BLACKHAWK BANCORP INC
Form 10QSB
May 12, 2004

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

FORM 10-QSB

[X] QUARTERLY REPORT UNDER SECTION 13 OR 15 (D)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2004

[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(D)
OF THE EXCHANGE ACT

FOR THE TRANSITION PERIOD FROM ---- TO ----

COMMISSION FILE NUMBER 0-18599

BLACKHAWK BANCORP, INC.
(EXACT NAME OF SMALL BUSINESS ISSUER AS SPECIFIED IN ITS CHARTER)

WISCONSIN	39-1659424
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I. R. S. EMPLOYER IDENTIFICATION NO.)

400 BROAD STREET
BELOIT, WISCONSIN 53511
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

(608) 364-8911
(ISSUER'S TELEPHONE NUMBER)
NOT APPLICABLE
(FORMER NAME, FORMER ADDRESS AND FORMER FISCAL YEAR, IF CHANGED SINCE LAST REPORT)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date:

CLASS OF COMMON STOCK	OUTSTANDING AT APRIL 21, 2004
$.01 PAR VALUE	2,526,145 SHARES

Transitional Small Business Disclosure Format (Check one): Yes No X

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PART I - FINANCIAL INFORMATION

Page

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
UNAUDITED CONSOLIDATED BALANCE SHEETS

	MARCH 31, 2004	DECEMBER 31 2003
ASSETS	(Dollars in thousands)	
Cash and due from banks	$ 13,669	$ 17,250
Federal funds sold and securities purchased under agreements to resell	12,254	6,120
Interest-bearing deposits in banks	3,224	2,841
Available-for-sale securities	102,225	118,107
Held to maturity securities, at amortized cost	16,531	17,606
Loans, less allowance for loan losses of $3,173 and $3,302 at March 31, 2004 and December 31, 2003, respectively	238,370	230,142

Office buildings and equipment, net	9,822	9,981
Intangible assets	7,147	7,246
Bank-owned life insurance	6,327	6,263
Other assets	9,576	9,846
Total Assets	$419,145	$425,402
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES:		
Deposits:		
Noninterest-bearing	$ 47,615	$ 47,999
Interest-bearing	266,501	275,640
Total deposits	314,116	323,639
Short-term borrowings	9,169	9,486
Subordinated debentures	7,217	7,217
Long-term borrowings	57,997	55,913
Other liabilities	4,388	3,384
Total Liabilities	392,887	399,639
STOCKHOLDERS' EQUITY:		
Preferred stock 1,000,000 shares, $.01 par value per share authorized, none issued or outstanding	--	--
Common stock 10,000,000 shares, $.01 par value per share authorized, shares issued and outstanding: 2,526,145 at March 31, 2004, 2,522,995 at December 31, 2003	25	25
Surplus	8,845	8,818
Retained earnings	16,271	16,092
Accumulated other comprehensive income	1,117	828
Total Stockholders' Equity	26,258	25,763
Total Liabilities and Stockholders' Equity	$419,145	$425,402

See Notes to Unaudited Consolidated Financial Statements

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
UNAUDITED CONSOLIDATED STATEMENTS OF INCOME

	THREE MONTHS ENDED MARCH	
	2004	2003
INTEREST INCOME:	(Dollars in thousands, except per	
Interest and fees on loans	$3,541	$3,249
Interest and dividends on securities:		
Taxable	1,056	927
Nontaxable	313	253
Interest on fed funds sold and securities purchased under agreements to resell	13	41
Interest on interest-bearing deposits in banks	17	10

Total Interest Income	4,940	4,480
INTEREST EXPENSE:		
Interest on deposits	1,124	1,266
Interest on short-term borrowings	29	34
Interest on subordinated debentures	103	84
Interest on long-term borrowings	560	505
Total Interest Expense	1,816	1,889
Net Interest Income	3,124	2,591
Provision for loan losses	104	222
Net Interest Income After Provision For Loan Losses	3,020	2,369
NONINTEREST INCOME:		
Service charges on deposit accounts	486	339
Gain on sale of loans	147	158
Securities gains, net	80	329
Increase in cash value of bank-owned life insurance	69	77
Other	246	136
Total Noninterest Income	1,028	1,039
NONINTEREST EXPENSES:		
Salaries and employee benefits	1,818	1,458
Occupancy	290	189
Equipment	308	230
Data processing services	278	196
Advertising and marketing	93	63
Amortization of intangibles	95	77
Professional fees	128	185
Office supplies	72	63
Telephone	96	75
Postage	51	57
Transportation	64	44
Other	289	313
Total Noninterest Expenses	3,582	2,950
Income Before Income Taxes	466	458
Income Taxes	60	60
Net Income	$ 406	$ 398
Basic Earnings Per Share	$ 0.16	$ 0.16
Diluted Earnings Per Share	$ 0.16	$ 0.16
Dividends Per Share	$ 0.09	$ 0.09

See Notes to Unaudited Consolidated Financial Statements

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
UNAUDITED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	THREE MONTHS ENDED MARCH 31, 2004	2003
	(Dollars in thousands)	
Common Stock:		
Balance at beginning of period	$ 25	$ 25
Stock options exercised	--	--
Balance at end of period	25	25
Surplus:		
Balance at beginning of period	8,818	8,698
Stock options exercised	27	65
Balance at end of period	8,845	8,763
Retained Earnings:		
Balance at beginning of period	16,092	15,788
Net income	406	398
Dividends declared on common stock	(227)	(227)
Balance at end of period	16,271	15,959
Accumulated other comprehensive income:		
Balance at beginning of period	828	1,287
Other comprehensive income (loss), net of taxes	289	(288)
Balance at end of period	1,117	999
Total Stockholders' Equity	$26,258	$25,746

See Notes to Unaudited Consolidated Financial Statements

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

	THREE MONTHS ENDE MARCH 31, 2004	200
	(Dollars in thousan	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 406	$
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	357	
Provision for loan losses	104	
Gain on sale of loans	(147)	
FHLB stock dividends	(87)	
Amortization of premiums on securities, net	171	

Securities gains, net	(80)	
Decrease in accrued interest receivable	98	
Decrease in accrued interest payable	(3)	
(Increase) decrease in other assets	10	(2
Increase (decrease) in other liabilities	855	
Net cash provided by (used in) operations before loan originations and sales	1,684	(2
Origination of loans for sale	(10,868)	(6
Proceeds from sale of loans	9,856	8
Net cash provided by (used in) operating activities	672	
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net (increase) decrease in interest-bearing deposits in banks	(383)	7
Net (increase) decrease in federal funds sold and securities purchased under agreements to resell	(6,134)	7
Proceeds from sales of available-for-sale securities	19,501	10
Proceeds from maturities and calls of available-for-sale securities	8,463	9
Proceeds from maturities and calls of held-to-maturity securities	1,064	2
Purchase of available-for-sale securities	(11,601)	(45
Net (increase) decrease in loans	(7,378)	6
Proceeds from the sale of office buildings, equipment, and other real estate owned	209	
Purchase of office buildings and equipment, net	(118)	
Net cash provided by (used in) investing activities	3,623	(1

See Notes to Unaudited Consolidated Financial Statements.

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
(CONTINUED)

	THREE MONTHS ENDE MARCH 31,	
	2004	
	(Dollars in thousan	
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net decrease in deposits	$(9,453)	$(11
Dividends paid	(227)	
Proceeds from long-term borrowings	6,000	5
Payments on long-term borrowings	(3,900)	
Net increase (decrease) in short-term borrowings	(317)	9
Proceeds from exercise of stock options	21	
Net cash provided by (used in) financing activities	(7,876)	2
Net increase (decrease) in cash and due from banks	(3,581)	
CASH AND DUE FROM BANKS:		
Beginning	17,250	12
Ending	$13,669	$13

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid during the year for:		
Interest	$ 1,904	$ 1
Income taxes	$ --	$
SUPPLEMENTAL SCHEDULES OF NON-CASH INVESTING ACTIVITIES:		
Change in accumulated other comprehensive income:		
Unrealized gains (losses) on available-for-sale securities, net	$ 390	$
Unrealized gains (losses) on interest rate swap contract, net	(101)	
Other assets acquired in settlement of loans	$ 163	$

See Notes to Unaudited Consolidated Financial Statements.

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2004

Note 1. General:

The unaudited consolidated financial statements include the accounts of Blackhawk Bancorp, Inc. and its subsidiary. Effective September 30, 2003, Blackhawk Bancorp, Inc. acquired the assets of DunC Corp. and its subsidiary, First Bank, bc., in a transaction accounted for as a purchase. The assets and liabilities and results of operations of those acquired companies have been included in the consolidated financial statements of Blackhawk Bancorp, Inc. subsequent to the date of acquisition and effect comparability of 2004 results with 2003.

In the opinion of management, all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the financial position, results of operation and cash flows for the interim periods have been made. The results of operations for the three months ended March 31, 2004 are not necessarily indicative of the results to be expected for the entire fiscal year.

The unaudited interim financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and industry practice. Certain information in footnote disclosure normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America and industry practice has been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission. The more significant policies used by the Company in preparing and presenting its financial statements are stated in the Corporation's Form 10-KSB. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's December 31, 2003 audited financial statements.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions which affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements, as well as the reported amounts of income and expenses during the reported periods. Actual results could differ from those estimates.

Certain reclassifications have been made to the 2003 historical financial statements to conform to the 2004 presentation.

Stock-Based Compensation Plan: The Company's stock-based director, key officer and employee compensation plans expired on December 31, 2003. The Company accounts for these plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. No stock-based employee compensation cost is reflected in income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The table on the following page illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of Financial Accounting Standards Board (FASB) Statement No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation. The pro-forma compensation expense is recognized over the three year option vesting period.

(Dollars in thousands, except per share data)	Three Months Ended March 31, 2004	2003
Net income, as reported	$ 406	$ 398
Deduct total stock-based employee and director compensation expense determined under fair value based method for all awards, net of related tax effects	(17)	(21)
Pro forma net income	$ 389	$ 377
Earnings per share:		
Basic:		
As reported	$0.16	$0.16
Pro forma	0.15	0.15
Diluted:		
As reported	0.16	0.16
Pro forma	0.15	0.15

In determining compensation cost using the fair value method prescribed in Statement No. 123, the value of each grant is estimated at the grant date with the following weighted-average assumptions used for grants in 2003 and 2002, respectively: dividend yield of 3 percent and 4 percent; expected price volatility of 23 percent and 25 percent; risk-free interest rates of 3 percent and 4 percent; and expected lives of 7 years and 10 years, respectively.

Note 2. Allowance for Loan Losses

A summary of transactions in the allowance for loan losses is as follows:

	THREE MONTHS ENDED MARCH 31, (Dollars in thousands) 2004	2003
Balance at beginning of period	$ 3,302	$ 2,079

Provision charged to expense	104	222
Loans charged off	257	157
Recoveries	24	53
Balance at end of period	$ 3,173	$2,197

Note 3. Earnings Per Share

Presented below are the calculations for basic and diluted earnings per share:

	THREE MONTHS ENDED MARCH 31, 2004	2003
Basic:		
Net income available to common stockholders	$ 406,000	$ 398,000
Weighted average shares outstanding	2,524,472	2,514,018
Basic earnings per share	$ 0.16	$ 0.16
Diluted:		
Net income available to common stockholders	$ 406,000	$ 398,000
Weighted average shares outstanding	2,524,472	2,514,018
Effect of dilutive stock options outstanding	27,668	4,721
Diluted weighted average shares outstanding	2,552,140	2,518,739
Diluted earnings per share	$ 0.16	$ 0.16

Note 4. Derivative Instrument

During June, 2003, the Company entered into an interest rate swap transaction, which resulted in the Company converting its $7,000,000 of variable rate subordinated debentures into fixed rate debt. This swap transaction requires the payment of interest by the Company at a fixed rate equal to 2.47% using an actual/360 day basis. In turn the Company receives a variable rate interest payment based on the 90 day LIBOR rate adjusted quarterly.

Summary information about the interest rate swap at March 31 is as follows:

	2004	2003
	(Dollars in thousands)	
Notional amount	$7,000	--

Weighted average fixed rate	2.51%	--
Weighted average variable rate	1.13%	--
Weighted average maturity	3.75 years	--
Fair value	$70	--

Note 5. Acquisition of DunC Corp.

As more fully described in Item 2 of this report under the caption "Acquisition or Disposition of Assets", Blackhawk Bancorp, Inc. acquired DunC Corp on September 30, 2003 in a transaction accounted for as a purchase. The assets and liabilities of DunC Corp., valued at fair market value, on the date of acquisition are included in the unaudited consolidated balance sheet of Blackhawk Bancorp, Inc. and Subsidiary at March 31, 2004 and in the audited consolidated balance sheet of Blackhawk Bancorp, Inc. and Subsidiary at December 31, 2003. The results of operations have been included in the unaudited consolidated statement of income for the three months ended March 31, 2004 and will effect the comparability to 2003 results.

Note 6. Recent Accounting Developments

FIN No. 46 Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51 (Revised December 2003). FIN 46 establishes accounting guidance for consolidation of variable interest entities (VIE) that function to support the activities of the primary beneficiary. The primary beneficiary of a VIE is the entity that absorbs a majority of the VIE's expected losses, receives a majority of the VIE's expected residual returns, or both, as a result of ownership, controlling interest, contractual relationship or other business relationship with a VIE. Prior to the implementation of FIN 46, VIEs were generally consolidated by an enterprise when the enterprise had a controlling financial interest through ownership of a majority of voting interest in the entity. The provisions of FIN 46 were effective immediately for all arrangements entered into after January 31, 2003. However, subsequent revisions to the interpretation deferred the implementation date of FIN 46 until the first period ending after March 15, 2004.

The Company adopted FIN 46, as revised, in connection with its consolidated financial statements for the quarter ended March 31, 2004. The implementation of FIN 46 required the Company to de-consolidate its investment in Blackhawk Statutory Trust I (the "Trust") because the Company is not the primary beneficiary. There was no impact on stockholders' equity, or net income upon adoption of the standard.

The trust preferred securities issued by the Trust are currently included in the Tier 1 capital of the Company for regulatory capital purposes. However, because the financial statements of the Trust will no longer be included in the Company's consolidated financial statements, the Federal Reserve Board may in the future disallow inclusion of the trust preferred securities in Tier 1 capital for regulatory capital purposes. In July 2003, the Federal Reserve Board issued a supervisory letter instructing bank holding companies to continue to include the trust preferred securities in their Tier 1 capital for regulatory capital purposes until notice is given to the contrary. The Federal Reserve Board intends to review the regulatory implications of the change in accounting treatment of subsidiary trusts that issue trust preferred securities and, if necessary or warranted, provide further appropriate guidance. There can be no assurance that the Federal Reserve Board will continue to permit institutions to include trust preferred securities in Tier 1 capital for regulatory capital purposes.

The Financial Accounting Standards Board has issued Statement 149, Amendment of Statement 133 on Derivative Instruments and Hedging. This Statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under Statement 133. The Statement was effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. Implementation of the Statement on July 1, 2003 did not have a material impact on the consolidated financial statements.

Note 7. Recent Regulatory Developments

The Sarbanes-Oxley Act of 2002 (the "Act") impacts corporate governance of public companies, affecting their officers and directors, their audit committees, their relationships with their accountants and the audit function itself. Certain provisions of the Act became effective on July 30, 2002. Other provisions will become effective as the SEC adopts appropriate rules.

The Act implements a broad range of corporate governance and accounting measures for public companies designed to promote honesty and transparency in corporate America and better protect investors from corporate wrongdoing. The Act includes the creation of an independent accounting oversight board to oversee the audit of public companies and their auditors, provisions restricting non-audit services performed by independent accountants for public companies and additional corporate governance and responsibility provisions.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

The purpose of Management's discussion and analysis is to provide relevant information regarding the Registrant's financial condition and its results of operations. The information included herein should be read in conjunction with the company's consolidated financial statements and footnotes thereto for the year ended December 31, 2003.

This report contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 with respect to the financial condition, results of operations, plans, objectives, future performance and business of Blackhawk Bancorp, Inc. Statements that are not historical facts, including statements about beliefs and expectations, are forward-looking statements. These statements are based upon beliefs and assumptions of Blackhawk's management and on information currently available to such management. The use of the words "believe", "expect", "anticipate", "plan", "estimate", "may", "will" or similar expressions are forward-looking statements.

Contemplated, projected, forecasted or estimated results in such forward-looking statements involve certain inherent risks and uncertainties. A number of factors - many of which are beyond the ability of the company to control or predict - could cause actual results to differ materially from those described in the forward-looking statements. Factors which could cause such a variance to occur include, but are not limited to: heightened competition; adverse state and federal regulation; failure to obtain new or retain existing customers; ability to attract and retain key executives and personnel; changes in interest rates; unanticipated changes in industry trends; unanticipated changes in credit quality and risk factors, including general economic conditions; success in gaining regulatory approvals when required; changes in the Federal Reserve Board monetary policies; unexpected outcomes of new and existing litigation in which Blackhawk or its subsidiaries, officers, directors or employees is named defendants; technological changes; changes in accounting principles generally accepted in the United States; changes in assumptions or conditions affecting the application of critical accounting policies; and the inability of third party vendors to perform critical services for the company or its customers.

The Company does not undertake, and specifically declines any obligation, to publicly release the results of any revisions which may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

ACQUISITION OR DISPOSITION OF ASSETS

On September 30, 2003 (the "Effective Date"), Blackhawk Bancorp, Inc., (the "Corporation") consummated its acquisition of DunC Corp. ("DunC"), a bank holding company registered under the Bank Holding Company Act of 1956, as amended, and DunC's wholly owned subsidiary, First Bank, bc ("First Bank"), an Illinois state bank.

The Corporation acquired DunC and First Bank pursuant to an Agreement and Plan of Merger dated as of March 17, 2003 (the "Merger Agreement"), between the Corporation, DunC Merger Corporation ("Merger Corp"), a wholly owned subsidiary of the Corporation, and DunC through a series of mergers.

Pursuant to the Merger Agreement, Merger Corp was merged with and into DunC at the close of business on the Effective Date, and DunC became a wholly owned subsidiary of the Corporation. The merger consideration was cash in the aggregate amount of $7,223,000, which was paid to former DunC shareholders. The price paid by the Corporation for the DunC common stock was arrived at through arms-length negotiations.

The terms of the merger of Merger Corp with and into DunC are described more fully in the Merger Agreement filed as Exhibit 2.1 to the Corporation's Form 10-QSB for the quarterly period ended March 31, 2003, which is incorporated herein by reference. The description of the transaction set forth above is qualified in its entirety by the terms set forth in the Merger Agreement.

Immediately following the merger of Merger Corp into DunC, DunC merged with and into the Corporation, and First Bank merged with and into Blackhawk State Bank, a wholly owned subsidiary of the Corporation. As a result of these mergers the Corporation and Blackhawk State Bank were the surviving entities, and DunC and First Bank ceased to exist.

The merger consideration paid to the former shareholders of DunC was funded through a term loan with U.S. Bank National Association, Milwaukee, Wisconsin. The term loan for $7.5 million was entered into in the ordinary course of business and on terms commensurate with prevailing market conditions on September 26, 2003. The term loan matures on September 26, 2008. A copy of the term loan agreement was filed as an exhibit on the Corporation's Current Report on Form 8-K dated September 30, 2003 and is incorporated herein by reference.

In accordance with the requirements of purchase accounting, the operations of the acquired companies have been included with the operations of the Company since date of acquisition. Because of the relative size of the Company and DunC, the acquisition has had a significant effect on both the operations and balance sheets of the Company, and significantly affects comparisons between 2003 and 2004. In addition, as part of that acquisition, the Company committed to its regulators to maintain the Bank's

Tier 1 leverage capital at not less than 7% for three years, and to raise capital in the event that the cash flow required to service debt incurred in the acquisition exceeds 80% of Bank net income.

The following provides certain summary financial information about the financial condition of DunC and the assets and liabilities acquired in the acquisition, and DunC's operations, prior to the acquisition to illustrate their impact upon the corporation:

Balance Sheet (Dollars in thousands)	At September 30, 2003
Loans	$46,781
Allowance for Loan Losses	(889)
Investments	11,104
Total Assets	77,726
Deposits	64,237
Borrowings	3,631

Income Statement (Dollars in thousands)	Nine Months Ended September 30, 2003	Year Ended December 31, 2002
Total Interest Income	$ 3,645	$4,602
Total Interest Expense	850	1,453
Net Interest Income	2,795	3,149
Provision for Loan Losses	200	628
Non-Interest Income	1,819	2,497
Non-Interest Expense	4,701	4,208
Net Income (Loss) before Tax	(287)	810

On the acquisition date, the First Bank branch located at 417 Ware Avenue, Rockford, Illinois was closed with its accounts being consolidated into the Bank's Rockford office located at 2475 North Perryville Road. On January 31, 2004 the Bank closed its branch office located at 1021 North State Street, Belvidere, Illinois and consolidated the accounts into the office located at 2141 North State Street, Belvidere, Illinois, which is a former First Bank branch obtained in the acquisition.

RESULTS OF OPERATIONS

The company reported net income of $406,000 for the three months ended March 31, 2004, an increase of $8,000 or 2.0% from the $398,000 reported for the same three month period in 2003. Diluted earnings per share were $0.16 for the three months ended March 31, 2004 and 2003.

NET INTEREST INCOME

Net interest income, which is the sum of interest and certain fees generated by earning assets minus interest paid on deposits and other funding sources, is the primary source of the company's earnings. All discussions of interest income amounts and rates are on a tax-equivalent basis, which accounts for income earned on loans and securities that are not fully subject to income taxes as if they were fully subject to income taxes. The following table sets forth the company's consolidated average balances of assets, liabilities and shareholders' equity, interest income and expense on related items, and the company's average rate for the three month periods ended March 31, 2004 and 2003. The tax-equivalent yield calculations assume a Federal Tax Rate of 34%:

AVERAGE BALANCE SHEET WITH RESULTANT INTEREST AND RATES

(yields on a tax-equivalent basis)	Three Months ended March 31, 2004			Three Months
	Average Balance	Interest	Average Rate	Average Balance
INTEREST EARNING ASSETS:				
Interest-bearing deposits in banks	$ 2,847	$ 17	2.40%	$ 2,144
Federal funds sold & securities purchased under agreements to resell	3,985	13	1.31%	8,543
Investment securities:				
Taxable investment securities	102,043	1,056	4.16%	86,439
Tax-exempt investment securities	32,303	474	5.90%	24,978
Total investment securities	134,346	1,530	4.58%	111,417
Loans	237,601	3,542	6.00%	182,957
TOTAL EARNING ASSETS	$378,779	$5,102	5.42%	$305,061
Allowance for loan losses	(3,251)			(2,146)
Cash and due from banks	13,450			10,453
Other assets	27,721			20,026
TOTAL ASSETS	$416,699			$333,394
INTEREST BEARING LIABILITIES:				
Interest bearing checking accounts	$ 47,327	$ 68	.58%	$ 37,974
Savings and money market deposits	76,796	150	.79%	52,577
Time deposits	139,174	906	2.62%	122,800
Total interest bearing deposits	263,297	1,124	1.72%	213,351
Short-term borrowings	14,062	29	.83%	12,448
Subordinated debentures	7,217	103	5.74%	7,217
Long-term borrowings	56,461	560	3.99%	40,844
TOTAL INTEREST-BEARING LIABILITIES	$341,037	$1,816	2.14%	$273,860
INTEREST RATE SPREAD			3.28%	
Checking accounts	46,447			31,789
Other liabilities	3,113			1,878
Total liabilities	390,597			307,527
Stockholders' equity	26,102			25,867

TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$416,699			$333,394
NET INTEREST INCOME/MARGIN		$3,286	3.49%	

Net interest income increased by $565,000, or 20.8%, to $3,286,000 for the quarter ended March 31, 2004, compared to $2,721,000 for the comparable period in 2003. The net interest margin, which is the tax equivalent net interest income divided by average interest earning assets was 3.49% for the three months ended March 31, 2004 compared to 3.62% for the same period in 2003. The 13 basis point decrease in net interest margin is primarily due to the impact of the sustained low interest rate environment and the inability of the Company to offset the effects of asset repricings with equivalent reductions in funding costs.

For the three months ended March 31, 2004, total interest income increased by $492,000, or 10.7%, to $5,102,000 compared to $4,610,000 for the same period in 2003. The yield on average earning assets decreased 71 basis points to 5.42% for the first quarter of 2004, compared to 6.13% for the same period in 2003. The decrease in the yield on earning assets is due to the impact of the sustained low interest rate environment on the Bank's asset repricing. Interest rates continued to remain at 45-year lows. The average balance sheet with resultant interest and rates reflects the earning assets of DunC for the first quarter of 2004, but not in the first quarter of 2003, as the acquisition was completed on September 30, 2003. At September 30, 2003 DunC had earning assets of $69,300,000. Other earning assets increased $4,418,000 or 1.2% quarter over quarter. The increase in total interest income is primarily due to the effects of the DunC acquisition offset by the Bank's lower overall yield on earning assets.

Interest and fees on loans increased 9.0% to $3,542,000 for the three months ended March 31, 2004 compared to $3,249,000 for the same period of 2003. This increase was the result of a $54,644,000 or 29.9% increase in average loans outstanding, which was partially offset by a 120 basis point decrease in yield on the portfolio. The Company acquired $46,781,000 of gross loans at September 30, 2003 in connection with the DunC acquisition. Excluding the loans obtained in the DunC acquisition, average total loans increased $7,863,000 or 4.3% and reflect the Company's efforts to reverse negative trends due to loan run-off. The lower yield on average loans reflects the overall lower interest rate environment previously discussed and competitive pricing pressure for quality credit customers.

Interest income on taxable securities increased by $129,000 or 13.9% in the first quarter of 2004 to $1,056,000 compared to $927,000 for the same period in 2003. Average balances of taxable investment securities increased 18.1% to $102,043,000 for the quarter ended March 31, 2004 compared to $86,439,000 for the same period in the prior year. However, the yield on average taxable investment securities decreased 19 basis points to 4.16% for the first quarter of 2004 compared to 4.35% for the first quarter of 2003. Tax exempt investment securities increased $7,325,000, or 29.3% to an average balance of $32,303,000 for the three months ended March 31, 2004 compared to $24,978,000 for the same period in 2003, while the tax-equivalent yield decreased 32 basis points to 5.90%. The DunC acquisition added $8,800,000 of taxable investment securities and $2,300,000 of tax-exempt investment securities at the acquisition date. Excluding the securities acquired in the DunC acquisition taxable investment securities increased $6,804,000 or 7.9% and tax exempt investment securities increased $5,025,000 or 20.1%.

Interest from fed funds sold and securities purchased under agreements to resell decreased to $13,000 for the three month period ended March 31, 2004, compared to $41,000 during the same period in 2003. The average balance of fed funds sold and securities purchased under agreements to resell decreased by $4,558,000 or 53.4% to $3,985,000 for the three months ended March 31, 2004 and reflects the reinvestment of excess funds into higher yielding investment securities.

Total interest expense decreased by $73,000, or 3.9%, to $1,816,000 for the three months ended March 31, 2004 compared to $1,889,000 for the same period in 2003. The decrease in total interest expense is primarily the result of the aforementioned lower market interest rate environment which reduced the average cost of interest-bearing liabilities by 66 basis points to 2.14% for the quarter ended March 31, 2004 compared to 2.80% for the same period in 2003. The DunC acquisition increased interest bearing liabilities by $54,000,000 at the acquisition date. Excluding the acquisition, interest bearing liabilities increased by $13,177,000 or 4.8% and partially offset the impact of lower rates.

Interest paid on deposits decreased $142,000, or 11.2% to $1,124,000 during the three months ended March 31, 2004 compared to $1,266,000 for the same period in 2003. The DunC acquisition added $50,300,000 in interest bearing deposits as of September 30, 2003. Excluding the acquisition, interest bearing deposits decreased $354,000 or 0.2% for the quarter ended March 31, 2004 compared to the same period in 2003. The decrease in interest paid on deposits was primarily due to the overall lower interest rate environment.

Interest on short-term borrowings decreased $5,000 to $29,000 for the three months ended March 31, 2004 compared to $34,000 for the same period in 2003. This decrease is the result of lower market rates paid on short-term borrowings. The decrease due to lower rates was partially offset by a $1,614,000 or 13.0% increase in the average balance of short-term borrowings.

Interest expense on long-term borrowings increased $55,000 to $560,000 for the three month period ended March 31, 2004 compared to $505,000 for the first three months of 2003. The increase is the result of a $15,617,000 or 38.2% increase in the average balance outstanding offset by a 102 basis point decrease in the average rate to 3.99% for the first quarter of 2004 compared to 5.01% for the first quarter of 2003. The increase in the average balance of long-term borrowings outstanding reflects the $7,500,000 in bank debt issued to finance the DunC acquisition and additional dependence on FHLBC borrowings in 2004.

Interest expense on subordinated debentures increased $19,000 to $103,000 for the first quarter of 2004 compared to $84,000 in the first quarter of 2003. The increase reflects the use of an interest rate swap, which was entered into by the company on June 26, 2003 to fix the cost of this borrowing. During the first quarter of 2003 the interest rate adjusted quarterly and was set at 325 basis points over the 3 month LIBOR rate. The interest rate swap was part of the Company's overall interest rate risk management strategy and was utilized to minimize significant unplanned fluctuations in earnings caused by interest rate volatility.

PROVISION FOR LOAN LOSSES

The provision for loan losses (provision) is an amount added to the allowance for loan losses (allowance) to provide for the known and estimated amount of loans that will not be collected. Actual loan losses are charged against (reduce) the allowance when management believes that the collection of principal will not occur. Subsequent recoveries of amounts previously charged to the allowance, if any, are credited to (increase) the allowance. Management determines the appropriate provision based upon a number of criteria, including a detailed evaluation of certain credits, historical performance, economic conditions and overall quality of the loan portfolio.

The provision was $104,000 in the first quarter of 2004, a decrease of $118,000 or 53.2% from the $222,000 in the first quarter of 2003.

Activity in the allowance for loan losses is detailed in note 2 to the unaudited consolidated financial statements. Charge-offs, net of recoveries for the first quarter of 2004 increased by $129,000 or 124.0% to $233,000 compared to $104,000 for the first quarter of 2003.

The ratio of the allowance to total loans was 1.31% at March 31, 2004 compared to 1.22% at March 31, 2003.

NONINTEREST INCOME

Total noninterest income decreased $11,000, or 1.1%, to $1,028,000 for the three months ended March 31, 2004 compared to $1,039,000 for the same period in 2003.

Service charges on deposit accounts were $486,000 for the quarter ended March 31, 2004 compared to $339,000 for the first quarter of 2003. The increase reflects a higher number of accounts as a result of the DunC acquisition and increased fee realization on previously existing accounts.

Gain on the sale of mortgage loans decreased $11,000 or 7.0% to $147,000 for the first quarter of 2004 compared to the $158,000 of gains recognized during the first quarter of 2003 primarily as the result of lower margins in 2004. In the first quarter of 2004, $9,856,000 of mortgage loans were sold to the secondary market compared to $8,989,000 for the same period in 2003. The average gain in 2004 was 1.49% compared to an average gain of 1.76% on the loans sold in the first quarter of 2003. The decrease in the margin is the result of more competitive pricing in 2004.

The Company recognized $80,000 of securities gains in the first quarter of 2004 compared to $329,000 in the first quarter of 2003. The decrease is primarily due to the one time sale of $10,884,000 of investment securities in the quarter ended March 31, 2003. These securities would have matured or been called in the next 12 to 18 months and the proceeds were reinvested into longer term securities.

Other noninterest income increased $110,000 or 80.9% for the three months ended March 31, 2004. Serviced loan fees increased $25,000 due to reduced amortization of mortgage servicing rights as mortgage prepayments slowed in the first quarter of 2004 compared to 2003. Service charges for customer services increased $40,000. Insurance commissions increased $16,000 and the Company recognized gains on the sale of OREO properties of $29,000 in 2004.

NONINTEREST EXPENSES

Total noninterest expense increased $632,000, or 21.4%, to $3,582,000 for the three months ended March 31, 2004 compared to $2,950,000 for the same period in 2003. The increase reflects increased costs in 2004 as a result of the DunC acquisition offset by the accretive benefits from the elimination of duplicative expenses.

Professional fees decreased $57,000 or 30.8%, to $128,000 for the three months ended March 31, 2004 compared to $185,000 for the same period in 2003 primarily as a result of lower legal fees in 2004 related to the Fiserv, Inc. litigation.

Other expenses decreased $24,000 or 7.7% to $289,000 for the three months ended March 31, 2004 compared to $313,000 for the same period a year ago. Other expenses for the quarter ended March 31, 2003 included a non-recurring expense of $56,000 related to a sales and use tax audit.

Income taxes were $60,000 for the three months ended March 31, 2004 and 2003. The decline in effective tax rate to 12.9% for the three month period ended March 31, 2004 from 13.1% for the same period of 2003 is reflective of greater tax efficiency brought about by an increase in non-taxable interest from the municipal bond portfolio offset by a reduction in non-taxable life insurance cash surrender value increases and a higher level of nondeductible intangible amortization as a result of the DunC acquisition.

BALANCE SHEET ANALYSIS

OVERVIEW

Total assets decreased to $419,145,000 at March 31, 2004 compared to $425,402,000 at December 31, 2003, a decrease of 1.5%. The December 31, 2003 balance sheet included short-term year-end deposits of $11,750,000, which were invested in federal funds sold and interest bearing deposits in banks at December 31, 2003. Excluding these deposits, total assets increased $5,493,000, or 1.3% from December 31, 2003 to March 31, 2004. In addition, excluding the effect of the short-term year end deposits there was a considerable shift in balances from investment securities to loans. Securities decreased by $16,957,000, while loans, net of allowance for loan losses, increased by $8,228,000.

LOANS

Net loans increased $8,228,000, or 3.6%, to $238,370,000 on March 31, 2004 compared to $230,142,000 on December 31, 2003. The composition of loans is shown in the following table:

	March 31, 2004	December 31, 2003	Change in Balance	As a % of Total Loans March 31, 2004	As a % of Total Loans December 31, 2003
	(Dollars in millions)				
Residential Real Estate	$101.7	$97.5	$4.2	42.1%	41.8%
Commercial Real Estate	$69.2	$67.0	$2.2	28.7%	28.7%
Construction and Land Development	$16.3	$11.3	$5.0	6.7%	4.8%
Commercial	$32.1	$35.6	($3.5)	13.3%	15.3%
Consumer	$19.3	$19.2	$0.1	8.0%	8.2%
Other	$2.9	$2.8	$0.1	1.2%	1.2%

All categories of loans except for commercial loans increased at March 31, 2004 compared to December 31, 2003. The bank held a consumer loan promotion during the first quarter of 2004 and has adopted strategies to aggressively price quality credits. In addition, improved loan demand in its primary markets is expected to lead to higher loan balances outstanding.

NON-PERFORMING LOANS

Non-performing loans include loans that are determined by management to be impaired because full collection of interest and principal is doubtful, have been placed in non-accrual status, and accruing loans which are past-due ninety days or more as to interest and/or principal payments.

The following summarizes information concerning non-performing loans:

	MARCH 31,	DECEMBER 31,

(Dollars in thousands)	2004	2003
Impaired loans-still accruing	$1,016	$ 923
Impaired loans-non-accrual	2,301	2,058
Other non-accrual	1,300	1,030
Past due 90 days or more and still accruing	622	42
Total non-performing loans	$5,239	$4,053

ASSET QUALITY

The allowance for loan losses was $3,173,000 or 1.31% of total loans at March 31, 2004 compared to $3,302,000 or 1.41% of total loans at December 31, 2003. As of March 31, 2004, non-performing loans totaled $5,239,000 compared to $4,053,000 at December 31, 2003. The increase during the first quarter of 2004 is due to three commercial loan relationships totaling $1,196,000 being added to non-performing loans. These loans are considered in determining the adequacy of the allowance for loan losses. Management believes the allowance for loan losses is adequate at March 31, 2004.

The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that the collectibility of the principal is unlikely. The allowance for loan losses is adequate to cover probable credit losses relating to specifically identified loans, as well as probable credit losses inherent in the balance of the loan portfolio. In accordance with FASB Statements 5 and 114, the allowance is provided for losses that have been incurred as of the balance sheet date. The allowance is based on past events and current economic conditions, and does not include the effects of expected losses on specific loans or groups of loans that are related to future events or expected changes in economic conditions. Management reviews a calculation of the allowance for loan losses on a quarterly basis. While management uses the best information available to make its evaluation, future adjustments to the allowance may be necessary if there are significant changes in economic conditions.

In addition, various regulatory agencies periodically review the allowance for loan losses. These agencies may require the bank to make additions to the allowance for loan losses based on their judgments of collectibility based on information available to them at the time of their examination. The policy of the Company is to place a loan on non-accrual status if: (a) payment in full of interest and principal is not expected, or (b) principal or interest has been in default for a period of 90 days or more, unless the obligation is both in the process of collection and well secured. Well secured is defined as collateral with sufficient market value to repay principal and all accrued interest. A debt is in the process of collection if collection of the debt is proceeding in due course either through legal action, including judgement enforcement procedures, or in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or in its restoration to current status.

At March 31, 2004 the allowance for loan losses to total non-performing and restructured loans equaled 60.6% compared to 81.5% at December 31, 2003.

SHORT-TERM INVESTMENTS

Fed funds sold and securities purchased under agreements to resell increased $6,134,000 to $12,254,000 at March 31, 2004 compared to $6,120,000 at December 31, 2003.

Interest-bearing deposits in banks increased $383,000 to $3,224,000 at March 31, 2004 compared to $2,841,000 at December 31, 2003. The increase reflects an increase in reinvestable balances at the company's Nevahawk subsidiary net of decreases in bank owned certificates of deposit.

INVESTMENT SECURITIES

Securities available for sale decreased $15,882,000, or 13.4%, to $102,225,000 at March 31, 2004 compared to $118,107,000 at December 31, 2003. The decrease in investments in securities available for sale resulted from the redeployment of balances to fund increased loan demand and the holding of funds in short-term investments awaiting appropriate reinvestment opportunities. Securities held to maturity decreased $1,075,000 or 6.1% to $16,531,000 at March 31, 2004 from $17,606,000 at December 31, 2003 as a result of security maturities.

DEPOSITS

Total deposits decreased $9,523,000 to $314,116,000 at March 31, 2004 compared to $323,639,000 at December 31, 2003. As noted above, the Company's December 31, 2003 financial statements reflect short-term year-end deposits of $11,750,000. Excluding the short-term year-end deposits, total deposits increased 0.7% from December 31, 2003. Excluding the short-term year-end deposits, non-interest bearing deposits decreased by $384,000 and interest bearing deposits increased by $2,611,000 at March 31, 2004 compared to December 31, 2003.

BORROWINGS

Short-term borrowings decreased $317,000 to $9,169,000 at March 31, 2004 from $9,486,000 at year-end. The decrease is due to lower outstanding balances of repurchase agreements with commercial customers. Long-term borrowings consist of Blackhawk Bancorp's bank term loan of $7,500,000 and term advances from the Federal Home Loan Bank ("FHLB") that were $50,497,000 at March 31, 2004 compared to $48,413,000 at December 31, 2003. The increase reflects a net additional $2,100,000 in FHLB advances outstanding at March 31, 2004.

SHAREHOLDERS' EQUITY

Total shareholders' equity increased $495,000 to $26,258,000 at March 31, 2004 compared to $25,763,000 at December 31, 2003. During the first three months of 2004 surplus increased by $27,000 from the sale of stock for options exercised. Accumulated other comprehensive income increased $289,000 to $1,117,000 at March 31, 2004 from $828,000 at December 31, 2003. In addition the company declared a dividend of $0.09 per share on common stock, which totaled $227,000.

The Company is subject to certain regulatory capital requirements and continues to remain in compliance with the requirements. The following table shows the company's capital ratios and regulatory requirements.

	MARCH 31, 2004	DECEMBER 31, 2003	REGULATORY REQUIREMENTS
Total Capital (To Risk-Weighted Assets)	10.8%	10.9%	8.0%
Tier I Capital (To Risk-Weighted Assets)	9.6%	9.6%	4.0%
Tier I Capital (To Average Assets)	6.1%	6.0%	4.0%

The Company's subsidiary bank meets regulatory capital requirements to be considered well capitalized.

ASSET/LIABILITY MANAGEMENT

Asset/liability management is the process of identifying, measuring and managing the risk to the Company's earnings and capital resulting from the movements in interest rates. It is the Company's objective to protect earnings and capital while achieving liquidity, profitability and strategic goals.

The Company focuses its measure of interest rate risk on the effect a shift in interest rates would have on earnings rather than on the amount of assets and/or liabilities subject to re-pricing in a given time period. Since not all assets or liabilities move at the same rate and at the same time, a determination must be made as to how each interest earning asset and each interest bearing liability adjusts with each change in the base rate. The Company develops, evaluates and amends its assumptions on an ongoing basis and analyzes its earnings exposure quarterly.

In addition to the effect on earnings, a quarterly evaluation is made to determine the change in the economic value of the equity with various changes in interest rates. This determination indicates how much the value of the assets and the value of the liabilities change with a specified change in interest rates. The net difference between the economic values of the assets and liabilities results in an economic value of equity.

During June 2003, the Company entered into an interest rate SWAP agreement related to the subordinated debentures. This SWAP is utilized to manage variable interest rate exposure and is designated as a highly effective cash flow hedge. The differential to be paid or received on the SWAP agreement is accrued as interest rates change and is recognized over the life of the agreement in interest expense. The SWAP agreement expires in December 2007 and essentially fixes the rate to be paid at 5.72%. The notional amount is $7,000,000. Included in other comprehensive income is a gain of $70,000, less $24,000 of deferred income tax, relating to the fair market value of the SWAP agreement as of March 31, 2004. Risk management results for the period ended March 31, 2004 related to the balance sheet hedging of the company obligated mandatorily redeemable preferred securities indicate that the hedge was 100% effective and that there was no component of the derivative instrument's gain or loss which was excluded from the assessment of hedge effectiveness.

LIQUIDITY

Liquidity, as it relates to the subsidiary bank, is a measure of its ability to fund loans and withdrawals of deposits in a cost-effective manner. The Bank's principal sources of funds are deposits, scheduled amortization and prepayment of loan principal, amortization, prepayment and maturity of investment securities, short-term borrowings and income from operations. Additional sources include purchasing fed funds, sale of securities, sale of loans, borrowing from both the Federal Reserve Bank and Federal Home Loan Bank, and dividends paid by Nevahawk, a wholly owned subsidiary of the Bank.

The liquidity needs of the Company generally consist of payment of dividends to its shareholders, payments of principal and interest on borrowed funds and subordinated debentures, and a limited amount of expenses. The sources of funds to provide this liquidity are issuance of capital stock and dividends from its subsidiary bank. Certain restrictions are imposed upon the Bank, which could limit its ability to pay dividends if it did not have net earnings or adequate capital in the future. The Company maintains adequate liquidity to pay its expenses.

The following table summarizes The Company's significant contractual obligations and other potential funding needs at March 31, 2004 (in thousands):

	Time	Long-term	Operating	Data Processing

Deposits debt(1)