

PROSPERITY BANCSHARES INC  
Form 10-Q  
May 10, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2007**

OR

**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: 000-25051

**PROSPERITY BANCSHARES, INC.<sup>®</sup>**

(Exact name of registrant as specified in its charter)

**TEXAS**  
(State or other jurisdiction of incorporation  
or organization)

**74-2331986**  
(I.R.S. Employer  
Identification No.)

**Prosperity Bank Plaza**

**4295 San Felipe**

**Houston, Texas 77027**

(Address of principal executive offices, including zip code)

**(713) 693-9300**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject

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to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer:  Accelerated filer:  Non-accelerated filer:

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of May 3, 2007, there were 43,801,635 shares of the registrant's Common Stock, par value \$1.00 per share, outstanding.

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

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## PART I FINANCIAL INFORMATION

## ITEM 1. INTERIM CONSOLIDATED FINANCIAL STATEMENTS

**PROSPERITY BANCSHARES, INC<sup>®</sup>. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(UNAUDITED)**

	March 31, 2007	December 31, 2006
	(Dollars in thousands, except share data)	
<b>ASSETS</b>		
Cash and due from banks	\$ 135,497	\$ 116,078
Federal funds sold	66,160	153,643
Total cash and cash equivalents	201,657	269,721
Interest bearing deposits in financial institutions	297	397
Available for sale securities, at fair value (amortized cost of \$574,410 and \$438,869, respectively)	571,975	434,331
Held to maturity securities, at cost (fair value of \$1,293,570, and \$1,131,096, respectively)	1,314,319	1,155,972
Loans held for investment	3,223,271	2,176,507
Loans held for sale	24,437	
Less allowance for credit losses	(36,341)	(23,990)
Loans, net	3,211,367	2,152,517
Accrued interest receivable	27,795	20,364
Goodwill	739,328	424,339
Core deposit intangibles, net of accumulated amortization of \$13,717 and \$11,573, respectively	51,883	23,032
Bank premises and equipment, net	118,287	63,057
Other real estate owned	2,138	140
Bank Owned Life Insurance (BOLI)	44,046	14,176
Leased assets	4,216	3,709
Other assets	39,391	25,014
<b>TOTAL ASSETS</b>	<b>\$ 6,326,699</b>	<b>\$ 4,586,769</b>

<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
<b>LIABILITIES:</b>		
Deposits:		
Noninterest-bearing	\$ 1,188,741	\$ 835,876
Interest-bearing	3,739,499	2,889,802
Total deposits	4,928,240	3,725,678
Other borrowings	65,621	26,408
Securities sold under repurchase agreements	73,916	47,225
Accrued interest payable	12,216	8,451
Other liabilities	34,777	14,077
Junior subordinated debentures	145,360	100,519
Total liabilities	5,260,130	3,922,358

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SHAREHOLDERS EQUITY:

Preferred stock, \$1 par value; 20,000,000 shares authorized; none issued or outstanding		
Common stock, \$1 par value; 50,000,000 shares authorized; 43,803,146 and 32,829,873 shares issued at March 31, 2007 and December 31, 2006, respectively; 43,766,058 and 32,792,785 shares outstanding at March 31, 2007 and December 31, 2006, respectively	43,803	32,830
Capital surplus	800,062	425,557
Retained earnings	224,894	209,581
Accumulated other comprehensive loss net unrealized loss on available for sale securities, net of tax benefit of \$852 and \$1,588, respectively	(1,583)	(2,950)
Less treasury stock, at cost, 37,088 shares	(607)	(607)
Total shareholders equity	1,066,569	664,411
<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>	<b>\$ 6,326,699</b>	<b>\$ 4,586,769</b>

See notes to interim consolidated financial statements.

**Table of Contents****PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME****(UNAUDITED)**

	<b>Three Months Ended March 31, 2007      2006 (Dollars in thousands, except per share data)</b>	
<b>INTEREST INCOME:</b>		
Loans, including fees	\$ 57,260	\$ 28,482
<b>Securities:</b>		
Taxable	20,661	16,555
Nontaxable	793	300
70% nontaxable preferred dividends	254	141
Federal funds sold	891	203
Deposits in other financial institutions	4	3
<b>Total interest income</b>	<b>79,863</b>	<b>45,684</b>
<b>INTEREST EXPENSE:</b>		
Deposits	29,113	14,093
Junior subordinated debentures	2,598	1,397
Note payable and other borrowings	2,064	1,004
<b>Total interest expense</b>	<b>33,775</b>	<b>16,494</b>
<b>NET INTEREST INCOME</b>	<b>46,088</b>	<b>29,190</b>
<b>PROVISION FOR CREDIT LOSSES</b>	<b>245</b>	<b>120</b>
<b>NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES</b>	<b>45,843</b>	<b>29,070</b>
<b>NONINTEREST INCOME:</b>		
Customer service fees	8,510	6,325
Other	3,161	1,342
<b>Total noninterest income</b>	<b>11,671</b>	<b>7,667</b>
<b>NONINTEREST EXPENSE:</b>		
Salaries and employee benefits	15,302	9,195
Net occupancy expense	2,458	1,681
Depreciation expense	1,876	1,175
Data processing	985	811
Communications expense	1,387	1,055
Core deposit intangibles amortization	2,145	1,067
Other	3,118	2,265
<b>Total noninterest expense</b>	<b>27,271</b>	<b>17,249</b>

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INCOME BEFORE INCOME TAXES	30,243	19,488
PROVISION FOR INCOME TAXES	10,014	6,624
NET INCOME	\$ 20,229	\$ 12,864
EARNINGS PER SHARE		
Basic	\$ 0.51	\$ 0.46
Diluted	\$ 0.50	\$ 0.46

See notes to interim consolidated financial statements.

**Table of Contents****PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY****(UNAUDITED)**

	Common Stock		Capital Surplus (Dollars in thousands, except share data)	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders Equity
	Shares	Amount					
BALANCE AT JANUARY 1, 2006	27,857,887	27,858	280,525	160,883	(3,942)	(607)	464,717
Comprehensive Income:							
Net income				61,725			61,725
Net change in unrealized income (loss) on available for sale securities					992		992
<b>Total comprehensive income</b>							<b>62,717</b>
Common stock issued in connection with the exercise of stock options and restricted stock awards	523,761	524	7,268				7,792
Common stock issued in connection with the SNB Bancshares acquisition	4,448,225	4,448	136,914				141,362
Stock based compensation expense			850				850
Cash dividends declared, \$0.41 per share				(13,027)			(13,027)
BALANCE AT DECEMBER 31, 2006	32,829,873	\$ 32,830	\$ 425,557	\$ 209,581	\$ (2,950)	\$ (607)	\$ 664,411
Comprehensive income:							
Net income				20,229			20,229
Net change in unrealized income (loss) on available for sale securities					1,367		1,367
<b>Total comprehensive income</b>							<b>21,596</b>
Common stock issued in connection with the exercise of stock options and restricted stock awards	203,331	203	1,596				1,799
Common stock issued in connection with the Texas United Bancshares acquisition	10,769,942	10,770	372,477				383,247
Stock based compensation expense			432				432
Cash dividends declared, \$0.1125 per share				(4,916)			(4,916)
BALANCE AT MARCH 31, 2007	43,803,146	\$ 43,803	\$ 800,062	\$ 224,894	\$ (1,583)	\$ (607)	\$ 1,066,569

See notes to interim consolidated financial statements.



**Table of Contents****PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(UNAUDITED)**

	<b>Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(Dollars in thousands)</b>	
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 20,229	\$ 12,864
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,021	2,242
Provision for credit losses	245	120
Net amortization of discount/premium on investments	(2,617)	308
Stock based compensation expense	432	172
Gain on sale of assets and other real estate	(14)	(10)
Gain on held for sale loans	(604)	
Proceeds from sales of held for sale loans	112,705	
Originations of held for sale loans	(13,696)	
Decrease (increase) in other assets and accrued interest receivable	11,494	(152)
(Decrease) increase in accrued interest payable and other liabilities	(3,486)	2,882
Net cash provided by operating activities	128,709	18,426
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Proceeds from maturities and principal paydowns of held to maturity securities	65,124	57,683
Purchase of held to maturity securities	(104,072)	(54,166)
Proceeds from maturities and principal paydowns of available for sale securities	251,460	12,443
Purchase of available for sale securities	(257,369)	
Proceeds from sales of available for sale securities		1,000
Net decrease (increase) in loans	42,601	(19,372)
Purchase of Grapeland Bancshares, Inc.		(65)
Purchase of Texas United Bancshares, Inc.	(1,187)	
Cash and cash equivalents acquired in the purchase of Texas United Bancshares, Inc.	114,469	
Purchase of bank premises and equipment	(1,917)	(273)
Net decrease in interest-bearing deposits in financial institutions	100	
Net proceeds from sale of bank premises, equipment, and other real estate	916	287
Net cash provided by (used in) investing activities	110,125	(2,463)

*(Table continued on following page)*

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	<b>Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(Dollars in thousands)</b>	
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net (decrease) increase in noninterest-bearing deposits	\$ (24,484)	\$ 18,306
Net decrease in interest-bearing deposits	(101,165)	(23,282)
Net repayments of lines of credit	(188,627)	(17,220)
Net proceeds (repayments) from securities sold under repurchase agreements	10,495	(28)
Redemption of Paradigm Capital Trust II, net		(6,000)
Proceeds from exercise of stock options	1,799	689
Payments of cash dividends	(4,916)	(2,787)
 Net cash used in financing activities	 (306,898)	 (30,322)
 NET DECREASE IN CASH AND CASH EQUIVALENTS	 \$ (68,064)	 \$ (14,359)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	269,721	97,364
 CASH AND CASH EQUIVALENTS, END OF PERIOD	 \$ 201,657	 \$ 83,005
<b>NONCASH ACTIVITIES:</b>		
Stock issued in connection with the Texas United Bancshares, Inc. acquisition	\$ 383,247	\$
<b>SUPPLEMENTAL DISCLOSURES</b>		
Cash paid for interest	\$ 33,416	\$ 17,923
Cash paid for income taxes	4,500	

See notes to interim consolidated financial statements.

**Table of Contents****PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES****NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS****MARCH 31, 2007****(UNAUDITED)****1. BASIS OF PRESENTATION**

The interim consolidated financial statements include the accounts of Prosperity Bancshares, Inc.® (the Company) and its wholly-owned subsidiaries, Prosperity Bank® (the Bank) and Prosperity Holdings of Delaware, LLC. All significant inter-company transactions and balances have been eliminated.

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, the statements reflect all adjustments necessary for a fair presentation of the financial position, results of operations and cash flows of the Company on a consolidated basis, and all such adjustments are of a normal recurring nature. These financial statements and the notes thereto should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2006. Operating results for the three month period ended March 31, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

**2. INCOME PER COMMON SHARE**

The following table illustrates the computation of basic and diluted earnings per share:

	<b>Three Months Ended March 31, 2007      2006</b>	
	<b>(In thousands, except per share data)</b>	
Net income available to shareholders	\$ 20,229	\$ 12,864
Weighted average shares outstanding	39,813	27,850
Potential dilutive shares	470	296
Weighted average shares and equivalents outstanding	40,283	28,146
Basic earnings per share	\$ 0.51	\$ 0.46
Diluted earnings per share	\$ 0.50	\$ 0.46

**3. NEW ACCOUNTING STANDARDS****Statements of Financial Accounting Standards**

*SFAS No. 155, Accounting for Certain Hybrid Financial Instruments.* SFAS 155 amends SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* and SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* SFAS 155 (i) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (ii) clarifies which interest-only strips and principal only strips are not subject to the requirements of SFAS 133, (iii) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, (iv) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and (v) amends SFAS 140 to eliminate the prohibition on a qualifying special purpose entity from holding a

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derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. Adoption of SFAS 155 on January 1, 2007 did not have a significant impact on the Company's financial statements.

*SFAS No. 157, Fair Value Measurements.* SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for the Company on January 1, 2008 and is not expected to have a significant impact on the Company's financial statements.

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*SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115.* SFAS 159 permits entities to choose to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. The fair value option (i) may be applied instrument by instrument, with certain exceptions, (ii) is irrevocable (unless a new election date occurs) and (iii) is applied only to entire instruments and not to portions of instruments. SFAS 159 is effective for the Company on January 1, 2008 and is not expected to have a significant impact on the Company's financial statements.

**Financial Accounting Standards Board Interpretations**

*FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109.* The Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109, effective January 1, 2007. Interpretation 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Interpretation 48 also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties. The Company's policy for recording interest and penalties associated with audits is to record such items as a component of income before taxes. Penalties are recorded in other (gains) losses, net, and interest paid or received is recorded in interest expense or interest income, respectively, in the statement of income. The Company has identified its federal tax return and its state franchise tax return in Texas as major tax jurisdictions, as defined. The only periods subject to examination for the Company's federal return are the 2003 through 2006 tax years. The Company believes that its income tax filing positions and deductions will be sustained on audit and does not anticipate any adjustments that will result in a material change to its financial position. Therefore, no reserves for uncertain income tax positions have been recorded pursuant to FIN 48. In addition, the Company did not record a cumulative effect adjustment related to the adoption of FIN 48.

**4. GOODWILL AND CORE DEPOSIT INTANGIBLES**

Changes in the carrying amount of the Company's goodwill and core deposit intangibles for the three months ended March 31, 2007 were as follows:

	Goodwill	Core Deposit Intangibles
	(Dollars in thousands)	
Balance as of December 31, 2006	\$ 424,339	\$ 23,032
Amortization		(2,145)
Acquisition of Texas United Bancshares, Inc. ( TXUI )	315,092	30,996
Acquisitions prior to December 31, 2006 (deferred taxes)	(103)	
Balance as of March 31, 2007	\$ 739,328	\$ 51,883

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Gross core deposit intangibles outstanding were \$65.6 million and \$34.6 million at March 31, 2007 and December 31, 2006, respectively. Net core deposit intangibles outstanding were \$51.9 million and \$23.0 million for the same periods, respectively. Purchase accounting adjustments to prior year acquisitions were made to adjust deferred tax asset and liability balances. Goodwill is recorded on the acquisition date of each entity. The Company may record subsequent adjustments to goodwill for amounts undeterminable at acquisition date, such as deferred taxes and real estate valuations, and therefore the goodwill amounts reflected in the table above may change accordingly. The Company initially records the total premium paid on acquisitions as goodwill. After a third party valuation, core deposit intangibles are identified and reclassified from goodwill to core deposit intangibles on the balance sheet. This reclassification had no effect on total assets, liabilities, shareholders' equity, net income or cash flows.

**Table of Contents****PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES****NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS****MARCH 31, 2007****(UNAUDITED)****5. STOCK BASED COMPENSATION**

The Company had two stock-based employee compensation plans at March 31, 2007 and five stock option plans assumed in connection with acquisitions under which no additional options will be granted. Prior to 2003, the Company accounted for those plans under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. The Company adopted SFAS 123 on January 1, 2003 and SFAS 123(R) on January 1, 2006. The Company recorded \$432,000 and \$172,000 in stock-based compensation expense for the three months ended March 31, 2007 and 2006, respectively. There was approximately \$37,000 and \$9,000 of income tax benefit recorded for the stock-based compensation expense for the same periods.

The Company has granted shares ( restricted stock ) to certain directors and associates under the 2004 Plan. The awardee is not entitled to the shares until they vest, which is generally over a 1 to 5 year period, but the awardee is entitled to receive dividends on and vote the shares prior to vesting. The shares granted do not have a cost to the awardee and the only requirement of vesting is continued service to the Company. Compensation cost related to restricted stock is calculated based on the fair value of the shares at the date of grant. If the awardee leaves the Company before the shares vest, the unvested shares are forfeited. As of March 31, 2007, there were 82,129 shares of restricted stock outstanding with a weighted average grant date fair value of \$34.67.

Stock options are issued at the current market price on the date of the grant, subject to a pre-determined vesting period with a contractual term of 10 years. Options assumed in connection with acquisitions also have a contractual term of 10 years from date of original issuance under the original plan. The fair value of stock options granted is estimated at the date of grant using the Black-Scholes option-pricing model. Stock-based compensation expense is recognized ratably over the requisite service period for all awards.

The fair value of options was estimated using an option-pricing model with the following weighted average assumptions as of the dates indicated:

	<b>March 31,</b>	
	<b>2007</b>	<b>2006</b>
Expected life...	4.35	4.73
Risk free interest rate	4.24%	4.18%
Volatility	21.14%	21.64%
Dividend yield	1.24%	1.29%

A summary of changes in outstanding options during the three months ended March 31, 2007 is set forth below:

	<b>Number of Options (In thousands)</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Term</b>	<b>Aggregate Intrinsic Value (In thousands)</b>
Options outstanding, beginning of period	1,142	\$ 21.68		
Options granted (1)	180	13.12		
Options forfeited	(12)	23.82		
Options exercised	(131)	13.71		

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Options outstanding, end of period	1,179	\$ 21.36	6.12	\$ 15,776
Options exercisable, end of period	426	\$ 14.66	4.31	\$ 8,549

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(1) Consists of options assumed in the acquisition of TXUI.



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No options were granted during the three months ended March 31, 2007 or 2006. The Company assumed 179,956 options in connection with the TXUI acquisition which were fully vested upon consummation of the transaction. The total intrinsic value of the options exercised during the three month periods ended March 31, 2007 and 2006 was \$2.8 million and \$772,000, respectively. Excluding the shares assumed in the TXUI acquisition, the total fair value of shares vested during the three month period ended March 31, 2007 was approximately \$11,000.

A summary of changes in non-vested options is set forth below:

	2007		Three Months Ended March 31,		2006	
	Number of Options (In thousands)	Weighted Average Grant Date Fair Value	Number of Options (In thousands)	Weighted Average Grant Date Fair Value	Number of Options (In thousands)	Weighted Average Grant Date Fair Value
Non-vested options outstanding, beginning of period	778	\$ 5.93	849	\$ 5.52		
Options granted						
Non-vested options forfeited	(12)	4.99	(17)	5.59		
Options vested	(13)	0.85	(12)	0.41		
Non-vested options outstanding, end of period	753	\$ 6.03	820	\$ 5.59		

The Company received \$1.8 million and \$689,000 in cash from the exercise of stock options during the three month periods ended March 31, 2007 and 2006, respectively. There was no tax benefit realized from option exercises of the share-based payment arrangements during the three month periods ended March 31, 2007 and 2006.

As of March 31, 2007, there was \$4.3 million of total unrecognized compensation expense related to stock-based compensation arrangements. That cost is expected to be recognized over a weighted average period of 2.0 years.

**6. RECENT ACQUISITION**

On January 31, 2007, the Company completed its acquisition of Texas United Bancshares, Inc., La Grange, Texas ( TXUI ). Under the terms of the merger agreement, TXUI was merged into the Company and subsequently each of TXUI's wholly owned subsidiary banks, State Bank, GNB Financial, n.a., Gateway National Bank and Northwest Bank, was merged into the Bank. The Company issued approximately 10.8 million shares of its common stock for all of the issued and outstanding capital stock of TXUI. In addition, options to acquire 179,956 shares of TXUI common stock were converted into options to acquire 179,956 shares of Company common stock. In connection with the acquisition, the Company assumed \$44.8 million in junior subordinated debentures issued to five subsidiary trusts. TXUI was publicly traded and operated forty-one (41) banking offices in Texas, two of which were subsequently consolidated with existing Prosperity banking centers. As of December 31, 2006, TXUI had, on a consolidated basis, total assets of \$1.806 billion, loans (including loans held for sale) of \$1.212 billion, deposits of \$1.362 billion and shareholders' equity of \$161.9 million.

The table below summarizes select pro forma data for the two combined companies for the periods indicated:

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	For the three months ended March 31, 2007      2006 (In thousands, except per share amounts)	
Net interest income	\$ 52,338	\$ 54,023
Net income	22,145	20,798
Earnings per share (diluted)	0.50	0.49

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**PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES**

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**MARCH 31, 2007**

**(UNAUDITED)**

7. SUBSEQUENT EVENT

On May 3, 2007, the Company announced its proposed acquisition of The Bank of Navasota, N.A., Navasota, Texas ( Navasota ). Under the terms of the merger agreement, The Bank of Navasota will be merged into the Bank. The Company will issue approximately 251,000 shares of its common stock and pay approximately \$8.6 million in cash for all of the issued and outstanding capital stock of Navasota, with the amount of common stock and cash subject to adjustment. Navasota operates one banking office in Navasota, Texas. As of March 31, 2007, Navasota had total assets of \$73.2 million, loans of \$33.6 million, deposits of \$63.6 million and shareholders' equity of \$9.0 million.

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

**Special Cautionary Notice Regarding Forward-Looking Statements**

Statements and financial discussion and analysis contained in this quarterly report on Form 10-Q that are not historical facts are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are based on assumptions and involve a number of risks and uncertainties, many of which are beyond the Company's control. Many possible events or factors could affect the future financial results and performance of the Company and could cause such results or performance to differ materially from those expressed in the forward-looking statements. These possible events or factors include, without limitation:

changes in interest rates and market prices, which could reduce the Company's net interest margins, asset valuations and expense expectations;

changes in the levels of loan prepayments and the resulting effects on the value of the Company's loan portfolio;

changes in local economic and business conditions which adversely affect the Company's customers and their ability to transact profitable business with the company, including the ability of the Company's borrowers to repay their loans according to their terms or a change in the value of the related collateral;

increased competition for deposits and loans adversely affecting rates and terms;

the timing, impact and other uncertainties of any future acquisitions, including the Company's ability to identify suitable future acquisition candidates, the success or failure in the integration of their operations, and the ability to enter new markets successfully and capitalize on growth opportunities;

increased credit risk in the Company's assets and increased operating risk caused by a material change in commercial, consumer and/or real estate loans as a percentage of the total loan portfolio;

the failure of assumptions underlying the establishment of and provisions made to the allowance for credit losses;

changes in the availability of funds resulting in increased costs or reduced liquidity;

increased asset levels and changes in the composition of assets and the resulting impact on the Company's capital levels and regulatory capital ratios;

the Company's ability to acquire, operate and maintain cost effective and efficient systems without incurring unexpectedly difficult or expensive but necessary technological changes;

the loss of senior management or operating personnel and the potential inability to hire qualified personnel at reasonable compensation levels;

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changes in statutes and government regulations or their interpretations applicable to financial holding companies and the Company's present and future banking and other subsidiaries, including changes in tax requirements and tax rates;

acts of terrorism, an outbreak of hostilities or other international or domestic calamities, weather or other acts of God and other matters beyond the Company's control; and

other risks and uncertainties listed from time to time in the Company's reports and documents filed with the Securities and Exchange Commission.

A forward-looking statement may include a statement of the assumptions or bases underlying the forward-looking statement. The Company believes it has chosen these assumptions or bases in good faith and that they are reasonable. However, the Company cautions you that assumptions or bases almost always vary from actual results, and the differences between assumptions or bases and actual results can be material.

The Company undertakes no obligation to publicly update or otherwise revise any forward-looking statements, whether as a result of new information, future events or otherwise, unless the securities laws require the Company to do so.

Management's Discussion and Analysis of Financial Condition and Results of Operations analyzes the major elements of the Company's interim consolidated financial statements and accompanying notes. This section should be read in conjunction with the Company's interim consolidated financial statements and accompanying notes included elsewhere in this report and with the consolidated financial statements and accompanying notes and other detailed information appearing in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

### COMPLETION OF ACQUISITION OF TEXAS UNITED BANCSHARES, INC.

On January 31, 2007, the Company completed its acquisition of Texas United Bancshares, Inc., La Grange, Texas (TXUI). Under the terms of the merger agreement, TXUI was merged into the Company and subsequently each of TXUI's wholly owned subsidiary banks, State Bank, GNB Financial, n.a., Gateway National Bank and Northwest Bank, was merged into the Bank. The Company issued approximately 10.8 million shares of its common stock for all of the issued and outstanding capital stock of TXUI. In addition, options to acquire 179,956 shares of TXUI common stock were converted into options to acquire 179,956 shares of Company common stock. In connection with the acquisition, the Company assumed \$44.8 million in junior subordinated debentures issued to five subsidiary trusts. TXUI was publicly traded and operated forty-one (41) banking offices in Texas, two of which were subsequently consolidated into existing Prosperity locations. As of December 31, 2006, TXUI had, on a consolidated basis, total assets of \$1.806 billion, loans (including loans held for sale) of \$1.212 billion, deposits of \$1.362 billion and shareholders' equity of \$161.9 million.

### OVERVIEW

The Company, a Texas corporation, was formed in 1983 as a vehicle to acquire the former Allied First Bank in Edna, Texas which was chartered in 1949 as The First National Bank of Edna. The Company is a registered financial holding company that derives substantially all of its revenues and income from the operation of its bank subsidiary, Prosperity Bank® (Prosperity Bank® or the Bank). The Bank provides a wide array of financial products and services to small and medium-sized businesses and consumers. At March 31, 2007, the Bank operated one hundred twenty-five (125) full-service banking locations in Texas; with forty-one (41) in the Greater Houston Consolidated Metropolitan Statistical Area (CMSA), thirty-three (33) in the south Texas area including Corpus Christi and Victoria, twenty-seven (27) in the Dallas/Fort Worth area, two (2) in East Texas and twenty-two (22) in the Central Texas area including Austin and Bryan/College Station. The Greater Houston CMSA includes Austin, Brazoria, Chambers, Fort Bend, Galveston, Harris, Liberty, Montgomery, San Jacinto and Waller counties. The Company's headquarters are located at Prosperity Bank Plaza, 4295 San Felipe in Houston, Texas and its telephone number is (713) 693-9300. The Company's website address is [www.prosperitybanktx.com](http://www.prosperitybanktx.com). Information contained on the Company's website is not incorporated by reference into this quarterly report on Form 10-Q and is not part of this or any other report.

The Company generates the majority of its revenues from interest income on loans, service charges on customer accounts and income from investment in securities. The revenues are partially offset by interest expense paid on deposits and other borrowings and non-interest expenses such as administrative, occupancy and general operating expenses. Net interest income is the difference between interest income on earning assets such as loans and securities and interest expense on liabilities such as deposits and borrowings which are used to fund those assets. The level of interest rates and the volume and mix of earning assets and interest-bearing liabilities impact net interest income and margin.

Three principal components of the Company's growth strategy are internal growth, stringent cost control practices and strategic merger transactions. The Company focuses on continual internal growth. Each banking center is operated as a separate profit center, maintaining separate data with respect to its net interest income, efficiency ratio, deposit growth, loan growth and overall profitability. Banking center presidents and managers are accountable for performance in these areas and compensated accordingly. The Company also focuses on

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maintaining stringent cost control practices and policies. The Company has invested significantly in the infrastructure required to centralize many of its critical operations, such as data processing and loan processing. Management believes that this centralized infrastructure can accommodate substantial

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additional growth while enabling the Company to minimize operational costs through certain economies of scale. The Company also intends to continue to seek expansion opportunities. On April 1, 2006, the Company acquired SNB Bancshares, Inc. (the "SNB acquisition") which added six (6) banking centers and on January 31, 2007, the Company acquired Texas United Bancshares, Inc. (the "TXUI acquisition") which added thirty-nine (39) additional banking centers after two locations were consolidated with existing Prosperity banking centers.

Total assets were \$6.33 billion at March 31, 2007 compared with \$4.59 billion at December 31, 2006, an increase of \$1.74 billion or 37.9%. Total loans were \$3.25 billion at March 31, 2007 compared with \$2.18 billion at December 31, 2006, an increase of \$1.07 billion or 49.2%. Total deposits were \$4.93 billion at March 31, 2007 compared with \$3.73 billion December 31, 2006, an increase of \$1.20 billion or 32.3%. Shareholders' equity increased \$402.2 million or 60.5%, to \$1.067 billion at March 31, 2007 compared with \$664.4 million at December 31, 2006. The increases were primarily due to the TXUI acquisition.

### CRITICAL ACCOUNTING POLICIES

The Company's accounting policies are integral to understanding the financial results reported. Accounting policies are described in detail in Note 1 to the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006. The Company believes that of its significant accounting policies, the following may involve a higher degree of judgment and complexity:

*Allowance for Credit Losses* The allowance for credit losses is a reserve established through charges to earnings in the form of a provision for credit losses. Management has established an allowance for credit losses which it believes is adequate for estimated losses in the Company's loan portfolio. Based on an evaluation of the loan portfolio, management presents a monthly review of the allowance for credit losses to the Bank's Board of Directors, indicating any change in the allowance since the last review and any recommendations as to adjustments in the allowance. In making its evaluation, management considers factors such as historical loan loss experience, industry diversification of the Company's commercial loan portfolio, the amount of nonperforming assets and related collateral, the volume, growth and composition of the Company's loan portfolio, current economic changes that may affect the borrower's ability to pay and the value of collateral, the evaluation of the Company's loan portfolio through its internal loan review process and other relevant factors. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. Charge-offs occur when loans are deemed to be uncollectible. The allowance for credit losses includes allowance allocations calculated in accordance with Statement of Financial Accounting Standards (SFAS) No. 114, *Accounting by Creditors for Impairment of a Loan*, as amended by SFAS 118, and allowance allocations determined in accordance with SFAS No. 5, *Accounting for Contingencies*.

*Goodwill and Intangible Assets* Goodwill and intangible assets that have indefinite useful lives are subject to at least an annual impairment test and more frequently if circumstances indicate their value may not be recoverable. Goodwill is tested for impairment using a two-step process that begins with an estimation of the fair value of each of the Company's reporting units compared with its carrying value. If the carrying amount exceeds the fair value of a reporting unit, a second test is completed comparing the implied fair value of the reporting unit's goodwill to its carrying value to measure the amount of impairment. Intangible assets that are not amortized will be tested for impairment at least annually by comparing the fair values of those assets to their carrying values. Other identifiable intangible assets that are subject to amortization are amortized on an accelerated basis over the years expected to be benefited. These amortizable intangible assets are reviewed for impairment if circumstances indicate their value may not be recoverable based on a comparison of fair value to carrying value. Based on the Company's annual goodwill impairment test as of September 30, 2006, management does not believe any of its goodwill is impaired as of March 31, 2007. While the Company believes no impairment existed at March 31, 2007 under accounting standards applicable at that date, different conditions or assumptions, or changes in cash flows or profitability, if significantly negative or unfavorable, could have a material adverse effect on the outcome of the Company's impairment evaluation and financial condition or future results of operations.

*Stock-Based Compensation* The Company adopted the provisions of SFAS No. 123R *Share-Based Payment (Revised 2004)*, on January 1, 2006 and its adoption did not have a material impact on the Company's financial statements. The Company had previously adopted SFAS No. 123 on January 1, 2003. Among other things, SFAS No. 123R eliminates the ability to account for stock-based compensation using the intrinsic value based method of accounting and requires that such transactions be recognized as compensation expense in the income statement based on their fair values on the date of the grant. SFAS No. 123R requires that management make assumptions including stock price volatility and employee turnover that are utilized to measure compensation expense. The fair value of stock options granted is estimated at the date of grant using the Black-Scholes option-pricing model. This model requires the input of highly subjective assumptions.

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RESULTS OF OPERATIONS

Net income available to shareholders was \$20.2 million (\$0.50 per common share on a diluted basis) for the quarter ended March 31, 2007 compared with \$12.9 million (\$0.46 per common share on a diluted basis) for the quarter ended March 31, 2006, an increase of \$7.4 million or 57.3%. The Company posted returns on average common equity of 8.71% and 10.92%, returns on average assets of 1.40% and 1.43% and efficiency ratios of 47.73% and 46.80% for the quarters ended March 31, 2007 and 2006, respectively.

*Net Interest Income*

The Company's net interest income is affected by changes in the amount and mix of interest-earning assets and interest-bearing liabilities, referred to as a volume change. It is also affected by changes in yields earned on interest-earning assets and rates paid on interest-bearing deposits and other borrowed funds, referred to as a rate change.

Net interest income before the provision for credit losses was \$46.1 million for the quarter ended March 31, 2007 compared with \$29.2 million for the quarter ended March 31, 2006, an increase of \$16.9 million or 57.9%. Net interest income increased primarily as a result of an increase in average interest-earning assets to \$4.82 billion for the quarter ended March 31, 2007 compared with \$3.14 billion for the quarter ended March 31, 2006, an increase of \$1.68 billion or 53.5% that was primarily due to the TXUI and SNB acquisitions.

The average rate paid on interest-bearing liabilities increased 84 basis points from 2.76% for the quarter ended March 31, 2006 to 3.60% for the quarter ended March 31, 2007, while the average yield on interest-earning assets increased 82 basis points from 5.90% for the quarter ended March 31, 2006 compared with 6.72% for the quarter ended March 31, 2007. The average volume of interest-bearing liabilities increased \$1.37 billion and the average volume of interest-earning assets increased \$1.68 billion for the same period.



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The following table sets forth, for each major category of interest-earning assets and interest-bearing liabilities, the average amounts outstanding, the interest earned or paid on such amounts, and the average rate earned or paid for the quarters ended March 31, 2007 and 2006. The table also sets forth the average rate paid on total interest-bearing liabilities, and the net interest margin on average total interest-earning assets for the same periods. Except as indicated in the footnotes, no tax-equivalent adjustments were made and all average balances are daily average balances. Any nonaccruing loans have been included in the table as loans carrying a zero yield.

	Three Months Ended March 31,					
	Average Outstanding Balance	2007 Interest Earned/ Paid	Average Yield/ Rate (4)	Average Outstanding Balance	2006 Interest Earned/ Paid	Average Yield/ Rate (4)
(Dollars in thousands)						
<b>Assets</b>						
Interest-earning assets:						
Loans	\$ 2,876,029	\$ 57,260	8.07%	\$ 1,551,397	\$ 28,482	7.45%
Securities(1)	1,873,905	21,708	4.63	1,572,259	16,996	4.32
Federal funds sold and other temporary investments	71,451	895	5.08	18,020	206	4.64
Total interest-earning assets	4,821,385	79,863	6.72%	3,141,676	45,684	5.90%
Less allowance for credit losses	(32,131)			(17,247)		
Total interest-earning assets, net of allowance	4,789,254			3,124,429		
Noninterest-earning assets	1,006,958			468,230		
Total assets	\$ 5,796,212			\$ 3,592,659		
<b>Liabilities and shareholders equity</b>						
Interest-bearing liabilities:						
Interest-bearing demand deposits	\$ 860,328	\$ 4,730	2.23%	\$ 478,259	\$ 1,374	1.17%
Savings and money market accounts	1,178,241	8,267	2.85	737,806	3,863	2.12
Certificates of deposit	1,462,241	16,116	4.47	1,042,215	8,856	3.45
Junior subordinated debentures	130,413	2,598	8.08	72,682	1,397	7.80
Federal funds purchased and other borrowings	110,703	1,462	5.36	53,639	643	4.86
Securities sold under repurchase agreements	59,236	602	4.12	42,741	361	3.43
Total interest-bearing liabilities	3,801,162	33,775	3.60%	2,427,342	16,494	2.76%
Noninterest-bearing liabilities:						
Noninterest-bearing demand deposits	1,035,294			670,547		
Other liabilities	31,050			23,690		
Total liabilities	4,867,506			3,121,579		
Shareholders equity	928,706			471,080		
Total liabilities and shareholders equity	\$ 5,796,212			\$ 3,592,659		
Net interest rate spread			3.12%			3.14%
Net interest income and margin (2)		\$ 46,088	3.88%		\$ 29,190	3.77%
Net interest income and margin (tax-equivalent basis) (3)		\$ 46,764	3.93%		\$ 29,524	3.81%

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- (1) Yield is based on amortized cost and does not include any component of unrealized gains or losses.
  - (2) The net interest margin is equal to net interest income divided by average interest-earning assets.
  - (3) In order to make pretax income and resultant yields on tax-exempt investments and loans comparable to those on taxable investments and loans, a tax-equivalent adjustment has been computed using a federal income tax rate of 35%.
  - (4) Annualized and based on an actual/365 basis.

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The following table presents the dollar amount of changes in interest income and interest expense for the major components of interest-earning assets and interest-bearing liabilities and distinguishes between the increase (decrease) related to higher outstanding balances and the changes in interest rates. For purposes of this table, changes attributable to both rate and volume which cannot be segregated have been allocated to rate.

	<b>Three Months Ended March 31, 2007 vs. 2006</b>		
	<b>Increase (Decrease)</b>		
	<b>Due to</b>		
	<b>Volume</b>	<b>Rate</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>		
<b>Interest-earning assets:</b>			
Loans	\$ 24,319	\$ 4,459	\$ 28,778
Securities	3,261	1,451	4,712
Federal funds sold and other temporary investments	611	78	689
<b>Total increase in interest income</b>	<b>28,191</b>	<b>5,988</b>	<b>34,179</b>
<b>Interest-bearing liabilities:</b>			
Interest-bearing demand deposits	1,098	2,258	3,356
Savings and money market accounts	2,306	2,098	4,404
Certificates of deposit	3,569	3,691	7,260
Junior subordinated debentures	1,110	91	1,201
Federal funds purchased and other borrowings	684	135	819
Securities sold under repurchase agreements	139	102	241
<b>Total increase in interest expense</b>	<b>8,906</b>	<b>8,375</b>	<b>17,281</b>
<b>Increase (decrease) in net interest income</b>	<b>\$ 19,285</b>	<b>\$ (2,387)</b>	<b>\$ 16,898</b>

*Provision for Credit Losses*

Management actively monitors the Company's asset quality and provides specific loss provisions when necessary. Provisions for credit losses are charged to income to bring the total allowance for credit losses to a level deemed appropriate by management of the Company based on such factors as historical credit loss experience, industry diversification of the commercial loan portfolio, the amount of nonperforming loans and related collateral, the volume growth and composition of the loan portfolio, current economic conditions that may affect the borrower's ability to pay and the value of collateral, the evaluation of the loan portfolio through the internal loan review function and other relevant factors.

Loans are charged-off against the allowance for credit losses when appropriate. Although management believes it uses the best information available to make determinations with respect to the provision for credit losses, future adjustments may be necessary if economic conditions differ from the assumptions used in making the initial determinations.

The Company made a \$245,000 and \$120,000 provision for credit losses for the quarters ended March 31, 2007 and 2006, respectively. For the quarter ended March 31, 2007, net charge-offs were \$635,000 compared with net charge-offs of \$11,000 for the quarter ended March 31, 2006.

*Noninterest Income*

The Company's primary sources of recurring noninterest income are service charges on deposit accounts and other banking service related fees. Noninterest income does not include loan origination fees which are recognized over the life of the related loan as an adjustment to yield using the interest method. Banking related service fees include check cashing fees, official check fees, safe deposit box rent and currency handling fees. Noninterest income totaled \$11.7 million for the three months ended March 31, 2007 compared with \$7.7 million for the same period in 2006, an increase of \$4.0 million or 52.2%. The increase was primarily due to an increase in insufficient funds charges and customer service charges which resulted from an increase in the number of accounts due to SNB acquisition on April 1, 2006 and the TXUI acquisition on January 31, 2007. As of March 31, 2007, approximately 109,000 deposit accounts were attributed to these two acquisitions.

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Income from bank owned life insurance increased \$248,000 for the quarter ended March 31, 2007 compared with the quarter ended March 31, 2006. Additional bank owned life insurance was acquired in the TXUI acquisition.

Gain on sale of held for sale loans increased \$604,000 for the quarter ended March 31, 2007 compared with none in the same quarter of 2006. The increase was primarily due to the TXUI acquisition which included a mortgage operations division that originated mortgage loans for sale into the secondary market.

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Other noninterest income increased \$488,000 or 126.1% from \$387,000 for the first quarter of 2006 compared with \$875,000 for the same period in 2007. The change includes increases in Federal Home Loan Bank stock dividends, rental income, lockbox income and credit card income and was primarily due to the TXUI and SNB acquisitions.

The following table presents, for the periods indicated, the major categories of noninterest income:

	<b>Three months ended March 31, 2007      2006 (Dollars in thousands)</b>	
Service charges on deposit accounts	\$ 8,510	\$ 6,325
Banking related service fees	401	303
Brokered mortgage income	132	183
Trust and investment income	468	70
Income from leased assets	299	269
Bank owned life insurance income (BOLI)	368	120
Gain on sale of assets, net	14	10
Gain on sale of held for sale loans	604	
Other noninterest income	875	387
 Total noninterest income	 \$ 11,671	 \$ 7,667

*Noninterest Expense*

Noninterest expense totaled \$27.3 million for the quarter ended March 31, 2007 compared with \$17.2 million for the quarter ended March 31, 2006, an increase of \$10.0 million or 58.1%. This increase was principally due to increases in salaries and employee benefits, net occupancy and equipment expense and core deposit intangibles amortization.

The following table presents, for the periods indicated, the major categories of noninterest expense:

	<b>Three Months Ended March 31, 2007      2006 (Dollars in thousands)</b>	
Salaries and employee benefits <sup>(1)</sup>	\$ 15,302	\$ 9,195
Non-staff expenses:		
Net occupancy expense	2,458	1,681
Depreciation expense	1,876	1,175
Data processing	985	811
Communications expense	1,387	1,055
Printing and supplies	295	266
Professional fees	364	300
Regulatory assessments and FDIC insurance	218	169
Ad valorem and franchise taxes	596	488
Core deposit intangibles amortization	2,145	1,067
Other	1,645	1,042
 Total non-staff expenses	 11,969	 8,054

Total noninterest expense	\$ 27,271	\$ 17,249
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(1) Includes stock-based compensation expense of \$432,000 and \$172,000 for the three months ended March 31, 2007 and 2006, respectively.

Salaries and employee benefit expenses were \$15.3 million for the quarter ended March 31, 2007 compared with \$9.2 million for the quarter ended March 31, 2006, an increase of \$6.1 million or 66.4%. The increase was principally due to additional staff associated with the SNB and TXUI acquisitions. The number of full-time equivalent (FTE) associates employed by the Company increased from 844 at March 31, 2006 to 1,432 at March 31, 2007.

Non-staff expenses increased \$3.9 million, or 48.6%, to \$12.0 million for the quarter ended March 31, 2007 compared with \$8.1 million during the same period in 2006. The increase was principally due to additional general and administrative expenses associated with the SNB and TXUI acquisitions, increases in core deposit intangibles amortization related to such

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acquisitions and increases in depreciation and net occupancy and equipment expenses related to the addition of thirty-nine banking centers in connection with the TXUI acquisition on January 31, 2007 and six banking centers in connection with the SNB acquisition on April 1, 2006.

*Income Taxes*

Income tax expense increased \$3.4 million to \$10.0 million for the quarter ended March 31, 2007 compared with \$6.6 million for the same period in 2006. The increase was primarily attributable to higher pretax net earnings for the quarter ended March 31, 2007 compared with the same period in 2006. The Company's effective tax rate for the three months ended March 31, 2007 was 33.1% compared with 34.0% for the same period in 2006.

**FINANCIAL CONDITION***Loan Portfolio*

Total loans were \$3.25 billion at March 31, 2007, an increase of \$1.07 billion or 49.2% compared with \$2.18 billion at December 31, 2006. The increase was primarily due to the TXUI and SNB acquisitions. At March 31, 2007, total loans outstanding acquired from TXUI totaled \$1.09 billion and total loans acquired from SNB totaled \$495.8 million. Period end loans comprised 67.4% of average earning assets for the quarter ended March 31, 2007 compared with 56.3% of average earning assets for the quarter ended December 31, 2006.

The following table summarizes the loan portfolio of the Company by type of loan as of March 31, 2007 and December 31, 2006:

	March 31, 2007		December 31, 2006	
	Amount	Percent	Amount	Percent
	(Dollars in thousands)			
Commercial and industrial	\$ 452,473	15.0%	\$ 280,957	12.9%
Real estate:				
Construction and land development	752,790	15.3	433,178	19.9
1-4 family residential	519,532	20.0	376,996	17.3
Home equity	93,348	3.8	63,427	2.9
Commercial mortgages	1,076,794	35.1	803,145	36.9
Farmland	57,971	1.9	30,925	1.4
Multifamily residential	89,844	2.0	77,980	3.6
Agriculture	51,550	1.7	26,504	1.2
Other	21,654	1.4	66,675	3.1
Consumer (net of unearned discount)	131,752	3.8	16,720	0.8
Total loans	\$ 3,247,708	100.0%	\$ 2,176,507	100.0%

*Nonperforming Assets*

The Company had \$4.3 million in nonperforming assets at March 31, 2007 and \$1.1 million in nonperforming assets at December 31, 2006, an increase of \$3.2 million or 285.2%. The increase in nonperforming assets was primarily due to the TXUI and SNB acquisitions with \$1.2 million in other real estate owned and nonaccrual loans being attributed to loans acquired from TXUI and \$1.7 million in other real estate owned being attributed to SNB. The ratio of nonperforming assets to loans and other real estate was 0.13% at March 31, 2007 compared with 0.05% at December 31, 2006.

The Company generally places a loan on nonaccrual status and ceases accruing interest when the payment of principal or interest is delinquent for 90 days, or earlier in some cases, unless the loan is in the process of collection and the underlying collateral fully supports the carrying value of the loan. The Company generally charges off all loans before attaining nonaccrual status.

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The following table presents information regarding past due loans and nonperforming assets as of the dates indicated:

	March 31, 2007	December 31, 2006
	(Dollars in thousands)	
Nonaccrual loans	\$ 1,307	\$ 181
Restructured loans		
Accruing loans 90 or more days past due	831	767
Total nonperforming loans	2,138	948
Repossessed assets	37	32
Other real estate	2,138	140
Total nonperforming assets	\$ 4,313	\$ 1,120
Nonperforming assets to total loans and other real estate	0.13%	0.05%

*Allowance for Credit Losses*

Management actively monitors the Company's asset quality and provides specific loss allowances when necessary. The allowance for credit losses is a reserve established through charges to earnings in the form of a provision for credit losses. Loans are charged-off against the allowance for credit losses when appropriate. Although management believes it uses the best information available to make determinations with respect to the allowance for credit losses, future adjustments may be necessary if economic conditions differ from the assumptions used in making the initial determinations. As of March 31, 2007, the allowance for credit losses amounted to \$36.3 million or 1.12% of total loans compared with \$24.0 million or 1.10% of total loans at December 31, 2006.

Set forth below is an analysis of the allowance for credit losses for the three months ended March 31, 2007 and the year ended December 31, 2006:

	Three Months Ended March 31, 2007	Year Ended December 31, 2006
	(Dollars in thousands)	
Average loans outstanding	\$ 2,876,029	\$ 2,037,379
Gross loans outstanding at end of period	\$ 3,247,708	\$ 2,176,507
Allowance for credit losses at beginning of period	\$ 23,990	\$ 17,203
Balance acquired with acquisitions	12,741	7,054
Provision for credit losses	245	504
Charge-offs:		
Commercial and industrial	(591)	(353)
Real estate and agriculture	(245)	(128)
Consumer	(250)	(696)
Recoveries:		
Commercial and industrial	235	95
Real estate and agriculture	101	59
Consumer	115	252
Net charge-offs	(635)	(771)



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Allowance for credit losses at end of period	\$ 36,341	\$ 23,990
Ratio of allowance to end of period loans	1.12%	1.10%
Ratio of net charge-offs to average loans	0.02%	0.04%
Ratio of allowance to end of period nonperforming loans	1,699.8%	2,530.6%

**Table of Contents***Securities*

The carrying cost of securities totaled \$1.89 billion at March 31, 2007 compared with \$1.59 billion at December 31, 2006, an increase of \$296.0 million or 18.6%. At March 31, 2007, securities represented 29.9% of total assets compared with 34.7% of total assets at December 31, 2006.

The following table summarizes the amortized cost of securities as of the dates shown (available-for-sale securities are not adjusted for unrealized gains or losses):

	March 31, 2007	December 31, 2006
	(Dollars in thousands)	
U.S. Treasury securities and obligations of U.S. government agencies	\$ 591,933	\$ 402,328
70% nontaxable preferred stock	24,000	24,000
States and political subdivisions	87,886	44,378
Corporate debt securities	5,214	6,218
Collateralized mortgage obligations	263,406	276,629
Mortgage-backed securities	900,972	829,195
Qualified Zone Academy Bond (QZAB)	8,000	8,000
Equity securities	7,318	4,093
<b>Total amortized cost</b>	<b>\$ 1,888,729</b>	<b>\$ 1,594,841</b>
<b>Total fair value</b>	<b>\$ 1,865,545</b>	<b>\$ 1,565,427</b>

*Premises and Equipment*

Premises and equipment, net of accumulated depreciation, totaled \$118.3 million and \$63.1 million at March 31, 2007 and December 31, 2006, respectively, an increase of \$55.2 million or 87.6%. The increase is primarily due to 39 banking centers acquired in the TXUI acquisition and six banking centers acquired in the SNB acquisition.

*Deposits*

Total deposits were \$4.93 billion at March 31, 2007 compared with \$3.73 billion at December 31, 2006, an increase of \$1.20 billion or 32.3%. The increase is due to the TXUI acquisition. At March 31, 2007, deposits attributed to TXUI totaled \$1.28 billion. At March 31, 2007, noninterest-bearing deposits accounted for approximately 24.1% of total deposits compared with 22.4% of total deposits at December 31, 2006. Interest-bearing demand deposits totaled \$3.74 billion or 75.9% of total deposits at March 31, 2007 compared with \$2.89 billion or 77.6% of total deposits at December 31, 2006.

The following table summarizes the daily average balances and weighted average rates paid on deposits for the periods indicated below:

	Three Months Ended March 31, 2007		Year Ended December 31, 2006	
	Average Balance	Average Rate	Average Balance	Average Rate
	(Dollars in thousands)			
Interest-bearing demand	\$ 860,328	2.23%	\$ 602,946	1.90%
Regular savings	208,718	0.93	164,963	1.11
Money market savings	969,523	3.26	732,704	2.96
Time deposits	1,462,241	4.47	1,165,056	3.95
<b>Total interest-bearing deposits</b>	<b>3,500,810</b>	<b>3.37</b>	<b>2,665,669</b>	<b>3.04</b>
Noninterest-bearing deposits	1,035,294		783,431	

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Total deposits	\$ 4,536,104	2.60%	\$ 3,449,100	2.35%
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**Table of Contents***Other Borrowings*

The Company utilizes borrowings to supplement deposits to fund its lending and investment activities. Borrowings consist of funds from the Federal Home Loan Bank ( FHLB ) and correspondent banks. FHLB advances are considered short-term, overnight borrowings. At March 31, 2007, the Company had \$65.6 million in FHLB borrowings of which \$25.0 million consisted of FHLB advances and \$40.6 million consisted of long-term FHLB notes payable compared with \$26.4 million in FHLB borrowings at December 31, 2006, all of which consisted of long-term FHLB notes payable. The \$39.2 million increase was primarily attributable to the \$25.0 million outstanding FHLB advance and the assumption of additional long term notes payable in the TXUI acquisition. The maturity dates on the FHLB notes payable range from the years 2007 to 2027 and have interest rates ranging from 2.92% to 6.48%. The highest outstanding balance of FHLB advances during the first quarter of 2007 was \$230.0 million compared with \$116.0 million during the year ended December 31, 2006. The Company had no federal funds purchased at March 31, 2007 or December 31, 2006.

At March 31, 2007, the Company had \$73.9 million in securities sold under repurchase agreements compared with \$47.2 million at December 31, 2006, an increase of \$26.7 million or 56.5%. The increase was primarily due to the TXUI acquisition.

The following table presents the Company's borrowings at March 31, 2007 and December 31, 2006:

	<b>March 31, 2007 (Dollars in thousands)</b>	<b>December 31, 2006</b>
FHLB advances	\$ 25,000	\$
FHLB long term notes payable	40,621	26,408
<b>Total other borrowings</b>	<b>65,621</b>	<b>26,408</b>
Federal funds purchased		
Securities sold under repurchase agreements	73,916	47,225
<b>Total</b>	<b>\$ 139,537</b>	<b>\$ 73,633</b>

*Junior Subordinated Debentures*

At March 31, 2007 and December 31, 2006, the Company had outstanding \$145.4 million and \$100.5 million, respectively, in junior subordinated debentures issued to the Company's unconsolidated subsidiary trusts. The increase of \$44.8 million was due to the Company's assumption of \$44.8 million in junior subordinated debentures issued by TXUI to its five subsidiary trusts.

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A summary of pertinent information related to the Company's thirteen issues of junior subordinated debentures outstanding at March 31, 2007 is set forth in the table below:

Description	Issuance Date	Trust Preferred Securities Outstanding	Interest Rate <sup>(1)</sup>	Junior Subordinated Debt Owed to Trusts	Maturity Date <sup>(2)</sup>
Prosperity Statutory Trust II	July 31, 2001	\$ 15,000,000	3-month LIBOR + 3.58%, not to exceed 12.50%	\$ 15,464,000	July 31, 2031
Prosperity Statutory Trust III	Aug. 15, 2003	12,500,000	6.50% <sup>(3)</sup>	12,887,000	Sept. 17, 2033
Prosperity Statutory Trust IV	Dec. 30, 2003	12,500,000	6.50% <sup>(4)</sup>	12,887,000	Dec. 30, 2033
First Capital Statutory Trust I <sup>(5)(10)</sup>	Mar. 26, 2002	20,000,000	3-month LIBOR +3.60%	20,619,000	Mar. 26, 2032
First Capital Statutory Trust II <sup>(5)</sup>	Sept. 26, 2002	7,500,000	3-month LIBOR +3.40%	7,732,000	Sept. 26, 2032
SNB Statutory Trust II <sup>(6)</sup>	Mar. 26, 2003	10,000,000	3-month LIBOR +3.15%	10,310,000	Mar. 26, 2033
SNB Capital Trust III <sup>(6)</sup>	Mar. 27, 2003	10,000,000	3-month LIBOR +3.15%	10,310,000	Mar. 27, 2033
SNB Capital Trust IV <sup>(6)</sup>	Sept. 25, 2003	10,000,000	3-month LIBOR +3.00%	10,310,000	Sept. 25, 2033
TXUI Statutory Trust I <sup>(7)</sup>	Sept. 7, 2000	7,000,000	10.60%	7,210,000	Sept. 7, 2030
TXUI Statutory Trust II <sup>(7)</sup>	Dec. 19, 2003	5,000,000	6.45% <sup>(8)</sup>	5,155,000	Dec. 19, 2033
TXUI Statutory Trust III <sup>(7)</sup>	Nov. 30, 2005	15,500,000	3-month LIBOR +1.39%	15,980,000	Dec. 15, 2035
Gateway Statutory Trust I <sup>(7)(10)</sup>	Mar. 26, 2002	4,000,000	3-month LIBOR +3.60%	4,124,000	Mar. 26, 2032
TXUI Statutory Trust IV <sup>(7)</sup>	Mar. 31, 2006	12,000,000	3-month LIBOR +1.39%	12,372,000	Jun. 30, 2036

(1) The 3-month LIBOR in effect as of March 31, 2007 was 5.35%.

(2) All debentures are callable five years from issuance date except for TXUI Statutory Trust I which is callable ten years from issuance date.

(3) The debentures bear a fixed interest rate until September 17, 2008, when the rate begins to float on a quarterly basis based on the three-month LIBOR plus 3.00%.

(4) The debentures bear a fixed interest rate until December 30, 2008, when the rate begins to float on a quarterly basis based on the three-month LIBOR plus 2.85%.

(5) Assumed in connection with the First Capital acquisition on March 1, 2005.

(6) Assumed in connection with the SNB acquisition on April 1, 2006.

(7) Assumed in connection with the TXUI acquisition on January 31, 2007.

(8) The debentures bear a fixed interest rate until December 19, 2008, when the rate begins to float on a quarterly basis based on the three-month LIBOR plus 2.85%.

(10) The Company has notified the respective trustees of its intent to redeem in full all outstanding junior subordinated debentures of First Capital Statutory Trust I and Gateway Statutory Trust I on June 26, 2007 in the amount of \$20.6 million and \$4.1 million, respectively. The trusts in turn will redeem in full the trust preferred securities and common securities they issued.

**Table of Contents***Liquidity*

Liquidity involves the Company's ability to raise funds to support asset growth or reduce assets to meet deposit withdrawals and other payment obligations, to maintain reserve requirements and otherwise to operate the Company on an ongoing basis. The Company's liquidity needs have primarily been met by growth in core deposits and the issuance of junior subordinated debentures. Although access to purchased funds from correspondent banks is available and has been utilized on occasion to take advantage of investment opportunities, the Company does not generally rely on these external funding sources. The cash and federal funds sold position, supplemented by amortizing investment and loan portfolios, have generally created an adequate liquidity position.

Asset liquidity is provided by cash and assets which are readily marketable or which will mature in the near future. As of March 31, 2007, the Company had cash and cash equivalents of \$201.7 million compared with \$269.7 million at December 31, 2006. The decrease of \$68.1 million is due to a reduction in federal funds sold of \$87.5 million offset by an increase in cash and due from banks of \$19.4 million primarily due to the TXUI acquisition.

*Contractual Obligations*

The following table summarizes the Company's contractual obligations and other commitments to make future payments as of March 31, 2007 (other than deposit obligations). The Company's future cash payments associated with its contractual obligations pursuant to its junior subordinated debentures, FHLB notes payable and operating leases as of March 31, 2007 are summarized below. Payments for FHLB notes payable do not include interest of \$9.5 million that will be paid over the future periods presented. Payments related to leases are based on actual payments specified in underlying contracts.

	Remaining Fiscal 2007	Fiscal 2008-2009	Payments due in:		Total
			Fiscal 2010-2011	Thereafter	
			(Dollars in thousands)		
Junior subordinated debentures	\$	\$	\$	\$ 145,360	\$ 145,360
Federal Home Loan Bank notes payable	9,065	4,859	14,056	12,641	40,621
Operating leases	3,175	6,480	3,470	2,627	15,752
Total	\$ 12,240	\$ 11,339	\$ 17,526	\$ 160,628	\$ 201,733

*Off-Balance Sheet Items*

In the normal course of business, the Company enters into various transactions, which, in accordance with accounting principles generally accepted in the United States, are not included in its consolidated balance sheets. The Company enters into these transactions to meet the financing needs of its customers. These transactions include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amounts recognized in the consolidated balance sheets.

The Company's commitments associated with outstanding standby letters of credit and commitments to extend credit as of March 31, 2007 are summarized below. Since commitments associated with letters of credit and commitments to extend credit may expire unused, the amounts shown do not necessarily reflect the actual future cash funding requirements:

	Remaining Fiscal 2007	Fiscal 2008-2009	Fiscal 2010-2011	Thereafter	Total
			(Dollars in thousands)		
Standby letters of credit	\$ 9,218	\$ 4,141	\$ 40	\$ 357	\$ 13,756
Commitments to extend credit	436,217	193,255	14,557	111,811	755,840
Total	\$ 445,435	\$ 197,396	\$ 14,597	\$ 112,168	\$ 769,596

*Capital Resources*

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Total shareholders' equity was \$1.07 billion at March 31, 2007 compared with \$664.4 million at December 31, 2006, an increase of \$402.2 million or 60.5%. The increase was due primarily to net earnings of \$20.2 million and the issuance of common stock in connection with the TXUI acquisition of \$383.2 million, partially offset by dividends paid of \$4.9 million for the three months ended March 31, 2007.

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Both the Board of Governors of the Federal Reserve System, with respect to the Company, and the Federal Deposit Insurance Corporation ( FDIC ), with respect to the Bank, have established certain minimum risk-based capital standards that apply to bank holding companies and federally insured banks. As of March 31, 2007, the Company's Tier 1 risk-based capital, total risk-based capital and leverage capital ratios were 11.90%, 12.94% and 8.31%, respectively. As of March 31, 2007, the Bank's risk-based capital ratios were above the levels required for the Bank to be designated as well capitalized by the FDIC, with Tier-1 risk-based capital, total risk-based capital and leverage capital ratios of 10.88%, 11.92% and 7.67%, respectively.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company manages market risk, which for the Company is primarily interest rate risk, through its Asset Liability Committee which is composed of senior officers of the Company, in accordance with policies approved by the Company's Board of Directors.

The Company uses simulation analysis to examine the potential effects of market changes on net interest income and market value. The Company considers macroeconomic variables, Company strategy, liquidity and other factors as it quantifies market risk. See the Company's Annual Report on Form 10-K, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations-Interest Rate Sensitivity and Liquidity which was filed on March 1, 2007 for further discussion.

### **ITEM 4. CONTROLS AND PROCEDURES**

*Evaluation of disclosure controls and procedures.* As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of its management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management was required to apply judgment in evaluating its controls and procedures. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act )) were effective as of the end of the period covered by this report.

*Changes in internal control over financial reporting.* On January 31, 2007, the Company completed the acquisition of TXUI. The Company is in the process of integrating TXUI and continuing its evaluation of internal controls pursuant to the Sarbanes-Oxley Act of 2002. Excluding the TXUI acquisition, there have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended March 31, 2007 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

Neither the Company nor the Bank is currently a party to any material legal proceeding.

### **ITEM 1A. RISK FACTORS**

There have been no material changes in the Company's risk factors from those disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

### **ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

- a. Not applicable
- b. Not applicable
- c. Not applicable

### **ITEM 3. DEFAULTS UPON SENIOR SECURITIES**



Not applicable

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ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

Not applicable

ITEM 6. EXHIBITS

<b>Exhibit Number</b>	<b>Description of Exhibit</b>
31.1*	Certification of the Chief Executive Officer pursuant to Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended
31.2*	Certification of the Chief Financial Officer pursuant to Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended
32.1**	Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2**	Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\* Filed with this Quarterly Report on Form 10-Q.

\*\* Furnished with this Quarterly Report on Form 10-Q.

**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.

PROSPERITY BANCSHARES, INC.®

(Registrant)

Date: 05/10/07

/s/ David Zalman  
David Zalman

Chief Executive Officer

Date: 05/10/07

/s/ David Hollaway  
David Hollaway

Chief Financial Officer