SOUTHERN FIRST BANCSHARES INC
Form 10-Q
August 05, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended June 30, 2011
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Transition Period from to
Commission file number 000-27719

Southern First Bancshares, Inc.

(Exact name of registrant as specified in its charter)

864-679-9000
(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 Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes x No o

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 3,473,613 shares of common stock, par value $0.01 per share, were issued and outstanding as of August 4, 2011.

SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY
June 30, 2011 Form 10-Q

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(dollars in thousands, except share data)

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SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - Nature of Business and Basis of Presentation

Business activity

Southern First Bancshares, Inc. (the "Company") is a South Carolina corporation that owns all of the capital stock of Southern First Bank, N.A. (the "Bank") and all of the stock of Greenville First Statutory Trust I and II (collectively, the "Trusts"). On July 2, 2007, the Company and Bank changed their names to Southern First Bancshares, Inc. and Southern First Bank, N.A., respectively. The Bank is a national bank organized under the laws of the United States located in Greenville County, South Carolina and operates as Greenville First Bank in Greenville County. The Bank is primarily engaged in the business of accepting demand deposits and savings deposits insured by the Federal Deposit Insurance Corporation (the "FDIC"), and providing commercial, consumer and mortgage loans to the general public. The Trusts are special purpose non-consolidated entities organized for the sole purpose of issuing trust preferred securities.

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles ("GAAP") for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six month periods ended June 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010 (Registration Number 000-27719) as filed with the Securities and Exchange Commission on March 7, 2011. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, the Bank. In accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 810, "Consolidation," the financial statements related to the special purpose subsidiaries, the Trusts, have not been consolidated.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amount of income and expenses during the reporting periods. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, fair value of financial instruments, evaluating other-than-temporary-impairment of investment securities and valuation of deferred tax assets.

Reclassifications

Certain amounts, previously reported, have been reclassified to state all periods on a comparable basis that had no effect on shareholders' equity or net income.

Formal Agreement with the Office of the Comptroller of the Currency

On June 8, 2010, the Bank entered into a formal agreement (the "Formal Agreement") with its primary regulator, the Office of the Comptroller of the Currency (the "OCC"). The Formal Agreement seeks to enhance the Bank's existing practices and procedures in the areas of credit risk management, credit underwriting, liquidity, and funds management. The Board of Directors and management of the Bank have aggressively worked to address the findings of the exam and believe the Company is currently in compliance with substantially all of the requirements of the Formal Agreement. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" for more discussion of the Formal Agreement.

Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Non-recognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management performed an evaluation to determine whether there have been any subsequent events since the balance sheet date and determined that no subsequent events occurred requiring accrual or disclosure.

Accounting Developments

In July 2010, the Receivables topic of the Accounting Standards Codification ("ASC") was amended by Accounting Standards Update ("ASU") 2010-20 to require expanded disclosures related to a company's allowance for credit losses and the credit quality of its financing receivables. The amendments require the allowance disclosures to be provided on a disaggregated basis. The Company is required to include these disclosures in their interim and annual financial statements. See Note 3.

NOTE 2 - Investment Securities

The amortized costs and fair value of investment securities available for sale and held to maturity are as follows:

Other investments are comprised of the following and are recorded at cost which approximates fair value.

Contractual maturities and yields on our investments that are available for sale and are held to maturity at June 30, 2011 and December 31, 2010 are shown in the following table. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. We had no securities with maturities less than one year at June 30, 2011 or December 31, 2010.

The tables below summarize gross unrealized losses on investment securities and the fair market value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position.

Other-than-temporary impairment ("OTTI")

As prescribed by FASB ASC 320-10-35, the Company recognizes the credit component of OTTI on debt securities through earnings and the non-credit component in other comprehensive income ("OCI") for those securities in which the Company does not intend to sell the security and it is more-likely-than-not that the Company will not be required to sell the security in the foreseeable future.

At June 30, 2011, the Company had 18 individual investments that were in an unrealized loss position for less than 12 months. The unrealized losses were primarily attributable to changes in interest rates, rather than deterioration in credit quality. The majority of these securities are government or agency securities currently rated AA or AAA by Moody's or Standard and Poor's, and therefore, pose minimal credit risk. The Company considers the length of time and extent to which the fair value of available-for-sale debt securities have been less than cost to conclude whether such securities are other-than-temporarily impaired. We also consider other factors such as the financial condition of the issuer including credit ratings and specific events affecting the operations of the issuer, volatility of the security, underlying assets that collateralize the debt security, and other industry and macroeconomic conditions. As the Company has no intent to sell securities with unrealized losses and it is not more-likely-than-not that the Company will be required to sell these securities before recovery of amortized cost, we have concluded that the securities are not impaired on an other-than-temporary basis.

At June 30, 2011, we held one private label collateralized mortgage obligation ("CMO") which has been in an unrealized loss position for 12 months or longer, with a book value of $2.7 million. A majority of "structured" investments within all credit markets have been impacted by volatility and credit concerns and economic stresses since 2008. The result has been that the market for these investments has become significantly less liquid and the spread as compared to alternative investments has widened dramatically.

The Company evaluates this security quarterly based on the methodology outlined below and, based on this evaluation, currently believes that it will receive substantially all of the principal and interest in accordance with the original contractual terms of the security. In addition, management has reviewed the independent assumptions utilized in evaluating the security for OTTI and based on its review, the Company recorded a $25,000 other-than-temporary impairment on this security during the second quarter of 2011. However, no assurance can be given that market conditions and certain characteristics of the security will continue to support this determination.

CMO Evaluation Methodology

The primary cause of mortgage delinquency and foreclosure is the loss of household income due to unemployment. Therefore, the change in unemployment rates is a predictor of the likelihood of mortgage loan delinquencies and foreclosures. Prime mortgage borrowers, with secure or steady employment tend to stay current on their mortgages, even if home prices drop significantly, as in a period of severe home price depreciation. Subprime borrowers, on the other hand, who only marginally sustained their initial home purchase, are more likely to become delinquent when home prices drop precipitously. There is evidence to support the premise that increases in unemployment rates and home price depreciation have a positive correlation with foreclosure rates.

In the non agency mortgage-backed securities ("MBS") sector, FICO scores that measure the credit worthiness of the mortgage borrower are a good indicator of future mortgage delinquency and foreclosure rates. In addition, the level of documentation that was obtained at the time the loan was originated is a strong indicator of future loan performance. Loans that have limited or reduced documentation have proven to result in higher delinquency and foreclosures. An additional indicator of the likelihood of delinquencies and foreclosures is the occupancy type. Generally speaking, loans on owner occupied properties tend to be less likely to default than loans on vacation or investment properties.

The company evaluates its private label CMO for other-than-temporary impairment quarterly based on a Bloomberg Default model which uses relevant assumptions such as prepayment rate, default rate and loss severity in determining the expected recovery of the contractual cash flows. Listed below is various historical data related to our private label CMO:

	June 30, 2011	**March 31, 2011**	**December 31, 2010**
Book value (in thousands)	$2,661	$2,803	$2,865
Other-than-temporary impairment	$25	$-	$-
Year of origination	2006	2006	2006
Original credit rating	Aaa	Aaa	Aaa
Current credit rating	Caa1	Caa1	Caa1
Deal Percentage of loans 60+ delinquent	28.3%	27.9%	26.3%
Group Percentage of loans 60+ delinquent	14.6%	13.7%	12.2%
12 month prepayment rate	17.8%	14.3%	17.6%
12 month default rate	4.7%	1.9%	1.9%
12 month severity rate	55.0%	72.4%	72.4%
Average prepayment rate	9.5%	6.5%	6.4%
Average default rate	1.5%	1.4%	1.5%
Average severity rate	41.0%	38.1%	38.1%
Weighted average:			
Coupon	6.2%	6.2%	6.2%
Months remaining	297	301	302
Loan size	$299,000	$302,000	$301,000
Current loan to value	79.0%	79.0%	79.0%
FICO scores:			
Original	736	736	736
Current	730	733	733
Current percentage of limited documents	44.0%	42.0%	41.0%
Current percentage - owner occupied	90.0%	90.0%	90.0%
Geographic concentration:			
Highest percentage	GA 78.2%	GA 79.7%	GA 79.9%
Second highest percentage	FL 17.8%	FL 16.6%	FL 16.5%

Based on the independent calculations and assumptions, management currently anticipates receiving substantially all of the outstanding principal and the related interest for this CMO security. Management has reviewed the independent assumptions utilized, compared them to current actual results, and believes that they are reasonable. However, there is no precise method to predict if credit losses in the future periods will exceed our current predictions. If actual results significantly vary from the assumptions noted above, we may be required to recognize losses that are later deemed to not be only temporary in nature. The valuation change has been recorded as a change in the unrealized gain/loss recognized in other comprehensive income.

NOTE 3 - Loans and Allowance for Loan Losses

The following table summarizes the composition of our loan portfolio.

Maturities and Sensitivity of Loans to Changes in Interest Rates

The information in the following tables summarizes the loan maturity distribution by type and related interest rate characteristics based on the contractual maturities of individual loans, including loans which may be subject to renewal at their contractual maturity. Renewal of such loans is subject to review and credit approval, as well as modification of terms upon maturity. Actual repayments of loans may differ from the maturities reflected below, because borrowers have the right to prepay obligations with or without prepayment penalties.

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Portfolio Segment Methodology

Commercial

Commercial loans are assessed for estimated losses by grading each loan using various risk factors identified through periodic reviews. We apply historic grade-specific loss factors to each funded loan. In the development of our statistically derived loan grade loss factors, we observe historical losses over a relevant period for each loan grade. These loss estimates are adjusted as appropriate based on additional analysis of external loss data or other risks identified from current economic conditions and credit quality trends. The allowance also includes an amount for the estimated impairment on nonaccrual commercial loans and commercial loans modified in a troubled debt restructuring ("TDR"), whether on accrual or nonaccrual status.

Consumer

For consumer loans, we determine the allowance on a collective basis utilizing forecasted losses to represent our best estimate of inherent loss. We pool loans, generally by product types with similar risk characteristics. In addition, we further stratify the pools risk grade and then apply historical loss rates over a relevant period to the stratified loan pools. In addition, we establish an allowance for consumer loans that have been modified in a TDR, whether on accrual or nonaccrual status.

Credit Quality Indicators

Commercial

We manage a consistent process for assessing commercial loan credit quality by monitoring our loan grading trends and past due statistics. All loans are subject to individual risk assessment. Our categories include Pass, Special Mention, Substandard, and Doubtful, each of which are defined by banking regulatory agencies. Delinquency statistics are also an important indicator of credit quality in the establishment of our allowance for credit losses.

The tables below provide a breakdown of outstanding commercial loans by risk category.

The following tables provide past due information for outstanding commercial loans and include loans on non-accrual.

Consumer

We manage a consistent process for assessing consumer loan credit quality by monitoring our loan grading trends and past due statistics. All loans are subject to individual risk assessment. Our categories include Pass, Special Mention, Substandard, and Doubtful, each of which are defined by banking regulatory agencies. Delinquency statistics is also an important indicator of credit quality in the establishment of our allowance for credit losses.

The tables below provide a breakdown of outstanding consumer loans by risk category.

The following tables provide past due information for outstanding consumer loans and include loans on non-accrual.

Nonperforming assets

The following table shows the nonperforming assets and the related percentage of nonperforming assets to total assets and gross loans. Generally, a loan is placed on nonaccrual status when it becomes 90 days past due as to principal or interest, or when we believe, after considering economic and business conditions and collection efforts, that the borrower's financial condition is such that collection of the contractual interest on the loan is doubtful. A payment of interest on a loan that is classified as nonaccrual is recognized as a reduction in principal when received.

(1)Loans over 90 days are included in nonaccrual loans

Impaired Loans

The tables below summarize key information for impaired loans. Our impaired loans include loans on nonaccrual status and loans modified in a TDR, whether on accrual or nonaccrual status. These impaired loans may have estimated impairment which is included in the allowance for loan losses.

The following tables disaggregate our allowance for loan losses and recorded investment in loans by impairment methodology.

Allowance for Loan Losses

The allowance for loan losses is management's estimate of credit losses inherent in the loan portfolio at the balance sheet date. We have an established process to determine the adequacy of the allowance for loan losses that assesses the losses inherent in our portfolio. While we attribute portions of the allowance to specific portfolio segments, the entire allowance is available to absorb credit losses inherent in the total loan portfolio. Our process involves procedures to appropriately consider the unique risk characteristics of our commercial and consumer loan portfolio segments. For each portfolio segment, impairment is measured collectively for groups of smaller loans with similar characteristics and individually for larger impaired loans. Our allowance levels are influenced by loan volumes, loan grade migration or delinquency status, historic loss experience and other economic conditions. As of June 30, 2011, we have modified our allowance methodology related to the commercial and consumer loan portfolios to use historical loss rates in determining the appropriate level of allowance needed. In addition, we have allocated the unallocated component of the allowance that existed at December 31, 2010 into the commercial and consumer portfolio segments.

Included in the allowance for loan losses for both portfolio segments is a component that reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio. Uncertainties and subjective issues such as changes in the lending policies and procedures, changes in the local/national economy, changes in volume or type of credits, changes in volume/severity or problem loans, quality of loan review and board of director oversight, concentrations of credit, and peer group comparisons are factors considered.

The following table summarizes the activity related to our allowance for loan losses:

The following tables summarize the activity in the allowance for loan losses by our commercial and consumer portfolio segments.

NOTE 4 - Fair Value Accounting

FASB ASC 820, "Fair Value Measurement and Disclosures," 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. FASB ASC 820 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:

Following is a description of valuation methodologies used for assets recorded at fair value.

Investment Securities

Securities available for sale are valued on a recurring basis at quoted market prices where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable securities. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange or U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities and debentures issued by government sponsored entities, municipal bonds and corporate debt securities. In certain cases where there is limited activity or less transparency around inputs to valuations, securities are classified as Level 3 within the valuation hierarchy. Securities held to maturity are valued at quoted market prices or dealer quotes similar to securities available for sale. The carrying value of Other Investments, such as Federal Reserve Bank and Federal Home Loan Bank ("FHLB") stock, approximates fair value based on their redemption provisions.

Loans

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan may be considered impaired and an allowance for loan losses may be established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures the impairment in accordance with FASB ASC 310, "Receivables." The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At June 30, 2011, substantially all of the impaired loans were evaluated based on the fair value of the collateral. In accordance with FASB ASC 820, "Fair Value Measurement and Disclosures," impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company considers the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company considers the impaired loan as nonrecurring Level 3.

Other Real Estate Owned ("OREO")

OREO, consisting of properties obtained through foreclosure or in satisfaction of loans, is reported at the lower of cost or fair value, determined on the basis of current appraisals, comparable sales, and other estimates of value obtained principally from independent sources, adjusted for estimated selling costs (Level 2). At the time of foreclosure, any excess of the loan balance over the fair value of the real estate held as collateral is treated as a charge against the allowance for loan losses. Gains or losses on sale and generally any subsequent adjustments to the value are recorded as a component of real estate owned activity.

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

The tables below present the recorded amount of assets and liabilities measured at fair value on a recurring basis.

The Company has no liabilities carried at fair value or measured at fair value on a recurring or nonrecurring basis.

The table below presents a reconciliation for the period of January 1, 2011 to June 30, 2011 for all Level 3 assets that are measured at fair value on a recurring basis.

Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis

The Company is predominantly an asset based lender with real estate serving as collateral on approximately 80.0% of loans as June 30, 2011. Loans which are deemed to be impaired are valued net of the allowance for loan losses and real estate acquired in settlement of loans are valued at the lower of cost or net realizable value of the underlying real estate collateral. Such market values are generally obtained using independent appraisals, which the Company considers to be level 2 inputs. The tables below present the recorded amount of assets and liabilities measured at fair value on a nonrecurring basis.

Fair Value of Financial Instruments

Financial instruments require disclosure of fair value information, whether or not recognized in the consolidated balance sheets, when it is practical to estimate the fair value. A financial instrument is defined as cash, evidence of an ownership interest in an entity or a contractual obligation which requires the exchange of cash. Certain items are specifically excluded from the disclosure requirements, including the Company's common stock, premises and equipment and other assets and liabilities.

The following is a description of valuation methodologies used to estimate fair value for certain other financial instruments.

Fair value approximates carrying value for the following financial instruments due to the short-term nature of the instrument: cash and due from banks, federal funds sold, federal funds purchased, and securities sold under agreement to repurchase.

Bank Owned Life Insurance - The cash surrender value of bank owned life insurance policies held by the Bank approximates fair values of the policies.

Deposit Liabilities - Fair value for demand deposit accounts and interest-bearing accounts with no fixed maturity date is equal to the carrying value. The fair value of certificate of deposit accounts are estimated by discounting cash flows from expected maturities using current interest rates on similar instruments.

FHLB Advances and Other Borrowings - Fair value for FHLB advances and other borrowings are estimated by discounting cash flows from expected maturities using current interest rates on similar instruments.

Junior subordinated debentures - Fair value for junior subordinated debentures are estimated by discounting cash flows from expected maturities using current interest rates on similar instruments.

The Company has used management's best estimate of fair value based on the above assumptions. Thus, the fair values presented may not be the amounts that could be realized in an immediate sale or settlement of the instrument. In addition, any income taxes or other expenses, which would be incurred in an actual sale or settlement, are not taken into consideration in the fair value presented.

The estimated fair values of the Company's financial instruments at June 30, 2011 and December 31, 2010 are as follows:

NOTE 5 - Preferred Stock Issuance

On February 27, 2009, as part of the Treasury Department's Capital Purchase Program ("CPP"), the Company entered into a Letter Agreement and a Securities Purchase Agreement (collectively, the "CPP Purchase Agreement") with the Treasury Department, pursuant to which the Company sold 17,299 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series T (the "Series T Preferred Stock") and a warrant (the "CPP Warrant") to purchase 363,609.4 shares of the Company's common stock for an aggregate purchase price of $17.3 million in cash. The Series T Preferred Stock qualifies as Tier 1 capital and is entitled to cumulative dividends at a rate of 5% per annum for the first five years, and 9% per annum thereafter. The Company must consult with the OCC before it may redeem the Series T Preferred Stock but, contrary to the original restrictions in the Emergency Economic Stabilization Act of 2008 (the "EESA"), will not necessarily be required to raise additional equity capital in order to redeem this stock. The CPP Warrant has a 10-year term and is immediately exercisable upon its issuance, with an exercise price, subject to anti-dilution adjustments equal to $7.136 per share of the common stock. The fair value allocation of the $17.3 million between the shares of Series T Preferred Stock and the CPP Warrant resulted in $15.9 million allocated to the shares of Series T Preferred Stock and $1.4 million allocated to the CPP Warrant.

NOTE 6 - Earnings Per Common Share and Stock Dividend

On January 18, 2011, the company's Board of Directors approved a ten percent stock dividend to the company's shareholders. The record date for shareholders entitled to receive the stock dividend was January 28, 2011 and the distribution date was February 14, 2011. Certain amounts in our Consolidated Balance Sheets, including common shares outstanding, have been adjusted for the prior period to reflect the stock dividend. In addition, earnings per share and average shares outstanding in our Consolidated Statements of Income have also been adjusted for the prior period to reflect the stock dividend.

The following schedule reconciles the numerators and denominators of the basic and diluted earnings per share computations for the three and six month periods ended June 30, 2011 and 2010. Dilutive common shares arise from the potentially dilutive effect of the Company's stock options and warrants that are outstanding. The assumed conversion of stock options and warrants can create a difference between basic and dilutive net income per common share. At June 30, 2011 and 2010, 79,970 and 96,360 options, respectively, were anti-dilutive in the calculation of earnings per share as their exercise price exceeded the fair market value.

(1)Preferred stock discount required to be accreted over estimated life of warrant issued in conjunction with preferred stock.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following discussion reviews our results of operations for the three and six month periods ended June 30, 2011 as compared to the three and six month periods ended June 30, 2010 and assesses our financial condition as of June 30, 2011 as compared to December 31, 2010. You should read the following discussion and analysis in conjunction with the accompanying consolidated financial statements and the related notes and the consolidated financial statements and the related notes for the year ended December 31, 2010 included in our Annual Report on Form 10-K for that period. Results for the three and six month periods ended June 30, 2011 are not necessarily indicative of the results for the year ending December 31, 2011 or any future period.

Discussion of forward-looking statements

This report, including information included or incorporated by reference in this document, contains statements which constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may relate to our financial condition, results of operation, plans, objectives, or future performance. These statements are based on many assumptions and estimates and are not guarantees of future performance. Our actual results may differ materially from those anticipated in any forward-looking statements, as they will depend on many factors about which we are unsure, including many factors which are beyond our control. The words "may," "would," "could," "should," "will," "expect," "anticipate," "predict," "project," "potential," "believe," "continue," "assume," "intend," "plan," and "estimate," as well as similar expressions, are meant to identify such forward-looking statements. Potential risks and uncertainties that could cause our actual results to differ from those anticipated in any forward-looking statements include, but are not limited to, those described under Item 1A- Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2010, as well as the following:

All forward-looking statements in this report are based on information available to us as of the date of this report. Although we believe that the expectations reflected in our forward-looking statements are reasonable, we cannot guarantee you that these expectations will be achieved. We undertake no obligation to publicly update or otherwise revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

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

Overview

We were incorporated in March 1999 to organize and serve as the holding company for Greenville First Bank, N.A. On July 2, 2007, we changed the name of our company and bank to Southern First Bancshares, Inc. and Southern First Bank, N.A., respectively. Since we opened our bank in January 2000, we have experienced growth in total assets, loans, deposits, and shareholders' equity.

Our business model continues to be client-focused, utilizing relationship teams to provide our clients with a specific banker contact and support team responsible for all of their banking needs. The purpose of this structure is to provide a consistent and superior level of professional service, and we believe it provides us with a distinct competitive advantage. We consider exceptional client service to be a critical part of our culture, which we refer to as "ClientFIRST."

Like most community banks, we derive the majority of our income from interest received on our loans and investments. Our primary source of funds for making these loans and investments is our deposits, on which we pay interest. Consequently, one of the key measures of our success is our amount of net interest income, or the difference between the income on our interest-earning assets, such as loans and investments, and the expense on our interest-bearing liabilities, such as deposits and borrowings. Another key measure is the spread between the yield we earn on these interest-earning assets and the rate we pay on our interest-bearing liabilities, which is called our net interest spread.

There are risks inherent in all loans, so we maintain an allowance for loan losses to absorb probable losses on existing loans that may become uncollectible. We maintain this allowance by charging a provision for loan losses against our operating earnings for each period. We have included a detailed discussion of this process, as well as several tables describing our allowance for loan losses.

In addition to earning interest on our loans and investments, we earn income through fees and other charges to our clients. We have also included a discussion of the various components of this noninterest income, as well as of our noninterest expense.

Economic conditions, competition, and the monetary and fiscal policies of the Federal government significantly affect most financial institutions, including the Bank. Lending and deposit activities and fee income generation are influenced by levels of business spending and investment, consumer income, consumer spending and savings, capital market activities, and competition among financial institutions, as well as customer preferences, interest rate conditions and prevailing market rates on competing products in our market areas.

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

The first six months of 2011 continue to reflect the tumultuous economic conditions which have negatively impacted our clients' liquidity and credit quality. Concerns regarding increased credit losses from the weakening economy have negatively affected capital and earnings of most financial institutions, including our Bank. Financial institutions have experienced significant declines in the value of collateral for real estate loans and heightened credit losses, which have resulted in record levels of non-performing assets, charge-offs and foreclosures.

Liquidity in the debt markets remains low in spite of efforts by the U.S. Treasury and the Board of Governors of the Federal Reserve System ("Federal Reserve") to inject capital into financial institutions. The federal funds rate set by the Federal Reserve has remained at 0.25% since December 2008, following a decline from 4.25% to 0.25% during 2008 through a series of seven rate reductions.

The weak economic conditions are expected to continue through the remainder of 2011. Financial institutions likely will continue to experience heightened credit losses and higher levels of non-performing assets, charge-offs and foreclosures. In light of these conditions, financial institutions also face heightened levels of scrutiny from federal and state regulators. These factors negatively influenced, and likely will continue to negatively influence, earning asset yields at a time when the market for deposits is intensely competitive. As a result, financial institutions experienced, and are expected to continue to experience, pressure on credit costs, loan yields, deposit and other borrowing costs, liquidity, and capital.

Earnings Review

Our net income was $628,000 and $94,000 for the three months ended June 30, 2011 and 2010, respectively, an increase of $534,000. After our dividend payment to the U.S. Treasury as preferred shareholder, net income to common shareholders was $306,000, or diluted earnings per share ("EPS") of $0.08, for the second quarter of 2011 as compared to a net loss to common shareholders of $238,000, or diluted EPS of $(0.07) for the same period in 2010. The increase in net income resulted primarily from an increase in net interest income and a decrease in the provision for loan losses, partially offset by a decrease in noninterest income, and an increase in noninterest expense. Our efficiency ratio, excluding gains on sale of investments and real estate owned activity, was 66.8% for the second quarter of 2011 compared to 76.0% for the same period in 2010. The improvement in the efficiency ratio relates primarily to the increase in net interest income and noninterest income, excluding the gain on sale of securities, during the 2011 period.

Our net income for the first six months of 2011 was $1.2 million as compared to $113,000 for the first six months of 2010. Net income to common shareholders was $514,000, or diluted EPS of $0.14, for the six months ended June 30, 2011, while we incurred a net loss to common shareholders of $560,000, or diluted EPS of $(0.16), during the six months ended June 30, 2010.

Net Interest Income and Margin

Our level of net interest income is determined by the level of earning assets and the management of our net interest margin. For the three month period ended June 20, 2011, our net interest income was $5.8 million, an 18.5% increase over net interest income of $4.9 million for the same period in 2010. In comparison, our average earning assets increased $9.7 million during the second quarter of 2011 compared to the second quarter of 2010, while our interest bearing liabilities decreased by $1.1 million during the same period. The increase in average earning assets is primarily related to an increase in federal funds sold while the decrease in average interest-bearing liabilities is a result of an $11.7 million decrease in notes payable and other borrowings, partially offset by a $10.6 million increase in interest bearing deposits.

We have included a number of tables to assist in our description of various measures of our financial performance. For example, the "Average Balances, Income and Expenses, Yields and Rates" table reflects the average balance of each category of our assets and liabilities as well as the yield we earned or the rate we paid with respect to each category during the three and six month periods ended June 30, 2011 and 2010. A review of this table shows that our loans typically provide higher interest yields than do other types of interest-earning assets, which is why we direct a substantial percentage of our earning assets into our loan portfolio. Similarly, the "Rate/Volume Analysis" table demonstrates the effect of changing interest rates and changing volume of assets and liabilities on our financial condition during the periods shown. We also track the sensitivity of our various categories of assets and liabilities to changes in interest rates, and we have included tables to illustrate our interest rate sensitivity with respect to interest-earning accounts and interest-bearing accounts. Finally, we have included various tables that provide detail about our investment securities, our loans, our deposits, and other borrowings.

The following table sets forth information related to our average balance sheets, average yields on assets, and average costs of liabilities. We derived these yields by dividing income or expense by the average balance of the corresponding assets or liabilities. We derived average balances from the daily balances throughout the periods indicated. During the same periods, we had no securities purchased with agreements to resell. All investments owned have an original maturity of over one year. Nonaccrual loans are included in the following tables. Loan yields have been reduced to reflect the negative impact on our earnings of loans on nonaccrual status. The net of capitalized loan costs and fees are amortized into interest income on loans.

Average Balances, Income and Expenses, Yields and Rates

(1)Annualized for the three month period.

(2)The tax-equivalent adjustment to net interest income adjusts the yield for assets earning tax-exempt income to a comparable yield on a taxable basis.

Our net interest margin, on a tax-equivalent basis, was 3.28% for the three months ended June 30, 2011 compared to 3.18% for the first quarter of 2011 and 2.79% for the second quarter of 2010. The 49 basis point increase in net interest margin during the second quarter of 2011 was driven primarily by a 60 basis point reduction in the cost of our interest bearing liabilities compared to the same period in 2010.

Despite the $9.7 million increase in interest-earning assets during the second quarter of 2011, our interest income decreased by $27,000 or nine basis points. The decline in yield on our interest earning assets was driven primarily by the increased levels of federal funds sold which yielded interest at only 24 basis points, combined with lower balances in our taxable and nontaxable investment securities. In addition, the yield on our investment securities decreased during the three months ended June 30, 2011 compared to the same period in 2010 as a result of the investment transactions we initiated during 2010 when we determined to utilize the gains in our investment portfolio. The securities we purchased yielded lower rates than the investment securities we sold. During the second quarter of 2011, our loan balances declined by $2.0 million as compared to the same period in 2010 and our loan yield increased by 18 basis points. The increase in loan yield was primarily driven by one loan relationship that was returned to accrual status and resulted in approximately $170,000 of additional interest income during the second quarter of 2011.

Our interest expense also decreased during the second quarter of 2011 as compared to the second quarter of 2010 due to lower rates on our interest-bearing liabilities. While our average interest-bearing liabilities decreased by $1.1 million during the second quarter of 2011, compared to the same period in 2010, the rate on these liabilities decreased by 60 basis points. In effect, our interest-bearing liabilities continue to reprice downward at a faster rate than our interest-earning assets. However, as of June 30, 2011, substantially all of our FHLB advances were at fixed interest rates, while all of our other borrowings, including notes payable and junior subordinated debt, had variable interest rates.

Our net interest spread was 3.06% for the three months ended June 30, 2011 compared to 2.55% for the same period in 2010. The net interest spread is the difference between the yield we earn on our interest-earning assets and the rate we pay on our interest-bearing liabilities. The 60 basis point reduction in rate on our interest-bearing liabilities, partially offset by a 9 basis point decline in yield on our earning assets, resulted in a 51 basis point increase in our net interest spread for the 2011 period.

(1)Annualized for the six month period.

(2)The tax-equivalent adjustment to net interest income adjusts the yield for assets earning tax-exempt income to a comparable yield on a taxable basis.

Our tax-equivalent net interest margin increased to 3.23% for the six months ended June 30, 2011 from 2.81% for the six months ended June 30, 2010 and 2.91% for the year ended December 31, 2010. The 42 basis point increase in net interest margin for the 2011 period was driven primarily by the 57 basis point decrease in the cost of our interest-bearing liabilities.

Our interest income declined by $252,000 despite higher levels of interest-earning assets during the first six months of 2011 due primarily to higher federal funds sold balances which yield interest at only 23 basis points compared to our higher earning investment and loan balances. Offsetting the decline in interest income was a $1.8 million decrease in interest expense, which resulted in an increase of $1.5 million in net interest income during the first six months of 2011. While our average interest-bearing deposits balance increased $14.5 million during the six months ended June 30, 2011, the cost of the deposits decreased by 49 basis points, reducing overall interest expense by $1.1 million for the six month period compared to the prior year. In addition, an $18.1 million reduction in the average balances and 62 basis point decline" in the cost of our note payable and other borrowings resulted in an additional $771,000 decrease in interest expense.

Our net interest spread for the six months ended June 30, 2011 and 2010 was 3.01% and 2.57%, respectively. The net interest spread measures the difference in the yield on our interest-earning assets and cost of our interest-bearing deposits. The 44 basis point increase in spread during the 2011 period resulted from our interest-bearing deposits and other liabilities repricing downward faster than our interest-earning assets.

Rate/Volume Analysis

Net interest income can be analyzed in terms of the impact of changing interest rates and changing volume. The following table sets forth the effect which the varying levels of interest-earning assets and interest-bearing liabilities and the applicable rates have had on changes in net interest income for the periods presented.

Net interest income, the largest component of our income, was $5.8 million for the three month period ended June 30, 2011 and $4.9 million for the three months ended June 30, 2010. Average interest-earning assets increased by $9.7 million during the second quarter of 2011 compared to the same period in 2010 while average interest-bearing liabilities decreased $1.1 million. While our average interest-earning assets increased by $10.8 million more than our interest-bearing liabilities during the 2011 period, the primary driver of the increase in net interest income was the decrease in rates on our interest-bearing liabilities which effectively reduced interest expense by $913,000 for the three months ended June 30, 2011.

Net interest income was $11.2 million and $9.7 million, respectively, for the six months ended June 30, 2011 and 2010. Average interest-earning assets increased by $8.3 million during the first six months of 2011 compared to the same period in 2010 while average interest-bearing liabilities decreased $3.6 million. While our average interest-earning assets increased by more than our interest-bearing liabilities, the 57 basis point reduction in the cost of our liabilities resulted in decreased interest expense of $2.0 million during the first six months of 2011 and was the primary driver of the increase in net interest income.

Provision for Loan Losses

We have established an allowance for loan losses through a provision for loan losses charged as an expense on our consolidated statements of income. We review our loan portfolio periodically to evaluate our outstanding loans and to measure both the performance of the portfolio and the adequacy of the allowance for loan losses. Please see the discussion below under "Balance Sheet Review - Allowance for Loan Losses" for a description of the factors we consider in determining the amount of the provision we expense each period to maintain this allowance.

For the three months ended June 30, 2011 and 2010, we incurred a noncash expense related to the provision for loan losses of $650,000 and $2.3 million, respectively, resulting in an allowance for loan losses of $8.7 million and $8.4 million, respectively, for the 2011 and 2010 periods. The $8.7 million allowance represented 1.51% of gross loans at June 30, 2011 while the $8.4 million allowance was 1.44% of gross loans at June 30, 2010. During the three months ended June 30, 2011, we charged-off $385,000 of loans and recorded $66,000 of recoveries on loans previously charged-off, for net charge-offs of $319,000, or 0.22% of average loans. Comparatively, we charged-off $2.0 million of loans and recorded $121,000 of recoveries on loans previously charged-off, resulting in net charge-offs of $1.9 million, or 1.30% of average loans for the second quarter of 2010.

Our provision for loan losses for the first six months of 2011 was $1.4 million compared to $3.7 million for the first six months of 2010. During the first half of 2011, we charged-off $1.1 million of loans and recorded recoveries on loans previously charged-off of $67,000, resulting in net charge-offs of $1.0 million. During the six months ended June 30, 2010 we charged-off $3.2 million of loans and recorded $121,000 of recoveries on loans previously charged-off, resulting in net charge0offs of $3.1 million. The $1.0 million and $3.1 million net charge-offs during the six months ended June 30, 2011 and 2010, respectively, represented 0.36% and 1.08% of average loans for the respective 2011 and 2010 periods. During the first six months of 2011, our loan balances remained relatively stable, the amount of total loans past due declined, and our amount of nonperforming assets declined. These positive factors allowed us to reduce the amount of loan loss provision necessary to maintain our allowance for loan losses at an adequate level.

Noninterest Income

The following table sets forth information related to our noninterest income.

Noninterest income decreased 61.5% in the second quarter of 2011 as compared to the same period in 2010. The decrease in total noninterest income during the 2011 period resulted primarily from the following:

No gain on sale of securities was recognized during the second quarter of 2011, compared to a pre-tax gain on sale of securities of $1.1 million in the second quarter of 2010.

Income from bank owned life insurance decreased by $17,000 as a result of reduced rates of return on the insurance policies due to the current market environment.

We recorded an other-than-temporary impairment of $25,000 on our one private label CMO during the second quarter of 2011, compared to no impairment during the same period of 2010.

Offsetting these decreases in noninterest income were increases related to the following:

Loan fee income increased 70.8%, or $75,000, resulting primarily from increased mortgage origination fee income.

Service fees on deposit accounts increased $15,000, or 10.6%, primarily related to increased income from service charges on our checking, money market, and savings accounts, and additional NSF fee income.

Other income increased by 44.6%, or $54,000, due primarily to rental income received from tenants at our Columbia, South Carolina headquarters building.

Noninterest income decreased by 45.6%, or $984,000, during the six months ended June 30, 2011 as compared to the same period in 2010. The decrease relates primarily to the $1.1 million gain on sale of securities recognized during the 2010 period. Excluding the securities gains in the prior year, noninterest income increased 11.4% during the first six months of 2011 as compared to the first half of 2010.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which was signed into law on July 21, 2010, calls for new limits on interchange transaction fees that banks receive from merchants via card networks like Visa, Inc. and MasterCard, Inc. when a customer uses a debit card. In June 2011, the Federal Reserve approved a final debit card interchange rule in accordance with the Dodd-Frank Act. The final rule caps an issuer's base fee at 21 cents per transaction and allows an additional 5 basis point charge per transaction to help cover fraud losses. Although the rule technically does not apply to institutions with less than $10 billion in assets, such as the Bank, there is concern that the price controls may harm community banks, which could be pressured by the marketplace to lower their own interchange rates. The Federal Reserve also adopted requirements for issuers to include two unaffiliated networks for debit card transactions - one signature-based and one PIN-based. The effective date for the final rules on the pricing and routing restrictions is October 1, 2011. The results of these final rules may significantly impact our interchange income from debit card transactions in the future. We believe this legislation also will ultimately impose significant new costs associated with compliance with new regulations as well as costs that will be passed in connection with increased regulatory oversight. We will continue to monitor the regulations as they are implemented and will review our policies, products and procedures to insure full compliance but also attempt to minimize any negative impact on our operations.

Noninterest expenses

The following table sets forth information related to our noninterest expenses.

Noninterest expense increased $725,000, or 17.6%, during the second quarter of 2011 as compared to the same period in 2010. The increase in total noninterest expense resulted primarily from the following:

Compensation and benefits expense increased 3.9%, or $83,000, relating primarily to annual salary increases and two additional employees.

Real estate owned activity increased $529,000, due primarily to the write-downs and sales costs associated with disposal of four real estate properties.

Data processing and related costs increased 14.4%, or $58,000, primarily related to the increased number of clients and accounts we service.

Insurance expenses increased $22,000, or 5.4% relating to increased FDIC and OCC assessments as a result of our formal agreement with the OCC.

Other noninterest expenses increased 11.7%, or $30,000, primarily related to increased travel, education, office supplies and deposit account losses.

Noninterest expense for the six months ended June 30, 2011 increased 14.8%, or $1.2 million, as compared to the six months ended June 30, 2010. The increase relates primarily to the $1.0 million expense incurred on the disposition of certain other real estate owned properties. Excluding the OREO expense, total noninterest expense increased 2.0% during the first half of 2011 as compared to the same period in 2010. The increase in noninterest expenses year over year relates primarily to increased data processing and related costs as well as insurance expenses.

We incurred income tax expense of $287,000 for the three months ended June 30, 2011 as compared to an income tax benefit of $23,000 during the same period in 2010. Income tax expense for the six months ended June 30, 2011 was $515,000 as compared to a benefit of $99,000 for the same period of 2010. The lower income tax expense for the 2010 period resulted from the lower pre-tax income offset by the effect of our tax exempt income.

Balance Sheet Review

At June 30, 2011, we had total assets of $758.1 million, consisting principally of $569.3 million in net loans, $93.9 million in investments, $52.0 million in cash and cash equivalents, $14.8 million in bank owned life insurance, and $16.1 million in property and equipment. Our liabilities at June 30, 2011 totaled $697.3 million, which consisted principally of $556.4 million in deposits, $122.7 million in FHLB advances and repurchase agreements, and $13.4 million in junior subordinated debentures. At June 30, 2011, our shareholders' equity was $60.8 million.

At December 31, 2010, we had total assets of $736.5 million, consisting principally of $564.0 million in net loans, $72.9 million in investments, $53.9 million in cash and cash equivalents, $14.5 million in bank owned life insurance, and $15.9 million in property and equipment. Our liabilities at December 31, 2010 totaled $677.3 million, consisting principally of $536.3 million in deposits, $122.7 million in FHLB advances and repurchase agreements, and $13.4 million in junior subordinated debentures. At December 31, 2010, our shareholders' equity was $59.2 million.

Federal Funds Sold

At June 30, 2011, our federal funds sold were $32.3 million, or 4.3% of total assets. At December 31, 2010, our $35.6 million in short-term investments in federal funds sold on an overnight basis comprised 4.8% of total assets.

Investment Securities

At June 30, 2011, the $93.9 million in our investment securities portfolio represented approximately 12.4% of our total assets. We held Government sponsored enterprise securities, municipal securities, and mortgage-backed securities with a fair value of $85.0 million and an amortized cost of $85.2 million for an unrealized loss of $169,000. During the second quarter of 2011, we began to re-distribute our excess liquidity from lower yielding federal funds sold into higher earning investment securities. We purchased $26.7 million in government-backed agencies and mortgage-backed securities as well as a variety of state and municipal obligations. We will continue to look for opportunities to invest excess federal funds sold into investment securities over the second half of 2011.

At December 31, 2010, the $72.9 million in our investment securities portfolio represented approximately 9.9% of our total assets. We held Government sponsored enterprise securities, municipal securities, and mortgage-backed securities with a fair value of $63.8 million and an amortized cost of $64.9 million for an unrealized loss of $1.1 million.

Loans

Since loans typically provide higher interest yields than other types of interest earning assets, a substantial percentage of our earning assets are invested in our loan portfolio. Our loan portfolio balance has remained relatively stable over the past twelve months with average balances of $577.8 million and $580.3 million for the six months ended June 30, 2011 and 2010, respectively. During the first six months of 2011, we repurchased approximately $9.0 million of loans that we had participated with other banks. The repurchased loans, combined with routine paydowns resulted in a $7.8 million increase in our owner occupied real estate loans.

The principal component of our loan portfolio is loans secured by real estate mortgages. As of June 30, 2011, our loan portfolio included $462.5 million, or 80.0%, of real estate loans. As of December 31, 2010, real estate loans made up 79.6% of our loan portfolio and totaled $455.4 million. Most of our real estate loans are secured by residential or commercial property. We do not generally originate traditional long term residential mortgages, but we do issue traditional second mortgage residential real estate loans and home equity lines of credit. We obtain a security interest in real estate, in addition to any other available collateral. This collateral is taken to increase the likelihood of the ultimate repayment of the loan. Generally, we limit the loan-to-value ratio on loans to coincide with the appropriate regulatory guidelines. We attempt to maintain a relatively diversified loan portfolio to help reduce the risk inherent in concentration in certain types of collateral.

Following is a summary of our loan composition:

Nonperforming assets

Following is a summary of our nonperforming assets.

At June 30, 2011 nonperforming assets were $13.1 million, or 1.73% of total assets and 2.27% of gross loans. Comparatively, nonperforming assets were $15.0 million, or 2.03% of total assets and 2.61% of gross loans at December 31, 2010. Nonaccrual loans increased $875,000 to $10.2 million at June 30, 2011 from $9.3 million at December 31, 2010. The increase in nonaccrual loans is primarily related to 17 loan relationships which were put on nonaccrual status during the six months ended June 30, 2011. In addition, eight loans were returned to accrual status or paid off during the first six months of 2011. The amount of foregone interest income on the nonaccrual loans in the first six months of 2011 was approximately $248,000. The amount of interest income recorded in the first six months of 2011 for loans that were on nonaccrual at June 30, 2011 was approximately $17,000.

Nonperforming assets include real estate acquired in settlement of loans which decreased by $2.7 million from December 31, 2010. During the first six months of 2011 we sold four properties totaling $2.0 million and added one new property for $63,000. In addition, we incurred write-downs totaling $751,000 on four of our properties. The balance at June 30, 2011 includes eight commercial properties totaling $2.9 million all of which are located in Upstate South Carolina. We believe that these properties are appropriately valued at the lower of cost or market as of June 30, 2011. In conjunction with the changes in the current economic environment and as required by our Formal Agreement with the OCC, we have revised and updated our credit risk policy which addresses treatment of other real estate owned.

Allowance for Loan Losses

We have established an allowance for loan losses through a provision for loan losses charged as an expense. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance, either in whole or in part, is confirmed. Subsequent recoveries, if any, are credited to the allowance.

In conjunction with the changes in the current economic environment and as required by our Formal Agreement with the OCC, we have revised and updated our allowance for losses policy. Management regularly evaluates the allowance for loan losses and periodically reviews the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. Periodically, we adjust the amount of the allowance based on changing circumstances.

Following is a summary of the activity in the allowance for loan losses.

The allowance for loan losses was $8.7 million and $8.4 million at June 30, 2011 and 2010, respectively, or 1.51% and 1.44% of outstanding loans, respectively. At December 31, 2010, our allowance for loan losses was $8.4 million, or 1.47% of outstanding loans, and we had net loans charged-off of $5.0 million for the year ended December 31, 2010. During the six months ended June 30, 2011 and 2010, we had net charge-offs of $1.0 and $3.1 million, respectively.

We increased the allowance for loan losses during the first six months of 2011 based on the loans evaluated for specific reserves in our commercial portfolio. As of June 30, 2011, $11.4 million of loans were evaluated for specific reserves compared to $8.1 million at December 31, 2010. Based on these evaluations, the allowance for loan losses includes specific reserves of $3.0 million and $1.6 million, at June 30, 2011 and December 31, 2010, respectively.

In addition, at June 30, 2011 and 2010, the allowance for loan losses represented 85.47% and 67.62% of the total amount of non-performing loans. A significant portion, or 63.5%, of nonperforming loans at June 30, 2011 is secured by real estate. Our nonperforming loans have been written down to approximately 76% of their original nonperforming balance. We have evaluated the underlying collateral on these loans and believe that the collateral on these loans is sufficient to minimize future losses. As a result of this level of coverage on non-performing loans, we believe the provision for loan losses of $1.4 million for the six months ended June 30, 2011 to be adequate.

For loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan are lower than the carrying value of that loan. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include, among other factors, payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including, without limitation, the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

A significant portion of the loans in our loan portfolio have been originated in the past five years. In general, loans do not begin to show signs of credit deterioration or default until they have been outstanding for some period of time, a process known as seasoning. The benefit of having time for loans to "season," is that it allows a company to evaluate how loans perform during different economic cycles. We believe that the recent prolonged recession has allowed us to evaluate the performance of our loan portfolio during "stressful" times. If delinquencies and defaults increase, we may be required to increase our provision for loan losses, which would adversely affect our results of operations and financial condition.

As a general practice, most of our loans are originated with relatively short maturities of five years or less. As a result, when a loan reaches its maturity we frequently renew the loan and thus extend its maturity using the same credit standards as those used when the loan was first originated. Due to these loan practices, we may, at times, renew loans which are classified as nonperforming after evaluating the loan's collateral value and financial strength of its guarantors. Nonperforming loans are renewed at terms generally consistent with the ultimate source of repayment and rarely at reduced rates. In these cases the Bank will seek additional credit enhancements, such as additional collateral or additional guarantees to further protect the loan. When a loan is no longer performing in accordance with its stated terms, the Bank will typically seek performance under the guarantee.

In addition, at June 30, 2011, approximately 80% of our loans are collateralized by real estate and approximately 90% of our impaired loans are secured by real estate. The Bank utilizes third party appraisers to determine the fair value of collateral dependent loans. Our current loan and appraisal policies require the Bank to obtain updated appraisals on an annual basis, either through a new external appraisal or an appraisal evaluation. Impaired loans are individually reviewed on a quarterly basis to determine the level of impairment. As of June 30, 2011, we do not have any impaired real estate loans carried at a value in excess of the appraised value. We typically charge-off a portion or create a specific reserve for impaired loans when we do not expect repayment to occur as agreed upon under the original terms of the loan agreement.

The Company's loan approval process includes review of modifications on all criticized loans greater than $100,000. A loan is considered to be a TDR when the debtor was experiencing financial difficulties and the Company provided concessions such that we will not collect all principal and interest in accordance with the original terms of the loan agreement. We determined that we had 15 loans totaling $6.5 million at June 30, 2011 and two loans totaling $488,000 at December 31, 2010, which we considered as TDRs. The related allowance for these loans was $1.6 million and $282,000 at June 30, 2011 and December 31, 2010, respectively. Included in the nonaccrual loan amounts in the table above is $2.8 million and $488,000 for the respective 2011 and 2010 periods.

For commercial loans, we generally fully charge off or charge collateralized loans down to net realizable value when management determines the loan to be uncollectible; repayment is deemed to be protracted beyond reasonable time frames; the loan has been classified as a loss by either our internal loan review process or our banking regulatory agencies; the customer has filed bankruptcy and the loss becomes evident owing to a lack of assets; or the loan is 120 days past due unless both well-secured and in the process of collection. For consumer loans, we generally charge down to net realizable value when the loan is 180 days past due.

Deposits and Other Interest-Bearing Liabilities

Our primary source of funds for loans and investments is our deposits, advances from the FHLB, and structured repurchase agreements. We have chosen to obtain a portion of our certificates of deposits from areas outside of our market, which are also know as out-of-market deposits or brokered deposits. The deposits obtained outside of our market area generally have lower rates than rates being offered for certificates of deposits in our local market. We also utilize out-of-market deposits in certain instances to obtain longer term deposits than are readily available in our local market. We generally obtain out-of-market time deposits of $100,000 or more through brokers with whom we maintain ongoing relationships. In accordance with our Formal Agreement, we have adopted guidelines regarding our use of brokered CDs that limit our brokered CDs to 25% of total deposits and dictate that our current interest rate risk profile determines the terms. In addition, we do not obtain time deposits of $100,000 or more through the Internet. These guidelines allow us to take advantage of the attractive terms that wholesale funding can offer while mitigating the inherent related risk.

The amount of out-of-market deposits was $51.3 million at June 30, 2011 and $86.4 million at December 31, 2010. As our wholesale deposits have matured during the past 12 months, we have successfully replaced them with local deposits. While wholesale deposits decreased $35.1 million during the first six months of 2011, our retail deposits have increased $55.2 million. We anticipate being able to continue to either renew or replace these out-of-market deposits when they mature, although we may not be able to replace them with deposits with the same terms or rates. Our loan-to-deposit ratio was 104% and 107% at June 30, 2011 and December 31, 2010, respectively.

The following table shows the average balance amounts and the average rates paid on deposits held by us.

The $87.3 million increase in average transaction accounts and the $55.6 million decrease in time deposits of $100,000 or more for the six months ended June 30, 2011 compared to the 2010 period is a result of our intense focus to replace our out-of-market deposits with local deposits.

Core deposits, which exclude out-of-market deposits and time deposits of $100,000 or more, provide a relatively stable funding source for our loan portfolio and other earning assets. Our core deposits were $394.2 million and $356.6 million at June 30, 2011 and December 31, 2010, respectively.

All of our time deposits are certificates of deposits. The maturity distribution of our time deposits of $100,000 or more at June 30, 2011 was as follows:

The Dodd-Frank Act also permanently raises the current standard maximum deposit insurance amount to $250,000. The standard maximum insurance amount of $100,000 had been temporarily raised to $250,000 until December 31, 2013. The FDIC insurance coverage limit applies per depositor, per insured depository institution for each account ownership category.

Capital Resources

Total shareholders' equity at June 30, 2011 was $60.8 million. At December 31, 2010, total shareholders' equity was $59.2 million. The $1.5 million increase from December 31, 2010 is primarily related to net income of $1.2 million during the six month period ended June 30, 2011.

On February 27, 2009, as part of the CPP, the Company entered into the CPP Purchase Agreement with the Treasury, pursuant to which we sold 17,299 shares of our Series T Preferred Stock and the CPP Warrant to purchase 363,609.4 shares of our common stock (adjusted for the stock dividend in 2011) for an aggregate purchase price of $17.3 million in cash. The Series T Preferred Stock is entitled to cumulative dividends at a rate of 5% per annum for the first five years, and 9% per annum thereafter. The CPP Warrant has a 10-year term and is immediately exercisable upon its issuance, with an exercise price, subject to anti-dilution adjustments equal to $7.136 per share of the common stock (adjusted for the stock dividend in 2011).

Under the capital adequacy guidelines, regulatory capital is classified into two tiers. These guidelines require an institution to maintain a certain level of Tier 1 and Tier 2 capital to risk-weighted assets. Tier 1 capital consists of common shareholders' equity, excluding the unrealized gain or loss on securities available for sale, minus certain intangible assets. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight factor of 0% to 100% based on the risks believed to be inherent in the type of asset. Tier 2 capital consists of Tier 1 capital plus the general reserve for loan losses, subject to certain limitations. We are also required to maintain capital at a minimum level based on total average assets, which is known as the Tier 1 leverage ratio.

At both the holding company and bank level, we are subject to various regulatory capital requirements administered by the federal banking agencies. To be considered "well-capitalized," we must maintain total risk-based capital of at least 10%, Tier 1 capital of at least 6%, and a leverage ratio of at least 5%. To be considered "adequately capitalized" under these capital guidelines, we must maintain a minimum total risk-based capital of 8%, with at least 4% being Tier 1 capital. In addition, we must maintain a minimum Tier 1 leverage ratio of at least 4%.

In addition, we have agreed with the OCC that the Bank will maintain total risk-based capital of at least 12%, Tier 1 capital of at least 10%, and a leverage ratio of at least 9%. As of June 30, 2011, our capital ratios exceed these ratios and we remain "well capitalized." However, if we fail to maintain these required capital levels, then the OCC may deem noncompliance to be an unsafe and unsound banking practice which may make the Bank subject to an additional capital directive, consent order, or such other administrative action or sanction as the OCC considers necessary. It is uncertain what actions, if any, the OCC would take with respect to noncompliance with these ratios, what action steps the OCC might require the Bank to take to remedy this situation, and whether such actions would be successful.

The following table summarizes the capital amounts and ratios of the Bank and the regulatory minimum requirements.

The following table summarizes the capital amounts and ratios of the Company and the minimum regulatory requirements.

The ability of the Company to pay cash dividends is dependent upon receiving cash in the form of dividends from the Bank. The dividends that may be paid by the Bank to the Company are subject to legal limitations and regulatory capital requirements. The approval of the OCC is required if the total of all dividends declared by a national bank in any calendar year exceeds the total of its net profits for that year combined with its retained net profits for the preceding two years, less any required transfers to surplus. Further, the Company cannot pay cash dividends on its common stock during any calendar quarter unless full dividends on the Series T preferred stock for the dividend period ending during the calendar quarter have been declared and the Company has not failed to pay a dividend in the full amount of the Series T preferred stock with respect to the period in which such dividend payment in respect of its common stock would occur. In addition, the Company must currently obtain preapproval of the Federal Reserve before paying dividends.

The following table shows the return on average assets (net income divided by average total assets), return on average equity (net income divided by average equity), and equity to assets ratio (average equity divided by average assets) annualized for the six months ended June 30, 2011 and the year ended December 31, 2010. Since our inception, we have not paid cash dividends.

Our return on average assets was 0.31% for the six months ended June 30, 2011 compared to 0.12% for the year ended December 31, 2010. In addition, our return on average equity increased to 3.89% for the six months ended June 30, 2011 from 1.47% for the year ended December 31, 2010. Our equity to assets ratio at June 30, 2011 was 8.08% compared to 8.16% at December 31, 2010. In addition, our return on average common equity was 2.27% and our tangible common equity to total assets ratio was 6.07% for the six months ended June 30, 2011.

Effect of Inflation and Changing Prices

The effect of relative purchasing power over time due to inflation has not been taken into account in our consolidated financial statements. Rather, our financial statements have been prepared on an historical cost basis in accordance with generally accepted accounting principles.

Unlike most industrial companies, our assets and liabilities are primarily monetary in nature. Therefore, the effect of changes in interest rates will have a more significant impact on our performance than will the effect of changing prices and inflation in general. In addition, interest rates may generally increase as the rate of inflation increases, although not necessarily in the same magnitude. As discussed previously, we seek to manage the relationships between interest sensitive assets and liabilities in order to protect against wide rate fluctuations, including those resulting from inflation.

Off-Balance Sheet Risk

Commitments to extend credit are agreements to lend money to a client as long as the client has not violated any material condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of a fee. At June 30, 2011, unfunded commitments to extend credit were $89.6 million, of which $8.8 million was at fixed rates and $80.8 million was at variable rates. At December 31, 2010, unfunded commitments to extend credit were $86.4 million, of which approximately $9.5 million was at fixed rates and $76.9 million was at variable rates. A significant portion of the unfunded commitments related to consumer equity lines of credit. Based on historical experience, we anticipate that a significant portion of these lines of credit will not be funded. We evaluate each client's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by us upon extension of credit, is based on our credit evaluation of the borrower. The type of collateral varies but may include accounts receivable, inventory, property, plant and equipment, and commercial and residential real estate.

At June 30, 2011 there was a $2.7 million commitment under letters of credit. At December 31, 2010 there was a $2.8 million commitment under letters of credit. The credit risk and collateral involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Since most of the letters of credit are expected to expire without being drawn upon, they do not necessarily represent future cash requirements.

Except as disclosed in this document, we are not involved in off-balance sheet contractual relationships, unconsolidated related entities that have off-balance sheet arrangements or transactions that could result in liquidity needs or other commitments that significantly impact earnings.

Market Risk and Interest Rate Sensitivity

Market risk is the risk of loss from adverse changes in market prices and rates, which principally arises from interest rate risk inherent in our lending, investing, deposit gathering, and borrowing activities. Other types of market risks, such as foreign currency exchange rate risk and commodity price risk, do not generally arise in the normal course of our business.

We actively monitor and manage our interest rate risk exposure in order to control the mix and maturities of our assets and liabilities utilizing a process we call asset/liability management. The essential purposes of asset/liability management are to ensure adequate liquidity and to maintain an appropriate balance between interest sensitive assets and liabilities in order to minimize potentially adverse impacts on earnings from changes in market interest rates. Our asset/liability management committee ("ALCO") monitors and considers methods of managing exposure to interest rate risk. We have both an internal ALCO consisting of senior management that meets at various times during each month and a board ALCO that meets monthly. The ALCOs are responsible for maintaining the level of interest rate sensitivity of our interest sensitive assets and liabilities within board-approved limits.

Our interest rate risk exposure is managed by measuring our interest sensitivity "gap," which is the positive or negative dollar difference between assets and liabilities that are subject to interest rate repricing within a given period of time. Interest rate sensitivity can be managed by repricing assets or liabilities, selling securities available for sale, replacing an asset or liability at maturity, or adjusting the interest rate during the life of an asset or liability. Managing the amount of assets and liabilities repricing in this same time interval helps to hedge the risk and minimize the impact on net interest income of rising or falling interest rates. We generally would benefit from increasing market rates of interest when we have an asset-sensitive gap position and generally would benefit from decreasing market rates of interest when we are liability-sensitive.

The following tables set forth information regarding our rate sensitivity for each of the time intervals indicated.

As measured over the one-year time intervals, we were liability sensitive at both June 30, 2011 and December 31, 2010. Our variable rate loans and a majority of our deposits reprice over a 12-month period. Approximately 48% and 50% of our loans were variable rate loans at June 30, 2011 and December 31, 2010, respectively. The ratio of cumulative gap to total earning assets after 12 months is (18.7%) because $131.0 million more liabilities will reprice in a 12 month period than assets. However, our gap analysis is not a precise indicator of our interest sensitivity position. The analysis presents only a static view of the timing of maturities and repricing opportunities, without taking into consideration that changes in interest rates do not affect all assets and liabilities equally. For example, rates paid on a substantial portion of core deposits may change contractually within a relatively short time frame, but those rates are viewed by us as significantly less interest-sensitive than market-based rates such as those paid on noncore deposits. Net interest income may be affected by other significant factors in a given interest rate environment, including changes in the volume and mix of interest-earning assets and interest-bearing liabilities.

At June 30, 2011, 87.7% of our interest-bearing liabilities were either variable rate or had a maturity of less than one year. Of the $387.6 million of interest-bearing liabilities set to reprice within three months, 66.9% are transaction, money market or savings accounts which are already at or near their lowest rates and provide little opportunity for benefit should market rates continue to decline or stay constant. However, certificates of deposit that are currently maturing or renewing are repricing at lower rates. We expect to benefit as these deposits reprice, even if market rates increase slightly. At June 30, 2011, we had $131.0 million more liabilities than assets that reprice within the next twelve months. Included in our other borrowings are a number of FHLB advances and structured repurchase agreements with callable features as of June 30, 2011. We believe that the optionality on many of these borrowings will not be exercised until interest rates increase significantly. In addition, we believe that the interest rates that we pay on the majority of our interest-bearing transaction accounts, would only be impacted by a portion of any change in market rates. This key assumption is utilized in our overall evaluation of our level of interest sensitivity.

Liquidity Risk

Liquidity represents the ability of a company to convert assets into cash or cash equivalents without significant loss, and the ability to raise additional funds by increasing liabilities. Liquidity management involves monitoring our sources and uses of funds in order to meet our day-to-day cash flow requirements while maximizing profits. Liquidity management is made more complicated because different balance sheet components are subject to varying degrees of management control. For example, the timing of maturities of our investment portfolio is fairly predictable and subject to a high degree of control at the time investment decisions are made. However, net deposit inflows and outflows are far less predictable and are not subject to the same degree of control.

At June 30, 2011 and December 31, 2010, our liquid assets, consisting of cash and due from banks and federal funds sold, amounted to $52.0 million and $53.9 million, or 6.9% and 7.3% of total assets, respectively. Our investment securities at June 30, 2011 and December 31, 2010 amounted to $93.9 million and $72.9 million, or 12.4% and 9.9% of total assets, respectively. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. However, a substantial portion of these securities are pledged against outstanding debt. Therefore, the related debt would need to be repaid prior to the securities being sold in order for these securities to be converted to cash.

Our ability to maintain and expand our deposit base and borrowing capabilities serves as our primary source of liquidity. We plan to meet our future cash needs through the liquidation of temporary investments, the generation of deposits, and from additional borrowings. In addition, we will receive cash upon the maturity and sale of loans and the maturity of investment securities. We maintain three federal funds purchased lines of credit with correspondent banks totaling $30.5 million for which there were no borrowings against the lines of credit at June 30, 2011.

We are also a member of the FHLB, from which applications for borrowings can be made. The FHLB requires that securities, qualifying mortgage loans, and stock of the FHLB owned by the bank be pledged to secure any advances from the FHLB. The unused borrowing capacity currently available from the FHLB at June 30, 2011 was $7.2 million, based on the bank's $6.1 million investment in FHLB stock, as well as qualifying mortgages available to secure any future borrowings. However, we are able to pledge additional securities to the FHLB in order to increase our available borrowing capacity.

We have a lease on our main office building with a remaining term of eight years. The lease provides for annual lease rate escalations based on cost of living adjustments.

We believe that our existing stable base of core deposits, borrowings from the FHLB, and short-term repurchase agreements will enable us to successfully meet our long-term liquidity needs.

As a result of the Treasury's CPP, we received $17.3 million of capital on February 27, 2009 in exchange for 17,299 shares of preferred stock. This additional capital should allow us to remain well-capitalized and provide additional liquidity on our balance sheet.

Critical Accounting Policies

We have adopted various accounting policies that govern the application of accounting principles generally accepted in the United States and with general practices within the banking industry in the preparation of our financial statements. Our significant accounting policies are described in the footnotes to our audited consolidated financial statements as of December 31, 2010, as filed in our Annual Report on Form 10-K.

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

Allowance for Loan Losses

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

Real Estate Acquired in Settlement of Loans

Real estate acquired through foreclosure is initially recorded at the lower of cost or estimated fair value. Subsequent to the date of acquisition, it is carried at the lower of cost or fair value, adjusted for net selling costs. Fair values of real estate owned are reviewed regularly and writedowns are recorded when it is determined that the carrying value of real estate exceeds the fair value less estimated costs to sell. Costs relating to the development and improvement of such property are capitalized, whereas those costs relating to holding the property are expensed.

Income Taxes

The financial statements have been prepared on the accrual basis. When income and expenses are recognized in different periods for financial reporting purposes versus for the purposes of computing income taxes currently payable, deferred taxes are provided on such temporary differences. Under ASC 740, "Income Taxes," deferred tax assets and liabilities are recognized for the expected future tax consequences of events that have been recognized in the consolidated financial statements or tax returns. Deferred tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be realized or settled. The Company believes that the income tax filing positions taken or expected to be taken in its tax returns will more likely than not be sustained upon audit by the taxing authorities and does not anticipate any adjustments that would result in a material adverse impact on the Company's financial condition, results of operations, or cash flow. Therefore, no reserves for uncertain income tax positions have been recorded pursuant to ASC 740.

Accounting, Reporting, and Regulatory Matters

Recently Issued Accounting Standards

The following is a summary of recent authoritative pronouncements that affect accounting, reporting, and disclosure of financial information by us:

In July 2010, the Receivables topic of the Accounting Standards Codification ("ASC") was amended by Accounting Standards Update ("ASU") 2010-20 to require expanded disclosures related to a company's allowance for credit losses and the credit quality of its financing receivables. The amendments require the allowance disclosures to be provided on a disaggregated basis. The Company is required to include these disclosures in its interim and annual financial statements. See Note 3.

Disclosures about TDRs required by ASU 2010-20 were deferred by the Financial Accounting Standards Board ("FASB") in ASU 2011-01 issued in January 2011. In April 2011 FASB issued ASU 2011-02 to assist creditors with their determination of when a restructuring is a TDR. The determination is based on whether the restructuring constitutes a concession and whether the debtor is experiencing financial difficulties as both events must be present. Disclosures related to TDRs under ASU 2010-20 will be effective for reporting periods beginning after June 15, 2011.

In April 2011, the criteria used to determine effective control of transferred assets in the Transfers and Servicing topic of the ASC was amended by ASU 2011-03. The requirement for the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms and the collateral maintenance implementation guidance related to that criterion were removed from the assessment of effective control. The other criteria to assess effective control were not changed. The amendments are effective for the Company beginning January 1, 2012 but are not expected to have a material effect on the financial statements.

ASU 2011-04 was issued in May 2011 to amend the Fair Value Measurement topic of the ASC by clarifying the application of existing fair value measurement and disclosure requirements and by changing particular principles or requirements for measuring fair value or for disclosing information about fair value measurements. The amendments will be effective for the Company beginning January 1, 2012 but are not expected to have a material effect on the financial statements.

The Comprehensive Income topic of the ASC was amended in June 2011. The amendment eliminates the option to present other comprehensive income as a part of the statement of changes in stockholders' equity. The amendment requires consecutive presentation of the statement of net income and other comprehensive income and requires an entity to present reclassification adjustments from other comprehensive income to net income on the face of the financial statements. The amendments will be applicable to the Company on January 1, 2012 and will be applied retrospectively.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on the consolidated financial statements upon adoption.

Recent Regulatory Developments

On June 8, 2010, the Bank entered into the Formal Agreement with its primary regulator, the OCC. The Formal Agreement is based on the findings of the OCC during their on-site examination of the Bank as of March 31, 2009. The Formal Agreement seeks to enhance the Bank's existing practices and procedures in the areas of credit risk management, credit underwriting, liquidity, and funds management. Specifically, under the terms of the Formal Agreement, the Bank is required to (i) protect its interest in assets criticized by the OCC; (ii) develop, implement, and adhere to a written program to reduce the high level of credit risk; (iii) obtain credit information on all loans lacking such information and ensure proper collateral documentation is in place; (iv) engage the services of an independent appraiser to provide updated appraisals for certain loans where the most recent appraisal is more than 12 months old; (v) update and implement written policies/programs addressing loan policy, allowance for loan and lease losses, and other real estate owned; (vi) continue to improve its liquidity position and maintain adequate sources of funding; (vii) obtain prior written determination of no supervisory objection from the OCC before accepting, renewing, or rolling over brokered deposits in excess of 25% of total deposits; (viii) update and adhere to its profit plan designed to improve the condition of the Bank; and (ix) submit periodic reports to the OCC regarding various aspects of the foregoing actions.

The Formal Agreement requires the establishment of certain plans and programs within various time periods. After having completed the following through June 30, 2011, management believes that the Bank is in compliance with substantially all of the conditions established in the Formal Agreement. However, no assurance can be given that the OCC will concur with management's assessment. In addition, the Formal Agreement requires that various reports be submitted to the OCC on a quarterly basis until the Formal Agreement is terminated.

The Bank has established a compliance committee of its Board of Directors to oversee management's response to all sections of the Formal Agreement. The committee consists of all 11 members of the Bank's Board of Directors and meets at least monthly to receive written progress reports from management on the results and status of actions needed to achieve full compliance with each article of the Formal Agreement.

Policies and procedures were revised or established and approved relating to the following issues:

Current and satisfactory credit information was obtained on all loans lacking such information to ensure proper collateral documentation is in place.

We received and evaluated current independent appraisals or updated appraisals on loans secured by certain properties.

The Bank's liquidity position was enhanced. We reduced our level of brokered deposits to comply with the OCC agreed upon levels.

A profit plan was updated to improve the financial condition of the Bank.

If the Bank does not satisfy and maintain adherence with each of the requirements listed above, the Bank will not be in compliance with the Formal Agreement. Failure to comply with the Formal Agreement could result in regulators taking additional enforcement actions against the Bank. The Bank's ability to meet the goals set forth in the Formal Agreement is contingent in part upon the stabilization of the local real estate markets and on its financial performance.

In addition, we have agreed with the OCC that the Bank will maintain total risk-based capital ratio of at least 12%, Tier 1 capital of at least 10%, and a leverage ratio of at least 9%. As of June 30, 2011, our capital ratios exceed these ratios and we remain "well capitalized." See "Management's Discussion and Analysis - Results of Operations - Capital Resources" for more discussion of the Minimum Capital Ratio levels established by the OCC and our capital ratios as of June 30, 2011.

Recent Legislative and Regulatory Initiatives to Address Financial and Economic Crises

Markets in the United States and elsewhere have experienced extreme volatility and disruption over the past three plus years. These circumstances have exerted significant downward pressure on prices of equity securities and virtually all other asset classes, and have resulted in substantially increased market volatility, severely constrained credit and capital markets, particularly for financial institutions, and an overall loss of investor confidence. Loan portfolio performances have deteriorated at many institutions resulting from, among other factors, a weak economy and a decline in the value of the collateral supporting their loans. Dramatic slowdowns in the housing industry, due in part to falling home prices and increasing foreclosures and unemployment, have created strains on financial institutions. Many borrowers are now unable to repay their loans, and the collateral securing these loans has, in some cases, declined below the loan balance. In response to the challenges facing the financial services sector, beginning in 2008 a multitude of new regulatory and governmental actions have been announced, including the EESA, approved by Congress and signed by President Bush on October 3, 2008 and the American Recovery and Reinvestment Act on February 17, 2009, among others. Some of the more recent actions include:

On September 27, 2010, the U.S. President signed into law the Small Business Jobs Act of 2010 (the "Act"). The Small Business Lending Fund (the "SBLF"), which was enacted as part of the Act, is a $30 billion fund that encourages lending to small businesses by providing Tier 1 capital to qualified community banks with assets of less than $10 billion. On December 21, 2010, the U.S. Treasury published the application form, term sheet and other guidance for participation in the SBLF. Under the terms of the SBLF, the Treasury will purchase shares of senior preferred stock from banks, bank holding companies, and other financial institutions that will qualify as Tier 1 capital for regulatory purposes and rank senior to a participating institution's common stock. The application deadline for participating in the SBLF is May 16, 2011. Based on the program criteria, we did not participate in the SBLF.

Internationally, both the Basel Committee on Banking Supervision (the "Basel Committee") and the Financial Stability Board (established in April 2009 by the Group of Twenty ("G-20") Finance Ministers and Central Bank Governors to take action to strengthen regulation and supervision of the financial system with greater international consistency, cooperation, and transparency) have committed to raise capital standards and liquidity buffers within the banking system ("Basel III"). On September 12, 2010, the Group of Governors and Heads of Supervision agreed to the calibration and phase-in of the Basel III minimum capital requirements (raising the minimum Tier 1 common equity ratio to 4.5% and minimum Tier 1 equity ratio to 6.0%, with full implementation by January 2015) and introducing a capital conservation buffer of common equity of an additional 2.5% with full implementation by January 2019. The U.S. federal banking agencies support this agreement. In December 2010, the Basel Committee issued the Basel III rules text, outlining the details and time-lines of global regulatory standards on bank capital adequacy and liquidity. According to the Basel Committee, the framework sets out higher and better-quality capital, better risk coverage, the introduction of a leverage ratio as a backstop to the risk-based requirement, measures to promote the build-up of capital that can be drawn down in periods of stress, and the introduction of two global liquidity standards.

In November 2010, the Federal Reserve's monetary policymaking committee, the Federal Open Market Committee ("FOMC"), decided that further support to the economy was needed. With short-term interest rates already nearing 0%, the FOMC agreed to deliver that support by committing to purchase additional longer-term securities, as it did in 2008 and 2009. The FOMC intends to buy an additional $600 billion of longer-term U.S. Treasury securities by mid-2011 and will continue to reinvest repayments of principal on its holdings of securities, as it has been doing since August 2010.

In November 2010, the FDIC approved two proposals that amend the deposit insurance assessment regulations. The first proposal implements a provision in the Dodd-Frank Act that changes the assessment base from one based on domestic deposits (as it has been since 1935) to one based on assets. The assessment base changes from adjusted domestic deposits to average consolidated total assets minus average tangible equity. The second proposal changes the deposit insurance assessment system for large institutions in conjunction with the guidance given in the Dodd-Frank Act. In February 2011, the FDIC approved the final rules that change the assessment base from domestic deposits to average assets minus average tangible equity, adopt a new scorecard-based assessment system for financial institutions with more than $10 billion in assets, and finalize the designated reserve ratio target size at 2.0% of insured deposits. We elected to voluntarily participate in the unlimited deposit insurance component of the Treasury's Transaction Account Guarantee Program ("TAGP") through December 31, 2010. Coverage under the program was in addition to and separate from the basic coverage available under the FDIC's general deposit insurance rules. As a result of the Dodd-Frank Act that was signed into law on July 21, 2010, the program ended on December 31, 2010, and all institutions are now required to provide full deposit insurance on noninterest-bearing transaction accounts until December 31, 2012. There will not be a separate assessment for this as there was for institutions participating in the deposit insurance component of the TAGP.

In June 2011, the Federal Reserve approved a final debit card interchange rule in accordance with the Dodd-Frank Act. The final rule caps an issuer's base fee at 21 cents per transaction and allows an additional 5 basis point charge per transaction to help cover fraud losses. Although the rule technically does not apply to institutions with less than $10 billion in assets, such as the Bank, there is concern that the price controls may harm community banks, which could be pressured by the marketplace to lower their own interchange rates.

Although it is likely that further regulatory actions will arise as the Federal government attempts to address the economic situation, we cannot predict the effect that fiscal or monetary policies, economic control, or new federal or state legislation may have on our business and earnings in the future.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Not applicable

Item 4. CONTROLS AND PROCEDURES.

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer (Principal Executive Officer) and Chief Financial Officer (Principal Financial Officer), of the effectiveness of our disclosure controls and procedures as defined in Exchange Act Rule 13a-15(e). Based upon that evaluation, our Chief Executive Officer (Principal Executive Officer) and Chief Financial Officer (Principal Financial Officer) have concluded that our current disclosure controls and procedures are effective as of June 30, 2011. There have been no significant changes in our internal controls over financial reporting during the fiscal quarter ended June 30, 2011 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

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

PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS.

There are no material pending legal proceedings to which the company is a party or of which any of its property is the subject.

Item 1A RISK FACTORS.

Not applicable

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

Not applicable

Item 3. DEFAULTS UPON SENIOR SECURITIES.

Not applicable

Item 4. (REMOVED AND RESERVED)

Not applicable

Item 5. OTHER INFORMATION.

Not applicable

Item 6. EXHIBITS.

31.1 Rule 13a-14(a) Certification of the Principal Executive Officer.

31.2 Rule 13a-14(a) Certification of the Principal Financial Officer.

32 Section 1350 Certifications.

101 The following materials from Southern First Bancshares, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2011, formatted in XBRL; (i) Consolidated Balance Sheets at June 30, 2011 and December 31, 2010, (ii) Consolidated Statements of Income (Loss) for the three and six months ended June 30, 2011 and 2010, (iii) Consolidated Statements of Shareholders Equity and Comprehensive Income (Loss) for the six months ended June 30, 2011 and 2010, (iv) Consolidated Statements of Cash Flows for the six months ended June 30, 2011 and 2010, and (iv) Notes to Consolidated Financial Statements*.

*Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or propsectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

SIGNATURES

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

INDEX TO EXHIBITS