# SECURITIES AND EXCHANGE COMMISSION 

Washington, D.C. 20549

## FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2008
Commission file number: 000-33063

## SIERRA BANCORP

## (Exact name of Registrant as specified in its charter)

(Address of principal executive offices) (Zip Code)
(559) 782-4900
(Registrant $s$ telephone number, including area code)

## Not Applicable

## (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 p 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.

> Large accelerated filer " Accelerated filer p Non-accelerated filer " Smaller Reporting Company " Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes * No p Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Common stock, no par value, 9,611,391 shares outstanding as of July 31, 2008

## Table of Contents

## FORM 10-Q

Table of Contents
Page
Part I - Financial Information ..... 3
Item 1. Financial Statements (Unaudited) ..... 3
Consolidated Balance Sheets ..... 3
Consolidated Statements of Income ..... 4
Consolidated Statements of Cash Flows ..... 5
Notes to Unaudited Consolidated Financial Statements ..... 6
Item 2. Management s Discussion \& Analysis of Financial Condition \& Results of Operations ..... 11
Forward-Looking Statements ..... 11
Critical Accounting Policies ..... 11
Overview of the Results of Operations and Financial Condition ..... 12
Earnings Performance ..... 14
Net Interest Income and Net Interest Margin ..... 14
Provision for Loan and Lease Losses ..... 18
Non-interest Revenue and Operating Expense ..... 19
Provision for Income Taxes ..... 22
Balance Sheet Analysis ..... 22
Earning Assets ..... 22
Investments ..... 22
Loan Portfolio ..... 23
Off-Balance Sheet Arrangements ..... 25
Nonperforming Assets ..... 25
Allowance for Loan and Lease Losses ..... 27
Other Assets ..... 29
Deposits and Interest Bearing Liabilities ..... 29
Deposits ..... 29
Other Interest-Bearing Liabilities ..... 30
Non-Interest Bearing Liabilities ..... 31
Liquidity and Market Risk Management ..... 31
Capital Resources ..... 33
Item 3. Qualitative \& Quantitative Disclosures about Market Risk ..... 35
Item 4. Controls and Procedures ..... 35
Part II - Other Information ..... 36
Item 1. - Legal Proceedings ..... 36
Item 1A. - Risk Factors ..... 36
Item 2. - Unregistered Sales of Equity Securities and Use of Proceeds ..... 36
Item 3. - Defaults upon Senior Securities ..... 36
Item 4. - Submission of Matters to a Vote of Security Holders ..... 36
Item 5. - Other Information ..... 37
Item 6. - Exhibits ..... 38
Signatures ..... 39

Table of Contents

## PART I - FINANCIAL INFORMATION

## Item 1

## SIERRA BANCORP

## CONSOLIDATED BALANCE SHEETS

(dollars in thousands)

|  | June 30, 2008 (unaudited) |  | $\underset{\text { (audited) }}{\substack{\text { December 31, } \\ \text { (and }}}$ |  |
| :---: | :---: | :---: | :---: | :---: |
| ASSETS |  |  |  |  |
| Cash and due from banks | \$ | 52,688 | \$ | 43,972 |
| Interest-bearing deposits in other banks |  | 49 |  | 50 |
| Federal funds sold |  | 5 |  |  |
| Total Cash \& Cash Equivalents |  | 52,742 |  | 44,022 |
| Investment securities available for sale |  | 241,150 |  | 184,917 |
| Loans and leases: |  |  |  |  |
| Gross loans and leases |  | 932,047 |  | 924,633 |
| Allowance for loan and lease losses |  | $(12,622)$ |  | $(12,276)$ |
| Deferred loan and lease fees, net |  | $(2,269)$ |  | $(3,045)$ |
| Net Loans and Leases |  | 917,156 |  | 909,312 |
| Premises and equipment, net |  | 18,809 |  | 18,255 |
| Other assets |  | 78,446 |  | 77,229 |
| TOTAL ASSETS | \$ | 1,308,303 | \$ | 1,233,735 |
| LIABILITIES AND SHAREHOLDERS EOUITY |  |  |  |  |
| LIABILITIES |  |  |  |  |
| Deposits: |  |  |  |  |
| Non-interest bearing | \$ | 230,157 | \$ | 243,764 |
| Interest bearing |  | 733,158 |  | 606,383 |
| Total Deposits |  | 963,315 |  | 850,147 |
| Federal funds purchased and repurchase agreements |  | 48,314 |  | 39,082 |
| Short-term borrowings |  | 117,900 |  | 193,000 |
| Long-term borrowings |  | 30,000 |  | 5,000 |
| Other liabilities |  | 15,955 |  | 16,114 |
| Junior subordinated debentures |  | 30,928 |  | 30,928 |
| TOTAL LIABILITIES |  | 1,206,412 |  | 1,134,271 |
| SHAREHOLDERS EQUITY |  |  |  |  |
| Common stock, no par value; 24,000,000 shares authorized; 9,597,391 and 9,576,388 shares issued and outstanding at June 30, 2008 and December 31, 2007, respectively |  | 20,024 |  | 18,757 |
| Additional paid in capital |  | 956 |  | 797 |
| Retained earnings |  | 83,319 |  | 80,125 |
| Accumulated other comprehensive income (loss) |  | $(2,408)$ |  | (215) |
| TOTAL SHAREHOLDER S EQUITY |  | 101,891 |  | 99,464 |

Table of Contents

## SIERRA BANCORP

## CONSOLIDATED STATEMENTS OF INCOME

(dollars in thousands, except per share data, unaudited)

|  | For the Three-Month Period Ended June 30, |  |  |  | For the Six-Month Period Ended June 30, |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2008 |  | 2007 |  | 2008 |  |  |  |
| Interest income: |  |  |  |  |  |  |  |  |
| Interest and fees on loans | \$ | 16,688 | \$ | 20,170 | \$ | 34,910 | \$ | 39,808 |
| Interest on investment securities: |  |  |  |  |  |  |  |  |
| Taxable |  | 2,080 |  | 1,523 |  | 3,673 |  | 3,076 |
| Tax-exempt |  | 600 |  | 558 |  | 1,178 |  | 1,106 |
| Interest on Federal funds sold and interest-bearing deposits |  | 6 |  | 12 |  | 11 |  | 18 |
| Total interest income |  | 19,374 |  | 22,263 |  | 39,772 |  | 44,008 |
| Interest expense: |  |  |  |  |  |  |  |  |
| Interest on deposits |  | 3,802 |  | 5,809 |  | 8,229 |  | 10,967 |
| Interest on short-term borrowings |  | 802 |  | 1,546 |  | 2,306 |  | 3,383 |
| Interest on long-term borrowings |  | 266 |  | 60 |  | 356 |  | 267 |
| Interest on manditorily redeemable trust preferred securities |  | 367 |  | 563 |  | 882 |  | 1,129 |
| Total interest expense |  | 5,237 |  | 7,978 |  | 11,773 |  | 15,746 |
| Net Interest Income |  | 14,137 |  | 14,285 |  | 27,999 |  | 28,262 |
| Provision for loan losses |  | 2,650 |  | 701 |  | 4,920 |  | 1,601 |
| Net Interest Income after Provision for Loan Losses |  | 11,487 |  | 13,584 |  | 23,079 |  | 26,661 |
| Non-interest revenue: |  |  |  |  |  |  |  |  |
| Service charges on deposit accounts |  | 2,737 |  | 1,754 |  | 5,205 |  | 3,329 |
| Gains on investment securities available-for-sale |  | 13 |  | 6 |  | 58 |  | 11 |
| Other |  | 1,174 |  | 2,986 |  | 2,909 |  | 4,395 |
| Total other operating income |  | 3,924 |  | 4,746 |  | 8,172 |  | 7,735 |
| Other operating expense: |  |  |  |  |  |  |  |  |
| Salaries and employee benefits |  | 4,409 |  | 4,435 |  | 8,906 |  | 9,098 |
| Occupancy expense |  | 1,542 |  | 1,642 |  | 3,027 |  | 3,107 |
| Other |  | 2,902 |  | 2,889 |  | 5,462 |  | 5,745 |
| Total other operating expenses |  | 8,853 |  | 8,966 |  | 17,395 |  | 17,950 |
| Income before income taxes |  | 6,558 |  | 9,364 |  | 13,856 |  | 16,446 |
| Provision for income taxes |  | 1,994 |  | 3,309 |  | 4,333 |  | 5,638 |
| Net Income | \$ | 4,564 | \$ | 6,055 | \$ | 9,523 | \$ | 10,808 |

PER SHARE DATA

| Book value | $\$$ | 10.62 | $\$$ | 9.64 | $\$$ | 10.62 | $\$$ |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Cash dividends | $\$$ | 0.17 | $\$$ | 0.15 | $\$$ | 0.34 | $\$$ |
| Earnings per share basic | $\$$ | 0.48 | $\$$ | 0.62 | $\$$ | 1.00 | $\$$ |
| Earnings per share diluted | $\$$ | 0.47 | $\$$ | 0.60 | $\$$ | 0.97 | $\$$ |
| Average shares outstanding, basic | $9,577,515$ | $9,738,048$ | $9,567,838$ | $9,733,862$ |  |  |  |
| Average shares outstanding, diluted | $9,766,734$ | $10,090,450$ | $9,783,702$ | $10,110,627$ |  |  |  |

The accompanying notes are an integral part of these consolidated financial statements

## Table of Contents

## SIERRA BANCORP

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands, unaudited)

|  | $\begin{array}{cc}\text { Six Months Ended June 30, } \\ 2008 & 2007\end{array}$ |  |  |  |
| :---: | :---: | :---: | :---: | :---: |
| Cash Flows from Operating Activities |  |  |  |  |
| Net income | \$ | 9,523 | \$ | 10,808 |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |  |  |  |
| Gain on investment securities | \$ | (58) | \$ | (11) |
| Gain on sales of loans |  | (1) |  | $(1,619)$ |
| (Gain) Loss on disposal of fixed assets |  | (81) |  | 6 |
| Loss (Gain) on sale on foreclosed assets |  | 62 |  | (7) |
| Share-based compensation expense |  | 159 |  | 188 |
| Provision for loan losses |  | 4,920 |  | 1,601 |
| Depreciation and amortization |  | 1,443 |  | 1,633 |
| Net amortization on securities premiums and discounts |  | 70 |  | 132 |
| Increase in unearned net loan fees |  | (776) |  | (207) |
| Increase in cash surrender value of life insurance policies |  | (239) |  | (613) |
| Proceeds from sales of loans held for sale |  |  |  | 1,167 |
| Proceeds from sales of loan portfolio |  |  |  | 11,952 |
| Originations of loans held for sale |  |  |  | $(1,152)$ |
| Decrease in interest receivable and other assets |  | 2,061 |  | 4,026 |
| Decrease in other liabilities |  | (848) |  | (54) |
| Excess tax benefit from share-based payment arrangements |  | (415) |  | (788) |
| Net cash provided by operating activities |  | 15,820 |  | 27,062 |
| Cash Flows from Investing Activities |  |  |  |  |
| Maturities of securities available for sale |  | 2,200 |  | 879 |
| Proceeds from sales/calls of securities available for sale |  | 9,075 |  | 2,503 |
| Purchases of securities available for sale |  | $(86,113)$ |  | $(13,645)$ |
| Principal paydowns on securities available for sale |  | 14,808 |  | 11,917 |
| Increase in loans receivable, net |  | $(14,840)$ |  | $(33,340)$ |
| Purchases of premises and equipment, net |  | $(2,099)$ |  | $(2,152)$ |
| Proceeds from sales of foreclosed assets |  | 1,527 |  | 66 |
| Net cash used in investing activities |  | $(75,442)$ |  | $(33,772)$ |
| Cash Flows from Financing Activities |  |  |  |  |
| Increase in deposits |  | 113,168 |  | 55,238 |
| Increase in federal funds purchased |  | 3,680 |  | 23,900 |
| Decrease in borrowed funds |  | $(50,100)$ |  | $(81,400)$ |
| Increase in repurchase agreements |  | 5,552 |  | 1,149 |
| Cash dividends paid |  | $(3,259)$ |  | $(2,922)$ |
| Stock repurchased |  | $(2,080)$ |  | $(5,260)$ |
| Stock options exercised |  | 966 |  | 845 |
| Excess tax benefit from share-based payment arrangements |  | 415 |  | 788 |
| Net cash provided by (used in) financing activities |  | 68,342 |  | $(7,662)$ |
| Increase (Decrease) in cash and due from banks |  | 8,720 |  | $(14,372)$ |

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| Cash and Cash Equivalents | 44,022 |  |
| :--- | ---: | ---: |
| Beginning of period | 59,015 |  |
|  | $\$ 52,742$ | $\$ 44,643$ |

The accompanying notes are an integral part of these consolidated financial statements

Table of Contents

## SIERRA BANCORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2008

## Note 1 The Business of Sierra Bancorp

Sierra Bancorp (the Company ), headquartered in Porterville, California, is a California corporation registered as a bank holding company under the Bank Holding Company Act of 1956, as amended. The Company was incorporated in November 2000 and acquired all of the outstanding shares of Bank of the Sierra (the Bank ) in August 2001. The Company s principal subsidiary is the Bank, and the Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. The Company s main source of income is dividends from the Bank, but we intend to explore supplemental sources of income in the future. The expenditures of the Company, including (but not limited to) the payment of dividends to shareholders, if and when declared by the Board of Directors, the cost of servicing debt, audit costs, and shareholder expenses will generally be paid from dividends remitted to the Company by the Bank.

At the present time, the Company s only other direct subsidiaries are Sierra Statutory Trust II and Sierra Capital Trust III, which were formed in March 2004 and June 2006, respectively, solely to facilitate the issuance of capital trust pass-through securities. Pursuant to Financial Accounting Standards Board (FASB) Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46), these trusts are not reflected on a consolidated basis in the financial statements of the Company. References herein to the Company include Sierra Bancorp and its consolidated subsidiary, the Bank, unless the context indicates otherwise.

The Bank is a California state-chartered bank headquartered in Porterville, California. It was incorporated in September 1977, opened for business in January 1978, and has grown to be the largest independent bank headquartered in the South San Joaquin Valley. The Bank is an independent multi-community bank that offers a full range of retail and commercial banking services primarily in the central and southern sections of the San Joaquin Valley. On the southern end, our footprint extends east through the Tehachapi plateau and into the northwestern tip of the Mojave Desert. We currently operate 22 full service branch offices throughout this geographic footprint, in addition to an internet branch which provides the ability to open deposit accounts online. The Bank stwo newest brick and mortar branches commenced operations in Bakersfield in July 2008 and Delano in March 2007. Our next office is expected to be a branch in the Sunnyside area of South Fresno, with an anticipated opening in the fourth quarter of 2008 . We have also executed a ground lease for a second location in the City of Tulare, and are negotiating a lease for a location in Selma. In addition to these full-service branches, the Bank has an agricultural credit unit and an SBA lending unit with staff located at our corporate headquarters, and eight offsite ATMs. The Bank s deposit accounts are insured by the Federal Deposit Insurance Corporation (FDIC) up to maximum insurable amounts.

## Note 2 Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in a condensed format, and therefore do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The information furnished in these interim statements reflects all adjustments that are, in the opinion of management, necessary for a fair statement of the results for such period. Such adjustments are of a normal recurring nature, unless otherwise disclosed in this Form 10-Q. The results of operations in the interim statements are not necessarily indicative of the results that may be expected for any other quarter, or for the full year. Certain amounts reported for 2007 have been reclassified to be consistent with the reporting for 2008. The interim financial information should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2007 as filed with the Securities and Exchange Commission.

## Note 3 Current Accounting Developments

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R) (FAS 158), which requires an employer to: (a) Recognize as an asset or a liability in its statement of financial position a plan soverfunded or underfunded status; (b) measure a plan s assets

## Table of Contents

and its obligations that determine its funded status as of the end of the employer $s$ fiscal year (with limited exceptions); and (c) recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. Those changes are reported in comprehensive income of a business entity and in changes in net assets of a not-for-profit organization. The requirement to recognize the funded status of benefit plans and the disclosure requirements of FAS 158 were adopted by the Company as of December 31, 2007, as required by FAS 158, and did not have a material impact on the financial position of the Company. The requirement to measure plan assets and benefit obligations as of the date of the employer s fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. The Company does not expect the adoption of the remaining provisions of FAS 158 to have a material effect on the financial position of the Company.

In September 2006, the Emerging Issues Task Force (EITF) reached a final consensus on the subject titled Issue No. 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Arrangements. EITF 06-4 requires the recognition of a liability and related compensation expense for the endorsement split dollar life insurance policies that provide a benefit to an employee that extends to post-retirement periods. Pursuant to the final consensus, if an employer has promised to pay a death benefit directly from the company to a participant (or designated beneficiary), then a liability for the present value of the death benefit must be accrued over the participant s required service period. However, if the employer has agreed to maintain a split-dollar arrangement and share some portion of the death benefits of the underlying insurance policy, then the postretirement cost of insurance, rather than the death benefit, should be accrued. Since most of the Company s agreements involving postretirement death benefits are split-dollar arrangements associated with an underlying insurance policy, our accrual requirement is, for the most part, limited to the postretirement cost of insurance. The new guidance was implemented by the Company effective January 1, 2008. Transition to the new guidance required a cumulative-effect charge of approximately $\$ 1.1$ million to retained earnings upon adoption. Furthermore, this guidance resulted in a net increase of $\$ 26,000$ in salaries expense in the second quarter of 2008 and $\$ 53,000$ for the first six months of 2008 , and the impact is expected to be approximately the same going forward.

## Note 4 Supplemental Disclosure of Cash Flow Information

During the six months ended June 30, 2008 and 2007, cash paid for interest due on interest-bearing liabilities was $\$ 11.8$ million and $\$ 16.2$ million, respectively. There was $\$ 3.5$ million in cash paid for income taxes during the six months ended June 30,2008 , and $\$ 4.0$ million in cash paid for income taxes during the six months ended June 30, 2007. There were $\$ 2.9$ million in assets acquired in the settlement of loans for the six months ended June 30, 2008, and $\$ 76,000$ for the six months ended June 30, 2007. There was $\$ 1.5$ million in foreclosed assets sold during the six months ended June 30, 2008, and $\$ 66,000$ sold for the six months ended June 30, 2007. There was one $\$ 825,000$ loan extended to finance the sale of other real estate during the six months ended June 30, 2008, and none for the six months ended June 30, 2007.

## Note 5 Share Based Compensation

On March 15, 2007, the Company s Board of Directors approved a new equity compensation plan, the 2007 Stock Incentive Plan (the 2007 Plan ), which was subsequently approved by the Company s shareholders on May 23, 2007. Our 1998 Stock Option Plan (the 1998 Plan ) was concurrently terminated, although 559,118 options that were granted prior to the termination of the 1998 Plan and were thus not affected by the termination were still outstanding as of June 30, 2008. The 2007 Plan provides for the issuance of both incentive and nonqualified stock options to officers and employees, and of nonqualified stock options to non-employee directors, of the Company. The 2007 Plan also provides for the issuance of restricted stock awards to these same classes of eligible participants, which awards may be granted on such terms and conditions as are established at the discretion of the Board of Directors or the Compensation Committee. The total number of shares of the Company s authorized but unissued stock reserved and available for issuance pursuant to Awards under the 2007 Plan was initially 1,500,000 shares, although options were granted in the fourth quarter of 2007 and the second quarter of 2008, and the number available for grant as of June 30, 2008 was $1,423,900$. The 3,200 stock options granted in the second quarter of 2008 were subsequently canceled, and no stock options were granted by the Company in the second quarter of 2007.

Pursuant to FASB Statement 123(R), share-based employee compensation expense is reflected in our income statement for each option granted, over the vesting period of such option. The Company is utilizing the Black-Scholes model to value stock options, and the multiple option approach is used to allocate the resulting valuation to actual expense. Under the multiple option approach,

## Table of Contents

an employee s options for each vesting period are separately valued and amortized. This appears to be the FASB-preferred method for option grants with multiple vesting periods, which is the case for most options granted by the Company. A pre-tax charge of $\$ 73,000$ was reflected in the Company s income statement during the second quarter of 2008 and $\$ 93,000$ was charged during the second quarter of 2007, as compensation expense related to outstanding and unvested stock options. For the first half, these charges amounted to $\$ 159,000$ in 2008 and $\$ 188,000$ in 2007.

## Note 6 Earnings Per Share

Earnings per share for all periods presented in the Consolidated Statements of Income are computed based on the weighted average number of shares outstanding during each period. There were $9,577,515$ weighted average shares outstanding during the second quarter of 2008, and $9,738,048$ during the second quarter of 2007. There were $9,567,838$ weighted average shares outstanding during the first six months of 2008, and $9,733,862$ during the first six months of 2007.

Diluted earnings per share include the effect of the potential issuance of common shares, which for the Company is limited to in-the-money shares that would be issued on the exercise of outstanding stock options. The dilutive effect of all options outstanding was calculated using the treasury stock method, excluding anti-dilutive shares and adjusting for unamortized expense and windfall tax benefits. For the second quarter and first six months of 2008, the dilutive effect of options outstanding calculated under the treasury stock method totaled 189,219 and 215,864, respectively, which were added to basic weighted average shares outstanding for purposes of calculating diluted earnings per share. Likewise, for the second quarter and first six months of 2007 , shares totaling 352,402 and 376,765 , respectively, were added to basic weighted average shares outstanding in order to calculate diluted earnings per share.

## Note 7 Comprehensive Income

Comprehensive income includes net income and other comprehensive income. The Company s only source of other comprehensive income is derived from unrealized gains and losses on investment securities available-for-sale. Reclassification adjustments, resulting from gains or losses on investment securities that were realized and included in net income of the current period that also had been included in other comprehensive income as unrealized holding gains or losses in the period in which they arose, are excluded from comprehensive income of the current period. The Company s comprehensive income was as follows (dollars in thousands):

|  | For the Three-month Period Ended June 30, 2008 <br> 2007 |  |  |  | For the Six-month Period Ended June 30, 2008 2007 |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Net income | \$ | 4,564 | \$ | 6,055 | \$ | 9,523 | \$ | 10,808 |
| Other comprehensive income/(loss): |  |  |  |  |  |  |  |  |
| Unrealized holding gain/(loss) |  | $(5,936)$ |  | $(2,995)$ |  | $(3,727)$ |  | $(2,405)$ |
| Less: reclassification adjustment |  | 13 |  | 6 |  | 58 |  | 11 |
| Pre-tax other comprehensive inc/(loss) |  | $(5,949)$ |  | $(3,001)$ |  | $(3,785)$ |  | $(2,416)$ |
| Less: tax impact of above |  | $(2,501)$ |  | $(1,262)$ |  | $(1,591)$ |  | $(1,016)$ |
| Net other comprehensive income/(loss) |  | $(3,448)$ |  | $(1,739)$ |  | $(2,194)$ |  | $(1,400)$ |
| Comprehensive income | \$ | 1,116 | \$ | 4,316 | \$ | 7,329 | \$ | 9,408 |

Note 8 Financial Instruments with Off-Balance-Sheet Risk
The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business, in order to meet the financing needs of its customers. These financial instruments consist of commitments to extend credit and standby letters of credit. They involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The

## Table of Contents

Company s exposure to credit loss in the event of nonperformance by the other party for commitments to extend credit and letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and issuing letters of credit as it does for making loans included on the balance sheet. The following financial instruments represent off-balance-sheet credit risk (dollars in thousands):

|  |  | June 30, 2008 | December 31, 2007 |
| :--- | ---: | ---: | ---: |
| Commitments to extend credit | $\$$ | 200,090 | $\$$ |
| 208,487 |  |  |  |
| Standby letters of credit | $\$$ | 11,520 | $\$$ |
| Commercial letters of credit | $\$$ | 10,588 | $\$$ |

Commitments to extend credit consist primarily of unfunded single-family residential construction loans and home equity lines of credit, and commercial real estate construction loans and commercial revolving lines of credit. Construction loans are established under standard underwriting guidelines and policies and are secured by deeds of trust, with disbursements made over the course of construction. Commercial revolving lines of credit have a high degree of industry diversification. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Standby letters of credit are generally unsecured and are issued by the Company to guarantee the performance of a customer to a third party, while commercial letters of credit represent the Company s commitment to pay a third party on behalf of a customer upon fulfillment of contractual requirements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

## Note 9 Fair Value Option and Fair Value Measurements

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (FAS 157). This statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The statement establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an asset. The standard became effective for the Company on January 1, 2008, the beginning of our current fiscal year. However, in February 2008 the FASB issued FASB Staff Position (FSP) No. FAS 157-2, Effective Date of FASB Statement No. 157. This FSP delays the effective date of FAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The impact of adoption has thus far not been material to the Company, nor is the implementation of the remaining provisions expected to be.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (FAS 159). The standard provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The new standard became effective for the Company on January 1, 2008. The Company did not elect the fair value option for any financial assets or financial liabilities as of January 1, 2008.

FAS 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. FAS 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:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

## Table of Contents

Level 3: Significant unobservable inputs that reflect a company s own assumptions about the assumptions that market participants would use in pricing an asset or liability.
The Company used the following methods and significant assumptions to estimate fair values for each category of financial asst noted below:

Securities: The fair values of trading securities and securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges or matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities relationship to other benchmark quoted securities.

Loans held for sale: Since loans designated by the Company as available-for-sale are typically sold shortly after making the decision to sell them, realized gains or losses are usually recognized within the same period and fluctuations in fair values are thus not relevant for reporting purposes. If available for sale loans exist on our books as of a reporting date, the fair value of those loans is determined using quoted secondary-market prices.

Impaired loans: A specific loss allowance is created for impaired loans, representing the difference between the face value of the loan and either its current appraised value less estimated disposition costs, or its net present value as determined by a discounted cash flow analysis.

Foreclosed assets: Repossessed real estate (OREO) and other assets are acquired at fair value, which is appraised value less expected selling costs for OREO and some other assets such as mobile homes, and estimated sales proceeds as determined by using reasonably available sources for all other assets. Foreclosed assets for which appraisals can be feasibly obtained are periodically measured for impairment using updated appraisals. Other foreclosed assets are periodically re-evaluated by adjusting expected cash flows and timing of resolution, again using reasonably available sources. If impairment is determined to exist, the book value of a foreclosed asset is immediately written down to its estimated impaired value through the income statement, thus the carrying amount is equal to the fair value and there is no valuation allowance.
Assets and liabilities measured at fair value on a recurring basis, including financial liabilities for which the Company has elected the fair value option, are summarized below:


Assets and liabilities measured at the lower of cost or fair value on a non-recurring basis are summarized below:

|  | Lower of Cost or Fair Value at June 30, 2008, Using |  |  |  |  |  |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Level 1 | Level 2 | Level 3 | Total |  |  |
| Impaired Loans | $\$$ | $\$$ | $7,713,535$ | $\$$ | $1,908,378$ | $\$$ |
| Foreclosed Assets | $\$$ | $\$$ | $1,819,996$ | $\$$ |  | $\$$ |

Impaired loans had a carrying amount of $\$ 12,407,026$ at June 30,2008 , with a valuation allowance of $\$ 2,785,113$.

## Note 10 Recent Developments

In March 2008 the Company received $\$ 289,000$ as proceeds from the mandatory redemption of a portion of the Visa shares held by the Company. The mandatory redemption of shares occurred in conjunction with Visa s initial public offering. The Company retained ownership of 10,731 Visa Class B shares, which have a lock-up provision and cannot be converted to Class A shares or sold for a period of three years.

Table of Contents

## PART I - FINANCIAL INFORMATION

## ITEM 2

## MANAGEMENT S DISCUSSION AND

## ANALYSIS OF FINANCIAL CONDITION

## AND RESULTS OF OPERATIONS

## FORWARD-LOOKING STATEMENTS

This Form 10-Q includes forward-looking statements that involve inherent risks and uncertainties. Words such as expects , anticipates , believes , projects , and estimates or variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed, forecast in, or implied by such forward-looking statements.

A variety of factors could have a material adverse impact on the Company $s$ financial condition or results of operations, and should be considered when evaluating the potential future financial performance of the Company. These include but are not limited to the possibility of deterioration in economic conditions in the Company s service areas; risks associated with fluctuations in interest rates; liquidity risks; increases in nonperforming assets and net credit losses that could occur, particularly in times of weak economic conditions or rising interest rates; the loss in market value of available-for-sale securities that could result if interest rates change substantially or an issuer has real or perceived financial difficulties; and risks associated with the multitude of current and future laws and regulations to which the Company is and will be subject.

## CRITICAL ACCOUNTING POLICIES

The Company s financial statements are prepared in accordance with accounting principles generally accepted in the United States. The financial information and disclosures contained within those statements are significantly impacted by Management s estimates and judgments, which are based on historical experience and various other assumptions that are believed to be reasonable under current circumstances. Actual results may differ from those estimates under divergent conditions.

Critical accounting policies are those that involve the most complex and subjective decisions and assessments, and have the greatest potential impact on the Company s stated results of operations. In Management s opinion, the Company s critical accounting policies deal with the following areas: the establishment of the Company s allowance for loan and lease losses, as explained in detail in the Provision for Loan and Lease Losses and Allowance for Loan and Lease Losses sections of this discussion and analysis; deferred loan origination costs, which are estimated based on an annual evaluation of expenses (primarily salaries) associated with successful loan originations and are allocated to individual loans as they are booked, but can actually vary significantly for individual loans depending on the characteristics of such loans; income taxes, especially with regard to the ability of the Company to recover deferred tax assets, as discussed in the Provision for Income Taxes and Other Assets sections of this discussion and analysis; goodwill, which is evaluated annually based on changes in the market capitalization of the Company and for which management has determined that no impairment exists; and equity-based compensation, which is discussed in greater detail in Note 5 to the consolidated financial statements. Critical accounting areas are evaluated on an ongoing basis to ensure that the Company s financial statements incorporate the most recent expectations with regard to these areas.

Table of Contents

# OVERVIEW OF THE RESULTS OF OPERATIONS 

## AND FINANCIAL CONDITION

## RESULTS OF OPERATIONS SUMMARY

## Second Quarter 2008 Compared to Second Quarter 2007

Net income for the quarter ended June 30, 2008 was $\$ 4.6$ million compared to $\$ 6.1$ million for the quarter ended June 30, 2007, a decline of $25 \%$. Basic and diluted earnings per share for the second quarter of 2008 were $\$ 0.48$ and $\$ 0.47$, respectively, compared to $\$ 0.62$ and $\$ 0.60$ for the second quarter of 2007. The Company s annualized return on average equity was $17.78 \%$ and annualized return on average assets was $1.43 \%$ for the quarter ended June 30, 2008, compared to a return on equity of $25.90 \%$ and return on assets of $2.00 \%$ for the quarter ended June 30, 2007. The primary drivers behind the variance in net income are as follows:

The Company realized a $\$ 1.6$ million pre-tax gain on sale of credit card loans in June 2007 that equates to approximately $\$ 930,000$ in net income. This non-recurring event added $\$ 0.09$ to diluted earnings per share in the second quarter of 2007, and is responsible for a large portion of the drop in net income between the two quarters.

The Company also experienced a $278 \%$ increase in its provision for loan losses, which was $\$ 1.9$ million higher in the second quarter of 2008 due mainly to an increase in specific reserves for potential losses on certain acquisition and development and residential construction loans, an increase in general reserves for equity loans and for outstanding balances on unsecured business and consumer lines of credit, and a higher level of loan charge-offs.

Our net interest margin declined from $5.35 \%$ to $4.98 \%$, due principally to a drop in the average balance of non-interest bearing demand deposits, an increase in the average balance of non-accruing loans, and $\$ 480,000$ in interest reversals on loans placed on non-accrual status during the second quarter of 2008. As a result, net interest income declined $1 \%$ despite a $\$ 75 \mathrm{million}$, or $7 \%$, increase in average interest-earning assets.

Even though average transaction account balances were $2 \%$ lower, service charges on deposit accounts increased by $\$ 983,000$, or $56 \%$, due primarily to returned item and overdraft fees generated by new consumer checking accounts, a fee increase that became effective mid-2007, and enhanced overdraft management and collection capabilities for all transaction accounts.

Other relatively large variances in non-interest income for the comparative quarters include the following: Bank-owned life insurance (BOLI) income was $\$ 176,000$, or $69 \%$, lower in the second quarter of 2008 due to losses on our separate account BOLI, although associated deferred compensation plan expense accruals also declined; fee income associated with credit cards declined $\$ 156,000$ in the second quarter of 2008 pursuant to the sale of our credit card portfolio in June 2007, although associated costs were also down; and EFT interchange fees increased $\$ 105,000$ for the quarter as the result of our new EFT contracts that became effective in the fourth quarter of 2007.

The expense recorded for salaries and benefits declined by $\$ 26,000$, or $1 \%$, because normal annual increases were more than offset by a $\$ 177,000$ increase in the deferral of salary costs associated with successful loan originations and a decline of $\$ 134,000$ in deferred compensation expense.

Significant changes in other non-interest expenses for the comparative second quarters include the following: Marketing costs increased by $\$ 222,000$ for the quarter, due to increased advertising and other program costs for our newest initiative targeting business deposit accounts as well as costs associated with our recent proxy contest; occupancy expense declined by $\$ 100,000$, or $6 \%$,

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due primarily to lower depreciation expense on furniture and equipment; costs associated with credit cards were essentially eliminated due to the sale of our credit card portfolio last year, and thus declined by $\$ 190,000$ for the quarter; ATM network and EFT processing costs were down by $\$ 128,000$ for the quarter, due in large part to a non-recurring $\$ 104,000$ EFT processing rebate received in the second quarter of 2008; and participant losses on balances associated with deferred directors fees caused a $\$ 141,000$ reduction in directors expense accruals for the quarter.

## Table of Contents

The Company s tax accrual declined to $30.4 \%$ of pre-tax income in the second quarter of 2008 from $35.3 \%$ in the second quarter of 2007, because taxable income declined and tax credits increased so tax credits are a proportionately higher percentage of taxable income in 2008 and had a relatively greater impact.

## First Half 2008 Compared to First Half 2007

Net income for the first six months of 2008 was $\$ 9.5$ million, which is $\$ 1.3$ million lower than net income for the first six months of 2007 and represents a $12 \%$ decline. Basic and diluted earnings per share were $\$ 1.00$ and $\$ 0.97$, respectively, for the first six months of 2008, compared to $\$ 1.11$ and $\$ 1.07$ for the first six months of the prior year. The Company realized an annualized return on average equity of $18.79 \%$ for the first half of 2008 and $23.69 \%$ for the first half of 2007, and achieved a return on assets for the same periods of $1.52 \%$ and $1.80 \%$, respectively. The principal reasons for the net income variance for the first half include the following:

As with second quarter results, the gain on sale of credit card balances in the prior year was a primary contributor to the difference in income for the half. The effect of the gain on diluted earnings per share for the first half of 2007 was the same as for the quarter.

The loan loss provision increased $\$ 3.3$ million for the half, for the same reasons discussed in the quarterly comparison.

Net interest income fell by $\$ 263,000$, or $1 \%$, despite a $\$ 53$ million, or $5 \%$, increase in average interest-earning assets, because of a 30 basis point drop in our net interest margin for the half.

Service charges on deposits increased by $\$ 1.9$ million, or $56 \%$, for the same reasons noted in the quarterly summary.

Other significant changes in non-interest revenue for the half include a $\$ 374,000$ decrease in BOLI income, a drop of $\$ 271,000$ in credit card income, and a $\$ 220,000$ increase in EFT interchange fees, all for the reasons outlined in the quarterly summary above. Also having an impact on the difference in non-interest income for the half was a one-time gain of $\$ 289,000$ in the first quarter of 2008 resulting from the mandatory redemption of a portion of our Visa shares, pursuant to Visa s initial public offering in March 2008.

Salaries and benefits were down $\$ 192,000$, or $2 \%$, for the same reasons noted in the quarterly comparison: Regular annual increases were more than offset by a $\$ 421,000$ increase in the deferral of salary costs associated with successful loan originations and a decline of $\$ 280,000$ in deferred compensation expense.

Occupancy expense declined by $\$ 80,000$, or $3 \%$, for the half, because of lower depreciation expense on furniture and equipment, although the benefit for the first half was partially offset by the fact that first quarter 2007 results reflect property tax refunds resulting from assessor audits.

Other non-interest expenses dropped by $\$ 283,000$, or $5 \%$, due mainly to the following: Credit card costs were reduced by $\$ 340,000$, ATM network and EFT processing costs declined $\$ 310,000$, deferred directors costs were $\$ 220,000$ lower, and marketing costs increased $\$ 246,000$, all for the reasons noted above in the quarterly discussion. Additional factors impacting EFT processing costs for the half include $\$ 242,000$ in EFT incentive payments received in the first quarter of 2008.

The tax accrual rate for the first half of 2008 was lower for the same reasons outlined in the quarterly summary.

## Table of Contents

## FINANCIAL CONDITION SUMMARY

## June 30, 2008 relative to December 31, 2007

The Company s total assets were $\$ 1.308$ billion at June 30 , 2008, an increase of $\$ 75$ million relative to total assets of $\$ 1.234$ billion at December 31, 2007. The most significant characteristics of and changes in the Company s balance sheet during the first six months of 2008 are outlined below:

Total deposits increased by $\$ 113$ million, or $13 \%$. Most of the growth was in time deposits, including $\$ 50$ million obtained from one of the counties in our market area and an additional $\$ 50$ million from the State of California. Wholesale-sourced brokered deposits, which are also included in time certificates of deposit, dropped by $\$ 10$ million. Core deposits, including all non-maturity deposits plus non-brokered time deposits under $\$ 100,000$, increased by $\$ 21$ million, or $3 \%$.

We were able to let $\$ 50$ million in Federal Home Loan Bank (FHLB) borrowings roll off due to the aggregate deposit influx, thus improving our liquidity position, although overnight fed funds purchased increased by $\$ 4$ million because of funding needed for a temporary quarter-end increase in cash items in process of collection.

Investment security balances increased by $\$ 56$ million, or $30 \%$, during the half, with most of the increase in mortgage-backed securities.

Gross loan balances increased by $\$ 7$ million, or $1 \%$, during the first half of 2008 , with overall growth of $\$ 11$ million in the second quarter offsetting a decline of $\$ 4$ million in the first quarter. While organic loan growth in most branches was consistent with our expectations, overall growth in aggregate balances has been hindered due to the prepayment of a few large loans totaling approximately $\$ 25$ million, including about $\$ 5$ million in loan participations purchased.

Total non-performing assets increased by $\$ 4.6$ million, or $48 \%$, ending the half at $\$ 14.2$ million. The bulk of the increase is comprised of acquisition and development loans, with residential construction loans, lot loans, and foreclosed assets also contributing. Non-performing assets were $1.09 \%$ of total assets at June 30, 2008 and $0.78 \%$ at December 31, 2007.

The Company had net charge-offs against the allowance for loan and lease losses totaling $\$ 4.6$ million during the first half of 2008, relative to $\$ 1.1$ million during the first half of 2007. Much of the $\$ 3.5$ million increase was centered in unsecured business and personal lines. As of June 30, 2008 our allowance for loan and lease losses was $1.35 \%$ of total loans, relative to $1.33 \%$ at December 31, 2007 and $1.33 \%$ at June 30, 2007.

EARNINGS PERFORMANCE

The Company earns income from two primary sources. The first is net interest income, which is interest income generated by earning assets less interest expense on interest-bearing liabilities. The second is non-interest income, which primarily consists of customer service charges and fees but also comes from non-customer sources such as bank-owned life insurance. The majority of the Company s non-interest expense is comprised of operating costs that relate to providing a full range of banking services to our customers.

## NET INTEREST INCOME AND NET INTEREST MARGIN

For the second quarter, net interest income declined by $\$ 148,000$, or $1 \%$, to $\$ 14.1$ million in 2008 from $\$ 14.3$ million in 2007. For the first half, net interest income went down by $\$ 263,000$, or $1 \%$, to $\$ 28.0$ million in 2008 from $\$ 28.3$ million in 2007 . Net interest income for the quarter and the half would have increased if not for $\$ 480,000$ in interest reversals in the second quarter of 2008 . The level of net interest income depends on several factors in combination, including growth in earning assets, yields on earning assets, the cost of interest-bearing liabilities, the relative volumes of earning assets and interest-bearing liabilities, and the mix of products which comprise the Company $s$ earning assets, deposits, and

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other interest-bearing liabilities. Occasionally, net interest income is also impacted by the recovery of interest on loans that have been on non-accrual and are either sold or returned to accrual status, or by the reversal of accrued but unpaid interest for loans placed on non-accrual.

The following Average Balances and Rates table shows, for the quarters noted, the average balance of each principal balance sheet category and the amount of interest income or interest expense associated with that category. This table also shows the calculated yields on each major component of the Company s investment and loan portfolio, the average rates paid on each key segment of the Company s interest bearing liabilities, and the net interest margin.

## Table of Contents

## Average Balances and Rates

(dollars in thousands, except per share data)

|  | For the Quarter <br> Ended June 30, 2008 (a) (b) (f) |  |  | For the Quarter <br> nded June 30, 2007 (a) (b) (f) |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Average Balance | Income/ <br> Expense | Average Rate/Yield | Average Balance | Income/ Expense | Average Rate/Yield |
| Assets |  |  |  |  |  |  |
| Investments: |  |  |  |  |  |  |
| Federal funds sold/Due from time | \$ 986 | \$ 6 | 2.45\% | \$ 850 | \$ 12 | 5.66\% |
| Taxable | 179,461 | 2,080 | 4.66\% | 133,078 | 1,523 | 4.59\% |
| Non-taxable | 59,371 | 600 | 6.25\% | 55,428 | 558 | 6.21\% |
| Equity | 1,788 |  | 0.00\% | 10 |  | 0.00\% |
| Total Investments | 241,606 | 2,686 | 5.01\% | 189,366 | 2,093 | 5.07\% |


| Loans and Leases:(c) (e) |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Agricultural | 10,188 | 191 | 7.54\% | 9,870 | 198 | 8.05\% |
| Commercial | 141,225 | 2,456 | 6.99\% | 139,190 | 3,335 | 9.61\% |
| Real Estate | 692,196 | 12,393 | 7.20\% | 675,770 | 14,744 | 8.75\% |
| Consumer | 55,651 | 1,314 | 9.50\% | 56,312 | 1,417 | 10.09\% |
| Consumer Credit Cards |  |  | 0.00\% | 5,736 | 202 | 14.13\% |
| Direct Financing Leases | 19,184 | 334 | 7.00\% | 17,259 | 274 | 6.37\% |
| Other | 8,590 |  | 0.00\% | 469 |  | 0.00\% |
| Total Loans and Leases | 927,034 | 16,688 | 7.24\% | 904,606 | 20,170 | 8.94\% |



| Other Earning Assets | 10,070 | 7,608 |
| :--- | ---: | ---: |
| Non-Earning Assets | 108,576 | 111,946 |
| Total Assets | $\$ 1,287,286$ | $\$ 1,213,526$ |

Liabilities and Shareholders Equity

| NOW | \$ | 95,373 | \$ | 94 | 0.40\% | \$ | 77,354 | \$ | 73 | 0.38\% |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Savings Accounts |  | 55,176 |  | 50 | 0.36\% |  | 59,620 |  | 78 | 0.52\% |
| Money Market |  | 143,105 |  | 620 | 1.74\% |  | 139,175 |  | 1,101 | 3.17\% |
| TDOA s \& IRA s |  | 26,753 |  | 186 | 2.80\% |  | 24,226 |  | 232 | 3.84\% |
| Certificates of Deposit<\$100,000 |  | 153,543 |  | 1,219 | 3.19\% |  | 124,193 |  | 1,400 | 4.52\% |
| Certificates of Deposit $\geq 100,000$ |  | 231,270 |  | 1,633 | 2.84\% |  | 237,329 |  | 2,925 | 4.94\% |
| Total Interest Bearing Deposits |  | 705,220 |  | 3,802 | 2.17\% |  | 661,897 |  | 5,809 | 3.52\% |
| Borrowed Funds: |  |  |  |  |  |  |  |  |  |  |
| Federal Funds Purchased |  | 19,545 |  | 103 | 2.12\% |  | 28,030 |  | 368 | 5.27\% |
| Repurchase Agreements |  | 28,018 |  | 23 | 0.33\% |  | 26,957 |  | 52 | 0.77\% |
| Short Term Borrowings |  | 120,914 |  | 676 | 2.25\% |  | 96,067 |  | 1,126 | 4.70\% |
| Long Term Borrowings |  | 31,099 |  | 266 | 3.44\% |  | 6,934 |  | 60 | 3.47\% |
| TRUPS |  | 30,928 |  | 367 | 4.77\% |  | 30,928 |  | 563 | 7.30\% |
| Total Borrowed Funds |  | 230,504 |  | 1,435 | 2.50\% |  | 188,916 |  | 2,169 | 4.61\% |
| Total Interest Bearing Liabilities |  | 935,724 |  | 5,237 | 2.25\% |  | 850,813 |  | 7,978 | 3.76\% |
| Demand Deposits |  | 229,494 |  |  |  |  | 253,658 |  |  |  |

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| Other Liabilities | 18,822 |  | 15,270 |
| :--- | ---: | ---: | ---: |
| Shareholders Equity | 103,246 | 93,785 |  |
| Total Liabilities and Shareholders | Equity | $\$ 1,287,286$ |  |
|  |  |  |  |
| Interest Income/Interest Earning Assets |  | $6.213,526$ |  |
| Interest Expense/Interest Earning Assets | $1.80 \%$ | $8.27 \%$ |  |
| Net Interest Income and Margin(d) | $\$ 14,137$ | $4.98 \%$ | $2.92 \%$ |

(a) Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.
(b) Yields and net interest margin have been computed on a tax equivalent basis.
(c) Loan fees have been included in the calculation of interest income. Loan fees were approximately $\$ 174$ thousand and $\$ 519$ thousand for the quarters ended June 30, 2008 and 2007.

Loans are gross of the allowance for possible loan losses.
(d) Represents net interest income as a percentage of average interest-earning assets.
(e) Non-accrual loans have been included in total loans for purposes of total earning assets.
(f) Annualized

## Table of Contents

Similar information, only for year-to-date periods, is presented in the Average Balances and Rates table which follows.

## Average Balances and Rates

(dollars in thousands, except per share data)

|  | Six Months Ended June 30, 2008 (a) (b) (f) |  |  | Six Months Ended June 30, 2007 (a) (b) (f) |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Average Balance | Income/ <br> Expense | Average Rate/Yield | Average Balance | Income/ <br> Expense | Average Rate/Yield |
| Assets |  |  |  |  |  |  |
| Investments: |  |  |  |  |  |  |
| Federal funds sold/Due from time | \$ 846 | \$ 11 | 2.61\% | \$ 756 | \$ 18 | 4.80\% |
| Taxable | 158,848 | 3,673 | 4.65\% | 134,712 | 3,076 | 4.60\% |
| Non-taxable | 58,898 | 1,178 | 6.19\% | 54,859 | 1,106 | 6.25\% |
| Equity | 1,061 |  | 0.00\% | 10 |  | 0.00\% |
| Total Investments | 219,653 | 4,862 | 5.03\% | 190,337 | 4,200 | 5.08\% |


| Loans and Leases:(c) (e) |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Agricultural | 10,924 | 424 | 7.81\% | 10,946 | 442 | 8.14\% |
| Commercial | 137,464 | 5,119 | 7.49\% | 139,437 | 6,584 | 9.52\% |
| Real Estate | 690,642 | 26,044 | 7.58\% | 666,555 | 29,059 | 8.79\% |
| Consumer | 55,431 | 2,686 | 9.74\% | 56,274 | 2,770 | 9.93\% |
| Consumer Credit Cards |  |  | 0.00\% | 7,079 | 412 | 11.74\% |
| Direct Financing Leases | 19,486 | 637 | 6.57\% | 17,188 | 541 | 6.35\% |
| Other | 7,562 |  | 0.00\% | 466 |  | 0.00\% |
| Total Loans and Leases | 921,509 | 34,910 | 7.62\% | 897,945 | 39,808 | 8.94\% |
| Total Interest Earning Assets (e) | 1,141,162 | 39,772 | 7.12\% | 1,088,282 | 44,008 | 8.27\% |


| Other Earning Assets | 10,318 | 8,742 |
| :--- | ---: | ---: |
| Non-Earning Assets | 108,562 | 111,765 |
| Total Assets | $\$ 1,260,042$ | $\$ 1,208,789$ |


| Liabilities and Shareholders Equity |  |  |  |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Interest Bearing Deposits: |  |  |  |  |  |  |  |  |  |  |
| NOW | \$ | 92,087 | \$ | 196 | 0.43\% | \$ | 72,393 | \$ | 110 | 0.31\% |
| Savings Accounts |  | 53,923 |  | 119 | 0.44\% |  | 59,795 |  | 154 | 0.52\% |
| Money Market |  | 134,567 |  | 1,335 | 2.00\% |  | 132,638 |  | 2,006 | 3.05\% |
| TDOA s \& IRA s |  | 25,758 |  | 399 | 3.12\% |  | 23,989 |  | 453 | 3.81\% |
| Certificates of Deposit<\$100,000 |  | 139,035 |  | 2,403 | 3.48\% |  | 119,952 |  | 2,674 | 4.50\% |
| Certificates of Deposit $\geq$ \$100,000 |  | 224,249 |  | 3,777 | 3.39\% |  | 227,462 |  | 5,570 | 4.94\% |
| Total Interest Bearing Deposits |  | 669,619 |  | 8,229 | 2.47\% |  | 636,229 |  | 10,967 | 3.48\% |
| Borrowed Funds: |  |  |  |  |  |  |  |  |  |  |
| Federal Funds Purchased |  | 13,639 |  | 169 | 2.49\% |  | 20,554 |  | 546 | 5.36\% |
| Repurchase Agreements |  | 25,740 |  | 52 | 0.41\% |  | 25,698 |  | 96 | 0.75\% |
| Short Term Borrowings |  | 147,620 |  | 2,085 | 2.84\% |  | 114,393 |  | 2,741 | 4.83\% |
| Long Term Borrowings |  | 20,962 |  | 356 | 3.42\% |  | 16,912 |  | 267 | 3.18\% |
| TRUPS |  | 30,928 |  | 882 | 5.73\% |  | 30,928 |  | 1,129 | 7.36\% |
| Total Borrowed Funds |  | 238,889 |  | 3,544 | 2.98\% |  | 208,485 |  | 4,779 | 4.62\% |
| Total Interest Bearing Liabilities |  | 908,508 |  | 11,773 | 2.61\% |  | 844,714 |  | 15,746 | 3.76\% |


| Demand Deposits | 230,947 | 255,877 |  |
| :--- | ---: | ---: | ---: |
|  |  |  |  |
| Other Liabilities | 18,642 | 16,198 |  |
| Shareholders Equity | 101,945 | 92,000 |  |
| Total Liabilities and Shareholders | Equity | $\$ 1,260,042$ | $\$ 1,208,789$ |
|  |  |  |  |
| Interest Income/Interest Earning Assets | $7.12 \%$ |  | $8.27 \%$ |
| Interest Expense/Interest Earning Assets | $2.07 \%$ | $2.92 \%$ |  |
| Net Interest Income and Margin(d) | $\$ 27,999$ | $5.05 \%$ | $\$ 28,262$ |

(a) Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.
(b) Yields and net interest margin have been computed on a tax equivalent basis.
(c) Loan fees have been included in the calculation of interest income. Loan fees were approximately $\$ 464$ thousand and $\$ 1.0$ million for the six months ended June 30, 2008 and 2007.

Loans are gross of the allowance for possible loan losses.
(d) Represents net interest income as a percentage of average interest-earning assets.
(e) Non-accrual loans have been included in total loans for purposes of total earning assets.
(f) Annualized

## Table of Contents

The Volume and Rate Variances table below sets forth the dollar difference in interest earned and paid for each major category of interest-earning assets and interest-bearing liabilities for the noted periods, and the amount of such change attributable to changes in average balances (volume) or changes in average interest rates. Volume variances are equal to the increase or decrease in average balance multiplied by prior period rates, and rate variances are equal to the increase or decrease in average rate times prior period average balances. Variances attributable to both rate and volume changes are calculated by multiplying the change in rate by the change in average balance, and are allocated to the rate variance.

## Volume \& Rate Variances

(dollars in thousands)

|  | Quarter Ended June 30, 2008 over 2007 <br> Increase (decrease) due to |  |  | Six Months Ended June 30, 2008 over 2007 <br> Increase (decrease) due to |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Volume | Rate | Net | Volume | Rate | Net |
| Assets: |  |  |  |  |  |  |
| Investments: |  |  |  |  |  |  |
| Federal funds sold / Due from time | \$ 2 | (8) | \$ (6) | \$ 2 | (9) | \$ (7) |
| Taxable | 531 | 26 | 557 | 551 | 46 | 597 |
| Non-taxable(1) | 40 | 2 | 42 | 81 | (9) | 72 |
| Equity |  |  |  |  |  |  |
| Total Investments | 573 | 20 | 593 | 634 | 28 | 662 |
| Loans and Leases: |  |  |  |  |  |  |
| Agricultural | 6 | (13) | (7) | (1) | (17) | (18) |
| Commercial | 49 | (928) | (879) | (93) | $(1,372)$ | $(1,465)$ |
| Real Estate | 358 | $(2,709)$ | $(2,351)$ | 1,050 | $(4,065)$ | $(3,015)$ |
| Consumer | (17) | (86) | (103) | (41) | (43) | (84) |
| Consumer Credit Cards | (202) |  | (202) | (412) |  | (412) |
| Direct Financing Leases | 31 | 29 | 60 | 72 | 24 | 96 |
| Other |  |  |  |  |  |  |
| Total Loans and Leases | 225 | $(3,707)$ | $(3,482)$ | 575 | $(5,473)$ | $(4,898)$ |
| Total Interest Earning Assets | 798 | $(3,687)$ | $(2,889)$ | 1,209 | $(5,445)$ | $(4,236)$ |

## Liabilities

| NOW | 17 | 4 | 21 | 30 | 56 | 86 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Savings Accounts | (6) | (22) | (28) | (15) | (20) | (35) |
| Money Market | 31 | (512) | (481) | 29 | (700) | (671) |
| TDOA s \& IRA s | 24 | (70) | (46) | 33 | (87) | (54) |
| Certificates of Deposit < \$100,000 | 331 | (512) | (181) | 425 | (696) | (271) |
| Certificates of Deposit $\geq \$ 100,000$ | (75) | $(1,217)$ | $(1,292)$ | (79) | $(1,714)$ | $(1,793)$ |
| Total Interest Bearing Deposits | 322 | $(2,329)$ | $(2,007)$ | 423 | $(3,161)$ | $(2,738)$ |
| Borrowed Funds: |  |  |  |  |  |  |
| Federal Funds Purchased | (111) | (154) | (265) | (184) | (193) | (377) |
| Repurchase Agreements | 2 | (31) | (29) |  | (44) | (44) |
| Short Term Borrowings | 291 | (741) | (450) | 796 | $(1,452)$ | (656) |
| Long Term Borrowings | 209 | (3) | 206 | 64 | 25 | 89 |
| TRUPS |  | (196) | (196) |  | (247) | (247) |


| Total Borrowed Funds | 391 | $(1,125)$ | $(734)$ | 676 | $(1,911)$ | $(1,235)$ |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Total Interest Bearing Liabilities | 713 | $(3,454)$ | $(2,741)$ | 1,099 | $(5,072)$ | $(3,973)$ |  |  |
|  |  |  |  |  |  |  | $(233)$ | $\$$ |
| Net Interest Margin/Income | $(148)$ | $\$$ | 110 | $\$$ | $(373)$ | $\$$ | $(263)$ |  |

(1) Yields on tax exempt income have not been computed on a tax equivalent basis.

As shown above, pure volume variances contributed only $\$ 85,000$ to net interest income in the second quarter of 2008 relative to the second quarter of 2007, despite growth of $\$ 75$ million, or $7 \%$, in average interest-earning assets. The net volume variance would have been much greater if not for the following: Much of the growth in average interest-earning assets came in the form of a $\$ 52$ million increase in investment securities, which have a lower weighted average yield than loans and leases; average demand deposit balances were $\$ 24$ million lower for the quarter, which had the undesirable effect of increasing the percentage of the Company s assets that are funded by interest-bearing liabilities, thus the average balance of interest-bearing liabilities increased by $\$ 10$ million more than

## Table of Contents

average interest-earning assets and the ratio of average demand deposits, other liabilities, and shareholders equity to average assets declined to $27 \%$ in the second quarter of 2008 from $30 \%$ in the second quarter of 2007 ; and, other borrowed money increased at a proportionately faster rate than relatively low-cost deposits, with the average balance of interest-bearing deposits increasing by $\$ 43$ million, or $7 \%$, for the second quarter of 2008 relative to the second quarter of 2007 , and the average balance of borrowed funds increasing by $\$ 42$ million, or $22 \%$.

In contrast to the favorable volume variance, the net rate variance for the quarterly comparison was negative $\$ 233,000$. Short-term market interest rates were relatively stable until the Federal Reserve Board approved a decrease in the fed funds rate in mid-September 2007, and short-term rates have fallen by a total of 325 basis points since then. This drop in rates impacted both interest-earning assets and interest-bearing liabilities, but our deposit rates did not drop as fast as loan yields because of $\$ 480,000$ in interest reversals on loans placed on non-accrual during the second quarter of 2008 and because of competitive pressures on deposit rates. Contrary to slow re-pricing for deposits, rates paid for other borrowed funds actually declined relatively quickly, so our yield on total interest-earning assets was down 149 basis points compared to a decline of 151 basis points in the cost of total interest-bearing liabilities for the quarter-over-quarter comparison. The reason for the negative rate variance, then, is inherent in our large net interest position, which is the difference between interest-earning assets and interest-bearing liabilities. Our average net interest position for the second quarter of 2007, which is the base period for the rate variance calculation, was $\$ 243$ million. The yield decrease for interest-earning assets was thus applied to a much larger amount than the rate decrease for interest-bearing liabilities, and interest income shows a rate-related decline that is relatively larger than the rate-related decline in interest expense.

The Company s net interest margin, which is tax-equivalent net interest income expressed as a percentage of average interest-earning assets, is affected by many of the same factors discussed relative to rate and volume variances. Our net interest margin was $4.98 \%$ in the second quarter of 2008 as compared to $5.35 \%$ in the second quarter of 2007, a drop of 37 basis points. For most of the past year the Company s interest rate risk profile has been slightly liability sensitive, meaning that, all else being equal, our net interest margin would benefit in a declining rate environment but would be negatively impacted in a rising rate environment. However, the positive impact of the declining rate environment during the past year has been more than offset by the impact of interest reversals, an increase in the average balance of non-performing assets, a drop in average non-interest bearing deposit balances and a corresponding increase in the balance of other borrowed funds, and competitive pressures that stalled anticipated declines in deposit rates.

For the first half of 2008 relative to the first half of 2007 , the favorable volume variance in net interest income was $\$ 110,000$, while the rate variance was negative $\$ 373,000$. Average interest-earning assets increased by $\$ 53$ million, or $5 \%$, for the half, but the positive impact of this increase was largely offset by the same factors denoted in the discussion of the quarterly volume variance. Namely, average investment balances account for over half of the increase in average earning assets, a $\$ 25$ million drop in demand deposits was the primary contributor to a lower ratio of non-interest bearing liabilities and shareholders equity to average assets, and average interest-bearing deposits increased by only $5 \%$ relative to a $15 \%$ increase in other borrowed funds. The unfavorable rate variance for the first half was due to the same factors outlined for the quarterly comparison. The Company s net interest margin for the first half of 2008 was $5.05 \%$, a decline of 30 basis points relative to the net interest margin of $5.35 \%$ in the first half of 2007, again due to the factors delineated in the quarterly comparison.

## PROVISION FOR LOAN AND LEASE LOSSES

Credit risk is inherent in the business of making loans. The Company sets aside an allowance for loan and lease losses through periodic charges to earnings that are reflected in the income statement as the provision for loan losses. These charges are in amounts sufficient to achieve an allowance for loan and lease losses that, in management s judgment, is adequate to absorb probable losses inherent in the Company s loan portfolio.

The most significant item impacting the Company s net income for the second quarter and first half of 2008 versus the second quarter and first half of 2007 was an increase in our loan loss provision, which was up by $\$ 1.9$ million for the quarter and by $\$ 3.3$ million for the half. Much of the increase can be explained by an increase in net charge-offs (detailed below in the table shown in Allowance for Loan and Lease Losses ), but many of the charged-off loan balances had specific reserves allocated to them as of the beginning of the quarter and charging them off did not necessarily create the need for reserve replenishment. In addition to the increase in reserves

## Table of Contents

related to charge-offs, we added specific reserves for certain acquisition and development loans and residential construction loans due to the weakened liquidity positions of some developers and deterioration in appraised collateral values. Our general reserves for equity loans and unsecured business and consumer lines were also enhanced, due to the recent uptick in charge-offs in those loan categories. The procedures for monitoring the adequacy of the allowance, and detailed information on the allowance, are included below in Allowance for Loan and Lease Losses.

## NON-INTEREST REVENUE AND OPERATING EXPENSE

The following table provides details on the Company s non-interest income and operating expense for the second quarter and first half of 2008 relative to the second quarter and first half of 2007:

## Non Interest Income/Expense

(dollars in thousands, unaudited)

|  | For the Quarter Ended June 30, |  |  | \% of Total | 2008 |  | For the Six-Month Period <br> Ended June 30, <br> \% of Total 2007 |  |  | \% of Total |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| OTHER OPERATING INCOME: |  |  |  |  |  |  |  |  |  |  |
| Service charges on deposit accounts | \$ 2,737 | 69.75\% | \$ 1,754 | 36.96\% | \$ | 5,205 | 63.69\% | \$ | 3,329 | 43.04\% |
| Other service charges, commissions \& fees | 1,049 | 26.73\% | 1,026 | 21.62\% |  | 2,181 | 26.69\% |  | 1,981 | 25.61\% |
| Gains on sales of loans |  | 0.00\% | 1,602 | 33.75\% |  | 1 | 0.01\% |  | 1,619 | 20.93\% |
| Gains on called securities | 13 | 0.33\% | 6 | 0.13\% |  | 58 | 0.71\% |  | 11 | 0.14\% |
| Loan servicing income | 3 | 0.08\% | 3 | 0.06\% |  | 18 | 0.22\% |  | 23 | 0.30\% |
| Bank owned life insurance | 79 | 2.01\% | 255 | 5.37\% |  | 239 | 2.93\% |  | 613 | 7.92\% |
| Other | 43 | 1.10\% | 100 | 2.11\% |  | 470 | 5.75\% |  | 159 | 2.06\% |
| Total non-interest income | 3,924 | 100.00\% | 4,746 | 100.00\% |  | 8,172 | 100.00\% |  | 7,735 | 100.00\% |
| As a \% of average interest-earning assets (2) |  | 1.35\% |  | 1.74\% |  |  | 1.44\% |  |  | 1.43\% |
| OTHER OPERATING EXPENSES: |  |  |  |  |  |  |  |  |  |  |
| Salaries and employee benefits | 4,409 | 49.80\% | 4,435 | 49.47\% |  | 8,906 | 51.20\% |  | 9,098 | 50.68\% |
| Occupancy costs |  |  |  |  |  |  |  |  |  |  |
| Furniture \& equipment | 642 | 7.25\% | 793 | 8.85\% |  | 1,297 | 7.46\% |  | 1,530 | 8.52\% |
| Premises | 900 | 10.17\% | 849 | 9.47\% |  | 1,730 | 9.95\% |  | 1,577 | 8.79\% |
| Advertising and marketing costs | 668 | 7.55\% | 446 | 4.97\% |  | 1,166 | 6.70\% |  | 920 | 5.13\% |
| Data processing costs | 310 | 3.50\% | 276 | 3.08\% |  | 639 | 3.67\% |  | 524 | 2.92\% |
| Deposit services costs | 349 | 3.94\% | 471 | 5.25\% |  | 595 | 3.42\% |  | 901 | 5.02\% |
| Loan services costs |  |  |  |  |  |  |  |  |  |  |
| Loan processing | 218 | 2.46\% | 27 | 0.30\% |  | 319 | 1.83\% |  | 59 | 0.33\% |
| Foreclosed assets | 23 | 0.26\% | 6 | 0.07\% |  | 31 | 0.18\% |  | 6 | 0.03\% |
| Credit card | 1 | 0.01\% | 191 | 2.13\% |  | 2 | 0.01\% |  | 342 | 1.91\% |
| Other operating costs |  |  |  |  |  |  |  |  |  |  |
| Telephone \& data communications | 241 | 2.72\% | 227 | 2.53\% |  | 466 | 2.68\% |  | 449 | 2.50\% |
| Postage \& mail | 116 | 1.31\% | 100 | 1.12\% |  | 230 | 1.32\% |  | 237 | 1.32\% |
| Other | 292 | 3.30\% | 327 | 3.65\% |  | 581 | 3.34\% |  | 646 | 3.60\% |
| Professional services costs |  |  |  |  |  |  |  |  |  |  |
| Legal \& accounting | 367 | 4.15\% | 316 | 3.52\% |  | 633 | 3.64\% |  | 605 | 3.37\% |
| Other professional service | 172 | 1.94\% | 288 | 3.21\% |  | 438 | 2.52\% |  | 609 | 3.39\% |
| Stationery \& supply costs | 140 | 1.58\% | 167 | 1.86\% |  | 257 | 1.48\% |  | 334 | 1.86\% |
| Sundry \& tellers | 5 | 0.06\% | 47 | 0.52\% |  | 105 | 0.60\% |  | 113 | 0.63\% |

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Total non-interest Expense
\$ 8,853
$100.00 \%$ \$8,966
100.00\% \$ 17,395
$100.00 \%$ \$ 17,950
100.00\%

| As a \% of average interest-earning |  |  |  |  |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| assets (2) |  | $3.05 \%$ |  | $3.29 \%$ |  | $3.07 \%$ |  | $3.33 \%$ |
| Efficiency Ratio (1) | $48.00 \%$ |  | $46.07 \%$ |  | $47.58 \%$ |  | $48.62 \%$ |  |

(1) Tax Equivalent
(2) Annualized

## Table of Contents

The Company s results reflect a decline of $\$ 822,000$, or $17 \%$, in total other operating income for the quarter ended June 30,2008 relative to the quarter ended June 30, 2007. The primary reason for the drop in income is the $\$ 1.6$ million non-recurring gain on sale of credit card balances realized in the second quarter of 2007. Because of that gain, total other operating income dropped to $1.35 \%$ of average earning assets in the second quarter of 2008 from $1.74 \%$ of average earning assets in the second quarter of 2007 . For the first half, total other operating income was $\$ 8.2$ million in 2008 and $\$ 7.7$ million in 2007, representing an increase of $\$ 437,000$, or $6 \%$. Total operating income was $1.44 \%$ of average earning assets in the first half of 2008, relative to $1.43 \%$ in the first half of 2007. Notwithstanding the impact of the credit card gain, first half results reflect an increase in non-interest income because of a large increase in deposit service charges and the following non-recurring income received in the first quarter of 2008: A $\$ 289,000$ gain on the mandatory redemption of Visa shares, an $\$ 82,000$ gain from vacant land adjacent to our Hanford branch which was sold to the city of Hanford at the request of the city, a $\$ 45,000$ gain on called securities, and a $\$ 75,000$ contingent payment received in the first quarter of 2008 which represents the final payment resulting from the outsourcing of our merchant services function in late 2006.

For the second quarter, despite a drop of $\$ 6$ million, or $2 \%$, in the average balance for aggregate transaction accounts, service charges on deposit accounts increased by $\$ 983,000$, or $56 \%$. For the first half, average transaction account balances were also $2 \%$ lower, but service charges on deposits were up by $\$ 1.9$ million, or $56 \%$. The increase in service charges for both the quarter and the half stem primarily from returned item and overdraft fees generated by new consumer checking accounts, a fee increase that became effective mid-2007, increased overdraft activity due to current economic conditions, and enhanced overdraft management and collection capabilities for all transaction accounts. In response to an aggressive marketing initiative, the number of active transaction accounts increased by 4,800 , or $12 \%$, from the end of June 2007 to the end of June 2008.

Other service charges, commissions, and fees increased by $\$ 23,000$, or $2 \%$, in the second quarter of 2008 relative to the second quarter of 2007, and by $\$ 200,000$, or $10 \%$, for the first half of 2008 relative to the prior year. The increase for the quarter includes a $\$ 53,000$ increase in dividends received on our restricted stock plus a $\$ 105,000$ increase in EFT interchange fees due to increased debit card activity and better interchange rates stemming from our new EFT contracts, net of a $\$ 156,000$ decline in credit card income due to the sale of our credit card portfolio in June 2007. For the half, the increase is mainly comprised of a $\$ 220,000$ increase in EFT interchange fees, increases in various other deposit-related fees totaling $\$ 101,000$, a $\$ 49,000$ increase in restricted stock dividends, the non-recurring $\$ 75,000$ contingent payment noted in the previous paragraph, and a $\$ 70,000$ drop in low-income housing tax credit investment costs which are accounted for as a reduction in income. These favorable variances were partially offset by a reduction of $\$ 271,000$ in credit card income.

Bank-owned life insurance (BOLI) income declined by $\$ 176,000$, or $69 \%$, in the second quarter of 2008 relative to the second quarter of 2007, and by $\$ 374,000$, or $61 \%$, for the first half of 2008 relative to the first half of 2007. At June 30, 2008 the Company had $\$ 26.4$ million invested in single-premium general account BOLI, with an interest credit rate that does not change frequently and is floored at no less than $3 \%$. This is up from $\$ 25.5$ million at June 30, 2007, due mainly to credited income. Income from general account BOLI is used to fund expense accruals associated with executive salary continuation plans and a directors retirement plan. In addition, as of June 30, 2008 and 2007 the Company had $\$ 1.8$ million invested in separate account BOLI. The earnings on separate account BOLI are used to help offset accruals under deferred compensation arrangements for certain directors and senior officers. These deferred compensation BOLI accounts have returns pegged to participant-directed investment allocations which can include equity, bond, or real estate indices, and are thus subject to gains or losses. The drop in BOLI income for the quarter and the half can be explained by losses on separate account BOLI of $\$ 194,000$ and $\$ 286,000$ for the second quarter and first half of 2008, respectively, relative to gains of $\$ 12,000$ in the second quarter of 2007 and $\$ 115,000$ in the first half of 2007. As noted, these fluctuations are related to participant losses on deferred compensation balances in 2008 and participant gains in 2007, which also caused a drop in comparative expense accruals for employee benefits and directors costs for the second quarter and first half.

Other non-interest income includes gains and losses on the disposition of real properties and other assets, and rental income generated by the Company s alliance with Investment Centers of America (ICA). Other non-interest income was $\$ 57,000$ lower in the second quarter of 2008 than in the second quarter of 2007 , because of a $\$ 30,000$ loss resulting from the disposition of an OREO property and a decline in ICA income. Other non-interest income increased by $\$ 311,000$ for the first half, because the first quarter of 2008 includes the aforementioned $\$ 289,000$ gain on the redemption of Visa stock and the $\$ 82,000$ gain on the sale of real property. Securities gains reflect a $\$ 47,000$ increase for the half due mainly to gains received on called securities in the first quarter of 2008.

## Table of Contents

Total operating expense (non-interest expense) was $\$ 8.9$ million for the quarter ended June 30, 2008, a drop of $\$ 113,000$, or $1 \%$, relative to total operating expense for the same period in 2007. The decrease includes a non-recurring expense reimbursement of $\$ 104,000$ received from our EFT processor in the second quarter of 2008 in conjunction with our EFT conversion in November 2007, a $\$ 54,000$ insurance recovery on fraud losses expensed in the prior year, and one-time expenses totaling $\$ 83,000$ associated with the initiation of our new mortgage program. Non-interest expense fell to $3.05 \%$ of average earning assets for the second quarter of 2008 from $3.29 \%$ in the second quarter of 2007. For the first half of 2008 , total non-interest expense was $\$ 555,000$ lower than in the first half of 2007 , a drop of $3 \%$. Total non-interest expense fell to $3.07 \%$ of average earning assets in the first half of 2008 , from $3.33 \%$ in the first half of 2007. In addition to the non-recurring items noted for the second quarter of 2008 , the decrease for the half includes non-recurring expense reductions totaling $\$ 242,000$, in the form of incentive payments/expense reimbursements received from certain vendors in the first quarter of 2008 in conjunction with our debit card and EFT processing conversions in November 2007.

The largest declines for any individual operating expense category were reductions in credit card costs of $\$ 190,000$ and $\$ 340,000$ for the quarter and the half, respectively, resulting from the elimination of almost all credit card costs subsequent to the sale of our credit card portfolio in June 2007. Deposit services costs also dropped by $\$ 122,000$, or $26 \%$, for the quarter and by $\$ 306,000$, or $34 \%$, for the half, due to the incentive payments discussed in the previous paragraph and lower operating costs subsequent to our EFT/debit card conversions. Deposit costs fell to $3.9 \%$ of total non-interest expense in the second quarter of 2008 compared to $5.3 \%$ in the second quarter of 2007 , and to $3.4 \%$ in the first half of 2008 from $5.0 \%$ in the first half of 2007. Another category that experienced a substantial decline was furniture and equipment costs, which were down by $\$ 151,000$, or $19 \%$, for the quarter and by $\$ 233,000$, or $15 \%$, for the half primarily due to lower depreciation expense. Because of the disproportionately large declines in credit card, deposit services, and furniture/equipment costs, most other expense categories increased as a percentage of aggregate operating expenses for 2008 relative to the 2007.

The largest component of non-interest expense, salaries and employee benefits, declined by $\$ 26,000$, or $1 \%$, for the comparative quarters, and by $\$ 192,000$, or $2 \%$, for the half. While we experienced normal annual increases in base salaries and benefits, and we added staff for our newest office in the second quarter of 2008, those increases were more than offset by a reduction in salaries resulting from an increase in the deferral of salaries directly attributable to successful loan originations, pursuant to FAS 91, and by a drop in deferred compensation expense. FAS 91 costs are deferred and amortized as an adjustment to loan yields, which, as noted, results in a corresponding reduction in salaries reflected in current-period expense. FAS 91 salary costs were up by $\$ 177,000$ for the quarter and by $\$ 421,000$ for the half mainly as the result of our annual evaluation and adjustment of the personnel costs involved in each successfully-originated loan, which was completed in August 2007. Deferred compensation expense was down significantly due to participant losses on deferred compensation investments, as explained above in our discussion of BOLI income. In the second quarter of 2008, deferred compensation losses were $\$ 95,000$ relative to gains of $\$ 39,000$ in the second quarter of 2007 , resulting in the quarter over quarter difference of $\$ 134,000$. In the first half of 2008 , deferred compensation losses were $\$ 148,000$ relative to gains of $\$ 132,000$ in the first half of 2007, resulting in a difference of $\$ 280,000$ for the half. Deferred compensation losses also impacted directors fees, as discussed below. Despite their overall decline, salaries and benefits rose slightly to $49.8 \%$ of total non-interest expense for the second quarter of 2008 from $49.5 \%$ in the second quarter of 2007 , and to $51.2 \%$ in the first half of 2008 from $50.7 \%$ in the first half of 2007.

Occupancy expense is comprised of furniture and equipment costs, which were discussed above, as well as premises expenses. Premises costs include rent, depreciation, utilities, maintenance, janitorial, security, property taxes and insurance, among other things. The $\$ 51,000$, or $6 \%$, increase in premises expense for the second quarter includes normal annual increases for the aforementioned categories, as well as partial rent for newer branches. The increase for the half was $\$ 153,000$, or $10 \%$, proportionately higher than for the quarter since first quarter 2007 expenses are net of one-time property tax refunds received pursuant to property valuation audits. Total occupancy expense was $17.4 \%$ of total non-interest expense for the second quarter of 2008 , down from $18.3 \%$ for the second quarter of 2007 , and was $17.4 \%$ of total non-interest expense in the first half 2008 relative to $17.3 \%$ in the first half of 2007.

Other notable changes in non-interest expense categories are as follows: Advertising and marketing costs were up by $\$ 222,000$, or $50 \%$, for the second quarter of 2008, due to increased advertising and other program costs for our newest initiative targeting business deposit accounts as well as approximately $\$ 41,000$ in costs associated with our recent proxy contest; data processing costs were up by $\$ 34,000$, or $12 \%$, for the quarter, and by $\$ 115,000$, or $22 \%$, for the half, primarily because of higher internet banking expenses; loan processing costs increased by $\$ 191,000$, or $707 \%$, for the quarter and by $\$ 260,000$, or $441 \%$, for the half, because of the aforementioned $\$ 83,000$ in costs related to the initiation of our new mortgage service, in addition to higher expenses for appraisals

## Table of Contents

and inspections, which were up by $\$ 89,000$ for the quarter and by $\$ 108,000$ for the half, higher demand and foreclosure costs, and increases in various other miscellaneous loan costs; other professional services expenses fell by $\$ 116,000$ for the quarter and by $\$ 171,000$ for the half, principally because of declines in directors deferred fee accruals totaling $\$ 141,000$ for the second quarter and $\$ 220,000$ for the half, partially offset by higher shareholder expenses related to our recent proxy contest; stationery and supply costs were down $\$ 27,000$, or $16 \%$, for the quarter, and by $\$ 77,000$, or $23 \%$, for the half, due to more efficient management of forms, envelopes and letterhead.

Because of the impact of the gain on sale of credit card loans, the percentage increase in net interest plus other income was lower than the increase in total non-interest expense for the half and the Company s tax-equivalent overhead efficiency ratio increased to $48.0 \%$ for the second quarter of 2008 from $46.1 \%$ for the second quarter of 2007. For the half, the increase in service charges on deposits and the overall decrease in non-interest expense more than offset the impact of the credit card gain, and our efficiency ratio dropped to $47.6 \%$ in 2008 from $48.6 \%$ in 2007. The overhead efficiency ratio represents total operating expense divided by the sum of fully tax-equivalent net interest and non-interest income, with the provision for loan losses and investment gains/losses excluded from the equation.

## PROVISION FOR INCOME TAXES

The Company sets aside a provision for income taxes on a monthly basis. The amount of the tax provision is determined by applying the Company s statutory income tax rates to pre-tax book income, adjusted for permanent differences between pre-tax book income and actual taxable income. Such permanent differences include but are not limited to tax-exempt interest income, increases in the cash surrender value of BOLI, California Enterprise Zone deductions, certain expenses that are not allowed as tax deductions, and tax credits. The Company s tax provision totaled $\$ 2.0$ million for the second quarter of 2008 and $\$ 3.3$ million for the second quarter of 2007, representing $30.4 \%$ of pre-tax income for the second quarter of 2008 and $35.3 \%$ for the second quarter of 2007 . For the half, the tax provision was $\$ 4.3$ million, or $31.3 \%$ of pre-tax income in 2008 , and $\$ 5.6$ million, or $34.3 \%$ of pre-tax income in 2007 . Since actual taxable income was approximately the same percentage of book pre-tax income in the first half of 2008 and the first half of 2007, and actual tax rates were close to the same for both periods, the large drop in the tax accrual rate can be explained by the fact that taxable income declined and tax credits increased so tax credits are a proportionately higher percentage of taxable income in 2008 and had a relatively greater impact.

## BALANCE SHEET ANALYSIS

## EARNING ASSETS

## INVESTMENTS

The major components of the Company searning asset base are its investments and loans, and the detailed composition and growth characteristics of both are significant determinants of the financial condition of the Company. The Company s investments are analyzed in this section, while the loan and lease portfolio is discussed in a later section of this Form 10-Q.

The Company s investments consist of debt and marketable equity securities (together, the investment portfolio ), investments in the time deposits of other banks, and overnight fed funds sold. These investments serve several purposes: 1) they provide liquidity to even out cash flows from the loan and deposit activities of customers; 2) they provide a source of pledged assets for securing public deposits, bankruptcy deposits and certain borrowed funds which require collateral; 3) they constitute a large base of assets with maturity and interest rate characteristics that can be changed more readily than the loan portfolio, to better match changes in the deposit base and other funding sources of the Company; 4) they are an alternative interest-earning use of funds when loan demand is light; and 5) they can provide partially tax exempt income.

Although the Company currently has the intent and the ability to hold the securities in its investment portfolio to maturity, the securities are all marketable and are classified as available for sale to allow maximum flexibility with regard to interest rate risk and liquidity management. Pursuant to SFAS 115, available for sale securities are carried on the Company s financial statements at their estimated fair market value, with monthly tax-effected mark-to-market adjustments made vis-à-vis the accumulated other comprehensive income account in shareholders equity. The following table sets forth the Company s investment portfolio by investment type as of the dates noted.

## Table of Contents

## Investment Portfolio

(dollars in thousands, unaudited)

|  | June 30, 2008 |  |  | December 31, 2007 |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Amortized Cost | Fair Market Value |  | Amortized Cost |  | Market Value |
| Available for Sale |  |  |  |  |  |  |
| US Treasury securities | \$ 499 | \$ | 507 | \$ 698 | \$ | 706 |
| US Gov t agencies | 9,638 |  | 9,771 | 18,613 |  | 18,831 |
| Mortgage-backed securities | 173,825 |  | 170,819 | 108,729 |  | 107,684 |
| State \& political subdivisions | 58,728 |  | 58,170 | 57,242 |  | 57,688 |
| Other equity securities | 2,616 |  | 1,883 | 6 |  | 8 |
| Total Investment Securities | \$ 245,306 | \$ | 241,150 | \$ 185,288 | \$ | 184,917 |

The fair market value (which for the Company is the carrying value) of the investment portfolio increased by $\$ 56$ million, or $30 \%$, during the first half of 2008. Mortgage-backed securities increased by $\$ 63$ million, as the company utilized liquidity freed up by the deposit influx to take advantage of a relatively favorable investment environment. US Government agency bonds fell by $\$ 9$ million, due to maturing balances that were not replaced as they were no longer needed for pledging purposes. Equity securities increased by $\$ 2$ million during the first half of 2008 , as the Company purchased equity positions in a few other community banks.

Securities that were pledged as collateral for FHLB borrowings, repurchase agreements, public deposits and for other purposes as required or permitted by law totaled $\$ 220$ million at June 30,2008 , and $\$ 162$ million at December 31,2007 . Of those amounts, securities pledged in excess of actual pledging needs, and thus available for liquidity purposes if necessary, totaled $\$ 18$ million at June 30 , 2008 and $\$ 27$ million at December 31, 2007. There was only $\$ 5,000$ in fed funds sold at June 30, 2008 and none at December 31, 2007, and the Company s investment in the time deposits of other banks totaled $\$ 49,000$ at June 30, 2008 and $\$ 50,000$ at December 31, 2007. Aggregate investments were $18 \%$ of total assets at June 30, 2008 and 15\% at December 31, 2007.

## LOAN PORTFOLIO

The Company s loans and leases, gross of the associated allowance for losses and deferred fees and origination costs, totaled $\$ 932$ million at the end of June 2008. Notwithstanding a drop of $\$ 4$ million in gross outstanding balances in the first quarter due to the prepayment of large loans totaling $\$ 14$ million in balances, and a few additional sizeable prepayments totaling about $\$ 11$ million in the second quarter of 2008 , gross loan and lease balances have increased by $\$ 7$ million since December 31, 2007. The current competitive lending environment has, in management $s$ view, led to a certain level of irrational pricing, which has increased our volume of prepayments. Because of this, and due to our tightened credit criteria and increased attention on monitoring and managing current loan relationships, we anticipate that outstanding loan balances will increase at a relatively slow pace for the remainder of the year.

A comparative schedule of the distribution of the Company s loans at June 30, 2008 and December 31, 2007, by outstanding balance as well as by percentage of total loans, is presented in the following Loan and Lease Distribution table. The balances shown for each loan type are before deferred or unamortized loan origination, extension, or commitment fees, and deferred origination costs for loans in that category.

## Table of Contents

## Loan and Lease Distribution

(dollars in thousands, unaudited)

|  | June 30 <br> $\mathbf{2 0 0 8}$ | December 31 <br> $\mathbf{2 0 0 7}$ |
| :--- | :---: | :---: |
| Agricultural | $\$ 10,953$ | $\$$ |
| Commercial and industrial | 122,628 | 117,183 |
| Real Estate: | 453,782 | 457,236 |
| Secured by commercial/professional office Properties including construction and development | 190,198 | 187,267 |
| Secured by residential properties | 56,870 | 51,607 |
| Secured by farmland |  |  |
|  | 700,850 | 696,110 |
| Total Real Estate | 21,276 | 20,366 |
| Small Business Administration loans | 54,223 | 54,731 |
| Consumer loans | 22,117 | 23,140 |
| Direct Financing Leases | $\$ 932,047$ | $\$$ |
|  |  | 924,633 |
| Total Loans and Leases |  |  |


| Percentage of Total Loans and Leases |  |  |
| :--- | ---: | ---: |
| Agricultural | $1.18 \%$ | $1.42 \%$ |
| Commercial and industrial | $13.16 \%$ | $12.67 \%$ |
| Real Estate: |  |  |
| Secured by commercial/professional office Properties including construction and development | $48.69 \%$ | $49.45 \%$ |
| Secured by residential properties | $20.40 \%$ | $20.26 \%$ |
| Secured by farmland | $6.10 \%$ | $5.58 \%$ |
|  |  |  |
| Total Real Estate | $75.19 \%$ | $75.29 \%$ |
| Small Business Administration loans | $2.28 \%$ | $2.20 \%$ |
| Consumer loans | $5.82 \%$ | $5.92 \%$ |
| Direct Financing Leases | $2.37 \%$ | $2.50 \%$ |
|  |  |  |
| Total | $100.00 \%$ | $100.00 \%$ |

As shown above, the relative composition of our loan portfolio did not change materially during the first half of 2008. Ag production loans dropped by about $\$ 2$ million, or $16 \%$, due mainly to the restructuring of a portion of our largest ag loan to provide additional real estate collateral, and the subsequent reclassification of those balances to real estate loans secured by farmland. This also explains a large part of the increase in loans secured by farmland. Commercial and industrial loan balances increased by $\$ 5$ million, or $5 \%$, due to solid organic growth that made up for over $\$ 3$ million in balances that were paid off prior to maturity. Management is currently prioritizing commercial loan growth in an effort to reduce the relative volume of commercial real estate loans and create a more balanced portfolio, and commercial loans have increased slightly as a percentage of total loans in the first half of 2008, to $13.16 \%$ at June 30, 2008 from $12.67 \%$ at December 31, 2007. Real estate loans secured by commercial properties and construction and development loans fell by $\$ 3$ million, or $1 \%$, due to the prepayment of around $\$ 22$ million in balances secured by commercial real estate, including over $\$ 5$ million in loan participations. Loans secured by other residential properties increased $\$ 3$ million, or $2 \%$. Direct finance leases fell by $\$ 1$ million, or $4 \%$, for the first six months of the year.

Although not reflected in the loan totals above, from time to time the Company originates and sells agricultural and residential mortgage loans to certain other investors, and we currently provide servicing for a small number of SBA loans and agricultural mortgage loans. The balance of loans serviced for others, including participations sold, was $\$ 11$ million as of June 30, 2008 compared to $\$ 12$ million at December 31, 2007.

## Table of Contents

## OFF-BALANCE SHEET ARRANGEMENTS

In the normal course of business, the Company makes commitments to extend credit as long as there are no violations of any conditions established in the outstanding contractual arrangement. Unused commitments to extend credit totaled $\$ 200$ million at June 30, 2008 as compared to $\$ 208$ million at December 31, 2007, although it is expected that not all of these commitments will ultimately be drawn down. Unused commitments represented approximately $21 \%$ of gross loans outstanding at June 30, 2008 and $23 \%$ at December 31, 2007. In addition to unused loan commitments, the Company had letters of credit totaling \$22 million at June 30, 2008 and December 31, 2007.

The effect on the Company s revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted because there is no guarantee that the lines of credit will ever be used. For more information regarding the Company s off-balance sheet arrangements, see Note 8 to the financial statements located elsewhere herein.

## NONPERFORMING ASSETS

Nonperforming assets are comprised of the following: loans for which the Company is no longer accruing interest; loans 90 days or more past due and still accruing interest (although loans are generally placed on non-accrual status when they become 90 days past due, whether or not interest is still being collected); loans restructured where the terms of repayment have been renegotiated resulting in a deferral of interest or principal; and foreclosed assets, including other real estate owned (OREO). Management s classification of a loan as non-accrual or restructured is an indication that there is reasonable doubt as to the Company $s$ ability to collect principal or interest on the loan. At that point, the Company stops accruing income from the interest on the loan, reverses any interest that has been accrued but is not yet collected, and recognizes interest income only when cash interest payments are received and as long as the collection of all outstanding principal is not in doubt. These loans may or may not be collateralized, but in all cases collection efforts are continuously pursued. The following table presents comparative data for the Company s nonperforming assets:

## Table of Contents

## Non-performing Assets

(dollars in thousands, unaudited)

|  | $\begin{gathered} \text { June } 30 \\ 2008 \end{gathered}$ | $\begin{gathered} \text { December } 31 \\ 2007 \end{gathered}$ | $\begin{gathered} \text { June } 30 \\ 2007 \end{gathered}$ |
| :---: | :---: | :---: | :---: |
| NON-ACCRUAL LOANS: |  |  |  |
| Agricultural | \$ | \$ | \$ |
| Commercial and industrial | 96 | 75 |  |
| Real Estate |  |  |  |
| Secured by commercial/professional office properties including construction and development | 9,692 | 6,976 |  |
| Secured by residential properties | 592 | 666 | 228 |
| Secured by farmland |  |  |  |

Held for sale

| TOTAL REAL ESTATE | 10,284 |  | 7,642 |  | 228 |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Small Business Administration loans | 1,573 |  | 1,174 |  | 96 |
| Consumer loans | 198 |  | 161 |  | 79 |
| Consumer credit cards |  |  |  |  |  |
| Direct financing leases | 256 |  |  |  |  |
| SUBTOTAL | \$ 12,407 | \$ | 9,052 | \$ | 403 |
| LOANS 90 DAYS OR MORE PAST DUE \& STILL ACCRUING: |  |  |  |  |  |
| (as to principal OR interest) |  |  |  |  |  |
| Agricultural | \$ | \$ |  | \$ |  |
| Commercial and industrial |  |  |  |  |  |
| Real Estate |  |  |  |  |  |
| Secured by commercial/professional office properties including construction and development |  |  |  |  |  |
| Secured by residential properties |  |  |  |  |  |
| Secured by farmland |  |  |  |  |  |
| Held for sale |  |  |  |  |  |

TOTAL REAL ESTATE
Small Business Administration loans
Consumer loans
Consumer credit cards
Direct financing leases
SUBTOTAL

| TOTAL NONPERFORMING LOANS | 12,407 | 9,052556 |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Foreclosed assets | 1,820 |  |  |  |  |
| Total nonperforming assets | \$ 14,227 | \$ | 9,608 | \$ | 403 |
| Restructured loans | N/A |  | N/A |  | N/A |
| Nonperforming loans as a \% of total gross loans and leases | 1.33\% |  | 0.98\% |  | 0.04\% |
| Nonperforming assets as a \% of total gross loans and leases and foreclosed assets | 1.52\% |  | 1.04\% |  | 0.04\% |

Total nonperforming assets were $\$ 14.2$ million at June 30 , 2008 relative to $\$ 9.6$ million at December 31, 2007, an increase of $\$ 4.6$ million, or $48 \%$. Loans secured by commercial properties and construction/development loans comprise the largest portion of the increase in nonperforming assets, rising by $\$ 2.7$ million, or $39 \%$, due mainly to the addition of the following: Three acquisition and development loans totaling $\$ 3.8$ million, four residential construction loans with an aggregate balance of $\$ 971,000$, two commercial real estate loans in the amount of $\$ 423,000$, and a commercial construction loan with a balance of $\$ 299,000$. These additions were partially offset by the resolution of the following loans

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that were included at December 31, 2007: A $\$ 1.2$ million note secured by commercial real estate was sold, a $\$ 1.1$ million construction loan secured by a personal residence and land was foreclosed on and subsequently sold, and residential construction loans of \$415,000 and \$125,000 were paid off. SBA loans on non-accrual also increased by $\$ 399,000$ due to the net addition of 5 loans. Other loans and leases downgraded to non-accrual status in the first half of 2008 include a few relatively small leases and various consumer loans. Approximately $\$ 1.2$ million of the June 30, 2008 total nonperforming loan balance in the table above is guaranteed by the U.S. Government, and an additional $\$ 10.3$ million is secured by real estate.

## Table of Contents

A total of $\$ 2.2$ million in loans which were classified as non-accrual at December 31, 2007 were written down and acquired into OREO in the first half of 2008. Two properties totaling $\$ 489,000$ that were held in OREO at year-end 2007 were sold during the first half of 2008, but several additional foreclosures during the first half resulted in an ending balance of $\$ 1.8$ million for foreclosed assets. The balance of foreclosed assets at June 30,2008 consists primarily of residential properties and vacant lots, but also includes three mobile homes with a combined appraised value of $\$ 157,000$.

Nonperforming assets were $1.52 \%$ of total gross loans and leases plus foreclosed assets at June 30, 2008 and $1.04 \%$ at December 31, 2007, up from $0.04 \%$ at June 30, 2007. While our nonperforming assets have experienced a sizeable increase relative to year-ago levels, an action plan is in place for each of our non-performing loans and foreclosed assets and they are all being actively managed. However, we cannot provide assurance that all will be resolved in a timely manner or that non-performing balances will not increase further.

## ALLOWANCE FOR LOAN AND LEASE LOSSES

The allowance for loan and lease losses is established through a provision for loan and lease losses based on management s evaluation of known and inherent risks in the Company s loan portfolio. At June 30, 2008 the allowance for loan and lease losses was $\$ 12.6$ million, or $1.35 \%$ of gross loans, a 3\% increase from the $\$ 12.3$ million allowance at December 31, 2007 which was $1.33 \%$ of gross loans. The allowance has increased by $\$ 519,000$, or $4 \%$, in comparison to June 30,2007 , at which time it was $1.33 \%$ of gross loans. An allowance for potential losses inherent in unused commitments is included in other liabilities, and totaled \$160,000 at June 30, 2008.

We employ a systematic methodology for determining the appropriate level of the allowance for loan and lease losses and adjusting it on at least a quarterly basis. Our process includes a periodic review of individual loans that have been specifically identified as problem loans or have characteristics that could lead to impairment, as well as detailed reviews of other loans either individually or in pools. While this methodology utilizes historical data, projected cash flows and other objective information, the classification of loans and the establishment of the allowance for loan and lease losses are both to some extent based on management s judgment and experience.

Our methodology incorporates a variety of risk considerations, both quantitative and qualitative, in establishing an allowance for loan and lease losses that management believes is appropriate at each reporting date. Quantitative factors include our historical loss experience, delinquency and charge-off trends, collateral values, the anticipated timing of collection of principal for non-performing loans, fluctuations in loan balances, the rate of loan portfolio growth, and other factors. Quantitative factors also incorporate known information about individual loans, including a borrower s sensitivity to interest rate movements or other quantifiable external factors such as commodity prices or acts of nature (freezes, earthquakes, fires, etc.).

Qualitative factors include the general economic environment in our markets and, in particular, the state of the agriculture industry and other key industries in the Central San Joaquin Valley. The way a particular loan might be structured, the extent and nature of waivers of existing loan policies, the results of bank regulatory examinations, and model imprecision are additional qualitative factors that are considered.

## Table of Contents

The table that follows summarizes the activity in the allowance for loan and lease losses for the periods indicated.

## Allowance for Loan and Lease Losses

(dollars in thousands, unaudited)

|  | For the Quarter Ended June 30 |  | For the Six-Month Period Ended June 30 |  | For the Year Ended December 31 2007 |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2008 | 2007 | 2008 | 2007 |  |  |
| Balances: |  |  |  |  |  |  |
| Average gross loans and leases outstanding during period | \$ 927,034 | \$ 904,606 | \$ 921,509 | \$ 897,945 | \$ | 903,046 |
| Gross loans and leases outstanding at end of period | \$ 932,047 | \$ 909,447 | \$ 932,047 | \$ 909,447 | \$ | 924,633 |
| Allowance for Loan and Lease Losses: |  |  |  |  |  |  |
| Balance at beginning of period | \$ 12,478 | \$ 11,612 | \$ 12,276 | \$ 11,579 | \$ | 11,579 |
| Provision charged to expense | 2,650 | 701 | 4,920 | 1,601 |  | 3,252 |
| Charge-offs |  |  |  |  |  |  |
| Agricultural |  |  |  | 15 |  | 15 |
| Commercial \& industrial loans(1) | 1,138 | 14 | 1,768 | 477 |  | 666 |
| Real estate loans | 295 | 250 | 608 | 250 |  | 724 |
| Consumer loans | 710 | 117 | 1,777 | 538 |  | 1,636 |
| Credit card loans | 11 | 75 | 11 | 139 |  | 139 |
| Direct Financing Leases | 243 |  | 243 |  |  |  |
| Overdrafts | 201 | 90 | 351 | 137 |  | 498 |
| Total | 2,598 | 546 | 4,758 | 1,556 |  | 3,678 |

Recoveries

| Agricultural |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Commercial \& industrial loans(1) | 24 | 255 | 58 | 361 |  | 862 |
| Real estate loans | 1 | 43 | 2 | 47 |  | 77 |
| Consumer loans | 35 | 8 | 45 | 18 |  | 77 |
| Credit card loans | 4 | 18 | 16 | 30 |  | 50 |
| Direct Financing Leases | 2 |  | 2 |  |  |  |
| Overdrafts | 26 | 12 | 61 | 23 |  | 57 |
| Total | 92 | 336 | 184 | 479 |  | 1,123 |
| Net loan charge offs (recoveries) | 2,506 | 210 | 4,574 | 1,077 |  | 2,555 |
| Balance | \$ 12,622 | \$ 12,103 | \$ 12,622 | \$ 12,103 | \$ | 12,276 |

## RATIOS

| Net Charge-offs to Average Loans and Leases (annualized) | 1.09\% | 0.09\% | 1.00\% | 0.24\% | 0.28\% |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Allowance for Loan Losses to Gross Loans and Leases |  |  |  |  |  |
| at End of Period | 1.35\% | 1.33\% | 1.35\% | 1.33\% | 1.33\% |
| Allowance for Loan Losses to Non-Performing Loans | 101.73\% | 3003.23\% | 101.73\% | 3003.23\% | 135.62\% |
| Net Loan Charge-offs to Allowance for Loan Losses at |  |  |  |  |  |
| End of Period | 19.85\% | 1.74\% | 36.24\% | 8.90\% | 20.81\% |
| Net Loan Charge-offs to Provision for Loan Losses | 94.57\% | 29.96\% | 92.97\% | 67.27\% | 78.57\% |

(1) Includes Small Business Administration Loans

The allowance is increased by a provision for possible loan and lease losses charged against current earnings, and by the recovery of previously charged-off balances. It is reduced by loan, lease and overdraft charge-offs. Specifically identifiable and quantifiable losses are immediately charged off against the allowance; recoveries are generally recorded only when cash payments are received subsequent to the charge-off. The Company s provision for loan and lease losses was $\$ 1.9$ million higher in the second quarter of 2008 than in the second quarter of 2007, and net charge-offs increased by $\$ 2.3$ million. As noted previously, the provision was higher primarily because of an increase in specific reserves for certain acquisition and development loans and construction loans, increased

## Table of Contents

general reserves for unsecured business and consumer loans, and the replenishment of general reserves utilized for charge-offs. Net charge-offs increased mainly because of an increase in charge-offs on unsecured business loans and consumer credit lines. We also experienced an increase in charge-offs on direct finance leases, and overdraft charge-offs increased due to significantly higher overdraft activity. We have adjusted underwriting policies in higher-risk areas to reduce the likelihood of future losses.

The Company considers its allowance for loan and lease losses at June 30, 2008 to be adequate to cover specifically identified losses and other losses inherent in its loan portfolio. However, no assurance can be given that the Company will not experience substantial losses relative to the size of the allowance.

## OTHER ASSETS

The balance of cash and due from banks was $\$ 53$ million at June 30, 2008, compared to the $\$ 44$ million balance at December 31, 2007. Since the actual balance of cash and due from banks depends on the timing of collection of outstanding cash items, it is subject to significant fluctuation in the normal course of business. While cash flows are normally predictable within limits, those limits are fairly broad and the Company manages its cash position through the utilization of overnight loans to and borrowings from correspondent banks, including the Federal Home Loan Bank of San Francisco. Should a large short overnight position persist for any length of time, the Company typically raises money through focused retail deposit gathering efforts or by adding brokered time deposits. If a long position is prevalent, the Company will, to the extent possible, let brokered deposits roll off as they mature.

Because of frequent balance fluctuations, a more accurate gauge of cash management efficiency is the average balance for the period. The $\$ 34$ million average of cash and due from banks for the first six months of 2008 was down about $8 \%$ from the $\$ 37$ million average for all of 2007. Average cash balances have been well-controlled due to close monitoring and effective management of branch cash levels, and our conversion to electronic presentment for all checks has helped reduce the level of cash items in process of collection. We expect that average cash balances will increase as new branches become operational and our transaction account customer base expands.

Net premises and equipment increased slightly during the first half of 2008 due to our most recent branch addition, and other assets were $\$ 1.2$ million higher largely because of the increase in foreclosed assets. At June 30, 2008, other assets includes as its largest components $\$ 28$ million in bank-owned life insurance (see discussion of BOLI in Non-Interest Revenue and Operating Expense section above), a $\$ 13$ million investment in low-income housing tax credit funds, an aggregate $\$ 10$ million investment in restricted stock, accrued interest receivable totaling $\$ 6$ million, goodwill of about $\$ 6$ million, a net deferred tax asset of $\$ 5$ million, close to $\$ 2$ million in OREO and other foreclosed assets, and about $\$ 2$ million in operating leases. Restricted stock is comprised primarily of FHLB stock that fluctuates in conjunction with our FHLB borrowings. This stock is not deemed to be marketable or liquid and is thus not grouped with the Company s investments described above. Dividends received on FHLB stock are reflected in other non-interest income rather than interest income, and are not factored into our yield analysis. The Company s goodwill is evaluated annually, and because the market value of the Company exceeded its book value as of the measurement date, no further testing was deemed necessary and management determined that no impairment exists. Likewise, our net deferred tax asset is evaluated as of every reporting date pursuant to FASB Interpretation No. 48 , and we have determined that no impairment exists.

## DEPOSITS AND INTEREST BEARING LIABILITIES

## DEPOSITS

Another key balance sheet component impacting the Company s net interest margin is our deposit base. The Company s net interest margin is improved to the extent that growth in deposits can be concentrated in less volatile and typically less costly core deposits, which include demand deposit accounts (DDA), interest-bearing demand accounts (NOW accounts), savings accounts, money market demand accounts (MMDA s), and non-brokered time deposits under $\$ 100,000$. Overall, deposits increased by $\$ 113$ million, or $13 \%$, to $\$ 963$ million at June 30,2008 from $\$ 850$ million at December 31, 2007. Most of the growth was in time deposits over $\$ 100,000$ and CDARS deposits, although core deposits also increased by $\$ 21$ million, or $3 \%$, for the half. The number of transaction accounts (DDA and NOW accounts) at the Company continues to increase as a result of our high performance checking (HPC) initiatives, rising by 2,500 accounts, or $6 \%$, in the first half of 2008, and by 4,800 accounts, or $12 \%$, from June 30, 2007 to June 30, 2008. This increase in accounts has been a significant contributor to service charges on deposit accounts, which has enhanced the Company s profitability. The average balance per transaction account has declined, however, and aggregate transaction account balances fell by $\$ 2$ million, or $1 \%$, in the first half. In spite of the overall decline in transaction account balances in the first half of 2008, over the past few months DDA balances seem to have stabilized while NOW balances continue to grow. We are optimistic that this base of relatively low-cost funding will continue to expand in the future, although no assurance can be provided in that regard.

## Table of Contents

A comparative schedule of the distribution of the Company s deposits at June 30, 2008 and December 31, 2007, by outstanding balance as well as by percentage of total deposits, is presented in the following Deposit Distribution Table.

## Deposit Distribution

(dollars in thousands, unaudited)

|  | $\begin{gathered} \text { June } 30 \\ 2008 \end{gathered}$ | $\begin{gathered} \text { December } 31 \\ 2007 \end{gathered}$ |  |
| :---: | :---: | :---: | :---: |
| Demand | \$ 230,157 | \$ | 243,764 |
| NOW | 98,169 |  | 86,936 |
| Savings | 55,979 |  | 51,442 |
| Money Market | 150,699 |  | 126,347 |
| TDOA s \& IRA s | 27,832 |  | 23,715 |
| Time deposit < \$ 100,000 | 168,052 |  | 118,799 |
| Time deposits $\geq$ \$100,000 | 232,427 |  | 199,144 |
| Total Deposits | \$ 963,315 | \$ | 850,147 |
| Percentage of Total Deposits |  |  |  |
| Demand | 23.89\% |  | 28.67\% |
| NOW | 10.19\% |  | 10.23\% |
| Savings | 5.81\% |  | 6.05\% |
| Money Market | 15.64\% |  | 14.86\% |
| TDOA s \& IRA s | 2.89\% |  | 2.79\% |
| Time deposit < \$100,000 | 17.45\% |  | 13.97\% |
| Time deposits $\geq$ \$100,000 | 24.13\% |  | 23.43\% |
| Total | 100.00\% |  | 100.00\% |

The increase in time deposits under $\$ 100,000$ includes $\$ 50$ million in deposits obtained from one of the counties in our market area, which are CDARS deposits and are thus technically classified as brokered deposits. The increase in time deposits over $\$ 100,000$ includes a $\$ 50$ million increase in deposits from the State of California. Wholesale-sourced brokered deposits, which are also included in time deposits over $\$ 100,000$, declined by $\$ 10$ million during the first half. Non-interest bearing demand deposits, while up slightly for the quarter, show a drop of $\$ 14$ million, or $6 \%$, for the year-to-date period, due to the migration of some business DDA s into our money market sweep product and some personal DDA s into NOW accounts. NOW account balances increased by $\$ 11$ million, or $13 \%$, savings balances were up by $\$ 5$ million, or $9 \%$, and money market deposits increased by $\$ 24$ million, or $19 \%$.

Management recognizes that maintaining a high level of core deposits is one of the keys to sustaining a strong net interest margin, and continues to focus energy in that direction. Our recent deposit-related efforts have involved expanding the HPC initiative to include business accounts, and designating deposit specialists in certain regions to assist current and potential business customers with their deposit needs. We are also in the process of initiating a special online-only checking account, and have retained consultants to assist in maximizing our potential for new deposits via that channel. Information concerning average balances and rates paid on deposits by deposit type for the quarters and six-month periods ended June 30, 2008 and 2007 is contained in the Average Rates and Balances table appearing above in the section titled Net Interest Income and Net Interest Margin.

## OTHER INTEREST-BEARING LIABILITIES

The Company s other interest-bearing liabilities include overnight borrowings from other banks ( fed funds purchased ), borrowings from the Federal Home Loan Bank, securities sold under agreement to repurchase, and junior subordinated debentures that consist entirely of long-term borrowings from trust subsidiaries formed specifically to issue trust preferred securities (see Capital Resources section for a more detailed explanation of trust-preferred securities).

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As of June 30, 2008, FHLB borrowings totaled $\$ 148$ million, with $\$ 118$ million in the form of short-term advances and $\$ 30$ million in the form of long-term borrowings (remaining maturity over one year). Short-term borrowings reflect a decline of $\$ 75$ million during the first half of 2008, enabled by the increase in deposits. Long term borrowings increased by $\$ 25$ million, as we locked in relatively low rates in an attempt to improve our interest rate risk position under rising interest rate scenarios.

## Table of Contents

The Company uses short-term FHLB advances and overnight fed funds purchased from correspondent banks to support liquidity needs created by seasonal deposit flows, to temporarily satisfy funding needs from increased loan demand, and for other short-term purposes. Uncommitted lines are available from several correspondent banks. The FHLB line is committed, but the amount of available credit is dependent on the level of pledged collateral. Overnight fed funds purchased were up by $\$ 4$ million for the first half of 2008 , necessitated by the temporary $\$ 9$ million increase in cash and due from banks. Repurchase agreements, which represent sweep accounts , or non-deposit investment accounts secured by pledged investment securities, totaled approximately $\$ 28$ million at June 30 , 2008, relative to a $\$ 22$ million balance at the end of December 2007. In addition, the Company had $\$ 31$ million in junior subordinated debentures at June 30, 2008 and December 31, 2007.

## OTHER NON-INTEREST BEARING LIABILITIES

Other non-interest bearing liabilities are principally comprised of accrued interest payable, accrued income taxes, other expenses accrued but unpaid, and certain clearing amounts. Other liabilities totaled approximately $\$ 16$ million at both June 30, 2008 and December 31, 2007.

## LIOUIDITY AND MARKET RISK MANAGEMENT

## INTEREST RATE RISK MANAGEMENT

Market risk arises from changes in interest rates, exchange rates, commodity prices and equity prices. The Company s market risk exposure is primarily that of interest rate risk, and it has established policies and procedures to monitor and limit earnings and balance sheet exposure to changes in interest rates. The Company does not engage in the trading of financial instruments or have exposure to currency exchange rates.

The principal objective of interest rate risk management (often referred to as asset/liability management ) is to manage the financial components of the Company $s$ balance sheet in a manner that will optimize the risk/reward equation for earnings and capital in relation to changing interest rates. To identify areas of potential exposure to rate changes, the Company performs an earnings simulation analysis and a market value of portfolio equity calculation on a monthly basis.

The Company uses Sendero modeling software for asset/liability management in order to simulate the effects of potential interest rate changes on the Company s net interest income, and to calculate the estimated fair values of the Company sfinancial instruments under different interest rate scenarios. The program imports current balances, interest rates, maturity dates and repricing information for individual financial instruments, and incorporates assumptions on the characteristics of embedded options along with pricing and duration for new volumes to project the effects of a given interest rate change on the Company s interest income and interest expense. Rate scenarios consisting of key rate and yield curve projections are run against the Company s investment, loan, deposit and borrowed funds portfolios. These rate projections can be shocked (an immediate and parallel change in all base rates, up or down), ramped (an incremental increase or decrease in rates over a specified time period), economic (based on current trends and econometric models) or stable (unchanged from current actual levels).

The Company uses seven standard interest rate scenarios in conducting its simulations: stable, upward shocks of 100,200 and 300 basis points, and downward shocks of 100,200 , and 300 basis points. Our policy is to limit any projected decline in net interest income relative to the stable rate scenario for the next 12 months to less than $5 \%$ for a 100 basis point (b.p.) shock, $10 \%$ for a 200 b.p. shock, and $15 \%$ for a 300 b.p. shock in interest rates. As of June 30, 2008, the Company had the following estimated net interest income sensitivity profile:

| Immediate Change in Rate |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | -300 b.p. | -200 b.p. | -100 b.p. | +100 b.p. | +200 b.p. | +300 b.p. |
| Change in Net Int. Inc. (in \$000 s) | -\$ 3,034 | -\$ 1,207 | -\$ 280 | -\$ 417 | -\$ 933 | -\$ 1,592 |
| \% Change | -5.04\% | -2.00\% | -0.47\% | -0.69\% | -1.55\% | -2.64\% |

## Table of Contents

The above profile illustrates that if there were an immediate increase of 100 basis points in interest rates, the Company s net interest income would likely be about $\$ 417,000$ lower, a decline of $0.69 \%$ relative to net interest income in a flat rate scenario. The negative variance becomes more pronounced the greater the increase in interest rates. If there were an immediate and sustained downward adjustment of 100 basis points in interest rates, all else being equal, net interest income over the next twelve months would likely be $\$ 280,000$ lower, a drop of $0.47 \%$ compared to net interest income under a stable rate scenario. The unfavorable variance increases if rates go down by 200 basis points, and turns down sharply when rates drop 300 basis points. The disproportionate drop in net interest income as rates decline is due to the fact that deposit rates (on NOW accounts and savings accounts, for example) and other interest-bearing liabilities would begin to hit a natural floor of close to zero while variable-rate loan yields would continue to fall, resulting in net interest margin compression. This effect is exacerbated by the fact that prepayments on fixed-rate loans tend to increase as rates decline. In the unlikely event that rates fall drastically, we would likely create an artificial floor on our prime lending rate (consistent with past practice), to mitigate some of the negative impact.

As noted in the discussion of our net interest margin, for most of the past year our interest rate risk profile was slightly liability sensitive, meaning that interest-bearing liabilities re-price more quickly than interest-earning assets and, all else being equal, the Company s net interest margin will be higher when short-term rates are falling and lower when short-term rates are rising. In reality, however, even though rates were falling for most of the past year, competitive pressures on deposit rates offset some of the favorable impact we otherwise would have experienced because of our liability sensitive position. Because of small structural changes in our balance sheet and slightly different assumptions for deposit rates to conform model results more closely to recent behavior, our interest rate risk profile has recently evolved so that our risk in rising rate scenarios has been mitigated to some extent, and it currently appears that both rate increases and rate decreases will have a slight negative impact on our net interest margin. Another characteristic inherent in our interest rate risk profile was experienced in 2006, when rates leveled off after an extended period of rising. Margin compression occurred, since the cost of rate-sensitive liabilities continued to rise even after yields on rate-sensitive earning assets stopped increasing.

The economic (or fair ) value of financial instruments on the Company s balance sheet will also vary under the interest rate scenarios previously discussed. Economic values for financial instruments are estimated by discounting projected cash flows (principal and interest) at current replacement rates for each account type, while the fair value of non-financial accounts is assumed to equal book value and does not vary with interest rate fluctuations. An economic value simulation is a static measure for balance sheet accounts at a given point in time, but this measurement can change substantially over time as the characteristics of the Company s balance sheet evolve and as interest rate and yield curve assumptions are updated.

The amount of change in economic value under different interest rate scenarios is dependent upon the characteristics of each class of financial instrument, including the stated interest rate or spread relative to current market rates or spreads, the likelihood of prepayment, whether the rate is fixed or floating, and the maturity date of the instrument. As a general rule, fixed-rate financial assets become more valuable in declining rate scenarios and less valuable in rising rate scenarios, while fixed-rate financial liabilities gain value as interest rates rise and lose value as interest rates decline. The longer the maturity of the financial instrument, the greater the impact a given rate change will have on its value. In our economic value simulations, estimated prepayments are factored in for financial instruments with stated maturity dates, and decay rates for non-maturity deposits are also projected based on management $s$ best estimates. We have found that model results are highly sensitive to changes in the assumed decay rate for non-maturity deposits, in particular.

The economic value of equity (EVE) is calculated by subtracting the estimated fair value of liabilities from the estimated fair value of assets. The table below shows estimated changes in the Company s EVE as of June 30, 2008, under different interest rate scenarios relative to a base case of current interest rates:

| Immediate Change in Rate |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | -300 b.p. | -200 b.p. | -100 b.p. | +100 b.p. | +200 b.p. | +300 b.p. |
| Change in EVE (in \$000 s) | \$ 27,665 | \$ 18,921 | \$ 10,534 | -\$ 15,547 | -\$ 30,474 | -\$ 45,372 |
| \% Change | 11.41\% | 7.80\% | 4.35\% | -6.41\% | -12.57\% | -18.72\% |

## Table of Contents

The slope of EVE under varying interest rate scenarios is different than the profile for the Company s net interest income simulations, due primarily to the fact that $\$ 535$ million in non-maturity deposits are assumed to run off at the rate of $10 \%$ per year. In contrast, our net interest income simulations incorporate growth rather than run-off for aggregate non-maturity deposits. If a higher deposit decay rate is used for EVE simulations the decline becomes more severe, while the slope flattens if non-maturity deposits do not run off. Under declining rates, a floor of zero (or slightly above zero) for the discount rate on variable rate deposits and other liabilities, and increased principal prepayments and calls on investment securities and fixed rate loans, partially offset the increase in the value of fixed-rate loans. During the past few years, the addition of fixed-rate assets and a shift into more rate-sensitive funding has caused the negative slope in rising rate scenarios to become steeper and the slope in declining rate scenarios to move from negative to positive.

## LIOUIDITY

Liquidity refers to the Company s ability to maintain cash flows that are adequate to fund operations and meet other obligations and commitments in a timely and cost-effective fashion. The Company also, on occasion, experiences short-term cash needs as the result of loan growth or deposit outflows, or other asset purchases or liability repayments. To meet short-term needs, the Company can borrow overnight funds from other financial institutions or solicit brokered deposits if deposits are not immediately obtainable from local sources. Further, funds can be obtained by drawing down the Company s correspondent bank deposit accounts, or by liquidating investments or other assets. In addition, the Company can raise immediate cash for temporary needs by selling under agreement to repurchase those investments in its portfolio which are not pledged as collateral. As of June 30, 2008, non-pledged securities, plus pledged securities in excess of current pledging requirements, comprised $\$ 37$ million of the Company s investment portfolio balances.

Other forms of balance sheet liquidity include but are not necessarily limited to vault cash and balances due from banks, and immediately marketable loan balances in the amount of $\$ 16$ million at June 30, 2008. In addition to the liquidity inherent in its balance sheet, the Company has off-balance-sheet liquidity in the form of lines of credit from correspondent banks, including the Federal Home Loan Bank. Availability on these lines totaled $\$ 199$ million at June 30, 2008. An additional $\$ 171$ million in credit is available from the Federal Home Loan Bank if the Company pledges additional real-estate related collateral in a like amount and purchases the required amount of FHLB stock. The Company is also eligible to borrow approximately $\$ 2$ million at the Federal Reserve Discount Window if necessary, based on current pledged amounts. The Company manages its liquidity in such a fashion as to be able to meet any unexpected change in levels of assets or liabilities.

The Company s liquidity ratio and average loans to assets ratio were $16 \%$ and $71 \%$, respectively, at June 30,2008 , as compared to internal policy guidelines of greater than $10 \%$ and less than $78 \%$. The liquidity ratio is calculated with marketable and otherwise liquid assets as the numerator and non-collateralized deposits and short-term liabilities as the denominator. While these ratios are merely indicators and are not measures of actual liquidity, they are monitored closely and we are focused on maintaining adequate liquidity resources to draw upon should the need arise. Other liquidity ratios reviewed by management and the Board on a regular basis include average net loans to core deposits, net non-core funding dependence, and reliance on wholesale funding, all of which were within policy guidelines at June 30, 2008. We anticipate that slower loan growth and our efforts to increase core deposits will have a positive impact on our liquidity position, although no assurance can be provided that this will be the case.

## CAPITAL RESOURCES

At June 30, 2008, the Company had total shareholders equity of $\$ 101.9$ million, comprised of $\$ 20.0$ million in common stock, additional paid-in capital of $\$ 956,000$, and $\$ 83.3$ million in retained earnings, less $\$ 2.4$ million in accumulated other comprehensive losses. Total shareholders equity at the end of 2007 was $\$ 99.5$ million. The $\$ 2.4$ million increase in shareholders equity during the first half of 2008 was due primarily to the addition of net earnings less $\$ 3.3$ million in dividends paid, a $\$ 1.5$ million increase related to stock options, and a $\$ 2.1$ million decrease due to the impact of shares repurchased and retired by the Company. It also includes the $\$ 2.2$ million decline in the difference between the market value and amortized cost of investment securities (net of the tax impact). Also reflected as of January 1, 2008 was a $\$ 1.1$ million charge for the cumulative impact of implementing FASB s guidance under EITF 06-04, as explained in Note 3 to the Consolidated Financial Statements.

## Table of Contents

The Company uses a variety of measures to evaluate its capital adequacy, with risk-based capital ratios calculated separately for the Company and the Bank. Management reviews these capital measurements on a quarterly basis and takes appropriate action to ensure that they are within established internal and external guidelines. The Company and the Bank are both classified as well capitalized, the highest rating of the categories defined under the Bank Holding Company Act and the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. The FDIC has promulgated risk-based capital guidelines for all state non-member banks such as the Bank. These guidelines establish a risk-adjusted ratio relating capital to different categories of assets and off balance sheet exposures. There are two categories of capital under the guidelines: Tier 1 capital includes common stockholders equity, qualifying minority interests in consolidated subsidiaries, and qualifying trust-preferred securities (including notes payable to unconsolidated special purpose entities that issue trust-preferred securities), less goodwill and certain other deductions, notably the unrealized net gains or losses (after tax adjustments) on available for sale investment securities carried at fair market value; Tier 2 capital can include qualifying subordinated debt and redeemable preferred stock, qualifying cumulative perpetual preferred stock, and the allowance for loan and lease losses, subject to certain limitations.

As noted previously, the Company s junior subordinated debentures represent borrowings from its unconsolidated subsidiaries. These debentures currently qualify for inclusion as Tier 1 capital for regulatory purposes to the extent that they do not exceed $25 \%$ of total Tier 1 capital, but are classified as long-term debt in accordance with generally accepted accounting principles. Generally, the amount of junior subordinated debentures in excess of the $25 \%$ Tier 1 limitation is included in Tier 2 capital. All of the $\$ 31$ million in junior subordinated debentures on the Company s balance sheet at June 30, 2008 was included in Tier 1 capital.

The following table sets forth the Company $s$ and the Bank $s$ regulatory capital ratios as of the dates indicated.

## Risk Based Ratios

(dollars in thousands, unaudited)

|  | June 30, <br> $\mathbf{2 0 0 8}$ | December 31, <br> $\mathbf{2 0 0 7}$ | Minimum Requirement <br> to be Well Capitalized |
| :--- | :---: | :---: | :---: |
| Sierra Bancorp | $13.62 \%$ | $13.33 \%$ | $10.00 \%$ |
| Total Capital to Total Risk-weighted Assets | $12.39 \%$ | $12.11 \%$ | $6.00 \%$ |
| Tier 1 Capital to Total Risk-weighted Assets | $10.07 \%$ | $10.22 \%$ | $5.00 \%$ |
| Tier 1 Leverage Ratio | $12.57 \%$ | $13.28 \%$ | $10.00 \%$ |
| Bank of the Sierra | $11.34 \%$ | $12.06 \%$ | $6.00 \%$ |
| Total Capital to Total Risk-weighted Assets | $9.20 \%$ | $10.17 \%$ | $5.00 \%$ |
| Tier 1 Capital to Total Risk-weighted Assets |  |  |  |
| Tier 1 Leverage Ratio |  |  |  |

At the current time, there are no commitments that would necessitate the use of material amounts of the Company s capital, and there are no foreseeable events that would cause the capital ratios for either the Bank or the consolidated holding company to fall below the threshold necessary to be considered well capitalized .

Table of Contents

PART I FINANCIAL INFORMATION

Item 3

## QUALITATIVE \& QUANTITATIVE DISCLOSURES

## ABOUT MARKET RISK

The information concerning quantitative and qualitative disclosures about market risk is included as part of Part I, Item 2 above. See Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Market Risk Management

## PART I FINANCIAL INFORMATION

## Item 4

## CONTROLS AND PROCEDURES

## Evaluation of Disclosure Controls and Procedures

The Company s Chief Executive Officer and its Chief Financial Officer, after evaluating the effectiveness of the Company s disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this report (the Evaluation Date ) have concluded that as of the Evaluation Date, the Company s disclosure controls and procedures were adequate and effective to ensure that material information relating to the Company and its consolidated subsidiaries would be made known to them by others within those entities, particularly during the period in which this quarterly report was being prepared.

Disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

## Changes in Internal Controls

There were no significant changes in the Company s internal controls over financial reporting that occurred in the second quarter of 2008 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

## Table of Contents

## PART II - OTHER INFORMATION

## ITEM 1: LEGAL PROCEEDINGS

In the normal course of business, the Company is involved in various legal proceedings. In the opinion of management, any liability resulting from such proceedings would not have a material adverse effect on the Company s financial condition or results of operation.

## ITEM 1A: RISK FACTORS

There were no material changes from the risk factors disclosed in the Company s Form 10-K for the fiscal year ended December 31, 2007.

## ITEM 2: UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

(c) Stock Repurchases

The following table provides information concerning the Company s repurchases of its Common Stock during the second quarter of 2008:

|  | April | May | June |
| :--- | ---: | ---: | ---: |
| Total shares purchased | 0 | 0 | 0 |
| Average per share price | N/A | N/A | N/A |
| Number of shares purchased as part of publicly announced plan or program | N/A | N/A | N/A |
| Maximum number of shares remaining for purchase under a plan or program (1) | 100,669 | 100,669 | 100,669 |

(1) The current stock repurchase plan became effective July 1, 2003 and has no expiration date. The repurchase program initially provided that up to 250,000 shares of Sierra Bancorp s common stock could be purchased by the Company from time to time. That amount was supplemented by 250,000 shares on May 19, 2005, another 250,000 shares on March 16, 2006, and an additional 500,000 shares on April 19, 2007.
ITEM 3: DEFAULTS UPON SENIOR SECURITIES
Not applicable

## ITEM 4: SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Company s annual meeting of shareholders was held on May 21, 2008. Proxies were solicited by the Company s management pursuant to Regulation 14 under the Securities Exchange Act of 1934, and proxies were solicited in opposition to management by Patricia Childress. A total of $8,198,297$ shares were represented and voting at the meeting, constituting $86.11 \%$ of the $9,521,273$ issued and outstanding shares entitles to vote at the meeting. Management s nominees for directorship are listed in the proxy statement, and all such nominees were elected pursuant to the vote of shareholders. The vote on the election of four individuals to serve as Class I directors for two-year terms was as follows:

|  | For | Withhold |
| :--- | ---: | ---: |
| Morris A. Tharp | $5,729,664$ | 14,062 |
| James C. Holly | $5,726,779$ | 16,947 |
| Robert L. Fields | $5,729,664$ | 14,062 |
| Lynda B. Scearcy | $5,716,021$ | 27,705 |
| Patricia L. Childress | $2,414,271(1)$ | 40,300 |

(1) Although included in the total noted above, all of the votes solicited by Ms. Childress in her proxy solicitation, i.e., all votes other than from the $1,214,729$ shares beneficially owned by Ms. Childress and her sister, were invalidated pursuant to the California Financial Code, due to Ms. Childress failure to obtain permission from the California Department of Financial Institutions prior to soliciting proxies in the election contest.

## Table of Contents

The terms of the following directors also continued after the shareholders meeting: Albert L. Berra, Vincent L. Jurkovich, Robert H. Tienken and Gordon T. Woods.

There were no broker non-votes received with respect to these items.

## ITEM 5: OTHER INFORMATION

Not applicable

## Table of Contents

## ITEM 6: EXHIBITS

| Exhibit \# | Description |
| :---: | :--- |
| 3.1 | Articles of Incorporation of Sierra Bancorp (1) |
| 3.2 | Amendment to Articles of Incorporation of Sierra Bancorp (1) |
| 3.3 | Amended and Restated By-laws of the Company (2) |
| 10.1 | 1998 Stock Option Plan (1) |
| 10.2 | Salary Continuation Agreement for Kenneth R. Taylor (3) |
| 10.3 | Salary Continuation Agreement for James C. Holly (3) |
| 10.4 | Salary Continuation Agreement and Split Dollar Agreement for James F. Gardunio (4) |
| 10.5 | Split Dollar Agreement for Kenneth R. Taylor (5) |
| 10.6 | Split Dollar Agreement and Amendment thereto for James C. Holly (5) |
| 10.7 | Director Retirement Agreement for Robert Tienken (5) |
| 10.8 | Director Retirement Agreement and Split dollar Agreement for Vincent Jurkovich (5) |
| 10.9 | Director Retirement Agreement and Split dollar Agreement for Robert Fields (5) |
| 10.10 | Director Retirement Agreement and Split dollar Agreement for Gordon Woods (5) |
| 10.11 | Director Retirement Agreement and Split dollar Agreement for Morris Tharp (5) |
| 10.12 | Director Retirement Agreement and Split dollar Agreement for Albert Berra (5) |
| 10.13 | 401 Plus Non-Qualified Deferred Compensation Plan (5) |
| 10.14 | Indenture dated as of March 17, 2004 between U.S. Bank National Association, as Trustee, and Sierra Bancorp, as Issuer (6) |
| 10.15 | Amended and Restated Declaration of Trust of Sierra Statutory Trust II, dated as of March 17, 2004 (6) |
| 10.16 | Guarantee Agreement between Sierra Bancorp and U.S. Bank National Association dated as of March 17, 2004 (6) |
| 10.17 | Indenture dated as of June 15, 2006 between Wilmington Trust Co., as Trustee, and Sierra Bancorp, as Issuer (7) |
| 10.18 | Amended and Restated Declaration of Trust of Sierra Capital Trust III, dated as of June 15, 2006 (7) |
| 10.19 | Guarantee Agreement between Sierra Bancorp and Wilmington Trust Company dated as of June 15, 2006 (7) |
| 10.20 | 2007 Stock Incentive Plan (8) |
| 10.21 | Sample Retirement Agreement Entered into with Each Non-Employee Director Effective January 1, 2007 (9) |
| 10.22 | Salary Continuation Agreement for Kevin J. McPhaill (9) |
| 10.23 | First Amendment to the Salary Continuation Agreement for Kenneth R. Taylor (9) Periodic Financial Report (Section 906 Certification) |
| 11 | Statement of Computation of Per Share Earnings (10) |
| 31.1 | Certification of Chief Executive Officer (Section 302 Certification) |
| 31.2 | Certief Financial Officer (Section 302 Certification) |
| 10 |  |

(1) Filed as an Exhibit to the Registration Statement of Sierra Bancorp on Form S-4 filed with the Securities and Exchange Commission ( SEC ) (Registration No. 333-53178) on January 4, 2001 and incorporated herein by reference.

## Edgar Filing: SIERRA BANCORP - Form 10-Q

(2) Filed as an Exhibit to the Form 8-K filed with the SEC on February 21, 2007 and incorporated herein by reference.
(3) Filed as Exhibits 10.5 and 10.7 to the Form 10-Q filed with the SEC on May 15, 2003 and incorporated herein by reference.
(4) Filed as an Exhibit to the Form 8-K filed with the SEC on August 11, 2005 and incorporated herein by reference.
(5) Filed as Exhibits 10.10, 10.12, and 10.15 through 10.20 to the Form 10-K filed with the SEC on March 15, 2006 and incorporated herein by reference.
(6) Filed as Exhibits 10.9 through 10.11 to the Form 10-Q filed with the SEC on May 14, 2004 and incorporated herein by reference.
(7) Filed as Exhibits 10.26 through 10.28 to the Form 10-Q filed with the SEC on August 9, 2006 and incorporated herein by reference.
(8) Filed as Exhibit 10.20 to the Form 10-K filed with the SEC on March 15, 2007 and incorporated herein by reference.
(9) Filed as an Exhibit to the Form 8-K filed with the SEC on January 8, 2007 and incorporated herein by reference.
(10) Computation of earnings per share is incorporated by reference to Note 6 of the Financial Statements included herein.

## Table of Contents

## SIGNATURES

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

August 8, 2008
Date

August 8, 2008
Date
/s/ James C. Holly
SIERRA BANCORP

James C. Holly

President \&

Chief Executive Officer
/s/ Kenneth R. Taylor
SIERRA BANCORP

Kenneth R. Taylor

Executive Vice President \&

Chief Financial Officer

