adjustment for gains included in net income, net of tax net of tax of \$4,870,580 | | | | | | 9,483,237 | |
| Other comprehensive income | | | | | | 422,619 | 422,619 |
| Total comprehensive income (loss) | | | | | | | (5,882,192) |
| Cumulative adjustment to initially apply EITF 06-4 | | | | | (410,644) | | (410,644) |
| Issuance of restricted stock | 16,250 | 16,250 | (195,000) | 178,750 | | | |
| Dividends paid (\$0.24 per share) | | | | | (768,895) | | (768,895) |
| Common stock repurchased | (17,700) | (17,700) | | (248,711) | | | (266,411) |
| Options exercised | 200 | 200 | | 1,646 | | | 1,846 |
| Dividend reinvestment plan | 11,438 | 11,438 | | 138,864 | | | 150,302 |
| Balance, September 30, 2008 | 3,221,199 | \$ 3,221,199 | (195,000) | \$ 48,687,061 | \$ 7,079,704 | \$ (1,973,338) | \$ 56,819,626 |

Table of Contents

FIRST COMMUNITY CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Nine months ended September 30, | |
|---|---------------------------------|----------------------|
| | 2008 | 2007 |
| Cash flows from operating activities: | | |
| Net income (loss) | \$ (6,304,811) | \$ 2,766,762 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 780,312 | 825,828 |
| Premium amortization (Discount accretion) | (432,384) | (533,987) |
| Amortization of intangibles | 383,941 | 502,228 |
| Provision for loan losses | 722,600 | 359,975 |
| (Gain) loss on sale of securities | 28,582 | (73,694) |
| Other-than-temporary-impairment charge on securities | 14,325,235 | |
| Net increase in fair value option instruments and derivatives | (165,082) | (45,792) |
| Increase (decrease) in other assets | (3,905,445) | 601,698 |
| Decrease in other liabilities | (956,993) | (9,122) |
| Net cash provided by operating activities | 4,475,955 | 4,393,896 |
| Cash flows from investing activities: | | |
| Purchase of investment securities available-for-sale | (47,822,655) | (41,271,466) |
| Maturity of investment securities available-for-sale | 44,703,355 | 23,159,061 |
| Proceeds from sale of securities available-for-sale | 7,796,627 | 6,356,924 |
| Maturity of investment securities held-to-maturity | 5,722,966 | 148,686 |
| Purchase of securities held-to-maturity | (71,110,383) | (3,098,097) |
| Maturity of securities-held-for-trading | 318,138 | 156,166 |
| Proceeds from sale of securities held-for-trading | | 3,463,665 |
| Proceeds from sale of interest rate cap agreement | 600,000 | |
| Increase in loans | (14,768,856) | (27,552,782) |
| Net cash disbursed in business combination | (627,402) | |
| Purchase of property and equipment | (563,845) | (132,284) |
| Net cash used in investing activities | (75,752,055) | (38,770,127) |
| Cash flows from financing activities: | | |
| Increase (decrease) in deposit accounts | 27,395,137 | (1,640,429) |
| Increase in securities sold under agreements to repurchase | 4,017,600 | 7,226,820 |
| Decrease in other borrowings | (53,218) | (24,872) |
| Advances from the Federal Home Loan Bank | 70,900,000 | 45,000,000 |
| Repayment of Advances from the Federal Home Loan Bank | (28,694,419) | (23,012,948) |
| Advances from FHLB, fair value option | 2,500,000 | 1,500,000 |
| Proceeds from exercise of stock options | 1,846 | 714,922 |
| Cash dividends paid | (768,895) | (648,316) |
| Purchase of common stock | (266,411) | (1,791,461) |
| Dividend reinvestment plan | 150,302 | 135,926 |
| Net cash provided from financing activities | 75,181,942 | 27,459,642 |
| Net increase (decrease) in cash and cash equivalents | 3,905,842 | (6,916,589) |
| Cash and cash equivalents at beginning of period | 13,681,631 | 27,814,971 |
| Cash and cash equivalents at end of period | \$ 17,587,473 | \$ 20,898,382 |
| Supplemental disclosure: | | |
| Cash paid during the period for: | | |
| Interest | \$ 12,754,941 | \$ 10,673,161 |
| Taxes | \$ 613,025 | \$ 250,000 |
| Non-cash investing and financing activities: | | |
| Unrealized gain (loss) on securities available-for-sale | \$ 422,619 | \$ 337,868 |

Table of Contents**Notes to Consolidated Financial Statements****Note 1 - Basis of Presentation**

In the opinion of management, the accompanying unaudited consolidated balance sheets, the consolidated statements of income (loss), the consolidated statements of changes in shareholders' equity, and the consolidated statements of cash flows of First Community Corporation (the Company) present fairly in all material respects the Company's financial position at September 30, 2008 and December 31, 2007, the Company's results of operations for the nine and three months ended September 30, 2008 and 2007, and the Company's cash flows for the nine months ended September 30, 2008 and 2007. The results of operations for the nine and three months ended September 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008.

In the opinion of management, all adjustments necessary to fairly present the consolidated financial position and consolidated results of operations have been made. All such adjustments are of a normal, recurring nature. All significant intercompany accounts and transactions have been eliminated in consolidation. The consolidated financial statements and notes thereto are presented in accordance with the instructions for Form 10-Q. The information included in the Company's 2007 Annual Report on Form 10-K should be referred to in connection with these unaudited interim financial statements.

Note 2 Earnings Per Share

The following reconciles the numerator and denominator of the basic and diluted earnings per share computation:

| | Nine months ended September 30, | | Three months ended September 30, | |
|---|------------------------------------|--------------|-------------------------------------|--------------|
| | 2008 | 2007 | 2008 | 2007 |
| Numerator (Included in basic and diluted earnings per share) | \$ (6,304,811) | \$ 2,766,762 | \$ (3,945,776) | \$ 1,148,096 |
| Denominator | | | | |
| Weighted average common shares | | | | |
| Outstanding for: | | | | |
| Basic earnings per share | 3,203,148 | 3,240,665 | 3,205,148 | 3,237,183 |
| Dilutive securities: | | | | |
| Stock options - Treasury Stock method | | 54,061 | | 44,574 |
| Diluted earnings per share | 3,203,148 | 3,294,726 | 3,205,148 | 3,281,757 |
| The average market price used in calculating assumed number of Shares | | | | |
| | \$ 13.13 | \$ 16.65 | \$ 11.27 | \$ 15.94 |

Note 3 Acquisition

On September 15, 2008, the Company completed the acquisition of two financial planning and investment advisory firms. These firms had combined assets under management of approximately \$40 million. This new division of the bank, First Community Financial Consultants, combines the investment services unit already in place at First Community with the added capabilities of holistic financial planning and investment advisory services. In addition, over time we believe the business will provide a consistent non-interest income revenue stream. The total purchase price for the two companies was approximately \$601,000 in cash and 16,250 shares of common stock valued at \$195,000. The common stock issued in connection with the acquisition is restricted and will vest at the end of two years. The purchase price of these two acquisitions is deemed not to be material to the Company's balance sheet.

Table of Contents**Note 4 SFAS No. 159 (SFAS 159) The Fair Value Option for Financial assets and Financial Liabilities**

The Company adopted the provisions of SFAS 159 effective January 1, 2007 which became effective in February 2007. SFAS 159 generally permits the measurement of selected eligible financial instruments at fair value at specified election dates. This election can generally be applied on an instrument by instrument basis. Following the initial measurement date, ongoing unrealized gains or losses on these securities as well as other financial instruments for which fair value reporting is elected are reported in earnings at each subsequent reporting date.

The following tables reflect the changes in fair values for the three-month and nine-month periods ended September 30, 2008 and 2007 and where these changes are included in the income statement:

| Description | Non-interest income:fair value adjustment gain (loss) nine months ended 9/30/2008 | | Non-interest income:fair value adjustment gain (loss) three months ended 9/30/2008 | |
|--------------------------------|---|----------|--|---------|
| Trading securities | \$ | (12,664) | \$ | 167 |
| Interest rate cap/floor | | 170,330 | | (795) |
| Federal Home Loan Bank Advance | | 7,416 | | (7,220) |
| Total | \$ | 165,082 | \$ | (7,848) |

| Description | Non-interest income:fair value adjustment gain (loss) nine months ended 9/30/2007 | | Non-interest income:fair value adjustment gain (loss) three months ended 9/30/2007 | |
|--------------------------------|---|----------|--|----------|
| Trading securities | \$ | 28,047 | \$ | 64,991 |
| Interest rate cap/floor | | 37,544 | | 92,008 |
| Federal Home Loan Bank Advance | | (19,798) | | (18,838) |
| Total | \$ | 45,793 | \$ | 138,161 |

There were no gains or losses on sale of trading securities in nine or three months ended September 30, 2008. During the nine and three months ended September 30, 2007 a gain on sale of trading securities in the amount of \$69,405 is included in gain (loss) on sale of securities in the consolidated statement of income (loss).

In connection with the adoption of SFAS 159, the Company was required to adopt SFAS No. 157, Fair Value Measurement (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements.

Effective January 1, 2007, the Company adopted SFAS No. 157, Fair Value Measurements (SFAS 157) which provides a framework for measuring and disclosing fair value under generally accepted accounting principles. SFAS 157 requires disclosures about the fair value of assets and liabilities recognized in the balance sheet in periods subsequent to initial recognition, whether the measurements are made on a recurring basis (for example, available-for-sale investment securities) or on a nonrecurring basis (for example, impaired loans).

SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Table of Contents

- Level 1** Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as U.S. Treasuries and money market funds
- Level 2** Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include debt securities with quoted prices that are traded less frequently than exchange-traded instruments mortgage-backed securities, municipal bonds, corporate debt securities and derivative contracts whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data. This category generally includes certain derivative contracts and impaired loans.
- Level 3** Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. For example, this category generally includes certain private equity investments, retained residual interests in securitizations, residential mortgage servicing rights, and highly-structured or long-term derivative contracts.

FASB Staff Position No. FAS 157-2 delays the implementation of SFAS 157 until the first quarter of 2009 with respect to goodwill, other intangible assets, real estate and other assets acquired through foreclosure and other non-financial assets measured at fair value on a nonrecurring basis.

The following table summarizes quantitative disclosures about the fair value measurement for each category of assets carried at fair value as of September 30, 2008.

| Description | September 30, 2008 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---------------------------------|-----------------------|---|--|--|
| Trading securities | \$ 2,545,284 | \$ | \$ 2,545,284 | \$ |
| Available for sale securities | 140,517,912 | 898,487 | 139,110,137 | 509,288 |
| Interest rate cap | 5,287 | | | 5,287 |
| Federal Home Loan Bank Advances | (2,493,787) | | | (2,493,787) |
| Total | \$ 140,574,696 | \$ 898,487 | \$ 141,655,421 | \$ (1,979,212) |

The Company has a large percentage of loans with real estate serving as collateral. Loans which are deemed to be impaired are primarily valued on a nonrecurring basis at the fair values of the underlying real estate collateral. Such fair values are obtained using independent appraisals, which the Company considers to be Level 2 inputs. The aggregate carrying amount of impaired loans at September 30, 2008 and 2007 was \$1,732,000 and \$557,000 respectively.

Table of Contents

The following table reconciles the changes in Level 3 financial instruments for the nine months ended September 30, 2008 and 2007:

| | Available for Sale securities | Interest rate Cap/Floor | Federal Home Loan Bank Advances |
|--------------------------------------|--|----------------------------|--|
| Beginning Balance, December 31, 2007 | \$ 509,288 | \$ 457,650 | \$ (1,532,541) |
| Gain (loss) recognized | | 170,330 | 7,415 |
| Payment | | (622,693) | 1,531,339 |
| Issuances | | | (2,500,000) |
| Balance, September 30, 2008 | \$ 509,288 | \$ 5,287 | \$ (2,493,787) |

| | Available for Sale securities | Interest rate Cap/Floor |
|--------------------------------------|--|----------------------------|
| Beginning Balance, December 31, 2006 | \$ 509,443 | \$ 371,632 |
| Gain (loss) recognized | | 37,544 |
| Payment | | (65,705) |
| Issuances | | |
| Ending Balance, September 30, 2007 | \$ 509,443 | \$ 343,471 |

Note 5 - Recently Issued Accounting Pronouncements

The following is a summary of recent authoritative pronouncements:

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations, (SFAS 141(R)) which replaces SFAS 141. SFAS 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for acquisitions by the Company taking place on or after January 1, 2009. Early adoption is prohibited. Accordingly, a calendar year-end company is required to record and disclose business combinations following existing accounting guidance until January 1, 2009. The Company will assess the impact of SFAS 141(R) if and when a future acquisition occurs.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 (SFAS 160). SFAS 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Before this statement, limited guidance existed for reporting noncontrolling interests (minority interest). As a result, diversity in practice exists. In some cases minority interest is reported as a liability and in others it is reported in the mezzanine section between liabilities and equity. Specifically, SFAS 160 requires the recognition of a noncontrolling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement. SFAS 160 clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this statement requires that a parent recognize gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the noncontrolling equity investment on the deconsolidation date. SFAS 160 also includes expanded disclosure

Edgar Filing: FIRST COMMUNITY CORP /SC/ - Form 10-Q

requirements regarding the interests of the parent and its noncontrolling interests. SFAS 160 is effective for the Company on January 1, 2009. Earlier adoption is prohibited. The Company is currently evaluating the impact, if any, the adoption of SFAS 160 will have on its financial position, results of operations and cash flows.

Table of Contents

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS 161). SFAS 161 requires enhanced disclosures about an entity's derivative and hedging activities and thereby improving the transparency of financial reporting. It is intended to enhance the current disclosure framework in SFAS 133 by requiring that objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation. This disclosure better conveys the purpose of derivative use in terms of the risks that the entity is intending to manage. SFAS 161 is effective for the Company on January 1, 2009. This pronouncement does not impact accounting measurements but will result in additional disclosures if the Company is involved in material derivative and hedging activities at that time.

In February 2008, the FASB issued FASB Staff Position No. 140-3, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions* (FSP 140-3). This FSP provides guidance on accounting for a transfer of a financial asset and the transferor's repurchase financing of the asset. This FSP presumes that an initial transfer of a financial asset and a repurchase financing are considered part of the same arrangement (linked transaction) under SFAS No. 140. However, if certain criteria are met, the initial transfer and repurchase financing are not evaluated as a linked transaction and are evaluated separately under Statement 140. FSP 140-3 will be effective for financial statements issued for fiscal years beginning after November 15, 2008, and interim periods within those fiscal years and earlier application is not permitted. Accordingly, this FSP is effective for the Company on January 1, 2009. The Company is currently evaluating the impact, if any, the adoption of FSP 140-3 will have on its financial position, results of operations and cash flows.

In April 2008, the FASB issued FASB Staff Position No. 142-3, *Determination of the Useful Life of Intangible Assets* (FSP 142-3). This FSP amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, *Goodwill and Other Intangible Assets*. The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141(R), *Business Combinations*, and other U.S. generally accepted accounting principles. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years and early adoption is prohibited. Accordingly, this FSP is effective for the Company on January 1, 2009. The Company does not believe the adoption of FSP 142-3 will have a material impact on its financial position, results of operations or cash flows.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* (SFAS No. 162). SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). SFAS No. 162 will be effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board's amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. The FASB has stated that it does not expect SFAS No. 162 will result in a change in current practice. The application of SFAS No. 162 will have no effect on the Company's financial position, results of operations or cash flows.

The FASB issued FASB Staff Position No. APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)* (FSP No. APB 14-1). This FSP specifies that issuers of convertible debt instruments that may be settled in cash upon conversion should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. FSP No. APB 14-1 provides guidance for initial and subsequent measurement as well as derecognition provisions. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is not permitted. The adoption of FSP No. APB 14-1 will have no material effect on the Company's financial position, results of operations or cash flows.

In September 2008, the FASB issued FASB Staff Position No. EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities* (FSP EITF 03-6-1). This FSP provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents are participating securities and must be included in the earnings per share

computation. FSP EITF 03-6-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. All prior-period earnings per share data presented must be adjusted retrospectively. Early application is not permitted.

Table of Contents

The adoption of FSP EITF 03-6-1 will have no material effect on the Company's financial position, results of operations or cash flows.

FSP SFAS 133-1 and FIN 45-4, Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161, (FSP SFAS 133-1 and FIN 45-4) was issued September 2008, effective for reporting periods (annual or interim) ending after November 15, 2008. FSP SFAS 133-1 and FIN 45-4 amends SFAS 133 to require the seller of credit derivatives to disclose the nature of the credit derivative, the maximum potential amount of future payments, fair value of the derivative, and the nature of any recourse provisions. Disclosures must be made for entire hybrid instruments that have embedded credit derivatives.

The staff position also amends FIN 45 to require disclosure of the current status of the payment/performance risk of the credit derivative guarantee. If an entity utilizes internal groupings as a basis for the risk, how the groupings are determined must be disclosed as well as how the risk is managed.

The staff position encourages that the amendments be applied in periods earlier than the effective date to facilitate comparisons at initial adoption. After initial adoption, comparative disclosures are required only for subsequent periods.

FSP SFAS 133-1 and FIN 45-4 clarifies the effective date of SFAS 161 such that required disclosures should be provided for any reporting period (annual or quarterly interim) beginning after November 15, 2008. The adoption of this Staff Position will have no material effect on the Company's financial position, results of operations or cash flows.

The SEC's Office of the Chief Accountant and the staff of the FASB issued press release 2008-234 on September 30, 2008 (Press Release) to provide clarifications on fair value accounting. The press release includes guidance on the use of management's internal assumptions and the use of market quotes. It also reiterates the factors in SEC Staff Accounting Bulletin (SAB) Topic 5M which should be considered when determining other-than-temporary impairment: the length of time and extent to which the market value has been less than cost; financial condition and near-term prospects of the issuer; and the intent and ability of the holder to retain its investment for a period of time sufficient to allow for any anticipated recovery in market value.

On October 10, 2008, the FASB issued FSP SFAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (FSP SFAS 157-3). This FSP clarifies the application of SFAS No. 157, Fair Value Measurements (see Note 4) in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that asset is not active. The FSP is effective upon issuance, including prior periods for which financial statements have not been issued. For the Company, this FSP is effective for the quarter ended September 30, 2008.

The Company considered the guidance in the Press Release and in FSP SFAS 157-3 when conducting its review for other-than-temporary impairment as of September 30, 2008 and determined that it did not result in a change to its impairment estimation techniques.

Edgar Filing: FIRST COMMUNITY CORP /SC/ - Form 10-Q

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

Table of Contents

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

This Report contains statements which constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements are based on many assumptions and estimates and are not guarantees of future performance. Our actual results may differ materially from those projected in any forward-looking statements, as they will depend on many factors about which we are unsure, including many factors, which are beyond our control. The words may, would, could, will, expect, anticipate, believe, intend, plan, and estimate, as well as similar expressions, are meant to identify such forward-looking statements. Potential risks and uncertainties include, but are not limited to, the following:

- increases in competitive pressure in the banking and financial services industries;
- changes in the interest rate environment which could reduce anticipated or actual margins;
- changes in political conditions or the legislative or regulatory environment;
- general economic conditions, either nationally or regionally and especially in our primary service area, becoming less favorable than expected resulting in, among other things, a deterioration in credit quality;
- changes occurring in business conditions and inflation;
- changes in technology;
- changes in deposit flows;
- the adequacy of our level of allowance for loan loss;
- the rate of delinquencies and amounts of charge-offs;

Edgar Filing: FIRST COMMUNITY CORP /SC/ - Form 10-Q

- the rates of loan growth;
- adverse changes in asset quality and resulting credit risk-related losses and expenses;
- changes in monetary and tax policies;
- loss of consumer confidence and economic disruptions resulting from terrorist activities;
- changes in the securities markets; and
- other risks and uncertainties detailed from time to time in our filings with the Securities and Exchange Commission.

These risks are exacerbated by the recent developments in national and international financial markets, and we are unable to predict what effect these uncertain market conditions will have on the Company. During 2008, the capital and credit markets have experienced extended volatility and disruption. In the last 90 days, the volatility and disruption have reached unprecedented levels. There can be no assurance that these unprecedented recent developments will not materially and adversely affect our business, financial condition and results of operations.

We undertake no obligation to publicly update or otherwise revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

Overview

We are a bank holding company registered under the Bank Holding Company Act of 1956, and were incorporated under the laws of South Carolina in 1994 primarily to own and control all of the capital stock of First Community Bank, N.A. (the "bank"), which commenced operations in August 1995. On October 1, 2004, we completed our acquisition of DutchFork Bancshares, Inc. and its wholly-owned subsidiary, Newberry Federal Savings Bank. During the second quarter of 2006, we completed our acquisition of DeKalb Bankshares, Inc., the holding company for The Bank of Camden. We engage in a commercial banking business from our main office in Lexington, South Carolina and our 11 full-service offices are located in Lexington (two), Forest Acres, Irmo, Cayce-West Columbia, Gilbert, Chapin, Northeast Columbia, Prosperity, Newberry and Camden. We offer a wide-range of traditional banking products and services for professionals and small-to medium-sized businesses, including consumer and commercial, mortgage, brokerage and investment, and insurance services. We also offer online banking to our customers.

The following discussion describes our results of operations for the three-month and nine-month periods ended September 30, 2008 as compared to the three-month and nine-month periods ended September 30, 2007, and also analyzes our financial condition as of September 30, 2008 as compared to December 31, 2007. Like most community banks, we derive most of our income from interest we receive on our loans and

investments. Our primary source of funds for making these loans and investments is our deposits, on which we pay interest. Consequently, one of the key measures of our success is our amount of net interest income, or the difference

Table of Contents

between the income on our interest-earning assets, such as loans and investments, and the expense on our interest-bearing liabilities, such as deposits. Another key measure is the spread between the yield we earn on these interest-earning assets and the rate we pay on our interest-bearing liabilities.

Of course, there are risks inherent in all loans, so we maintain an allowance for loan losses to absorb probable losses on existing loans that may become uncollectible. We establish and maintain this allowance by charging a provision for loan losses against our operating earnings. In the following section, we have included a detailed discussion of this process.

In addition to earning interest on our loans and investments, we earn income through fees and other expenses we charge to our customers. We describe the various components of this non-interest income, as well as our non-interest expense, in the following discussion.

The following discussion and analysis also identifies significant factors that have affected our financial position and operating results during the periods included in the accompanying financial statements. We encourage you to read this discussion and analysis in conjunction with the financial statements and the related notes and the other statistical information also included in this report.

Emergency Economic Stabilization Act of 2008

In response to financial conditions affecting the banking system and financial markets and the potential threats to the solvency of investment banks and other financial institutions, the United States government has taken unprecedented actions. On October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act of 2008 (the EESA). Pursuant to the EESA, the U.S. Treasury will have the authority to, among other things, purchase mortgages, mortgage-backed securities, and other financial instruments from financial institutions for the purpose of stabilizing and providing liquidity to the U.S. financial markets. On October 14, 2008, the U.S. Department of Treasury, which we refer to as the Treasury, announced the Capital Purchase Program under the EESA, pursuant to which the Treasury intends to make senior preferred stock investments in participating financial institutions. Regardless of our participation, governmental intervention and new regulations under these programs could materially and adversely affect our business, financial condition and results of operations.

On November 6, 2008, the Treasury informed us that we had received preliminary approval to participate in the Capital Purchase Program. Under the Capital Purchase Program, the Treasury would purchase up to approximately \$11.3 million of our senior preferred stock and would receive warrants to purchase shares of our common stock. While we can provide no assurance that we will close on this investment by the Treasury, we currently anticipate that we will close on the Treasury's investment under the Capital Purchase Program during 2008. Under the Capital Purchase Program, each senior preferred share purchased by the Treasury would have a liquidation value of \$1,000 per share. We would pay a cumulative dividends at a rate of 5% per annum on these senior preferred shares for the first five years and 9% per annum thereafter, payable quarterly. For 3 years following issue of the senior preferred shares we would be restricted in our ability to, among other things, (i) increase common dividends, (ii) repurchase common shares and (iii) redeem the senior preferred shares. Participation in the Capital Purchase Program would subject us to restrictions on payment and deduction of executive compensation. Pursuant to an interim final rule issued by the Board of Governors of the Federal Reserve System on October 16, 2008, bank holding companies that issue senior preferred stock to the Treasury under the Capital Purchase Program are permitted to include such capital instruments in Tier 1 capital for purposes of the Board's risk-based and leverage capital rules and guidelines for bank holding companies.

Edgar Filing: FIRST COMMUNITY CORP /SC/ - Form 10-Q

Under the Capital Purchase Program, we would also issue warrants to the Treasury to purchase shares of our common stock having an aggregate market price, as of the date of Treasury's investment in our senior preferred stock, equal to 15% of the amount of the Treasury's investment in our senior preferred stock. The exercise price of the common stock subject to these warrants would be set based on a 20-day trailing average price for our common stock and the warrants would be exercisable for a period of 10 years following issue. More details of the Capital Purchase Program may be found in the public term sheet, application documents and other materials found at the Treasury's website: <http://www.treas.gov>.

Another aspect of the EESA (in addition to the Capital Purchase Plan described above) which became effective on October 3, 2008 is a temporary increase of the basic limit on federal deposit insurance coverage from \$100,000 to \$250,000 per depositor. The basic deposit insurance limit will return to \$100,000 after December 31, 2009. In addition, the bank anticipates participating in the FDIC's Temporary Liquidity Guarantee Program which was

Table of Contents

announced October 14, 2008 as part of the EESA. This guarantee applies to the following transactions:

- Newly issued senior unsecured debt (up to \$1.5 trillion) issued on or before June 30, 2009, including promissory notes, commercial paper, inter-bank funding, and any unsecured portion of secured debt. For eligible debt issued on or before June 30, 2009, coverage would only be provided for three years beyond that date, even if the liability has not matured; and
- Funds in non-interest-bearing transaction deposit accounts (up to \$500 billion) held by FDIC-insured banks until December 31, 2009.

All FDIC institutions are covered until December 5, 2008 at no cost. After this initial period expires, the institution must opt out if it no longer wishes to participate in the program; otherwise, it will be assessed for future participation. There will be a 75-basis point fee to protect new debt issues and an additional 10-basis point fee to fully cover non-interest bearing deposit transaction accounts.

Critical Accounting Policies

We have adopted various accounting policies that govern the application of accounting principles generally accepted in the United States and with general practices within the banking industry in the preparation of our financial statements. Our significant accounting policies are described in the notes to our unaudited consolidated financial statements as of September 30, 2008 in this report and our notes included in the consolidated financial statements in our 2007 Annual Report on Form 10-K as filed with the Securities and Exchange Commission.

Certain accounting policies involve significant judgments and assumptions by us that have a material impact on the carrying value of certain assets and liabilities. We consider these accounting policies to be critical accounting policies. The judgment and assumptions we use are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Because of the nature of the judgment and assumptions we make, actual results could differ from these judgments and estimates that could have a material impact on the carrying values of our assets and liabilities and our results of operations.

We believe the allowance for loan losses is the critical accounting policy that requires the most significant judgment and estimates used in preparation of our consolidated financial statements. Some of the more critical judgments supporting the amount of our allowance for loan losses include judgments about the credit worthiness of borrowers, the estimated value of the underlying collateral, the assumptions about cash flow, determination of loss factors for estimating credit losses, the impact of current events, and conditions, and other factors impacting the level of probable inherent losses. Under different conditions or using different assumptions, the actual amount of credit losses incurred by us may be different from management's estimates provided in our consolidated financial statements. Refer to the portion of this discussion that addresses our allowance for loan losses for a more complete discussion of our processes and methodology for determining our allowance for loan losses.

Comparison of Results of Operations for Nine Months Ended September 30, 2008 to the Nine Months Ended September 30, 2007:

Net Income (loss)

Our net loss for the nine months ended September 30, 2008 was \$6.3 million, or \$1.97 diluted loss per share, as compared to net income of \$2.8 million, or \$.84 diluted earnings per share, for the nine months ended September 30, 2007. The net loss for the nine months ended September 30, 2008 included a charge to recognize an other-than-temporary-impairment in the amount of \$14.3 million on our investment in a preferred stock issue of the Federal Home Loan Mortgage Corporation (Freddie Mac), a government sponsored enterprise (GSE) reflecting a write-down of substantially all of its carrying value. During the second quarter we made a decision to recognize an unrealized mark-to-market loss on this previously investment grade security in the amount of \$6.2 million as an other-than-temporary impairment (OTTI) charge based on the significant decline in the market value of the security caused by potential deterioration of Freddie Mac 's financial condition, and the then current lack of clarity about the impact of an announced plan (which was approved by the House and Senate and signed into law by the President) that provided support for Freddie Mac as well as other GSE 's. On September 7, 2008, the Secretary of the Treasury announced a decision to place Freddie Mac into conservatorship and as part of that decision the dividend payments on existing preferred shares would be terminated for an unspecified period of time. As a result of that decision we took an additional \$8.1 million OTTI charge in the third quarter of 2008 to write off substantially all of

Table of Contents

the remaining investment in this Freddie Mac security. The preferred stock issue was purchased in 2003 and acquired by the Company in the 2004 merger with Dutchfork Bankshares. This Freddie Mac preferred stock, which has a current cost basis of \$3.0 thousand, is included in the available-for-sale securities portfolio. If at some time in the future quarterly dividend payments are resumed these securities may recover some or all of their value. We had operating earnings for the nine months ended September 30, 2008 of \$3.5 million or \$1.09 per share as compared to \$2.7 million or \$0.82 per share for the nine months ended September 30, 2007.

Another significant decision that impacted our results for the nine and three months ended September 30, 2008 was the implementation of a leverage strategy during the second quarter of 2008 whereby we acquired approximately \$63.2 million in certain non-agency mortgage backed securities and collateralized mortgage obligations. We initiated this strategy because we believe the pricing levels of these securities and related funding opportunities provided the ability to realize significant interest rate spreads not typically available in leverage strategies. The weighted average yield on the investment securities purchased was approximately 6.82%. All of the mortgage assets acquired were classified as prime or ALT-A securities and represent the senior or super-senior tranches of the securities. The assets acquired as part of this strategy have been classified as held-to-maturity in the investment portfolio. The securities were acquired on the open market through securities dealers. Prior to initiating each transaction, we performed a thorough analysis, evaluating the associated credit risk, interest rate risk, liquidity and capital risk as well as related funding options. We continue to perform an evaluation of these securities and the related risk on a monthly basis. The funding for this strategy was provided through Federal Home Loan Bank Advances in the amount of \$36.0 million and brokered certificates of deposit in the amount of \$23.0 million. The weighted average cost of funding was approximately 4.28%. We believe this opportunity existed as a result of the ongoing volatility in this market sector and the economic value of these securities was not reflected at the pricing levels.

The increase in operating earnings is primarily due to an increase in net interest income resulting primarily from an increase in the level of average earning assets for the nine months ended September 30, 2008, as compared to the same period in 2007, reflecting the continued growth of our bank including the above mentioned leverage strategy. Average earning assets were \$537.1 million during the nine months ended September 30, 2008, as compared to \$469.2 million during the nine months ended September 30, 2007, an increase of \$67.9 million. This increase in average earning assets was the primary factor responsible for the increase in net interest income of \$1.6 million in the first nine months of 2008 as compared to the first nine months of 2007. As a result of the OTTI charge, we had a non-interest income loss during the first nine months of 2008 of \$10.3 million. Non-interest income (excluding the OTTI charge and gains and losses on sale of securities) was \$4.0 million for the nine months ended September 30, 2008 as compared to \$3.5 million for the same period in 2007. This increase of \$504,000, or 14.2%, also contributed to the increase in operating income in the first nine months of 2008 as compared to the same period in 2007. Non-interest expense increased by \$685,000, or 6.5%, in the first nine months of 2008, as compared to the same period in 2007.

Please refer to the table at the end of this Item 2 for the yield and rate data for interest-bearing balance sheet components during the nine-month periods ended September 30, 2008 and 2007, along with average balances and the related interest income and interest expense amounts.

Net interest income was \$12.9 million for the nine months ended September 30, 2008 as compared to \$11.3 million for the nine months ended September 30, 2007. This increase was primarily due to an increase in the level of earning assets. The yield on earning assets decreased by 35 basis points during the nine months ended September 30, 2008 as compared to the same period in 2007. The cost of interest-bearing liabilities decreased by 44 basis points during these two periods. Interest rates decreased significantly during the last quarter of 2007 and first quarter of 2008. The larger decline in our funding cost as compared to our earning asset yields results from our balance sheet mix being liability sensitive. The net interest margin on a taxable equivalent basis was 3.27% for the nine months ended September 30, 2008 as compared to 3.30% during the same period in 2007.

Table of Contents**Reconciliations**

The following is a reconciliation for both the nine- and three-month periods ended September 30, 2008 and 2007, of net income (loss) as reported for generally accepted accounting principles (GAAP) and the non-GAAP measure referred to throughout our discussion of operating earnings .

| (Dollars in thousands) | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|----------|------------------------------------|----------|
| | 2008 | 2007 | 2008 | 2007 |
| Net income (loss), As Reported (GAAP) | \$ (3,946) | \$ 1,148 | \$ (6,305) | \$ 2,767 |
| Add: Income tax expense (benefit) | (2,686) | 517 | (3,123) | 1,152 |
| | (6,632) | 1,665 | (9,428) | 3,919 |
| Non-operating items: | | | | |
| (Gain) loss on sale of securities | | | 28 | (74) |
| Other-than-temporary-impairment charge | 8,163 | | 14,325 | |
| Pre-tax operating earnings (loss) | 1,531 | 1,665 | 4,925 | 3,845 |
| Related income tax expense | 393 | 517 | 1,406 | 1,131 |
| Operating earnings, (net income, excluding non operating items) | \$ 1,138 | \$ 1,148 | \$ 3,519 | \$ 2,714 |

The following is a reconciliation for both the nine-and three-month periods ended September 30, 2008 and 2007, of non-interest income (loss) as reported for generally accepted accounting principles (GAAP) and the non-GAAP measure referred to throughout our discussion regarding non-interest income (loss).

| (Dollars in thousands) | Three months ended September 30, | | Nine months ended September 30, | |
|--|-------------------------------------|----------|------------------------------------|----------|
| | 2008 | 2007 | 2008 | 2007 |
| Non-interest income (loss), As Reported (GAAP) | \$ (6,838) | \$ 1,363 | \$ (10,317) | \$ 3,606 |
| Non-operating items: | | | | |
| (Gain) loss on sale of securities | | | 28 | (74) |
| Other-than-temporary-impairment charge | 8,163 | | 14,325 | |
| Operating non-interest income | \$ 1,325 | \$ 1,363 | \$ 4,036 | \$ 3,532 |

Our management believes that the non-GAAP measures above are useful because they enhance the ability of investors and management to evaluate and compare our operating results from period to period in a meaningful manner. These non-GAAP measures should not be considered as an alternative to any measure of performance as promulgated under GAAP, and investors should consider the OTTI charge in the second and third quarters of 2008 when assessing the performance of the Company. Non-GAAP measures have limitations as analytical tools, and investors should not consider them in isolation or as a substitute for analysis of the Company's results as reported under GAAP.

Provision and Allowance for Loan Losses

Edgar Filing: FIRST COMMUNITY CORP /SC/ - Form 10-Q

At September 30, 2008, the allowance for loan losses was \$3.7 million, or 1.13% of total loans, as compared to \$3.5 million, or 1.14% of total loans, at December 31, 2007. Our provision for loan losses was \$723,000 for the nine months ended September 30, 2008, as compared to \$360,000 for the nine months ended September 30, 2007. The increase in the provision between the two periods is directly a result of the increased charge-offs primarily on one-to-four family residential property loans to several borrowers that had a number of residential investment property loans. These loans have been placed in non-accrual status and have been written down to fair value. Our provision is made based on our assessment of general loan loss risk and asset quality. The allowance for loan losses represent an amount which we believe will be adequate to absorb probable losses on existing loans that may become uncollectible. Our judgment as to the adequacy of the allowance for loan losses is based on a number of assumptions about future events, which we believe to be reasonable, but which may or may not prove to be accurate. Our determination of the allowance for loan losses is based on evaluations of the collectibility of loans, including consideration of factors such as the balance of impaired loans, the quality, mix, and size of our overall loan portfolio, economic conditions that may affect the borrower's ability to repay, the amount and quality of collateral securing the loans, our historical loan loss experience, and a review of specific problem loans. We also

Table of Contents

consider subjective issues such as changes in the lending policies and procedures, changes in the local/national economy, changes in volume or type of credits, changes in volume/severity of problem loans, quality of loan review and board of director oversight, and concentrations of credit. Periodically, we adjust the amount of the allowance based on changing circumstances. We charge recognized losses to the allowance and add subsequent recoveries back to the allowance for loan losses.

We perform an analysis quarterly to assess the risk within the loan portfolio. The portfolio is segregated into similar risk components for which historical loss ratios are calculated and adjusted for identified changes in current portfolio characteristics. Historical loss ratios are calculated by product type and by regulatory credit risk classification. The allowance consists of an allocated and unallocated allowance. The allocated portion is determined by types and ratings of loans within the portfolio. The unallocated portion of the allowance is established for losses that exist in the remainder of the portfolio and compensates for uncertainty in estimating the loan losses. There can be no assurance that charge-offs of loans in future periods will not exceed the allowance for loan losses as estimated at any point in time or that provisions for loan losses will not be significant to a particular accounting period. The allowance is also subject to examination and testing for adequacy by regulatory agencies, which may consider such factors as the methodology used to determine adequacy and the size of the allowance relative to that of peer institutions. Such regulatory agencies could require us to adjust our allowance based on information available to them at the time of their examination.

Accrual of interest is discontinued on loans when management believes, after considering economic and business conditions and collection efforts that a borrower's financial condition is such that the collection of interest is doubtful. A delinquent loan is generally placed in nonaccrual status when it becomes 90 days or more past due. At the time a loan is placed in nonaccrual status, all interest, which has been accrued on the loan but remains unpaid is reversed and deducted from earnings as a reduction of reported interest income. No additional interest is accrued on the loan balance until the collection of both principal and interest becomes reasonably certain.

At September 30, 2008, we had \$132,000 in loans delinquent more than 90 days and still accruing interest, and loans totaling \$1.3 million that were delinquent 30 days to 89 days and still accruing interest. Closed-end installment loans with payments scheduled monthly are considered past due 30 days or more when the borrower is in arrears two or more monthly payments. Due to the current loan to collateral values or other factors it is anticipated that all of the principal and interest will be collected on those loans greater than 90 days or more delinquent and still accruing interest. We had sixteen loans in a nonaccrual status in the amount of \$1.7 million at September 30, 2008. Our management continuously monitors non-performing, classified and past due loans, to identify deterioration regarding the condition of these loans. We have identified six loans in the amount of \$796,000 that are current as to principal and interest and not included in non-performing assets that could be potential problem loans.

Table of Contents

| Allowance for Loan Losses (Dollars in thousands) | Nine Month Ended September 30, | |
|---|-----------------------------------|------------|
| | 2008 | 2007 |
| Average loans outstanding | \$ 316,064 | \$ 293,478 |
| Loans outstanding at period end | \$ 324,333 | \$ 302,829 |
| Non-performing assets: | | |
| Nonaccrual loans | \$ 1,732 | \$ 557 |
| Loans 90 days past due still accruing | 132 | 542 |
| Foreclosed real estate | 180 | 63 |
| Total non-performing assets | \$ 2,044 | \$ 1,162 |
| Beginning balance of allowance | \$ 3,530 | \$ 3,215 |
| Loans charged-off: | | |
| 1-4 family residential mortgage | 454 | 148 |
| Multi-family residential | 29 | |
| Non-residential real estate | 29 | |
| Home equity | | 32 |
| Commercial | 81 | 22 |
| Installment & credit card | 126 | 160 |
| Total loans charged-off | 719 | 362 |
| Recoveries: | | |
| 1-4 family residential mortgage | 39 | 23 |
| Non-residential real estate | 9 | 54 |
| Home equity | 4 | 4 |
| Commercial | 35 | 167 |
| Installment & credit card | 43 | 64 |
| Total recoveries | 130 | 312 |
| Net loan charge offs | 589 | 50 |
| Provision for loan losses | 723 | 360 |
| Balance at period end | \$ 3,664 | \$ 3,525 |
| Net charge -offs to average loans | .19% | .02% |
| Allowance as percent of total loans | 1.13% | 1.16% |
| Non-performing assets as % of total assets | 0.32% | 0.20% |
| Allowance as % of non-performing loans | 196.57% | 303.36% |

The following allocation of the allowance to specific components is not necessarily indicative of future losses or future allocations. The entire allowance is available to absorb losses in the portfolio.

Composition of the Allowance for Loan Losses

| (Dollars in thousands) | September 30, 2008 | | December 31, 2007 | |
|---|--------------------|------------------------------|-------------------|------------------------------|
| | Amount | % of loans in Category | Amount | % of loans in Category |
| Commercial, Financial and Agricultural | \$ 121 | 7.9% | \$ 129 | 8.7% |
| Real Estate Construction | 211 | 9.5% | 343 | 9.1% |
| Real Estate Mortgage: | | | | |
| Commercial | 3,126 | 57.1% | 1,989 | 55.8% |
| Residential | 74 | 16.0% | 553 | 16.8% |
| Consumer | 176 | 9.5% | 198 | 9.6% |
| Unallocated | 33 | N/A | 318 | N/A |

Edgar Filing: FIRST COMMUNITY CORP /SC/ - Form 10-Q

| | | | | | | |
|-------|----|-------|--------|----|-------|--------|
| Total | \$ | 3,664 | 100.0% | \$ | 3,530 | 100.0% |
|-------|----|-------|--------|----|-------|--------|

Table of Contents

Non-interest Income and Non-interest Expense

As a result of the OTTI charge on Freddie Mac preferred stock, we had a non-interest income loss during the first nine months of 2008 of \$10.3 million. Non-interest income (excluding the OTTI charge) during the first nine months of 2008 was \$4.0 million as compared to \$3.6 million during the same period in 2007. During the first nine months of 2008, we realized losses on sale of securities in the amount of \$29,000 as compared to gains of \$74,000 in the same period of 2007. Deposit service charges increased \$99,000, or 5.0%. The increase in deposit service charges results from an increase in certain fees in the middle of the second quarter of 2007. Mortgage origination fees increased \$202,000 or 78.1% in the nine months ended September 30, 2008 as compared to the same period in 2007. This increase results from a continued emphasis on this source of revenue as well as the continued favorable mortgage interest rate environment. In the nine months ended September 30, 2008, we recognized gains on financial instruments and derivatives carried at fair value in the amount of \$165,000, as compared to a gain of \$46,000 in the same period of 2007. Other non-interest income increased by \$60,000 in the first nine months of 2008 as compared to the same period in 2007. The increase reflects an increase in ATM surcharge and debit card exchange fees as a result of continued increased usage by our customer base.

On September 15, 2008, the Company completed the acquisition of two financial planning and investment advisory firms. These firms had combined assets under management of approximately \$40 million. The purchase price of these two acquisitions is not material to the Company's balance sheet. The total purchase price for the two companies was approximately \$601,000 in cash and 16,250 shares of common stock valued at \$195,000. This new division, First Community Financial Consultants, combines the investment services unit already in place at the Company with the added capabilities of holistic financial planning and investment advisory services. This line of business is consistent with our vision to be a provider of financial solutions to local businesses, entrepreneurs, and professionals. In addition, over time we believe the business will provide a consistent non-interest income revenue stream.

Total non-interest expense increased by \$686,000 during the first nine months of 2008 as compared to the same period of 2007. In the first nine months of 2008 salaries and employee benefits increased \$446,000 as compared to the same period in 2007. At September 30, 2008 we had 147 full time equivalent employees as compared to 134 at September 30, 2007. The increases in staffing included one addition each to our network support services, internal audit, training, branch administration and retail deposit sales staff. The acquisition of the investment advisory firms mentioned above added three full time equivalents. Also contributing to the increase in salary and benefits are some modifications to our commercial lender, retail banker and customer service staff incentive plans. The amortization of intangibles decreased to \$384,000 in the first nine months of 2008 from \$502,000 in the same period of 2007. In January 2008 we recorded the final monthly amortization of core deposit premium related to the 2001 acquisition of our Chapin Branch. Other non-interest expense increased to \$2.8 million in the nine months ending September 30, 2008 as compared to \$2.4 million in the same period of 2007. Throughout 2007 we received a credit against our FDIC insurance assessments as a result of the acquisition of Newberry Federal Savings Bank in 2004. This credit was used up in the first quarter of 2008. It is expected that we will be assessed FDIC total insurance premiums of approximately \$240,000 for 2008. These FDIC premiums account for approximately \$127,000 of the increase in other non-interest expense. The FDIC has put forth the proposed rates (which are currently in the comment period) for 2009. Due to the increasing problems within the financial industry premiums for 2009 will increase substantially. Based on our estimate our FDIC premiums will increase to between 12 and 14 basis points of deposits in 2009 from the current 5 basis points in 2008.

Other non-interest expense in the first nine months of 2008 also includes our share of accumulated losses in a limited partnership of approximately \$255,000. In December 2007 we committed to invest as a limited partner in the South Carolina Preservation Fund I. This partnership is designed to raise capital to invest in qualified low-income housing projects that among other things qualify for low-income housing tax credits. Our investment commitment is for \$2.0 million (10.05% limited partner) and will be funded throughout 2008 and early 2009. The investment is also designed to assist in meeting our commitment under the Community Reinvestment Act. The low-income housing tax credits will reduce our effective income tax rate in 2008 and in succeeding years.

Table of Contents

The following is a summary of the components of non-interest expense-Other:

| (Dollars in thousands) | Nine months ended | |
|--------------------------------------|-------------------|----------|
| | September 30, | |
| | 2008 | 2007 |
| ATM/debit card processing | \$ 252 | \$ 251 |
| Supplies | 132 | 162 |
| Telephone | 243 | 277 |
| Correspondent services | 84 | 117 |
| Loss on limited partnership interest | 255 | |
| FDIC/FICO insurance assessment | 166 | 39 |
| Insurance | 145 | 167 |
| Postage | 144 | 146 |
| Professional fees | 689 | 678 |
| Director fees | 171 | 126 |
| Other | 530 | 463 |
| | \$ 2,811 | \$ 2,426 |

Income Tax Expense

In the first nine months of 2008, we had an effective tax benefit rate of 33.1% as compared to an effective tax expense rate of 29.4% during the same period of 2007. The benefit rate in 2008 reflects the deferred tax benefit resulting from the OTTI charge of \$14.3 million. Our effective tax rate is currently expected to be 30.0% to 32.0% during the remainder of 2008.

Comparison of Results of Operations for Three Months Ended September 30, 2008 to the Three Months Ended September 30, 2007:***Net Income (loss)***

Our net loss for the third quarter of 2008 was \$3.9 million, or \$1.23 diluted loss per share, as a result of the OTTI charge on Freddie Mac preferred stock, as compared to net income of \$1.1 million, or \$0.35 diluted earnings per share during the comparable period in 2007. As noted above under Reconciliations, our operating earnings were \$1.1 million, or \$0.35 per diluted share, for the three months ended September 30, 2008 as compared to \$1.1 million, or \$0.35 diluted earnings per share, for the same period in 2007. Net interest income increased by \$527,000 for the three months ended September 30, 2008 from \$3.9 million in 2007 to \$4.4 million in 2008. The increase in net interest income is primarily due to the increase in the level of average earning assets resulting from the implementation of the leverage strategy discussed previously as well as core internal growth. Average earning assets equaled \$560.2 million during the third quarter of 2008 as compared to \$483.7 million during the third quarter of 2007. As a result of stopping dividends on our Freddie Mac preferred stock holdings in the third quarter of 2008, net interest income was reduced by approximately \$146,000 as compared to prior quarters.

Please refer to the table at the end of this Item 2 for the yield and rate data for interest-bearing balance sheet components during the three-month periods ended September 30, 2008 and 2007, along with average balances and the related interest income and interest expense amounts.

The yield on average earning assets decreased to 5.98% in the third quarter of 2008 from 6.56% in the third quarter of 2007. The cost of interest bearing liabilities also decreased to 3.18% in third quarter of 2008 as compared to 3.88% in the third quarter of 2007. The net interest margin was 3.15% for the three months ended September 30, 2008 as compared to 3.21% in the same period of 2007. On a fully taxable equivalent basis, we had a net interest margin of 3.17% and 3.29% for the three months ended September 30, 2008 and 2007, respectively.

Non-interest Income and Non-interest Expense

As a result of the OTTI charge on Freddie Mac preferred stock, we had a non-interest income loss of \$6.8 million for the three months ended September 30, 2008. As reflected in the chart above under Reconciliations, we

Table of Contents

earned \$1.3 million in non-interest income (excluding the OTTI charge) for the three months ended September 30, 2008 as compared to \$1.4 million in the same period of 2007. Deposit service charges increased by \$36,000 in the three months ended September 30, 2008 as compared to the same period in 2007. Mortgage origination fees increased by \$53,000 or 68.4% during the three months ended September 30, 2008 as compared to the same period in 2007. As previously discussed, this increase results from a continued emphasis on this source of revenue as well as the continued favorable mortgage interest rate environment. During the three months ended September 30, 2008 we had a loss on fair value adjustments of \$8,000 as compared to a gain of \$138,000 in the same period of 2007.

Total non-interest expense increased by \$398,000 in the third quarter of 2008 as compared to the same quarter of 2007. Salaries and benefits increased by \$148,000 in the third quarter of 2008 as compared to the same period in 2007. This was primarily due to the staff additions and incentive plan modifications made for our commercial lenders. Other non-interest expense increased by \$342,000 in the third quarter of 2008 as compared to the same period in 2007. As discussed in the nine month results, FDIC insurance premium cost account for approximately \$56,000 of the increase. Losses on the limited partnership investment discussed in the nine month results account for approximately \$127,000 of the increase in other non-interest expense between the two periods. An increase in professional fees in the third quarter of 2008 compared to the same period in 2007 accounted for approximately \$107,000 of the increase in other non-interest expense. During the third quarter of 2008 we incurred higher legal fees related to amending plans to comply with IRS section 409A as well as various other legal fees including those associated with the increase in the level of non-performing assets. All other variances in non-interest expenses during the three months ended September 30, 2008 as compared to the same period of 2007 reflect normal fluctuations in each of the categories.

Financial Position

Assets totaled \$633.9 million at September 30, 2008 as compared to \$565.6 million at December 31, 2007, an increase of \$68.3 million. As previously discussed during the second quarter of 2008 we implemented a leverage strategy whereby we acquired approximately \$63.2 million in certain non-agency mortgage backed securities and collateralized mortgage obligations (CMOs). The weighted average yield on the investment securities purchased was approximately 6.82%. All of the mortgage assets acquired were classified as prime or ALT-A securities and represent the senior or super-senior tranches of the securities. The assets acquired as part of this strategy were classified as held-to-maturity in the investment portfolio. Prior to initiating each transaction, we performed a thorough analysis, evaluating the associated credit risk, interest rate risk, liquidity and capital risk as well as related funding options. The funding for this strategy was provided through Federal Home Loan Bank Advances in the amount of \$36.0 million and brokered certificate of deposits in the amount of \$23.0 million. The weighted average cost of funding was approximately 4.28%.

Due to falling interest rates during the first quarter of 2008 we had a large dollar amount of government sponsored enterprise (GSE) securities with call features redeemed. These funds were reinvested in other GSE securities including certain GSE mortgage-backed securities. All of these purchased securities were placed in the available-for-sale portfolio. In addition, we purchased approximately \$6.0 million private label whole loan pools and collateralized mortgage obligations. Due to the current volatility in this market sector and our intent to hold these private label whole loan securities to maturity we placed these securities in the held-to-maturity portfolio. In addition, to the securities acquired in the leverage strategy we own approximately \$104.2 million in other mortgage-backed securities and CMO s that are included in our available-for-sale portfolio. Of these \$25.6 million are non-agency mortgage- backed or CMO securities and \$78.6 million are securities issued by GSE s.

As previously discussed we recognized an OTTI charge to write down our investment in a Freddie Mac preferred stock issue. The carrying value of the preferred stock prior to the write down was \$14.3 million. We wrote down \$6.2 million of the security in the second quarter of 2008 and \$8.1 million in the third quarter. The decision to recognize the unrealized mark-to-market loss on this investment security in the second quarter was based on the significant decline in the market value of the security caused by potential deterioration of Freddie Mac s financial condition, and the then current lack of clarity about the impact of an announced plan (which had been approved by the House and Senate and

Edgar Filing: FIRST COMMUNITY CORP /SC/ - Form 10-Q

signed into law by the President) that provided support for Freddie Mac as well as other GSE s. The third quarter write-down was based on the decision by the Treasury Department to place Freddie Mac into conservatorship and cease paying the dividends on all of their outstanding preferred security issues. The preferred stock issue was purchased in 2003 and acquired by the Company in the 2004 merger with Dutchfork Bankshares.

With the significant volatility and uncertainty in the financial markets we have implemented procedures to insure that we are monitoring and evaluating the securities portfolio on a monthly basis. The procedures enable us to identify

Table of Contents

deterioration or potential problems in the portfolio on a security by security basis. The procedures include evaluating changes in credit ratings on securities and the issuers, changes in market values and reviewing the underlying collateral and credit support on individual securities. The analysis of privately issued mortgage-backed securities and CMOs includes stressing the securities under various continuous default scenarios to identify the potential for future credit/principal losses. Based on our evaluation we have not identified any other securities that we consider other-than-temporarily-impaired. Depending on how severe and prolonged the current economic cycle lasts and how severe the continued adverse impact this cycle has on the financial markets there can be no assurances that future impairment charges will not be necessary on other segments of our investment portfolio.

As of January 1, 2007, we elected early adoption of Statement of Financial Accounting Standards No. 159 (SFAS 159) The Fair Value Option for Financial Assets and Financial Liabilities. We reclassified certain corporate structured securities, which did not contain an interest rate floor, from the available-for-sale category to the trading category. Changes in the fair value of assets or liabilities classified under the fair value option in accordance with SFAS 159 are recognized in earnings on a going forward basis. The change in the fair value during the first quarter of 2007 was a decrease of approximately \$7,600. Prior to adoption of SFAS 159 we had not maintained any investment securities in a trading account. Subsequent to the adoption of SFAS 159 we have also classified certain Federal Home Loan Bank advances under the fair value option. With the ability to classify both financial assets and liabilities under the fair value option on an instrument by instrument basis, we believe this standard can provide an opportunity to assist us in managing the impact of interest rate volatility in the future. See Note 3 under Part I, Item 1 above for related disclosures required under SFAS 159.

Short-term federal funds sold and interest bearing bank balances increased from \$4.2 million at December 31, 2007 to \$8.0 million at September 30, 2008.

Loans grew by \$14.3 million during the nine months ended September 30, 2008 from \$310.0 million at December 31, 2007 to \$324.3 million at September 30, 2008. At September 30, 2008, loans accounted for 58.5% of earning assets, as compared to 63.3% at December 31, 2007. The loan to deposit ratio at September 30, 2008 was 74.8%, as compared to 76.4% at December 31, 2007.

The following table shows the composition of the loan portfolio by category:

| (In thousands) | September 30, 2008 | | December 31, 2007 | |
|--------------------------------------|-----------------------|---------|----------------------|---------|
| | Amount | Percent | Amount | Percent |
| Commercial, financial & agricultural | \$ 25,815 | 7.9% | \$ 26,912 | 8.7% |
| Real estate: | | | | |
| Construction | 30,626 | 9.5% | 28,141 | 9.1% |
| Mortgage residential | 52,043 | 16.0% | 52,018 | 16.8% |
| Mortgage commercial | 185,037 | 57.1% | 173,173 | 55.8% |
| Consumer | 30,812 | 9.5% | 29,784 | 9.6% |
| Total gross loans | 324,333 | 100.0% | 310,028 | 100.0% |
| Allowance for loan losses | (3,664) | | (3,530) | |
| Total net loans | \$ 320,669 | | \$ 306,498 | |

In the context of this discussion, a real estate mortgage loan is defined as any loan, other than loans for construction purposes and advances on home equity lines of credit, secured by real estate, regardless of the purpose of the loan. Advances on home equity lines of credit are included in consumer loans. We follow the common practice of financial institutions in our market areas of obtaining a security interest in real estate

Edgar Filing: FIRST COMMUNITY CORP /SC/ - Form 10-Q

whenever possible, in addition to any other available collateral. This collateral is taken to reinforce the likelihood of the ultimate repayment of the loan and tends to increase the magnitude of the real estate loan components. Generally we limit the loan-to-value ratio to 80%.

The increase in loans, investment securities and short-term overnight investments were funded through growth in deposits of \$27.5 million and Federal Home Loan Bank (FHLB) advances of \$43.4 million. As previously discussed the leverage strategy implemented in the second quarter of 2008 was funded by \$36.0 million in FHLB advances and \$23.0 million in brokered certificates of deposits (CDs). These FHLB advances have a weighted

Table of Contents

average life of 5.8 years and weighted average rate of 3.94%. The brokered CDs had a weighted average life of 5.9 years and weighted average rate of 4.82%. We have not relied on brokered CDs to fund any of our assets in the past. These CDs have a call feature whereby we have the option to call the CD as of any quarter end until maturity. The flexibility to call these CDs provides us some protection in a declining rate environment whereby if the cash flows from the acquired assets accelerate we can then call the CDs. If rates drop we also have the option to call the CDs and refinance at possibly lower rates.

Excluding the brokered CDs, deposits grew \$4.5 million in the nine months ended September 30, 2008. Securities sold under agreements to repurchase (repo agreements) increased \$4.1 million from December 31, 2007 to September 30, 2008. All of these repo agreements are transacted with local customers that typically have other relationships with the bank. With an overall decline in deposits in 2007 we have refocused on core deposit growth both through our marketing and officer calling efforts in 2008 and beyond.

Market Risk Management

The effective management of market risk is essential to achieving our strategic financial objectives. Our most significant market risk is interest rate risk. We have established an Asset/Liability Management Committee (ALCO) to monitor and manage interest rate risk. The ALCO monitors and manages the pricing and maturity of assets and liabilities in order to diminish the potential adverse impact that changes in interest rates could have on net interest income. The ALCO has established policy guidelines and strategies with respect to interest rate risk exposure and liquidity.

A monitoring technique employed by the ALCO is the measurement of interest sensitivity gap, which is the positive or negative dollar difference between assets and liabilities that are subject to interest rate repricing within a given period of time. Also, asset/liability simulation modeling is performed to assess the impact varying interest rates and balance sheet mix assumptions will have on net interest income. Interest rate sensitivity can be managed by repricing assets or liabilities, selling securities available-for-sale, replacing an asset or liability at maturity or by adjusting the interest rate during the life of an asset or liability. Managing the amount of assets and liabilities repricing in the same time interval helps to hedge the risk and minimize the impact on net interest income of rising or falling interest rates.

We are currently liability sensitive within one year. However, neither the gap analysis nor asset/liability modeling are precise indicators of our interest sensitivity position due to the many factors that affect net interest income including changes in the volume and mix of earning assets and interest-bearing liabilities. Net interest income is also impacted by other significant factors, including changes in the volume and mix of earning assets and interest-bearing liabilities. Through simulation modeling we monitor the effect that an immediate and sustained change in interest rates of 100 basis points and 200 basis points up and down will have on net interest income over the next 12 months.

During the first quarter of 2008, we sold an interest rate floor agreement that had an expiration date of August 31, 2011 for \$600,000. The floor agreement was originally purchased in August of 2006 with a floor rate of 5.0% three-month LIBOR and a notional amount of \$10.0 million to protect in a falling rate environment. In the first quarter of 2008, we made the decision that interest rates were at or near the bottom of the current interest rate cycle and therefore made the decision to sell. At September 30, 2008, we continue to hold an interest rate cap agreement with a notional amount of \$10.0 million. The cap rate of interest is 4.50% three-month LIBOR. The fair value of the agreement at September 30, 2008 is \$5,000. This agreement was entered into to protect assets and liabilities from the negative effects of volatility in interest rates. Both the agreement that was sold and the current agreement provide for payments to our bank of the difference between the cap/floor rate of interest and the market rate of interest. The bank's exposure to credit risk is limited to the ability of the counterparty to make potential future payments required pursuant to the agreement. The bank's current exposure to market risk of loss is limited to the market value of the cap. Any gain or loss on the value of this contract is recognized in earnings on a current basis. The bank received payments under the terms of the cap

Edgar Filing: FIRST COMMUNITY CORP /SC/ - Form 10-Q

contract in the amount of \$65,000 during the nine months of 2007. No payments were received under the terms of the cap contract during the nine months ended September 30, 2008. No payments were received under the terms of the floor contract in 2007. In the first quarter of 2008, the bank received \$22,000 in payments under the terms of the floor prior to the sale. The bank recognized an increase of \$170,000 and a increase of \$38,000 in other income to reflect the increase/decrease in the fair value of the contracts for the nine months ended September 30, 2008 and 2007, respectively. The cap agreement expires on August 1, 2009.

Table of Contents

Based on the many factors and assumptions used in simulating the effect of changes in interest rates, the following table estimates the percentage change in net interest income at September 30, 2008, June 30, 2008, March 31, 2008 and December 31, 2007 over twelve months.

Net Interest Income Sensitivity

| Change in short-term interest rates | September 30, 2008 | June 30, 2008 | March 31, 2008 | December 31, 2007 |
|--|---------------------------|----------------------|-----------------------|--------------------------|
| +200bp | -3.13% | -3.74% | + 0.52% | - 0.67% |
| +100bp | -1.97% | -2.07% | + 0.34% | + 0.35% |
| Flat | | | | |
| -100bp | +2.46% | +2.84% | - 3.32% | - 2.75% |
| -200bp | -0.65% | +3.28% | - 8.29% | - 7.07% |

In implementing the previously discussed leverage strategy we impacted the effect changes in interest rates will have on our net interest income. At the current level of market interest rates our model shows improvement in a 100 basis point down rate environment. In the current rate environment we do not believe that a significant decline in rates is likely. In an up rate environment the model shows a decline in net interest income. This is a result of acquiring long term assets in the leverage strategy. Because of the spreads we were able to obtain in the leverage we felt that the economics of the strategy was reasonable since we are being adequately compensated for the additional risk taken in a rising rate environment. This decline reflected in net interest income at September 30, 2008 in a rising rate environment assumes an immediate parallel shift in interest rates. The ratios reflected in the table above as of September 30, 2008 remain well within the policy limits as approved in our Asset/Liability Management Policy. At March 31, 2008 and December 31, 2007 the model indicated we would have a negative impact on net interest income in a declining 100 and 200 basis point rate environment and at September 30 2008 a slight decrease in a 200 basis point decline, despite the fact that we are and were liability sensitive. This primarily results from the level of interest rates being paid on our interest bearing transaction accounts as well as money market accounts. The interest rates on these accounts were and are currently at a level where we believe they cannot be repriced in proportion to the change in interest rates. The increase and decrease of 100 and 200 basis points assume a simultaneous and parallel change in interest rates along the entire yield curve.

We also perform a valuation analysis projecting future cash flows from assets and liabilities to determine the Present Value of Equity (PVE) over a range of changes in market interest rates. The sensitivity of PVE to changes in interest rates is a measure of the sensitivity of earnings over a longer time horizon. At September 30, 2008, June 30, 2008 and March 31, 2008, the negative PVE exposure in a plus 200 basis point increase in market interest rates was estimated to be 28.36%, 23.54% and 20.31%, as compared to 15.39% at December 31, 2007. As explained above the additional risk to PVE is deemed to be acceptable as we believe the spread on the leverage transaction adequately compensates for this additional risk. The increase between June 30 and September 30 was impacted by the write-down of the Freddie Mac preferred stock and the resulting lower equity base.

Liquidity and Capital Resources

Our liquidity remains adequate to meet operating and loan funding requirements. Interest-bearing bank balances, federal funds sold, trading securities and investment securities available-for-sale represents 23.8% of total assets at September 30, 2008. We believe that our existing stable base of core deposits along with continued growth in this deposit base will enable us to meet our long-term and short-term liquidity needs successfully. These needs include the ability to respond to short-term demand for funds caused by the withdrawal of deposits, maturity of

Edgar Filing: FIRST COMMUNITY CORP /SC/ - Form 10-Q

repurchase agreements, extensions of credit and the payment of operating expenses. Sources of liquidity, in addition to deposit gathering activities, include maturing loans and investments, purchase of federal funds from other financial institutions and selling securities under agreements to repurchase. We monitor closely the level of large certificates of deposits in amounts of \$100,000 or more as they tend to be more sensitive to interest rate levels, and thus less reliable sources of funding for liquidity purposes. At September 30, 2008, the amount of certificates of deposits of \$100,000 or more represented 19.4% of total deposits. These deposits are issued to local customers many of whom have other product relationships with the bank and none are brokered deposits. In implementing our leverage strategy, discussed previously, we funded \$23.0 million of the assets acquired with brokered CDs. The underlying CDs were in increments of less than \$100,000.

Table of Contents

Through the operations of our bank, we have made contractual commitments to extend credit in the ordinary course of our business activities. These commitments are legally binding agreements to lend money to our customers at predetermined interest rates for a specified period of time. At September 30, 2008, we had issued commitments to extend credit of \$53.7 million, including \$25.8 million in unused home equity lines of credit, through various types of lending arrangements. We evaluate each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by us upon extension of credit, is based on our credit evaluation of the borrower. Collateral varies but may include accounts receivable, inventory, property, plant and equipment, and commercial and residential real estate. We manage the credit risk on these commitments by subjecting them to normal underwriting and risk management processes.

We are not aware of any trends, events or uncertainties not discussed in this report that we expect to result in a significant adverse effect on our liquidity position. However, no assurances can be given in this regard, as rapid growth, deterioration in loan quality, and poor earnings, or a combination of these factors, could change the liquidity position in a relatively short period of time.

We have generally maintained a high level of liquidity and adequate capital, which along with continued retained earnings, we believe will be sufficient to fund the operations of the bank for at least the next 12 months. We anticipate that the bank will remain a well capitalized institution for at least the next 12 months. Shareholders' equity was 9.0% and 11.3% of total assets at September 30, 2008 and December 31, 2007, respectively. The bank maintains federal funds purchased lines in the amount of \$10.0 million with several financial institutions, although these have not been utilized in 2008. The FHLB Atlanta has approved a line of credit of up to 25% of the bank's assets, which would be collateralized by a pledge against specific investment securities and/or eligible loans. We regularly review the liquidity position of the Company and have implemented internal policies establishing guidelines for sources of asset based liquidity and evaluate and monitor the total amount of purchased funds used to support the balance sheet and funding from non-core sources. We believe that our existing stable base of core deposits, along with continued growth in this deposit base, will enable us to meet our long term liquidity needs successfully. The Federal Reserve Board and bank regulatory agencies require bank holding companies and financial institutions to maintain capital at adequate levels based on a percentage of assets and off-balance sheet exposures, adjusted for risk weights ranging from 0% to 100%. Under the capital adequacy guidelines, regulatory capital is classified into two tiers. These guidelines require an institution to maintain a certain level of Tier 1 and Tier 2 capital to risk-weighted assets. Tier 1 capital consists of common shareholders' equity, excluding the unrealized gain or loss on securities available for sale, minus certain intangible assets. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight factor of 0% to 100% based on the risks believed to be inherent in the type of asset. Tier 2 capital consists of Tier 1 capital plus the general reserve for loan losses, subject to certain limitations. We are also required to maintain capital at a minimum level based on total average assets, which is known as the Tier 1 leverage ratio. At both the holding company and bank level, we are subject to various regulatory capital requirements administered by the federal banking agencies. To be considered well-capitalized, we must maintain total risk-based capital of at least 10%, Tier 1 capital of at least 6%, and a leverage ratio of at least 5%.

Table of Contents

The bank's risk-based capital ratios of Tier 1, total capital and leverage ratio were 9.9%, 10.9% and 6.2%, respectively, at September 30, 2008, as compared to 12.8%, 13.8% and 8.8%, respectively, at December 31, 2007. The Company's risk-based capital ratios of Tier 1, total capital and leverage ratio were 10.7%, 11.7% and 6.7%, respectively, at September 30, 2008, as compared to 13.7%, 14.6% and 9.3%, respectively, at December 31, 2007. This compares to required OCC and Federal Reserve regulatory capital guidelines for Tier 1 capital, total capital and leverage capital ratios of 4.0%, 8.0% and 4.0%, respectively.

On November 6, 2008, the Treasury informed us that we had received preliminary approval to participate in the Capital Purchase Program. Under the Capital Purchase Program, the Treasury would purchase up to approximately \$11.3 million of our senior preferred stock and would receive warrants to purchase shares of our common stock. While we can provide no assurance that we will close on this investment by the Treasury, we currently anticipate that we will close on the Treasury's investment under the Capital Purchase Program during 2008. See Emergency Economic Stability Act of 2008 above for a discussion of our currently anticipated participation on the Capital Purchase Program.

FIRST COMMUNITY CORPORATION**Yields on Average Earning Assets and Rates****on Average Interest-Bearing Liabilities**

| | Nine months ended September 30, 2008 | | | Nine months ended September 30, 2007 | | |
|--|--------------------------------------|----------------------|------------|--------------------------------------|----------------------|------------|
| | Average Balance | Interest Earned/Paid | Yield/Rate | Average Balance | Interest Earned/Paid | Yield/Rate |
| Assets | | | | | | |
| Earning assets | | | | | | |
| Loans | \$ 316,064,456 | \$ 16,263,431 | 6.87% | \$ 293,478,383 | \$ 16,493,118 | 7.51% |
| Securities: | 210,513,945 | 8,208,388 | 5.21% | 168,211,757 | 6,020,892 | 4.79% |
| Other short-term investments | 10,498,953 | 292,536 | 3.72% | 7,542,454 | 321,957 | 5.71% |
| Total earning assets | 537,077,354 | 24,764,355 | 6.16% | 469,232,594 | 22,835,967 | 6.51% |
| Cash and due from banks | 9,437,078 | | | 10,719,958 | | |
| Premises and equipment | 19,651,388 | | | 20,644,006 | | |
| Other assets | 50,158,714 | | | 50,085,398 | | |
| Allowance for loan losses | (3,640,703) | | | (3,375,065) | | |
| Total assets | \$ 612,683,831 | | | \$ 547,306,891 | | |
| Liabilities | | | | | | |
| Interest-bearing liabilities | | | | | | |
| Interest-bearing transaction | | | | | | |
| accounts | \$ 57,450,894 | 379,165 | 0.88% | \$ 53,447,912 | 171,963 | 0.43% |
| Money market accounts | 36,220,882 | 598,234 | 2.21% | 42,014,903 | 994,694 | 3.17% |
| Savings deposits | 24,085,072 | 85,053 | 0.47% | 25,888,474 | 137,348 | 0.71% |
| Time deposits | 230,531,500 | 7,467,651 | 4.33% | 209,616,283 | 7,469,641 | 4.76% |
| Other borrowings | 123,413,922 | 3,324,171 | 3.60% | 75,256,291 | 2,776,976 | 4.93% |
| Total interest-bearing liabilities | 471,702,270 | 11,854,274 | 3.36% | 406,223,863 | 11,550,622 | 3.80% |
| Demand deposits | 72,785,466 | | | 72,964,376 | | |
| Other liabilities | 5,864,524 | | | 4,855,258 | | |
| Shareholders' equity | 62,331,571 | | | 63,263,394 | | |
| Total liabilities and shareholders' equity | \$ 612,683,831 | | | \$ 547,306,891 | | |

Edgar Filing: FIRST COMMUNITY CORP /SC/ - Form 10-Q

| | | | | | | | | |
|----------------------------|---------|------------|------------|-------|------------|-------|------------|-------|
| Net interest spread | | | 2.80% | | | 2.71% | | |
| Net interest income/margin | \$ | 12,910,081 | 3.21% | \$ | 11,285,345 | 3.22% | | |
| Net interest income/margin | | | | | | | | |
| FTE basis | 235,015 | \$ | 13,145,096 | 3.27% | 306,445 | \$ | 11,591,790 | 3.30% |

Table of Contents

| | Three months ended September 30, 2008 | | | Three months ended September 30, 2007 | | |
|---|---------------------------------------|-------------------------|----------------|---------------------------------------|-------------------------|----------------|
| | Average Balance | Interest Earned/Paid | Yield/ Rate | Average Balance | Interest Earned/Paid | Yield/ Rate |
| Assets | | | | | | |
| Earning assets | | | | | | |
| Loans | \$ 321,600,910 | \$ 5,336,553 | 6.60% | \$ 302,268,770 | \$ 5,754,554 | 7.55% |
| Securities: | 231,974,071 | 2,965,679 | 5.09% | 172,076,150 | 2,108,151 | 4.86% |
| Other short-term investments | 6,616,449 | 124,298 | 7.47% | 9,338,699 | 133,876 | 5.69% |
| Total earning assets | 560,191,430 | 8,426,530 | 5.98% | 483,683,619 | 7,996,581 | 6.56% |
| Cash and due from banks | 8,584,012 | | | 10,301,924 | | |
| Premises and equipment | 19,581,327 | | | 20,409,450 | | |
| Other assets | 50,803,654 | | | 50,108,234 | | |
| Allowance for loan losses | (3,620,936) | | | (3,467,322) | | |
| Total assets | \$ 635,539,487 | | | \$ 561,035,905 | | |
| Liabilities | | | | | | |
| Interest-bearing liabilities | | | | | | |
| Interest-bearing | | | | | | |
| transaction accounts | \$ 64,373,633 | 174,010 | 1.08% | \$ 48,716,749 | 45,308 | 0.37% |
| Money market accounts | 34,162,258 | 168,676 | 1.96% | 42,130,175 | 334,841 | 3.15% |
| Savings deposits | 24,045,583 | 25,793 | 0.43% | 26,221,835 | 49,677 | 0.75% |
| Time deposits | 237,968,124 | 2,420,367 | 4.05% | 218,893,642 | 2,660,286 | 4.82% |
| Other borrowings | 138,027,712 | 1,201,632 | 3.46% | 81,589,455 | 997,475 | 4.85% |
| Total interest-bearing liabilities | 498,577,310 | 3,990,478 | 3.18% | 417,551,856 | 4,087,587 | 3.88% |
| Demand deposits | 72,175,261 | | | 74,448,178 | | |
| Other liabilities | 5,689,228 | | | 5,399,077 | | |
| Shareholders' equity | 59,097,688 | | | 63,636,794 | | |
| Total liabilities and shareholders' equity | \$ 635,539,487 | | | \$ 561,035,905 | | |
| Net interest spread | | | 2.80% | | | 2.68% |
| Net interest income/margin | | \$ 4,436,052 | 3.15% | | \$ 3,908,994 | 3.21% |
| Net interest income/margin FTE basis | \$ 44,500 | \$ 4,480,552 | 3.17% | \$ 101,615 | \$ 4,010,609 | 3.29% |

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Not Applicable

Item 4. Controls and Procedures.

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as defined in Exchange Act Rule 13a-15(e). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our current disclosure controls and procedures are effective as of September 30, 2008. There have been no significant changes in our internal controls over financial reporting during the fiscal quarter ended September 30, 2008 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

The design of any system of controls and procedures is based in part upon certain assumptions about the likelihood of future events. There can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

Table of Contents

PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

There are no material pending legal proceedings to which we or any of our subsidiaries are a party or of which any of our property is the subject.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

On September 21, 2006, our board of directors approved a new plan to repurchase up to 150,000 shares of our common stock on the open market. At both the April 17, 2007 and January 15, 2008 meetings our board of directors increased the shares authorized to be repurchased by 50,000 for a total of 250,000. The Board has not established an expiration date for this repurchase plan. There was no share repurchase activity during the third quarter of 2008. The maximum number of shares that may yet be repurchased under the plan is 42,487.

Item 3. Defaults Upon Senior Securities.

Not Applicable.

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

Not Applicable

Item 5. Other Information.

None.

Item 6. Exhibits.

Edgar Filing: FIRST COMMUNITY CORP /SC/ - Form 10-Q

| Exhibit | Description |
|----------------|---|
| 31.1 | Rule 13a-14(a) Certification of the Principal Executive Officer |
| 31.2 | Rule 13a-14(a) Certification of the Principal Financial Officer |
| 32 | Section 1350 Certifications |

Table of Contents

INDEX TO EXHIBITS

| Exhibit Number | Description |
|---------------------------|---|
| 31.1 | Rule 13a-14(a) Certification of the Principal Executive Officer |
| 31.2 | Rule 13a-14(a) Certification of the Principal Financial Officer |
| 32 | Section 1350 Certifications |