

GREENVILLE FIRST BANCSHARES INC
Form 10KSB
March 30, 2005

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

FORM 10-KSB

Annual Report Pursuant to Section 13 Or 15(d) of The Securities Exchange Act Of 1934
For The Fiscal Year December 31, 2004.

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. 000-27719

Greenville First Bancshares, Inc.
(Exact name of registrant as specified in its charter)

South Carolina
(State of Incorporation)

58-2459561
(I.R.S. Employer
Identification No.)

112 Haywood Road
Greenville, S.C.
(Address of principal executive offices)

29607
(Zip Code)

864-679-9000
(Telephone Number)

Not Applicable
(Former Name, former address,
and former fiscal year,
if changed since last report)

Securities registered pursuant to Section 12(b) of the Act: None
Securities registered pursuant to Section 12(g) of the Act: Common Stock

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 past 90 days. Yes No

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

The issuer's revenue for its most recent fiscal year was \$14,726,163. As of March 29, 2005, 2,647,994 shares of Common Stock were issued and outstanding.

The estimated aggregate market value of the Common Stock held by non-affiliates (shareholders holding less than 5% of an outstanding class of stock, excluding directors and executive officers) of the Company on March 29, 2005 was \$45,800,978. This calculation is based upon an estimate of the fair market value of the Common Stock of \$20.00 per share, which was the price of the last trade of which management is aware prior to this date.

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

DOCUMENTS INCORPORATED BY REFERENCE

Company's Proxy Statement for the 2005 Annual Meeting of Shareholders

Part III

Item 1. Business

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

General

Greenville First Bancshares, Inc. (the Company) is a South Carolina corporation that owns all of the capital stock of Greenville First Bank, N.A. (the bank) and all of the stock of Greenville First Statutory Trust I (the Trust). The bank is a national bank organized under the laws of the United States located in Greenville County, South Carolina. The bank is primarily engaged in the business of accepting demand deposits and savings deposits insured by the Federal Deposit Insurance Corporation, and providing commercial, consumer and mortgage loans to the general public. The Trust is a special purpose subsidiary organized for the sole purpose of issuing trust preferred securities.

On October 26, 1999, the Company sold 1,100,000 shares of its common stock at \$10 per share and on November 30, 1999 sold 50,000 additional shares for a total of 1,150,000 shares (1,724,994 after adjustment of 3 for 2 stock split). The offering raised approximately \$10.6 million, net of underwriting discounts, commissions and offering expenses.

On June 26, 2003, the Trust offered and sold \$6,000,000 of floating rate securities. The Company received the proceeds from the issuance of these securities and has reflected the obligation resulting from the receipt of the proceeds as junior subordinate debentures in the balance sheets.

On November 17, 2003, shareholders of record as of November 3, 2003, received one additional share of stock for every two shares of stock owned prior to the 3 for 2 stock split. All fractional shares were paid in cash. The earnings per share amounts for all periods shown have been adjusted to reflect the 3 for 2 split.

On September 24, 2004, the Company received \$14.3 million from the sale of 800,000 common stock at a price of \$17.875. On October 15, 2004, the Company's underwriter exercised its option to purchase an additional 120,000 shares at the same price. The total gross proceeds were approximately \$16.4 million. The net proceeds to the Company after offering costs and underwriter's discount were approximately \$14.9 million.

Risk Factors

Our recent operating results may not be indicative of our future operating results.

We may not be able to sustain our historical rate of growth and may not even be able to grow our business at all. Because of our relatively small size and short operating history, it will be difficult for us to generate similar earnings growth as we continue to expand, and consequently our historical results of operations will not necessarily be indicative of our future operations. Various factors, such as economic conditions, regulatory and legislative considerations, and competition, may also impede our ability to expand our market presence. If we experience a significant decrease in our historical rate of growth, our results of operations and financial condition may be adversely affected because a high percentage of our operating costs are fixed expenses.

Our decisions regarding credit risk and reserves for loan losses may materially and adversely affect our business.

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Making loans and other extensions of credit is an essential element of our business. Although we seek to mitigate risks inherent in lending by adhering to specific underwriting practices, our loans and other extensions of credit may not be repaid. The risk of nonpayment is affected by a number of factors, including:

- o the duration of the credit;
- o credit risks of a particular customer;
- o changes in economic and industry conditions; and
- o in the case of a collateralized loan, risks resulting from uncertainties about the future value of the collateral.

We attempt to maintain an appropriate allowance for loan losses to provide for potential losses in our loan portfolio. We periodically determine the amount of the allowance based on consideration of several factors, including:

- o an ongoing review of the quality, mix, and size of our overall loan portfolio;
- o our historical loan loss experience;
- o evaluation of economic conditions;
- o regular reviews of loan delinquencies and loan portfolio quality; and
- o the amount and quality of collateral, including guarantees, securing the loans.

There is no precise method of predicting credit losses; therefore, we face the risk that charge-offs in future periods may exceed our allowance for loan losses and that additional increases in the allowance for loan losses will be required. Additions to the allowance for loan losses would result in a decrease of our net income, and possibly our capital.

Lack of seasoning of our loan portfolio may increase the risk of credit defaults in the future.

Due to the rapid growth of our bank over the past several years and our relatively short operating history, a large portion of the loans in our loan portfolio and of our lending relationships are of relatively recent origin. In general, loans do not begin to show signs of credit deterioration or default until they have been outstanding for some period of time, a process we refer to as seasoning. As a result, a portfolio of older loans will usually behave more predictably than a newer portfolio. Because our loan portfolio is relatively new, the current level of delinquencies and defaults may not be representative of the level that will prevail when the portfolio becomes more seasoned, which may be higher than current levels. If delinquencies and defaults increase, we may be required to increase our provision for loan losses, which would adversely affect our results of operations and financial condition.

An economic downturn, especially one affecting the Greenville County area, could reduce our customer base, our level of deposits, and demand for financial products such as loans.

Our success significantly depends upon the growth in population, income levels, deposits, and housing starts in our markets, especially in Greenville County. If the communities in which we operate do not grow or if prevailing economic conditions locally or nationally are unfavorable, our business may not succeed. An economic downturn would likely contribute to the deterioration of the quality of our loan portfolio and reduce our level of deposits, which in turn would hurt our business. Interest received on loans represented approximately 92.9% of our interest income for the year ended December 31, 2004. If an economic downturn occurs in the economy as a whole, or especially in the Greenville County area, borrowers may be less likely to repay their loans as scheduled. Moreover, the value of real estate or other collateral that may secure our loans could be adversely affected. Unlike many larger institutions, we are not able to spread the risks of unfavorable local economic conditions across a large number of diversified economies. An economic downturn could, therefore, result in losses that materially and adversely affect our business.

Changes in prevailing interest rates may reduce our profitability.

Our results of operations depend in large part upon the level of our net interest income, which is the difference between interest income from interest-earning assets, such as loans and mortgage-backed securities, and interest expense on interest-bearing liabilities, such as deposits and other borrowings. Depending on the terms and maturities of our assets and liabilities, a significant change in interest rates could have a material adverse effect on our profitability. Many factors cause changes in interest rates, including governmental monetary policies and domestic and international economic and political conditions. While we intend to manage the effects of changes in interest rates by adjusting the terms, maturities, and pricing of our assets and liabilities, our efforts may not be effective and our financial condition and results of operations could suffer. After operating in a historically low interest rate environment, the Federal Reserve began raising short-term interest rates in the second quarter of 2004. We anticipate that we will benefit from a rising interest rate environment. However, no assurance can be given that the Federal

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Reserve will actually continue to raise interest rates or that the results we anticipate will actually occur.

We are dependent on key individuals and the loss of one or more of these key individuals could curtail our growth and adversely affect our prospects.

R. Arthur Seaver, Jr., our president and chief executive officer, has extensive and long-standing ties within our primary market area and substantial experience with our operations, and he has contributed significantly to our growth. If we lose the services of Mr. Seaver, he would be difficult to replace and our business and development could be materially and adversely affected.

Our success also depends, in part, on our continued ability to attract and retain experienced loan originators, as well as other management personnel, including Jim Austin, Fred Gilmer, III, Eddie Terrell, and Fred Gilmer, Jr. The loss of the services of several of such key personnel could adversely affect our growth strategy and prospects to the extent we are unable to replace such personnel.

We are subject to extensive regulation that could limit or restrict our activities.

We operate in a highly regulated industry and are subject to examination, supervision, and comprehensive regulation by various regulatory agencies. Our compliance with these regulations is costly and restricts certain of our activities, including payment of dividends, mergers and acquisitions, investments, loans and interest rates charged, interest rates paid on deposits, and locations of offices. We are also subject to capitalization guidelines established by our regulators, which require us to maintain adequate capital to support our growth.

The laws and regulations applicable to the banking industry could change at any time, and we cannot predict the effects of these changes on our business and profitability. Because government regulation greatly affects the business and financial results of all commercial banks and bank holding companies, our cost of compliance could adversely affect our ability to operate profitably.

The Sarbanes-Oxley Act of 2002, and the related rules and regulations promulgated by the Securities and Exchange Commission that are now applicable to us, have increased the scope, complexity, and cost of corporate governance, reporting, and disclosure practices. We have experienced, and we expect to continue to experience, greater compliance costs, including costs related to internal controls, as a result of the Sarbanes-Oxley Act.

Our continued pace of growth may require us to raise additional capital in the future, but that capital may not be available when it is needed.

We are required by regulatory authorities to maintain adequate levels of capital to support our operations. To support our continued growth, we may need to raise additional capital. Our ability to raise additional capital, if needed, will depend in part on conditions in the capital markets at that time, which are outside our control. Accordingly, we cannot assure you of our ability to raise additional capital, if needed, on terms acceptable to us. If we cannot raise additional capital when needed, our ability to further expand our operations through internal growth and acquisitions could be materially impaired. In addition, if we decide to raise additional equity capital, your interest could be diluted.

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We face strong competition for clients, which could prevent us from obtaining clients and may cause us to pay higher interest rates to attract clients.

The banking business is highly competitive, and we experience competition in our market from many other financial institutions. We compete with commercial banks, credit unions, savings and loan associations, mortgage banking firms, consumer finance companies, securities brokerage firms, insurance companies, money market funds, and other mutual funds, as well as other super-regional, national, and international financial institutions that operate offices in our primary market areas and elsewhere. We compete with these institutions both in attracting deposits and in making loans. In addition, we have to attract our client base from other existing financial institutions and from new residents. Many of our competitors are well-established, larger financial institutions. These institutions offer some services, such as extensive and established branch networks, that we do not provide. There is a risk that we will not be able to compete successfully with other financial institutions in our market, and that we may have to pay higher interest rates to attract deposits, resulting in reduced profitability. In addition, competitors that are not depository institutions are generally not subject to the extensive regulations that apply to us.

We will face risks with respect to future expansion and acquisitions or mergers.

We may seek to acquire other financial institutions or parts of those institutions. We may also expand into new markets or lines of business or offer new products or services. These activities would involve a number of risks, including:

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the potential inaccuracy of the estimates and judgments used to evaluate credit, operations, management, and market risks with respect to a target institution;

- o the time and costs of evaluating new markets, hiring or retaining experienced local management, and opening new offices and the time lags between these activities and the generation of sufficient assets and deposits to support the costs of the expansion;
- o the incurrence and possible impairment of goodwill associated with an acquisition and possible adverse effects on our results of operations; and
- o the risk of loss of key employees and customers.

Marketing Focus

Greenville First Bank commenced operations in January 2000 and at that time was the first community bank organized in the city of Greenville, South Carolina in over 10 years. During the 1990s, several community banks operating in the Greenville market were acquired by larger regional financial institutions. We formed Greenville First to take advantage of market opportunities resulting from this continued consolidation of the financial services industry. Responding to this opportunity, we created a marketing plan focusing on the professional market in Greenville, including doctors, dentists, and small business owners. We serve this market with a client-focused structure called relationship teams, which provides each client with a specific banker contact and support team responsible for all of the client's banking needs. The purpose of this structure is to provide a consistent and superior level of professional service, and we believe it provides us with a distinct competitive advantage. We consider exceptional client service to be a critical part of our culture, which we refer to as Client FIRST. We emphasize this Client FIRST culture in the training that we provide our employees, and we strive to reflect this Client FIRST culture in all aspects of our business.

Location and Service Area

Our primary market is Greenville County, which is located in the upstate region of South Carolina, approximately midway between Atlanta and Charlotte on the heavily traveled I-85 business corridor. It is South Carolina's most populous county with over 390,000 residents. Greenville is also one of the state's wealthiest counties, with average household income of \$61,023 in 2004. In the past decade, Greenville County has attracted more than \$6 billion in new business investments and 43,000 new jobs and is now considered the economic engine of South Carolina. During the same period, Greenville County was rated first in the United States by Site Selection Magazine for both new and expanding international firms and, in 2002, was ranked fifth out of America's top 50 cities for European business expansion. Greenville was also recognized by Expansion Management Magazine in December 2000 for having the best worker training program in the United States.

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Our primary service area consists of Greenville County, South Carolina. We draw a large percentage of our business from the central portion of Greenville County, within a ten mile radius of our main office. This principal service area is bounded by Rutherford Road to the north, Poinsett Highway to the west, Mauldin Road and Butler Road to the south, and Highway 14 and Batesville Road to the east. Included in this area is the highest per capita income tract in the county.

We opened our first office located on The Parkway near Thornblade Country Club in Greenville on March 14, 2005. We anticipate opening our second office that will be located in the mature and historic Augusta Road area of Greenville in the third quarter of 2005. We believe that the demographics and growth characteristics of these locations will provide us with significant opportunities to further develop existing client relationships and expand our client base.

Lending Activities

General. We emphasize a range of lending services, including real estate, commercial, and equity-line consumer loans to individuals and small- to medium-sized businesses and professional firms that are located in or conduct a substantial portion of their business in our market area. Our underwriting standards vary for each type of loan, as described below. Since loans typically provide higher interest yields than other types of interest-earning assets, we invest a substantial percentage of our earning assets in our loan portfolio. At December 31, 2004, we had total loans of \$276.6 million, representing 87.6% of our total assets.

We have focused our lending activities primarily on the professional market in Greenville, including doctors, dentists, and small business owners. By focusing on this client base and by serving each client with a consistent relationship team of bankers, we have generated a loan portfolio with larger average loan amounts than we believe is typical for a community bank. As of December 31, 2004, our average loan size was approximately \$133,000. Excluding home equity lines of credit, the average loan size was approximately \$184,000. At the same time, we

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have strived to maintain a diversified loan portfolio and limit the amount of our loans to any single client. As of December 31, 2004, our 10 largest client loan relationships represented approximately \$16.8 million, or 6.8% of our loan portfolio.

Loan Approval. Certain credit risks are inherent in making loans. These include prepayment risks, risks resulting from uncertainties in the future value of collateral, risks resulting from changes in economic and industry conditions, and risks inherent in dealing with individual borrowers. We attempt to mitigate repayment risks by adhering to internal credit policies and procedures. These policies and procedures include officer and client lending limits, a multi-layered approval process for larger loans, documentation examination, and follow-up procedures for any exceptions to credit policies. Our loan approval policies provide for various levels of officer lending authority. When the amount of aggregate loans to a single borrower exceeds an individual officer's lending authority, the loan request will be considered by an officer with a higher lending limit or by the officers' loan committee, which is comprised of our three most senior lenders and our chief credit officer. The officers' loan committee has pre-determined lending limits, and any loans in excess of this lending limit will be submitted for approval by the finance committee of our board or by the full board. We do not make any loans to any director, officer, or employee of the bank unless the loan is approved by the board of directors of the bank and is on terms not more favorable to such person than would be available to a person not affiliated with the bank.

Credit Administration and Loan Review. We maintain a continuous loan review system. We also apply a credit grading system to each loan, and we use an independent consultant to review the loan files on a test basis to confirm the grading of each loan. The bank has a chief credit officer who has over 35 years of banking and credit management experience that reviews and has established performance benchmarks in the areas of nonperforming assets, charge-offs, past dues, and loan documentation. Each loan officer is responsible for each loan he or she makes, regardless of whether other individuals or committees joined in the approval. This responsibility continues until the loan is repaid or until the loan is officially assigned to another officer.

Lending Limits. Our lending activities are subject to a variety of lending limits imposed by federal law. In general, the bank is subject to a legal limit on loans to a single borrower equal to 15% of the bank's capital and unimpaired surplus. Based upon the capitalization of the bank at December 31, 2004, we self-imposed a loan limit of \$2.2 million per borrower, which represented approximately 47% of our legal lending limit at December 31, 2004. These limits will increase or decrease in response to increases or decreases in the bank's level of capital. We are able to sell participations in our larger loans to other financial institutions, which allow us to manage the risk involved in these loans and to meet the lending needs of our clients requiring extensions of credit in excess of these limits.

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Real Estate Mortgage Loans. The principal component of our loan portfolio is loans secured by real estate mortgages. We obtain a security interest in real estate whenever possible, in addition to any other available collateral, in order to increase the likelihood of the ultimate repayment of the loan. At each of December 31, 2004, loans secured by first or second mortgages on real estate made up approximately 81% of our loan portfolio.

These loans will generally fall into one of four categories: commercial real estate loans, construction and development loans, residential real estate loans, or home equity loans. Most of our real estate loans are secured by residential or commercial property. Interest rates for all categories may be fixed or adjustable, and will more likely be fixed for shorter-term loans. We generally charge an origination fee for each loan. Other loan fees consist primarily of late charge fees. Real estate loans are subject to the same general risks as other loans and are particularly sensitive to fluctuations in the value of real estate. Fluctuations in the value of real estate, as well as other factors arising after a loan has been made, could negatively affect a borrower's cash flow, creditworthiness, and ability to repay the loan.

- o *Commercial Real Estate Loans.* At December 31, 2004, our individual commercial real estate loans ranged in size from \$6,623 to \$2.6 million, with an average loan size of approximately \$308,000. These loans generally have terms of five years or less, although payments may be structured on a longer amortization basis. We evaluate each borrower on an individual basis and attempt to determine the business risks and credit profile of each borrower. We attempt to reduce credit risk in the commercial real estate portfolio by emphasizing loans on owner-occupied office and retail buildings where the loan-to-value ratio, established by independent appraisals, does not exceed 85%. We also generally require that a borrower's cash flow exceeds 115% of monthly debt service obligations. In order to ensure secondary sources of payment and liquidity to support a loan request, we typically review all of the personal financial statements of the principal owners and require their personal guarantees. At December 31, 2004, commercial real estate loans (other than construction loans) amounted to \$130.6 million, or approximately 46.6% of our loan portfolio. Of our commercial real estate loan portfolio, \$76.3 million in loans were not owner-occupied properties, representing 58.4% of our commercial real estate portfolio and 27.2% of our total loan portfolio. The remainder of our commercial real estate loan portfolio, \$54.3 million in loans or 41.6% of the commercial loan portfolio, were owner-occupied. Owner-occupied loans represented 19.4% of our total loan portfolio.
- o *Construction and Development Real Estate Loans.* We offer adjustable and fixed rate residential and commercial construction loans to builders and developers and to consumers who wish to build their own homes. At December 31, 2004, our commercial construction and development real estate loans ranged in size from approximately \$85,000 to \$2.2 million, with an average loan size

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of approximately \$540,000. At December 31, 2004, our individual residential construction and development real estate loans ranged in size from approximately \$41,000 to \$730,000, with an average loan size of approximately \$312,000. The duration of our construction and development loans generally is limited to 18 months, although payments may be structured on a longer amortization basis. Construction and development loans generally carry a higher degree of risk than long-term financing of existing properties because repayment depends on the ultimate completion of the project and usually on the sale of the property. Specific risks include:

- o cost overruns;
- o mismanaged construction;
- o inferior or improper construction techniques;
- o economic changes or downturns during construction;
- o a downturn in the real estate market;
- o rising interest rates which may prevent sale of the property; and
- o failure to sell completed projects in a timely manner.

We attempt to reduce the risk associated with construction and development loans by obtaining personal guarantees where possible and by keeping the loan-to-value ratio of the completed project at or below 80%. At December 31, 2004, total construction loans amounted to \$18.1 million, or 6.5% of our loan portfolio. Included in the \$18.1 million was \$12.2 million, or 4.4% of our loan portfolio, that were commercial construction, and \$5.9 million, or 2.1% of our loan portfolio, that were consumer construction loans.

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- o *Residential Real Estate Loans and Home Equity Loans.* We do not generally originate traditional long term residential mortgages, but we do issue traditional second mortgage residential real estate loans and home equity lines of credit. At December 31, 2004, our individual residential real estate loans ranged in size from \$8,000 to \$1.2 million, with an average loan size of approximately \$235,000. Generally, we limit the loan-to-value ratio on our residential real estate loans to 80%. We offer fixed and adjustable rate residential real estate loans with terms of up to 30 years. We typically offer these fixed rate loans through a third party rather than originating and retaining these loans ourselves. We typically originate and retain residential real estate loans only if they have adjustable rates. We also offer home equity lines of credit. At December 31, 2004, our individual home equity lines of credit ranged in size from \$800 to \$948,000, with an average of approximately \$92,600. Our underwriting criteria and the risks associated with, home equity loans and lines of credit are generally the same as those for first mortgage loans. Home equity lines of credit typically have terms of five years or less. We generally limit the extension of credit to 90% of the available equity of each property, although we may extend up to 100% of the available equity. At December 31, 2004, residential real estate loans (other than construction loans) amounted to \$81.3 million, or 29.0% of our loan portfolio. Included in the residential real estate loans was \$46.2 million, or 16.5% of our loan portfolio, in first and second mortgages on individuals' homes, and \$35.1 million, or 12.5% of our loan portfolio, in home equity loans.

Commercial Business Loans. We make loans for commercial purposes in various lines of businesses, including the manufacturing, service industry, and professional service areas. At December 31, 2004, our individual commercial business loans ranged in size from approximately \$650 to \$870,000, with an average loan size of approximately \$107,000. Commercial loans are generally considered to have greater risk than first or second mortgages on real estate because commercial loans may be unsecured, or if they are secured, the value of the collateral may be difficult to assess and more likely to decrease than real estate. At December 31, 2004, commercial business loans amounted to \$44.9 million, or 16.0% of our loan portfolio.

We are eligible to offer small business loans utilizing government enhancements such as the Small Business Administration's (SBA's) 7(a) program and SBA's 504 programs. These loans typically are partially guaranteed by the government, which helps to reduce their risk. Government guarantees of SBA loans do not exceed, and are generally less than, 80% of the loan. As of December 31, 2004, we had not originated any small business loans utilizing government enhancements.

Consumer Loans. We make a variety of loans to individuals for personal and household purposes, including secured and unsecured installment loans and revolving lines of credit. Consumer loans are underwritten based on the borrower's income, current debt level, past credit history, and the availability and value of collateral. Consumer rates are both fixed and variable, with terms negotiable. At December 31, 2004, our individual consumer loans ranged in size from \$500 to \$375,000, with an average loan size of approximately \$14,000. Our installment loans typically amortize over periods up to 60 months. We will offer consumer loans with a single maturity date when a specific source of repayment is available. We typically require monthly payments of interest and a portion of the principal on our revolving loan products. Consumer loans are generally considered to have greater risk than first or second mortgages on real estate because they may be unsecured, or, if they are secured, the value of the collateral may be difficult to assess and more likely to decrease in value than real estate. At December 31, 2004, consumer loans amounted to \$6.0 million, or 2.2% of our loan portfolio.

Deposit Services

Our principal source of funds is core deposits. We offer a full range of deposit services, including checking accounts, commercial accounts, savings accounts, and other time deposits of various types, ranging from daily money market accounts to long-term certificates of deposit. Because of the historically low interest rate environment in the last three years, we have chosen to obtain a portion of our deposits from outside our local market. Our out-of-market, or wholesale, certificates of deposits represented 37.7% of total deposits at December 31, 2004. The deposits obtained outside of our market area generally have lower rates than rates being offered for certificates of deposits in our local market. This funding strategy allowed us to continue to operate in one location, maintain a smaller staff, and not incur significant marketing costs to advertise deposit rates, which in turn has allowed us to maintain our focus on growing our loan portfolio. In anticipation of rising interest rates and our continued growth, we have recently begun to focus on expanding our retail deposit program. We are planning to open two new retail deposit offices, one in the first quarter of

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2005 and the other in the third quarter of 2005, which we believe will assist us in obtaining low cost transaction accounts that are less affected by rising rates. Deposit rates are reviewed regularly by senior management of the bank. We believe that the rates we offer are competitive with those offered by other financial institutions in our area. We focus on customer service and our ClientFIRST culture to attract and retain deposits.

Other Banking Services

We offer other bank services including safe deposit boxes, traveler's checks, direct deposit, United States Savings Bonds, and banking by mail. We earn fees for most of these services, including debit and credit card transactions, sales of checks, and wire transfers. We also receive ATM transaction fees from transactions performed by our clients. We are associated with the Honor, Cirrus, and Master-Money ATM networks, which are available to our clients throughout the country. Since we outsource our ATM services, we are charged related transaction fees from our ATM service provider. We have contracted with Fidelity Integrated Financial Solutions, an outside computer service company, to provide our core data processing services and our ATM processing. By outsourcing these services, we believe we are able to reduce our overhead by matching the expense in each period to the transaction volume that occurs during the period, as a significant portion of the fee charged is directly related to the number of loan and deposit accounts and the related number of transactions we have during the period. We believe that by being associated with a shared network of ATMs, we are better able to serve our clients and are able to attract clients who are accustomed to the convenience of using ATMs, although we do not believe that maintaining this association is critical to our success. We also offer Internet banking services, bill payment services, and cash management services. We do not expect to exercise trust powers during our next few years of operation.

Competition

The banking business is highly competitive, and we experience competition in our market from many other financial institutions. Competition among financial institutions is based upon interest rates offered on deposit accounts, interest rates charged on loans, other credit and service charges relating to loans, the quality and scope of the services rendered, the convenience of banking facilities, and, in the case of loans to commercial borrowers, relative lending limits. We compete with commercial banks, credit unions, savings and loan associations, mortgage banking firms, consumer finance companies, securities brokerage firms, insurance companies, money market funds, and other mutual funds, as well as other super-regional, national, and international financial institutions that operate offices in Greenville County and elsewhere.

As of June 30, 2004, there were 24 financial institutions other than us in Greenville County. We compete with these institutions both in attracting deposits and in making loans. In addition, we have to attract our customer base from other existing financial institutions and from new residents. Many of our competitors are well-established, larger financial institutions with substantially greater resources and lending limits, such as BB&T, Bank of America, Wachovia, and Carolina First Bank. These institutions offer some services, such as extensive and established branch networks and trust services that we do not provide. In addition, many of our non-bank competitors are not subject to the same extensive federal regulations that govern bank holding companies and federally insured banks.

We believe our commitment to quality and personalized banking services through our Client FIRST culture is a factor that contributes to our competitiveness.

Market Share

As of June 30, 2004, the most recent date for which market data is available, total deposits in the bank's primary service area were almost \$7.4 billion, which represented a 11.4% deposit increase from 2003. At June 30, 2004, the bank represented 2.4% of the market. Our plan over the next five years is to grow our deposit base to \$300 million. Of course, we cannot be sure that these deposit growth rates will continue, or that we will accomplish this objective.

SUPERVISION AND REGULATION

Both the company and the bank are subject to extensive state and federal banking laws and regulations that impose specific requirements or restrictions on and provide for general regulatory oversight of virtually all aspects of

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our operations. These laws and regulations are generally intended to protect depositors, not shareholders. The following summary is qualified by reference to the statutory and regulatory provisions discussed. Changes in applicable laws or regulations may have a material effect on our business and prospects. Beginning with the enactment of the Financial Institutions Reform Recovery and Enforcement Act in 1989 and followed by the FDIC Improvement Act in 1991 and the Gramm-Leach-Bliley Act in 1999, numerous additional regulatory requirements have been placed on the banking industry in the past several years, and additional changes have been proposed. Our operations may be affected by legislative changes and the policies of various regulatory authorities. We cannot predict the effect that fiscal or monetary policies, economic control, or new federal or state legislation may have on our business and earnings in the future.

The following discussion is not intended to be a complete list of all the activities regulated by the banking laws or of the impact of such laws and regulations on our operations. It is intended only to briefly summarize some material provisions.

USA PATRIOT Act of 2002

In October 2002, the USA PATRIOT Act of 2002 was enacted in response to the terrorist attacks in New York, Pennsylvania, and Washington D.C. that occurred on September 11, 2001. The PATRIOT Act is intended to strengthen U.S. law enforcement's and the intelligence communities' abilities to work cohesively to combat terrorism on a variety of fronts. The potential impact of the PATRIOT Act on financial institutions is significant and wide ranging. The PATRIOT Act contains sweeping anti-money laundering and financial transparency laws and imposes various regulations, including standards for verifying client identification at account opening, and rules to promote cooperation among financial institutions, regulators, and law enforcement entities in identifying parties who may be involved in terrorism or money laundering.

Check 21

On October 28, 2003, President Bush signed into law the Check Clearing for the 21st Century Act, also known as Check 21. The new law, which became effective October 28, 2004, gives substitute checks, such as a digital image of a check and copies made from that image, the same legal standing as the original paper check. Some of the major provisions include:

- o allowing check truncation without making it mandatory;
- o demanding that every financial institution communicate to accountholders in writing a description of its substitute check processing program and their rights under the law;
- o legalizing substitutions for and replacements of paper checks without agreement from consumers;
- o retaining in place the previously mandated electronic collection and return of checks between financial institutions only when individual agreements are in place;
- o requiring that when accountholders request verification, financial institutions produce the original check (or a copy that accurately represents the original) and demonstrate that the account debit was accurate and valid; and
- o requiring recrediting of funds to an individual's account on the next business day after a consumer proves that the financial institution has erred.

This new legislation will likely affect bank capital spending as many financial institutions assess whether technological or operational changes are necessary to stay competitive and take advantage of the new opportunities presented by Check 21.

Greenville First Bancshares, Inc.

We own 100% of the outstanding capital stock of the bank, and therefore we are considered to be a bank holding company under the federal Bank Holding Company Act of 1956 and the South Carolina Banking and Branching Efficiency Act.

The Bank Holding Company Act. Under the Bank Holding Company Act, we are subject to periodic examination by the Federal Reserve and are required to file periodic reports of our operations and any additional information that the Federal Reserve may require. Our activities at the bank and holding company levels are limited to:

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- o banking and managing or controlling banks;

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- o furnishing services to or performing services for our subsidiaries; and
- o engaging in other activities that the Federal Reserve determines to be so closely related to banking and managing or controlling banks as to be a proper incident thereto.

Investments, Control, and Activities. With certain limited exceptions, the Bank Holding Company Act requires every bank holding company to obtain the prior approval of the Federal Reserve before:

- o acquiring substantially all the assets of any bank;
- o acquiring direct or indirect ownership or control of any voting shares of any bank if after the acquisition it would own or control more than 5% of the voting shares of such bank (unless it already owns or controls the majority of such shares); or
- o merging or consolidating with another bank holding company.

In addition, and subject to certain exceptions, the Bank Holding Company Act and the Change in Bank Control Act, together with regulations promulgated there under, require Federal Reserve approval prior to any person or company acquiring control of a bank holding company. Control is conclusively presumed to exist if an individual or company acquires 25% or more of any class of voting securities of a bank holding company. Control is rebuttably presumed to exist if a person acquires 10% or more, but less than 25%, of any class of voting securities and either the company has registered securities under Section 12 of the Securities Exchange Act of 1934 or no other person owns a greater percentage of that class of voting securities immediately after the transaction. Our common stock is registered under the Securities Exchange Act of 1934. The regulations provide a procedure for rebutting control when ownership of any class of voting securities is below 25%.

Under the Bank Holding Company Act, a bank holding company is generally prohibited from engaging in, or acquiring direct or indirect control of more than 5% of the voting shares of any company engaged in, nonbanking activities unless the Federal Reserve Board, by order or regulation, has found those activities to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. Some of the activities that the Federal Reserve Board has determined by regulation to be proper incidents to the business of a bank holding company include:

- o making or servicing loans and certain types of leases;
- o engaging in certain insurance and discount brokerage activities;
- o performing certain data processing services;
- o acting in certain circumstances as a fiduciary or investment or financial adviser;
- o owning savings associations; and
- o making investments in certain corporations or projects designed primarily to promote community welfare.

The Federal Reserve Board imposes certain capital requirements on the company under the Bank Holding Company Act, including a minimum leverage ratio and a minimum ratio of qualifying capital to risk-weighted assets. These requirements are described below under - Greenville First Bank, N.A. - Capital Regulations. Subject to our capital requirements and certain other restrictions, we are able to borrow money to make a capital contribution to the bank, and these loans may be repaid from dividends paid from the bank to the company. Our ability to pay dividends will be subject to regulatory restrictions as described below in - Greenville First Bank, N.A. Dividends. We are also able to raise capital for contribution to the bank by issuing securities without having to receive regulatory approval, subject to compliance with federal and state securities laws.

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Source of Strength; Cross-Guarantee. In accordance with Federal Reserve Board policy, we are expected to act as a source of financial strength to the bank and to commit resources to support the bank in circumstances in which we might not otherwise do so. Under the Bank Holding Company Act, the Federal Reserve Board may require a bank holding company to terminate any activity or relinquish control of a nonbank subsidiary, other than a nonbank subsidiary of a bank, upon the Federal Reserve Board's determination that such activity or control constitutes a serious risk to the financial soundness or stability of any depository institution subsidiary of the bank holding company. Further, federal bank regulatory authorities have additional discretion to require a bank holding company to divest itself of any bank or nonbank subsidiaries if the agency determines that divestiture may aid the depository institution's financial condition.

The Gramm-Leach-Bliley Act. The Gramm-Leach-Bliley Act was signed into law on November 12, 1999. Among other things, the Act repealed the restrictions on banks affiliating with securities firms contained in sections 20 and 32 of the Glass-Steagall Act. The Act also permits bank holding companies that become financial holding companies to engage in a statutorily provided list of financial activities, including insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities. The Act also authorizes activities that are complementary to financial activities. We have not elected to become a financial holding company.

The Act is intended, in part, to grant to community banks certain powers as a matter of right that larger institutions have accumulated on an ad hoc basis. Nevertheless, the Act may have the result of increasing the amount of competition that we face from larger institutions and other types of companies. In fact, it is not possible to predict the full effect that the Act will have on us.

South Carolina State Regulation. As a South Carolina bank holding company under the South Carolina Banking and Branching Efficiency Act, we are subject to limitations on sale or merger and to regulation by the South Carolina Board of Financial Institutions. We are not required

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to obtain the approval of the Board prior to acquiring the capital stock of a national bank, but we must notify them at least 15 days prior to doing so. We must receive the Board's approval prior to engaging in the acquisition of a South Carolina state chartered bank or another South Carolina bank holding company.

Greenville First Bank, N.A.

The bank operates as a national banking association incorporated under the laws of the United States and subject to examination by the Office of the Comptroller of the Currency. Deposits in the bank are insured by the Federal Deposit Insurance Corporation (FDIC) up to a maximum amount, which is generally \$100,000 per depositor subject to the aggregation rule.

The Office of the Comptroller of the Currency and the FDIC regulate or monitor virtually all areas of the bank's operations, including

- o security devices and procedures;
- o adequacy of capitalization and loss reserves;
- o loans;
- o investments;
- o borrowings;
- o deposits;
- o mergers;
- o issuances of securities;
- o payment of dividends;
- o interest rates payable on deposits;
- o interest rates or fees chargeable on loans;
- o establishment of branches;
- o corporate reorganizations;
- o maintenance of books and records; and
- o adequacy of staff training to carry on safe lending and deposit gathering practices.

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The Office of the Comptroller of the Currency requires the bank to maintain specified capital ratios and imposes limitations on the bank's aggregate investment in real estate, bank premises, and furniture and fixtures. The Office of the Comptroller of the Currency also requires the bank to prepare annual reports on the bank's financial condition and to conduct an annual audit of its financial affairs in compliance with its minimum standards and procedures.

Under the FDIC Improvement Act, all insured institutions must undergo regular on-site examinations by their appropriate banking agency. The cost of examinations of insured depository institutions and any affiliates may be assessed by the appropriate agency against each institution or affiliate as it deems necessary or appropriate. Insured institutions are required to submit annual reports to the FDIC, their federal regulatory agency, and state supervisor when applicable. The FDIC Improvement Act directs the FDIC to develop a method for insured depository institutions to provide supplemental disclosure of the estimated fair market value of assets and liabilities, to the extent feasible and practicable, in any balance sheet, financial statement, report of condition or any other report of any insured depository institution. The FDIC Improvement Act also requires the federal banking regulatory agencies to prescribe, by regulation, standards for all insured depository institutions and depository institution holding companies relating, among other things, to the following:

- o internal controls;
- o information systems and audit systems;
- o loan documentation;
- o credit underwriting;
- o interest rate risk exposure; and
- o asset quality.

National banks and their holding companies which have been chartered or registered or have undergone a change in control within the past two years or which have been deemed by the Office of the Comptroller of the Currency or the Federal Reserve Board to be troubled institutions must give the Office of the Comptroller of the Currency or the Federal Reserve Board 30 days prior notice of the appointment of any senior executive officer or director. Within the 30 day period, the Office of the Comptroller of the Currency or the Federal Reserve Board, as the case may be, may approve or disapprove any such appointment.

Deposit Insurance - The FDIC has adopted a risk-based assessment system for determining an insured depository institutions' insurance assessment rate. The system takes into account the risks attributable to different categories and concentrations of assets and liabilities. An institution is placed into one of three capital categories: (1) well capitalized; (2) adequately capitalized; or (3) undercapitalized. The FDIC also assigns an institution to one of three supervisory subgroups, based on the FDIC's determination of the institution's financial condition and the risk posed to the deposit insurance funds. Assessments range from 0 to 27 cents per \$100 of deposits, depending on the institution's capital group and

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supervisory subgroup. In addition, the FDIC imposes assessments to help pay off the \$780 million in annual interest payments on the \$8 billion Financing Corporation bonds issued in the late 1980s as part of the government rescue of the thrift industry. Our FDIC assessment rate is currently 1A or .000036 per million of insured deposits, but may change in the future. The FDIC may increase or decrease the assessment rate schedule on a semiannual basis. An increase in the BIF assessment rate could have a material adverse effect on our earnings, depending on the amount of the increase.

The FDIC may terminate its insurance of deposits if it finds that the institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order, or condition imposed by the FDIC.

Transactions with Affiliates and Insiders - The bank is subject to the provisions of Section 23A of the Federal Reserve Act, which places limits on the amount of loans or extensions of credit to, or investments in, or certain other transactions with, affiliates and on the amount of advances to third parties collateralized by the securities or obligations of affiliates. The aggregate of all covered transactions is limited in amount, as to any one affiliate, to 10% of the bank's capital and surplus and, as to all affiliates combined, to 20% of the bank's capital and surplus. Furthermore, within the foregoing limitations as to amount, each covered transaction must meet specified collateral requirements. Compliance is also required with certain provisions designed to avoid the taking of low quality assets.

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The bank also is subject to the provisions of Section 23B of the Federal Reserve Act which, among other things, prohibits an institution from engaging in certain transactions with certain affiliates unless the transactions are on terms substantially the same, or at least as favorable to such institution or its subsidiaries, as those prevailing at the time for comparable transactions with nonaffiliated companies. The bank is subject to certain restrictions on extensions of credit to executive officers, directors, certain principal shareholders, and their related interests. Such extensions of credit (i) must be made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with third parties and (ii) must not involve more than the normal risk of repayment or present other unfavorable features.

The Federal Reserve Board has recently issued Regulation W, which codifies prior regulations under Sections 23A and 23B of the Federal Reserve Act and interpretative guidance with respect to affiliate transactions. Regulation W incorporates the exemption from the affiliate transaction rules but expands the exemption to cover the purchase of any type of loan or extension of credit from an affiliate. In addition, under Regulation W:

- o a bank and its subsidiaries may not purchase a low-quality asset from an affiliate;
- o covered transactions and other specified transactions between a bank or its subsidiaries and an affiliate must be on terms and conditions that are consistent with safe and sound banking practices; and
- o with some exceptions, each loan or extension of credit by a bank to an affiliate must be secured by collateral with a market value ranging from 100% to 130%, depending on the type of collateral, of the amount of the loan or extension of credit.

Regulation W generally excludes all non-bank and non-savings association subsidiaries of banks from treatment as affiliates, except to the extent that the Federal Reserve Board decides to treat these subsidiaries as affiliates. Concurrently with the adoption of Regulation W, the Federal Reserve Board has proposed a regulation which would further limit the amount of loans that could be purchased by a bank from an affiliate to not more than 100% of the bank's capital and surplus. This regulation has not yet been adopted.

Dividends - A national bank may not pay dividends from its capital. All dividends must be paid out of undivided profits then on hand, after deducting expenses, including reserves for losses and bad debts. In addition, a national bank is prohibited from declaring a dividend on its shares of common stock until its surplus equals its stated capital, unless there has been transferred to surplus no less than one-tenth of the bank's net profits of the preceding two consecutive half-year periods (in the case of an annual dividend). The approval of the Office of the Comptroller of the Currency is required if the total of all dividends declared by a national bank in any calendar year exceeds the total of its net profits for that year combined with its retained net profits for the preceding two years, less any required transfers to surplus.

Branching - National banks are required by the National Bank Act to adhere to branch office banking laws applicable to state banks in the states in which they are located. Under current South Carolina law, the bank may open branch offices throughout South Carolina with the prior approval of the Office of the Comptroller of the Currency. In addition, with prior regulatory approval, the bank is able to acquire existing banking operations in South Carolina. Furthermore, federal legislation permits interstate branching, including out-of-state acquisitions by bank holding companies, interstate branching by banks if allowed by state law, and interstate merging by banks. South Carolina law, with limited exceptions, currently permits branching across state lines through interstate mergers.

Community Reinvestment Act - The Community Reinvestment Act requires that, in connection with examinations of financial institutions within their respective jurisdictions, the Federal Reserve, the FDIC, or the Office of the Comptroller of the Currency, shall evaluate the record of each financial institution in meeting the credit needs of its local community, including low and moderate income neighborhoods. These factors are also considered in evaluating mergers, acquisitions, and applications to open a branch or facility. Failure to adequately meet these criteria could impose additional requirements and limitations on our bank.

The Gramm-Leach-Bliley Act - Under the Gramm-Leach-Bliley Act, subject to certain conditions imposed by their respective banking regulators, national and state-chartered banks are permitted to form financial subsidiaries that may conduct financial or incidental activities, thereby permitting bank subsidiaries to engage in certain activities that previously were impermissible. The Gramm-Leach-Bliley Act imposes several safeguards and restrictions on financial subsidiaries, including that the parent bank's equity investment in the financial subsidiary be deducted from the bank's assets and tangible equity for purposes of calculating the bank's capital adequacy. In addition, the Gramm-Leach-Bliley Act imposes new restrictions on transactions between a bank and its financial subsidiaries similar to restrictions applicable to transactions between banks and nonbank affiliates.

The Gramm-Leach-Bliley Act also contains provisions regarding consumer privacy. These provisions require financial institutions to disclose their policy for collecting and protecting confidential information. Customers generally may prevent financial institutions from sharing personal financial information with nonaffiliated third parties except for third parties that market an institution's own products and services. Additionally, financial institutions generally may not disclose consumer account numbers to any nonaffiliated third party for use in telemarketing, direct mail marketing, or other marketing to the consumer.

Other Regulations - Interest and other charges collected or contracted for by the bank are subject to state usury laws and federal laws concerning interest rates. The bank's loan operations are also subject to federal laws applicable to credit transactions, such as:

- o the federal Truth-In-Lending Act, governing disclosures of credit terms to consumer borrowers;
- o the Home Mortgage Disclosure Act of 1975, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;
- o the Equal Credit Opportunity Act, prohibiting discrimination on the basis of race, creed or other prohibited factors in extending credit;
- o the Fair Credit Reporting Act of 1978, governing the use and provision of information to credit reporting agencies;
- o the Fair Debt Collection Act, governing the manner in which consumer debts may be collected by collection agencies; and
- o the rules and regulations of the various federal agencies charged with the responsibility of implementing such federal laws.

The deposit operations of the bank also are subject to:

- o the Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records; and
- o the Electronic Funds Transfer Act and Regulation E issued by the Federal Reserve Board to implement that Act, which governs automatic deposits to and withdrawals from deposit accounts and customers' rights and liabilities arising from the use of automated teller machines and other electronic banking services.

Capital Regulations - The federal bank regulatory authorities have adopted risk-based capital guidelines for banks and bank holding companies that are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks and bank holding companies and account for off-balance sheet items. The guidelines are minimums, and the federal regulators have noted that banks and bank holding companies contemplating significant expansion programs should not allow expansion to diminish their capital ratios and should maintain ratios in excess of the minimums. We have not received any notice indicating that either Greenville First Bancshares, Inc. or Greenville First Bank, N.A. is subject to higher capital requirements. The current guidelines require all bank holding companies and federally-regulated banks to maintain a minimum risk-based total capital ratio equal to 8%, of which at least 4% must be Tier 1 capital. Tier 1 capital includes common shareholders' equity, qualifying perpetual preferred stock, and minority interests in equity accounts of consolidated subsidiaries, but excludes goodwill and most other intangibles and excludes the allowance for loan and lease losses. Tier 2 capital includes the excess of any preferred stock not included in Tier 1 capital, mandatory convertible securities, hybrid capital instruments, subordinated debt and intermediate term-preferred stock, and general reserves for loan and lease losses up to 1.25% of risk-weighted assets.

Under these guidelines, banks' and bank holding companies' assets are given risk-weights of 0%, 20%, 50%, or 100%. In addition, certain off-balance sheet items are given credit conversion factors to convert them to asset equivalent amounts to which an appropriate risk-weight applies. These computations result in the total risk-weighted assets. Most loans are assigned to the 100% risk category, except for first mortgage loans fully secured by residential property and, under certain circumstances, residential construction loans, both of which carry a 50% rating. Most investment securities are assigned to the 20% category, except for municipal or state revenue bonds, which have a 50% rating, and direct obligations of or obligations guaranteed by the United States Treasury or United States Government agencies, which have a 0% rating.

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The federal bank regulatory authorities also have implemented a leverage ratio, which is equal to Tier 1 capital as a percentage of average total assets less intangibles, to be used as a supplement to the risk-based guidelines. The principal objective of the leverage ratio is to place a constraint on the maximum degree to which a bank holding company may leverage its equity capital base. The minimum required leverage ratio for top-rated institutions is 3%, but most institutions are required to maintain an additional cushion of at least 100 to 200 basis points.

The FDIC Improvement Act established a new capital-based regulatory scheme designed to promote early intervention for troubled banks, which requires the FDIC to choose the least expensive resolution of bank failures. The new capital-based regulatory framework contains five categories of compliance with regulatory capital requirements, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. To qualify as a well capitalized institution, a bank must have a leverage ratio of no less than 5%, a Tier 1 risk-based ratio of no less than 6%, and a total risk-based capital ratio of no less than 10%, and the bank must not be under any order or directive from the appropriate regulatory agency to meet and maintain a specific capital level. Currently, we qualify as well capitalized.

Under the FDIC Improvement Act regulations, the applicable agency can treat an institution as if it were in the next lower category if the agency determines (after notice and an opportunity for hearing) that the institution is in an unsafe or unsound condition or is engaging in an unsafe or unsound practice. The degree of regulatory scrutiny of a financial institution increases, and the permissible activities of the institution decrease, as it moves downward through the capital categories. Institutions that fall into one of the three undercapitalized categories may be required to do some or all of the following:

- o submit a capital restoration plan;
- o raise additional capital;
- o restrict their growth, deposit interest rates, and other activities;
- o improve their management;
- o eliminate management fees; or
- o divest themselves of all or a part of their operations.

These capital guidelines can affect us in several ways. If we grow at a rapid pace, our capital may be depleted too quickly, and a capital infusion from our holding company may be necessary which could impact our ability to pay dividends. Our capital levels currently are adequate; however, rapid growth, poor loan portfolio performance, poor earnings performance, or a combination of these factors could change our capital position in a relatively short period of time. If we fail to meet these capital requirements, our bank would be required to develop and file a plan with the Office of the Comptroller of the Currency describing the means and a schedule for achieving the minimum capital requirements. In addition, our bank would generally not receive regulatory approval of any application that requires the consideration of capital adequacy, such as a branch or merger application, unless our bank could demonstrate a reasonable plan to meet the capital requirement within a reasonable period of time. A bank that is not well capitalized is also subject to certain limitations relating to so-called brokered deposits. Bank holding companies controlling financial institutions can be called upon to boost the institutions' capital and to partially guarantee the institutions' performance under their capital restoration plans.

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Enforcement Powers - The Financial Institutions Reform Recovery and Enforcement Act expanded and increased civil and criminal penalties available for use by the federal regulatory agencies against depository institutions and certain institution-affiliated parties. Institution-affiliated parties primarily include management, employees, and agents of a financial institution, as well as independent contractors and consultants such as attorneys and accountants and others who participate in the conduct of the financial institution's affairs. These practices can include the failure of an institution to timely file required reports or the filing of false or misleading information or the submission of inaccurate reports. Civil penalties may be as high as \$1,000,000 a day for such violations. Criminal penalties for some financial institution crimes have been increased to twenty years. In addition, regulators are provided with greater flexibility to commence enforcement actions against institutions and institution-affiliated parties. Possible enforcement actions include the termination of deposit insurance. Furthermore, banking agencies' power to issue cease-and-desist orders were expanded. Such orders may, among other things, require affirmative action to correct any harm resulting from a violation or practice, including restitution, reimbursement, indemnifications or guarantees against loss. A financial institution may also be ordered to restrict its growth, dispose of certain assets, rescind agreements or contracts, or take other actions as determined by the ordering agency to be appropriate.

Effect of Governmental Monetary Policies - Our earnings are affected by domestic economic conditions and the monetary and fiscal policies of the United States government and its agencies. The Federal Reserve Bank's monetary policies have had, and are likely to continue to have, an important impact on the operating results of commercial banks through its power to implement national monetary policy in order, among other things, to curb inflation or combat a recession. The monetary policies of the Federal Reserve Board have major effects upon the levels of bank loans, investments and deposits through its open market operations in United States government securities and through its regulation of the discount rate on borrowings of member banks and the reserve requirements against member bank deposits. It is not possible to predict the nature or impact of future changes in monetary and fiscal policies.

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Proposed Legislation and Regulatory Action. - New regulations and statutes are regularly proposed that contain wide-ranging proposals for altering the structures, regulations, and competitive relationships of the nation's financial institutions. We cannot predict whether or in what form any proposed regulation or statute will be adopted or the extent to which our business may be affected by any new regulation or statute.

Item 2. Description of Property

Our main office facility is located at the corner of Haywood Road and Halton Road in downtown Greenville, South Carolina. The building is a full service banking facility with three drive-through banking stations and an automatic teller machine. We lease this building from Halton Properties, LLC, which is 50% owned by our director Mark A. Cothran, for approximately \$342,000 per year. Rental payments are subject to increase in accordance with a formula based on the Consumer Price Index. The lease has an initial term of 20 years, expiring in 2021, with options for three additional five-year renewal periods. We have the option to purchase the building at any time at a price based on a fair market value calculation.

On March 5, 2004, we received permission from the OCC to open two additional offices. We opened our first office on March 14, 2005, which is located in the Thornblade area of Greenville, South Carolina on The Parkway, near the intersection of I-85 and Pelham Road. We purchased the site for approximately \$422,000, and as of December 31, 2004, had committed approximately \$1.2 million to construct the office.

We plan to open the second office, which will be located at 2125 Augusta Road in Greenville, South Carolina, during the third quarter of 2005. We lease the land for this office from Augusta Road Holdings, LLC, which is owned by one of our directors, Mark A. Cothran, for approximately \$57,000 per year. Rental payments are subject to increase in accordance with a formula based on the Consumer Price Index. The term of the lease is 99 years. By the end of the third quarter of this year, we expect to have constructed this office for approximately \$1.1 million.

We believe that all of our properties are adequately covered by insurance.

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Item 3. Legal Proceedings.

In the ordinary course of operations, we may be a party to various legal proceedings from time to time. We do not believe that there is any pending or threatened proceeding against us, which, if determined adversely, would have a material effect on our business, results of operations, or financial condition.

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

No matter was submitted to a vote of security holders during the fourth quarter of the fiscal year covered by this report.

Item 5. Market for Common Equity and Related Stockholder Matters.

From the date of our initial public offering on October 26, 1999 to September 24, 2004, our common stock had been quoted on the OTC Bulletin Board under the symbol GVBK. On September 24, 2004, our common stock began trading on the Nasdaq National Market under the same symbol GVBK on March 11, 2005, we had approximately 1,000 shareholders of record.

The following table shows the reported high and low bid information (adjusted for stock splits) reported by the OTC Bulletin Board for 2003 and the first three quarter of 2004 and the high and low sales prices reported by the Nasdaq National Market for the fourth quarter of 2004. The prices listed by the OTC Bulletin Board are quotations, which reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not represent actual transactions.

| 2004 | High | Low |
|-------------------|-------------|-------------|
| First Quarter | \$ 24.00 | \$ 17.91 |
| Second Quarter | 21.65 | 18.40 |
| Third Quarter | 19.75 | 17.00 |
| Fourth Quarter | 20.00 | 18.18 |

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| 2003 | High | Low |
|----------------|---------|---------|
| First Quarter | \$ 9.67 | \$ 8.67 |
| Second Quarter | 11.47 | 10.83 |
| Third Quarter | 12.50 | 11.67 |
| Fourth Quarter | 18.00 | 15.75 |

We have not declared or paid any cash dividends on our common stock since our inception. For the foreseeable future we do not intend to declare cash dividends. We intend to retain earnings to grow our business and strengthen our capital base. Our ability to pay dividends depends on the ability of our subsidiary, Greenville First Bank, to pay dividends to us. As a national bank, Greenville First Bank may only pay dividends out of its net profits, after deducting expenses, including losses and bad debts. In addition, the bank is prohibited from declaring a dividend on its shares of common stock until its surplus equals its stated capital, unless there has been transferred to surplus no less than one-tenth of the bank's net profits of the preceding two consecutive half-year periods (in the case of an annual dividend). The approval of the Office of the Comptroller of the Currency (the OCC) will be required if the total of all dividends declared in any calendar year by the bank exceeds the bank's net profits to date for that year combined with its retained net profits for the preceding two years less any required transfers to surplus. The OCC also has the authority under federal law to enjoin a national bank from engaging in what in its opinion constitutes an unsafe or unsound practice in conducting its business, including the payment of a dividend under certain circumstances.

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The following table sets forth equity compensation plan information at December 31, 2004. The number of shares and the exercise prices for options and warrants has been adjusted for the 3 for 2 stock split.

Equity Compensation Plan Information

| Plan Category | Number of securities to be issued upon exercise of outstanding options, warrants and rights(a) | Weighted-average exercise price of outstanding options, warrants and rights (b) | Number of securities remaining available for future issuance under equity compensation plans (c) (excluding securities reflected in column(a)) |
|---|--|---|--|
| Equity compensation plans approved by security holders (1) | 258,750 | \$ 7.15 | 6,500 |
| Equity compensation plans not approved by security holders(2) | 191,925 | \$ 6.67 | - |
| Total | 450,675 | \$ 6.95 | 6,500 |

- (1) The 258,750 of shares of common stock available under the 2000 Greenville First Bancshares, Inc. Stock Incentive Plan will automatically increase each time we issue additional shares so that it continues to equal 15% of our total outstanding shares.
- (2) Each of our organizers received, for no additional consideration, a warrant to purchase one share of common stock for \$6.67 per share for each share purchased during our initial public offering. The warrants are represented by separate warrant agreements. One third of the warrants vest on each of the first three anniversaries of the date our bank opened for business, and they are exercisable in whole or in part during the ten year period following that date. The warrants may not be assigned, pledged, or hypothecated in any way. The 191,925 of shares issued pursuant to the exercise of such warrants are transferable, subject to compliance with applicable securities laws. If the South Carolina Board of Financial Institutions or the FDIC issues a capital directive or other order requiring the bank to obtain additional capital, the warrants will be forfeited, if not immediately exercised.

Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operation.

CRITICAL ACCOUNTING POLICIES

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We have adopted various accounting policies that govern the application of accounting principles generally accepted in the United States and with general practices within the banking industry in the preparation of our financial statements. Our significant accounting policies are described in footnote 1 to our audited consolidated financial statements as of December 31, 2004.

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

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

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Refer to the portion of this discussion that addresses our allowance for loan losses for a more complete discussion of our processes and methodology for determining our allowance for loan losses.

GENERAL

We were incorporated in March 1999 to organize and serve as the holding company for Greenville First Bank, N.A. Since we opened our bank in January 2000, we have experienced consistent growth in total assets, loans, deposits, and shareholders' equity. We experienced our first quarterly profit in the third quarter of 2001, and we have been profitable in each subsequent quarter. We became cumulatively profitable in the third quarter of 2003.

The following table sets forth selected measures of our financial performance for the periods indicated.

| | Years Ended December 31, | | | | |
|-------------------|--------------------------|----------|----------|----------|----------|
| | 2004 | 2003 | 2002 | 2001 | 2000 |
| | (In thousands) | | | | |
| Total revenues(1) | \$ 9,410 | \$ 6,526 | \$ 5,181 | \$ 3,241 | \$ 1,683 |
| Net income (loss) | 2,013 | 1,006 | 752 | (119) | (662) |
| Total assets | 315,811 | 230,841 | 170,358 | 118,565 | 61,428 |
| Total net loans | 276,630 | 206,077 | 148,079 | 95,340 | 46,025 |
| Total deposits | 204,864 | 168,964 | 133,563 | 92,700 | 49,994 |

(1) Total revenue equals net interest income plus total noninterest income.

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

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

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

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

Effect of Economic Trends

During the three years ended December 31, 2003 and the six months ended June 30, 2004, our rates on both short-term or variable rate earning assets and short-term or variable rate interest-bearing liabilities declined primarily as a result of the actions taken by the Federal Reserve. Beginning in July of 2004, our short-term or variable rates began to increase as the Federal Reserve began to increase short-term rates.

During most of 2001 and during 2002, the United States experienced an economic decline. During this period, the economy was affected by lower returns of the stock markets. Economic data led the Federal Reserve to begin an aggressive program of reducing rates that moved the Federal Funds rate down 11 times during 2001 for a total reduction of 475 basis points. During the fourth quarter of 2002 and the first quarter of 2003, the Federal Reserve reduced the Federal Funds rate down an additional 75 basis points, bringing the Federal Funds rate to its lowest level in 40 years. During the last six months of 2004, the Federal Reserve increased rates five times for a total of 125 basis points. The Federal Reserve chose to again increase rates 25 basis points at each of their meetings in February and March of 2005.

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Despite sharply lower short-term rates, stimulus to the economy during 2003 was muted and consumer demand and business investment activity remained weak. During all of 2003 and substantially all of the six months ended June 30, 2004, the financial markets operated under historically low interest rates. As a result of these unusual conditions, Congress passed an economic stimulus plan in 2003. During 2004, many economists believed the economy began to show signs of strengthening and the Federal Reserve began to increase the short-term interest rates. Many economists believe that the Federal Reserve will continue to increase rates during 2005 and during most of 2006. The following discussion includes our analysis of the effect we anticipate these rising interest rates will have on our financial condition. However, no assurance can be given that the Federal Reserve will actually continue to raise interest rates or that the results we anticipate will actually occur.

Results of Operations

Income Statement Review

Summary

Years ended December 31, 2004 and 2003

Our net income was \$2.0 million and \$1.0 million for the years ended December 31, 2004 and 2003, respectively. Our net income in 2004 increased \$1.0 million, or 100.0%, compared to our net income in 2003.

The \$1.0 million increase in net income resulted from a \$2.5 million increase in net interest income, a \$339,779 increase in noninterest income offset by a \$260,000 additional provision for loan losses, a \$1.0 million increase in noninterest expense and \$617,188 higher income tax expense. Our efficiency ratio was 51.58% and 59.04% for the years ended December 31, 2004 and 2003, respectively. We compute our efficiency ratio by dividing noninterest expense by the sum of net interest income and noninterest income. The efficiency ratio represents the percentage of one dollar of expense required to be incurred to earn a full dollar of revenue. For the year ended December 31, 2004, we spent on average \$0.52 to earn each \$1.00 of revenue.

Net Interest Income

Our level of net interest income is determined by the level of earning assets and the management of our net interest margin. The continuous growth in our loan portfolio is the primary driver of the increase in net interest income. During the three years ended December 31, 2004, our loan portfolio had increased an average of \$60.4 million per year. The growth in 2004 was \$70.6 million. We anticipate the growth in loans will continue to drive the growth in assets and the growth in net interest income. However, no assurance can be given that we will be able to continue to increase loans at the same levels we have experienced in the past.

Our decision to grow the loan portfolio at the current pace created the need for a higher level of capital and the need to increase deposits and borrowings. This loan growth strategy also resulted in a significant portion of our assets being in higher earning loans than in lower yielding investments. At December 31, 2004, loans represented 87.6% of total assets, while investments and federal funds sold represented 9.7% of total assets. While we plan to continue our focus on increasing the loan portfolio, as rates on investment securities begin to rise and additional deposits are obtained, we also anticipate increasing the size of the investment portfolio.

The historically low interest rate environment in the last three years allowed us to obtain short-term borrowings and wholesale certificates of deposit at rates that were lower than certificate of deposit rates being offered in our local market. Therefore, we decided not to begin our retail deposit expansion program until the beginning of 2005. This funding strategy allowed us to continue to operate in one location, maintain a smaller staff, and not incur marketing costs to advertise deposit rates, which in turn allowed us to focus on the fast growing loan portfolio. At

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December 31, 2004, retail deposits represented \$127.6 million, or 40.5% of total assets, borrowings represented \$79.9 million, or 25.3% of total assets, and wholesale out-of-market deposits represented \$77.3 million, or 24.5% of total assets.

In anticipation of rising interest rates, we opened one retail deposit office, in March of 2005 and the other is expected to open in the third quarter of 2005. We plan to focus our efforts at these two locations on obtaining low cost transaction accounts that are less affected by rising rates.

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Also, in anticipation of rising rates, during 2004, we offered aggressive promotional rates on new checking accounts and new money market accounts. The promotional rates offered were 2.00% on checking accounts and 2.25% on money market accounts and were guaranteed until January 31, 2005. Based on prior experience, we anticipate the majority of these funds to be retained at the end of the promotion. Our goal is to increase both the percentage of assets being funded by in market retail deposits and to increase the percentage of low-cost transaction accounts to total deposits. No assurance can be given that these objectives will be achieved; however, we anticipate that the two additional retail deposit offices will assist us in meeting these objectives. We also anticipate the current deposit promotion and the opening of the two new offices will have a negative impact on earnings in the years ending 2005 and 2006. However, we believe that these two strategies will provide additional clients in our local market and will provide a lower alternative cost of funding in a higher or rising interest rate environment, which we believe will increase earnings in future periods.

As more fully discussed in the - Market Risk and - Liquidity and Interest Rate Sensitivity sections below, at December 31, 2004, 68.0% of our loans had variable rates. Given our high percentage of rate-sensitive loans, our primary focus during the three years ended December 31, 2004 has been to obtain short-term liabilities to fund our asset growth. This strategy allows us to manage the impact on our earnings resulting from changes in market interest rates.

Also in anticipation of rising rates, in May 2004 we converted a total of \$25.0 million of short-term deposits and borrowings with a term of less than three months into \$25.0 million of deposits and borrowings with a weighted average life of five years. At December 31, 2004 72.8% of interest-bearing liabilities had a maturity of less than one year. We believe that we are positioned to benefit from future increases in short-term rates. At December 31, 2004, we had \$37.4 million more assets than liabilities that reprice within the next three months.

We intend to maintain a capital level for the bank that exceeds the OCC requirements to be classified as a well capitalized bank. To provide the additional capital needed to support our bank's growth in assets, in 2003 we issued \$6.2 million in junior subordinated debentures in connection with our trust preferred securities offering. During 2004, we issued 920,000 additional shares of common stock that resulted in \$14.9 million of additional capital. The company also has a \$4.5 million unused short-term holding company line of credit that could be utilized to provide additional capital for the bank if deemed necessary. As of December 31, 2004, the company's regulatory capital levels were over \$11.7 million in excess of the various well capitalized requirements.

In addition to the growth in both assets and liabilities, and the timing of repricing of our assets and liabilities, net interest income is also affected by the ratio of interest-earning assets to interest-bearing liabilities and the changes in interest rates earned on our assets and interest rates paid on our liabilities.

Our net interest income margin for the three years ended December 31, 2004, exceeded our net interest spread because we had more interest-earning assets than interest-bearing liabilities. For the years ended December 31, 2004 and 2003, average interest-earning assets exceeded average interest-bearing liabilities by \$14.4 million and \$6.9 million, respectively. The estimated \$2.5 million cost of the two additional retail offices will reduce the amount by which interest-earning assets exceed interest-bearing liabilities.

During the three years ended December 31, 2004, our rates on both short-term or variable rate earning-assets and short-term or variable rate interest-bearing liabilities declined primarily as a result of the actions taken by the Federal Reserve to lower short-term rates.

The impact of the Federal Reserve's actions during the three years ended December 31, 2004, resulted in a decline in both the yields on our variable rate assets and the rates that we paid for our short-term deposits and borrowings. Our net interest spread and net interest margins also declined since more of our rate sensitive assets repriced sooner than our rate sensitive liabilities during the three year period ending December 31, 2004. Our net interest margin for the years ended December 31, 2002, 2003, and 2004 was 3.30%, 3.24% and 3.17%, respectively.

During the last six months of 2004, the Federal Reserve increased rates five times for a total of 125 basis points. The Federal Reserve actions resulted in our net interest margin increasing during the last six months of 2004. Our net interest margin was 3.35% for the fourth quarter of 2004.

We have included a number of unaudited tables to assist in our description of various measures of our financial performance. For example, the Average Balances tables show the average balance of each category of our assets and liabilities as well as the yield we earned or the rate we

paid with respect to each category during 2004, 2003, 2002,

2001, and 2000. A review of these tables shows that our loans typically provide higher interest yields than do other types of interest-earning assets, which is why we direct a substantial percentage of our earning assets into our loan portfolio. Similarly, the Rate/Volume Analysis tables help demonstrate the effect of changing interest rates and changing volume of assets and liabilities on our financial condition during the periods shown. We also track the sensitivity of our various categories of assets and liabilities to changes in interest rates, and we have included tables to illustrate our interest rate sensitivity with respect to interest-earning accounts and interest-bearing accounts. Finally, we have included various tables that provide detail about our investment securities, our loans, our deposits, and other borrowings.

Years Ended December 31, 2004, 2003, and 2002

The following tables set forth information related to our average balance sheet, average yields on assets, and average costs of liabilities. We derived these yields by dividing income or expense by the average balance of the corresponding assets or liabilities. We derived average balances from the daily balances throughout the periods indicated. During the five years ended December 31, 2004, all investments were taxable. During the same periods, we had no interest-bearing deposits in other banks or any securities purchased with agreements to resell. All investments were owned at an original maturity of over one year. Nonaccrual loans are included in the following tables. Loan yields have been reduced to reflect the negative impact on our earnings of loans on nonaccrual status. The net of capitalized loan costs and fees are amortized into interest income on loans.

**Average Balances, Income and Expenses, and Rates
For the Years Ended December 31,**

| | 2004 | | | 2003 | | | 2002 | | |
|------------------------------------|-----------------|----------------|------------|-----------------|----------------|------------|-----------------|----------------|------------|
| | Average Balance | Income/Expense | Yield/Rate | Average Balance | Income/Expense | Yield/Rate | Average Balance | Income/Expense | Yield/Rate |
| | (In thousands) | | | | | | | | |
| Earning assets: | | | | | | | | | |
| Federal funds sold | \$ 1,842 | \$ 23 | 1.25% | \$ 1,676 | \$ 18 | 1.07% | \$ 2,879 | \$ 50 | 1.74% |
| Investment securities | 22,585 | 967 | 4.28% | 12,498 | 517 | 4.14% | 14,913 | 713 | 4.78% |
| Loans | 248,115 | 12,975 | 5.23% | 174,289 | 9,187 | 5.27% | 123,261 | 7,390 | 6.00% |
| Total earning-assets | 272,542 | 13,965 | 5.12% | 188,463 | 9,722 | 5.16% | 141,053 | 8,153 | 5.78% |
| Nonearning assets | 4,534 | | | 6,295 | | | 7,112 | | |
| Total assets | \$ 277,076 | | | \$ 194,758 | | | \$ 148,165 | | |
| Interest-bearing liabilities: | | | | | | | | | |
| NOW accounts | \$ 39,634 | \$ 332 | 0.84% | \$ 30,105 | \$ 127 | 0.42% | \$ 27,367 | \$ 261 | 0.95% |
| Savings & money market | 43,188 | 630 | 1.46% | 22,822 | 129 | 0.57% | 22,811 | 316 | 1.39% |
| Time deposits | 99,419 | 2,608 | 2.62% | 90,585 | 2,511 | 2.77% | 71,846 | 2,584 | 3.60% |
| Total interest-bearing deposits | 182,241 | 3,570 | 1.96% | 143,512 | 2,767 | 1.93% | 122,024 | 3,161 | 2.59% |
| FHLB advances | 54,515 | 1,204 | 2.21% | 27,569 | 591 | 2.14% | 7,090 | 216 | 3.05% |
| Other borrowings | 21,375 | 543 | 2.54% | 10,478 | 260 | 2.48% | 5,293 | 115 | 2.17% |
| Total interest-bearing liabilities | 258,131 | 5,317 | 2.06% | 181,559 | 3,618 | 1.99% | 134,407 | 3,492 | 2.60% |
| Noninterest bearing liabilities | 2,675 | | | 2,356 | | | 4,023 | | |

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| | Average Balances, Income and Expenses, and Rates | | | | | |
|---|--|-------|-------------------|-------|-------------------|-------|
| Shareholders' equity . | 16,270 | | 10,843 | | 9,735 | |
| | <u> </u> | | <u> </u> | | <u> </u> | |
| Total liabilities and shareholders' equity | \$ 277,076 | | \$ 194,758 | | \$ 148,165 | |
| | <u> </u> | | <u> </u> | | <u> </u> | |
| Net interest spread | | 3.06% | | 3.17% | | 3.18% |
| Net interest income/ margin | \$ 8,648 | 3.17% | \$ 6,104 | 3.24% | \$ 4,661 | 3.30% |
| | <u> </u> | | <u> </u> | | <u> </u> | |

Our net interest spread was 3.06% for the year ended December 31, 2004, compared to 3.17% for the year ended December 31, 2003 and 3.18% for the year ended December 31, 2002. The net interest spread is the difference between the yield we earn on our interest-earning assets and the rate we pay on our interest-bearing liabilities.

The net interest margin is calculated as net interest income divided by average interest-earning assets.

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Our net interest margin for the period ended December 31, 2004 was 3.17%, compared to 3.24% for the year ended December 31, 2003 and 3.30% for the year ended December 31, 2002. During 2004, interest-earning assets averaged \$272.5 million, compared to \$188.5 million in 2003 and \$141.1 million in 2002.

The net interest spread and net interest margin declined during the three years ended December 31, 2004 as a result of the bank having more interest-earning assets than interest-bearing liabilities that repriced as market rates declined over most of the three year period.

Net interest income, the largest component of our income, was \$8.6 million, \$6.1 million, and \$4.7 million, for the years ended December 31, 2004, 2003, and 2002, respectively. The significant increase in both 2004 and 2003 related to the net effect of higher levels of both average earning assets and interest-bearing liabilities, offset by a slightly lower net interest margin. In 2004 and 2003, average earning assets increased \$84.1 million and \$47.4 million, respectively. During the same periods, average interest-bearing liabilities increased \$76.6 million and \$47.2 million, respectively.

The \$2.5 million increase in net interest income for the year ended December 31, 2004 compared to the same period in 2003 resulted from a \$2.7 million increase in net interest income due to higher volume offset by a \$185,000 decrease in net interest income due change in rate. The \$1.4 million increase in net interest income for the year ended December 31, 2003 compared to the same period in 2002 resulted from a \$1.6 million increase in net interest income due to volume offset by a \$151,000 decrease in net interest income due to rate. The increases in net interest income were caused by higher average earning assets and interest-bearing liabilities. The decreases in net interest income were caused by the lower net interest margin.

Interest income for the year ended December 31, 2004 was \$14.0 million, consisting of \$13.0 million on loans, \$966,653 on investments, and \$22,751 on federal funds sold. Interest income for 2003 was \$9.7 million, consisting of \$9.2 million on loans, \$517,005 on investments, and \$18,171 on federal funds sold. Interest on loans for the years ended December 31, 2004 and 2003 represented 92.9% and 94.5%, respectively, of total interest income, while income from investments and federal funds sold represented 7.1% and 5.5% of total interest income for the years ended December 31, 2004 and 2003, respectively. The high percentage of interest income from loans related to our strategy to maintain a significant portion of our assets in higher earning loans compared to lower yielding investments. Average loans represented 91.0% and 92.5% of average interest-earning assets for the years ended December 31, 2004 and 2003, respectively. Included in interest income on loans for the years ended December 31, 2004 and 2003 was \$496,119 and \$349,887, respectively, related to the net amortization of loan fees and capitalized loan origination costs.

Interest expense for the year ended December 31, 2004 was \$5.3 million, consisting of \$3.6 million related to deposits and \$1.7 million related to borrowings. Interest expense for the year ended December 31, 2003 was \$3.6 million, consisting of \$2.8 million related to deposits and \$850,989 related to borrowings. Interest expense on deposits for the years ended December 31, 2004 and 2003 represented 67.2% and 76.5%, respectively, of total interest expense, while interest expense on borrowings represented 32.8% and 23.5%, respectively, of total interest expense. The smaller increase in interest expense on deposits compared to the increase in interest on borrowings during the year ended December 31, 2004 resulted from our decision to delay our retail deposit office expansion program and instead utilize additional borrowings from both the FHLB, and from the sale of securities under agreements to repurchase with brokers. During the year ended December 31, 2004, average deposits were higher by \$38.7 million than for the same period 2003, while other borrowings during the year ended December 31, 2003 were \$37.8 million higher than for the same period in 2003.

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During the year ended December 31, 2004, we were able to pledge additional collateral to the FHLB, allowing us the ability to increase our FHLB borrowings. Both the short-term borrowings related to the sale of securities under agreements to repurchase and the FHLB advances provide us with the opportunity to obtain low cost funding with various maturities similar to the maturities on our loans and investments.

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The following table sets forth, for the years ended December 31, 2001 and 2000, information related to our average balance sheet and average yields on assets and average costs of liabilities. We derived these yields by dividing income or expense by the average balance of the corresponding assets or liabilities. We derived average balances from the daily balances throughout the periods indicated.

Average Balances, Income and Expenses, and Rates For the Years Ended December 31, (Dollars in thousands)

| | 2001 | | | 2000 | | |
|--|--------------------|-------------------|----------------|--------------------|-------------------|----------------|
| | Average Balance | Income Expense | Yields Rate | Average Balance | Income Expense | Yields Rate |
| Federal funds sold | \$ 3,716 | \$ 160 | 4.31% | \$ 6,059 | \$ 388 | 6.40% |
| Investment securities | 15,456 | 963 | 6.23% | 6,934 | 442 | 6.37% |
| Loans | 67,046 | 5,187 | 7.74% | 23,798 | 2,318 | 9.74% |
| | <u>86,218</u> | <u>6,310</u> | 7.32% | <u>36,791</u> | <u>3,148</u> | 8.56% |
| Total earning-assets | | | | | | |
| Nonearnings assets | 5,364 | | | 4,203 | | |
| | <u>\$ 91,582</u> | | | <u>\$ 40,994</u> | | |
| NOW accounts | 12,559 | \$ 164 | 1.31% | \$ 7,410 | \$ 234 | 3.16% |
| Savings & money market | 19,588 | 675 | 3.45% | 9,267 | 513 | 5.54% |
| Time deposits | 42,982 | 2,405 | 5.60% | 11,553 | 777 | 6.72% |
| | <u>75,129</u> | <u>3,244</u> | 4.32% | <u>28,230</u> | <u>1,524</u> | 5.40% |
| Total interest-bearing deposits | | | | | | |
| FHLB advance | 1,858 | 74 | 3.98% | - | - | -% |
| Other borrowings | 1,333 | 35 | 2.63% | - | - | -% |
| | <u>78,320</u> | <u>3,353</u> | 4.28% | <u>28,230</u> | <u>1,524</u> | 5.40% |
| Total interest-bearing liabilities | | | | | | |
| Noninterest bearing liabilities | 3,813 | | | 3,082 | | |
| Shareholders' equity | 9,449 | | | 9,682 | | |
| | <u>\$ 91,582</u> | | | <u>\$ 40,994</u> | | |
| Total liabilities and shareholders' equity | | | | | | |
| Net interest spread | | | 3.04% | | | 3.16% |
| Net interest income/ margin | | <u>\$ 2,957</u> | 3.43% | | <u>\$ 1,624</u> | 4.41% |

Our net interest spread was 3.04% for the year ended December 31, 2001 as compared to 3.16% for the year ended December 31, 2000. Our net interest margin for the period ended December 31, 2001 was 3.43% as compared to 4.41% for the year ended December 31, 2000. During 2001, earning assets averaged \$86.2 million as compared to \$36.8 million in 2000.

Rate/Volume Analysis

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

interest income for the periods presented.

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| | Years Ended | | | | | | | |
|-------------------------------|----------------------------|--------------|-----------------|--------------|----------------------------|----------------|-----------------|--------------|
| | December 31, 2004 vs. 2003 | | | | December 31, 2003 vs. 2002 | | | |
| | Increase (Decrease) Due to | | | | Increase (Decrease) Due to | | | |
| | Volume | Rate | Rate/ Volume | Total | Volume | Rate | Rate/ Volume | Total |
| (In thousands) | | | | | | | | |
| Interest income | | | | | | | | |
| Loans | \$ 3,883 | (73) | (23) | 3,787 | 3,059 | (893) | (370) | 1,796 |
| Investment securities | 417 | 18 | 15 | 450 | (115) | (96) | 16 | (195) |
| Federal funds sold | 2 | 3 | -- | 5 | (21) | (19) | 8 | (32) |
| Total interest income | 4,302 | (52) | (8) | 4,243 | 2,923 | (1,008) | (346) | 1,569 |
| Interest expense | | | | | | | | |
| Deposits | 743 | 44 | 16 | 803 | 557 | (808) | (142) | (393) |
| FHLB advances | 578 | 18 | 17 | 613 | 624 | (64) | (185) | 375 |
| Other borrowings | 270 | 6 | 6 | 282 | 114 | 15 | 15 | 144 |
| Total interest expense | 1,591 | 68 | 39 | 1,698 | 1,295 | (857) | (312) | 126 |
| Net interest income | \$ 2,711 | (120) | (47) | 2,544 | 1,628 | (151) | (34) | 1,443 |

Provision for Loan Losses

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

Included in the statement of income for the years ended December 31, 2004 and 2003 is a noncash expense related to the provision for loan losses of \$1.3 million and \$1.1 million, respectively. The additional provision added to our allowance for loan losses in each year resulted in a net increase in the allowance for loan losses of \$1.0 million for the year ended December 31, 2004 and \$881,001 for the year ended December 31, 2003. The allowance for loan losses did not increase by the entire amount of each of the two provisions for loan losses because we reported net charge-offs of \$298,505 and \$168,999 for the years ended December 31, 2004 and 2003, respectively. The \$298,505 net charge-offs during 2004 represented 0.12% of the average outstanding loans portfolio for the year ended December 31, 2004. The \$168,999 net charge-offs during 2003 represented 0.10% of the average outstanding loan portfolio for the year ended December 31, 2003. The \$1.0 million and the \$881,001 increases in the allowance for the years ended December 31, 2004 and 2003, respectively, related to our decision to increase the allowance in response to the \$71.6 million and the \$58.9 million growth in loans for the years ended December 31, 2004 and 2003, respectively. The loan loss reserve was \$3.7 million and \$2.7 million as of December 31, 2004 and 2003, respectively. The allowance for loan losses as a percentage of gross loans was 1.33% at December 31, 2004 and 1.30% at December 31, 2003, while the percentage of nonperforming loans to gross loans was 0.30% and 0.21% at December 31, 2004 and 2003, respectively.

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Noninterest Income

The following tables set forth information related to our noninterest income.

Years ended December 31,

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| | Years ended December 31, | | |
|---------------------------------|--------------------------|----------------|----------------|
| | 2004 | 2003 | 2002 |
| Loan fee income | \$ 146,986 | 183,932 | 155,401 |
| Service fees on deposits | 296,100 | 251,938 | 182,667 |
| Write-down on real estate owned | (2,725) | (253,699) | - |
| Other income | 321,102 | 239,513 | 182,183 |
| Total noninterest income | \$ 761,463 | 421,684 | 520,251 |

Years ended December 31, 2004 and 2003

Noninterest income for the year ended December 31, 2004 was \$761,463, an increase of \$339,779 compared to noninterest income of \$421,684 during the same period in 2003. During 2003, we incurred a \$253,699 write-down on real estate that was previously acquired in foreclosure and was sold in December 2003 compared to only a \$2,725 write-down on real estate in 2004. Excluding the \$250,974 net difference in the loss on real estate owned in 2003 compared to 2004, noninterest income from loan and service fees and other noninterest income in 2004 increased \$88,805, or 21.1%, from 2003.

Loan fees consist primarily of late charge fees and mortgage origination fees we receive on residential loans funded and closed by a third party. Loan fees were \$146,986 and \$183,932 for the years ended December 31, 2004 and 2003, respectively. The \$36,946 decrease relates primarily to the \$90,467 reduction in mortgage origination fees. We received \$16,591 of mortgage origination fees in 2004 compared to \$107,058 in 2003. We anticipate that the level of mortgage origination fees will remain low as the mortgage refinancing business has declined due to higher mortgage rates currently being offered. As a result of our larger loan portfolio, late fees and other related loans fees increase \$53,521 in 2004 compared to 2003.

Service fees on deposits consist primarily of service charges on our checking, money market, and savings accounts and the fee income received from client non-sufficient funds (NSF) transactions. Deposit fees were \$296,100 and \$251,938 for the years ended December 31, 2004 and 2003, respectively. The additional \$44,162 of income related to both higher service charges and an increase in NSF transactions which resulted from the larger number of client accounts. NSF income was \$188,880 and \$160,260 for the years ended December 31, 2004 and 2003, respectively, representing 63.8% of total service fees on deposits in 2004 compared to 63.6% of total service fees on deposits in 2003.

Other income consists primarily of fees received on debit and credit card transactions, income from sales of checks, and the fees received on wire transfers. Other income was \$321,102 and \$239,513 for the years ended December 31, 2004 and 2003, respectively. The \$81,589 increase resulted primarily from an increase in the volume of ATM transactions for which we receive fees. The ATM transaction fees were \$290,143 and \$213,844 for the years ended December 31, 2004 and 2003, respectively. The ATM transaction fees represented 90.4% and 89.3% of total other income for the years ended December 31, 2004 and 2003, respectively. Included in noninterest data processing and related costs was \$252,581 and \$201,970 related to corresponding transaction costs associated with ATM transaction fees for the years ended December 31, 2004 and 2003, respectively. The net impact of the fees received and the related cost of the ATM transactions on earnings for the years ended December 31, 2004 and 2003 was \$37,562 and \$11,874, respectively.

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Noninterest expenses

The following tables set forth information related to our noninterest expenses.

| | Years ended December 31, | | |
|-----------------------------------|--------------------------|-----------|-----------|
| | 2004 | 2003 | 2002 |
| Compensation and benefits | \$ 2,497,445 | 1,983,204 | 1,768,878 |
| Professional fees | 213,168 | 175,126 | 153,257 |
| Marketing | 292,043 | 159,486 | 123,553 |
| Insurance | 128,978 | 110,219 | 93,282 |
| Occupancy | 603,033 | 587,992 | 587,783 |
| Data processing and related costs | 813,097 | 625,779 | 473,577 |
| Telephone | 32,216 | 22,097 | 23,674 |

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| | Years ended December 31, | | |
|---------------------------|--------------------------|-----------|-----------|
| | | | |
| Other | 273,315 | 188,946 | 154,478 |
| Total noninterest expense | \$ 4,853,295 | 3,852,849 | 3,378,482 |

Years ended December 31, 2004 and 2003

We incurred noninterest expenses of \$4.9 million for the year ended December 31, 2004, compared to \$3.9 million for the year ended December 31, 2003. Average interest-earning assets increased 44.6% during this period, while general and administrative expense increased by only 26.0%.

The \$514,241 increase in compensation and benefits and \$187,318 increase in additional data processing and related costs accounted for 70.1% of the \$1.0 million increase in noninterest expense for the year ended December 31, 2004 compared to the same period in 2003. The remaining \$298,887 increase resulted primarily from increases of \$38,042 in professional fees, \$132,557 in marketing costs, \$18,759 in insurance expenses, and \$84,369 in other expenses. A significant portion of the increase in professional fees related to additional audit expenses. The increase in marketing expenses related to expanding our market awareness in the Greenville market, while a significant portion of the increase in other expenses was due to increased costs of postage and office supplies, additional staff education and training, and higher dues and subscription costs.

Occupancy expense, which represented 12.4% and 15.3% of total noninterest expense for the years ended December 31, 2004 and 2003, respectively, increased only \$15,041. Occupancy expense was \$603,033 and \$587,992 for the years ended December 31, 2004 and 2003, respectively.

The following tables set forth information related to our compensation and benefits.

| | Years ended December 31, | | |
|------------------------------------|--------------------------|-----------|-----------|
| | 2004 | 2003 | 2002 |
| Base compensation | \$ 1,708,492 | 1,396,373 | 1,272,785 |
| Incentive compensation | 570,049 | 420,000 | 352,000 |
| Total compensation | 2,278,541 | 1,816,373 | 1,624,785 |
| Benefits | 341,124 | 285,941 | 245,263 |
| Capitalized loan origination costs | (122,220) | (119,110) | (101,170) |
| Total compensation and benefits | \$ 2,497,445 | 1,983,204 | 1,768,878 |

Compensation and benefits expense was \$2.5 million and \$2.0 million for the years ended December 31, 2004 and 2003, respectively. Compensation and benefits represented 51.5% of our total noninterest expense in both of the years ended December 31, 2004 and 2003. The \$514,241 increase in compensation and benefits expense in 2004 compared to 2003 resulted from increases of \$312,119 in base compensation, \$150,049 in additional incentive compensation, and \$55,183 in higher benefits costs, offset by an increase of \$3,110 in loan origination compensation expense, which is required to be capitalized and amortized over the life of the loans as a reduction of loan interest income.

The \$312,119 increase in base compensation expense related to the additional employees needed to support the growth in earning assets and related deposit expenses, plus the impact of annual salary increases. Incentive compensation represented 25.0% and 23.1% of total compensation for the years ended December 31, 2004 and 2003, respectively. Approximately 33.4% of the total pay for the seven highest compensated officers was earned and accrued in the form of incentive compensation because we believe that a significant portion of the compensation for our officers should be tied to their level of performance. Benefits expense increased \$55,183 in the year ended December 31, 2004 compared to the year ended December 31, 2003. Benefits expense represented 15.0% and 15.7% of the total compensation for the years ended December 31, 2004 and 2003, respectively.

The following tables set forth information related to our data processing and related costs.

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| | Years ended December 31, | | |
|---|--------------------------|---------|---------|
| | 2004 | 2003 | 2002 |
| Data processing costs | \$ 420,588 | 292,526 | 208,943 |
| ATM transaction expense | 252,581 | 201,970 | 152,563 |
| Courier expense | 74,166 | 61,826 | 52,209 |
| Other expenses | 65,762 | 69,457 | 59,862 |
| | | | |
| Total data processing and related costs | \$ 813,097 | 625,779 | 473,577 |

Data processing and related costs were \$813,097 and \$625,779 for the years ended December 31, 2004 and 2003, respectively. During the year ended December 31, 2004, our data processing costs for our core processing system were \$420,588 compared to \$292,526 for the year ended December 31, 2003. We have contracted with an outside computer service company to provide our core data processing services.

Data processing costs increased \$128,062, or 43.8%, for the year ended December 31, 2004 compared to the same period in 2003. The increases in costs were caused by the higher number of loan and deposit accounts. A significant portion of the fee charged by the third party processor is directly related to the number of loan and deposit accounts and the related number of transactions.

We receive ATM transaction income from transactions performed by our clients. Since we also outsource this service, we are charged related transaction fees from our ATM service provider. ATM transaction expense was \$252,581 and \$201,970 for the years ended December 31, 2004 and 2003, respectively. The increase relates to the higher transaction volume during the respective periods.

Income tax expense was \$1.2 million for the year ended December 31, 2004 compared to \$616,534 for the year ended December 31, 2003. The \$617,188 increase related to the higher level of income before taxes.

Balance Sheet Review

General

At December 31, 2004, we had total assets of \$315.8 million, consisting principally of \$276.6 million in loans, \$29.2 million in investments, \$1.4 million in federal funds sold, and \$3.9 million in cash and due from banks. Our liabilities at December 31, 2004 totaled \$287.7 million, consisting principally of \$204.9 million in deposits, \$60.7 million in FHLB advances, \$13.1 million of short-term borrowings, and \$6.2 million of junior subordinated debentures. At December 31, 2004, our shareholders' equity was \$28.1 million.

Federal Funds Sold

At December 31, 2004, our \$1.4 million in short-term investments in federal funds sold on an overnight basis comprised .4% of total assets, compared to \$2.8 million, or 1.2% of total assets, at December 31, 2003. As a result of the historically low yields paid for federal funds sold during the last three years, we have maintained a lower than normal level of federal funds.

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Investments

At December 31, 2004, the \$29.2 million in our investment securities portfolio represented approximately 9.2% of our total assets. We held U.S. Government agency securities, mortgage-backed securities, Federal reserve stock and Federal Home loan bank stock with a fair value of \$25.2 million and an amortized cost of \$25.2 million for an unrealized gain of \$75,739. As a result of the strong growth in our loan portfolio and the historical low fixed rates that were available during the last two and one-half years, we have maintained a lower than normal level of investments. As rates on investment securities rise and additional capital and deposits are obtained, we anticipate increasing the size of the investment portfolio.

Contractual maturities and yields on our investments at December 31, 2004 are shown in the following table. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. At December 31, 2004, we had no securities with a maturity of less than one year.

| One to Five Years | Five to Ten Years | Over Ten Years | Total |
|-------------------|-------------------|----------------|-------|
|-------------------|-------------------|----------------|-------|

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| | One to Five Years | | Five to Ten Years | | Over Ten Years | | Total | |
|----------------------------------|-------------------|--------------|-------------------|--------------|-----------------|--------------|------------------|--------------|
| | Amount | Yield | Amount | Yield | Amount | Yield | Amount | Yield |
| (Dollars in thousands) | | | | | | | | |
| Available for Sale | | | | | | | | |
| U.S. Government sponsored agency | \$ 1,053 | 5.45% | \$ - | - | \$ - | - | \$ 1,053 | 5.45% |
| Mortgage-backed securities | - | - | 1,708 | 4.04% | 9,399 | 4.14% | 11,107 | 4.14% |
| Total | \$ 1,053 | 5.45% | \$ 1,708 | 4.04% | \$ 9,399 | 4.14% | \$ 12,160 | 4.24% |
| Held to Maturity | | | | | | | | |
| Mortgage-backed securities | \$ - | - | \$ 758 | 3.77% | \$ 12,381 | 4.31% | \$ 13,139 | 4.28% |

At December 31, 2004, our investments included securities issued by Federal Home Loan Bank, Federal Home Loan Mortgage Corporation, and Federal National Mortgage Association with carrying values of \$1.1 million, \$4.9 million, and \$19.3 million, respectively.

Other investments at December 31, 2004 consisted of Federal Reserve Bank stock with a cost of \$485,150, an investment in Greenville First Statutory Trust I of \$186,000, and Federal Home Loan Bank stock with a cost of \$3.2 million. At December 31, 2003, we owned Federal Reserve Bank stock with a cost of \$485,150, Federal Home Loan Bank stock with a cost of \$1.6 million, and an investment in the Trust of \$186,000.

The amortized costs and the fair value of our investments at December 31, 2004, 2003, and 2002 are shown in the following table

| | 2004 | | 2003 | | 2002 | |
|------------------------------------|------------------|------------------|-----------------|-----------------|------------------|---------------|
| | Amortized Costs | Fair Value | Amortized Costs | Fair Value | Amortized Costs | Fair Value |
| (Dollars in thousands) | | | | | | |
| Available for Sale | | | | | | |
| U.S. Government sponsored agencies | \$ 1,014 | \$ 1,053 | \$ 1,022 | \$ 1,098 | \$ 9,641 | 9,784 |
| Mortgage-backed securities | 11,070 | 11,107 | 2,460 | 2,531 | 4,727 | 4,808 |
| Total | \$ 12,084 | \$ 12,160 | \$ 3,482 | \$ 3,629 | \$ 14,368 | 14,592 |
| Held to Maturity | | | | | | |
| Mortgage-backed securities | \$ 13,139 | \$ 13,089 | \$ 9,834 | \$ 9,761 | \$ - | - |

Loans

Since loans typically provide higher interest yields than other types of interest-earning assets, a substantial percentage of our earning assets are invested in our loan portfolio. Average loans for the years ended December 31, 2004 and 2003 were \$248.1 million and \$174.3 million, respectively. Before allowance for loan losses, total loans outstanding at December 31, 2004 and 2003 were \$280.3 million and \$208.8 million, respectively.

The principal component of our loan portfolio is loans secured by real estate mortgages. Most of our real estate loans are secured by residential or commercial property. We do not generally originate traditional long term residential mortgages, but we do issue traditional second mortgage residential real estate loans and home equity lines of credit. We obtain a security interest in real estate whenever possible, in addition to any other available collateral. This collateral is taken to increase the likelihood of the ultimate repayment of the loan. Generally, we limit the loan-to-value ratio on loans we make to 80%. Due to the short time our portfolio has existed, the current mix may not be indicative of the

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ongoing portfolio mix. We attempt to maintain a relatively diversified loan portfolio to help reduce the risk inherent in concentration in certain types of collateral.

The following table summarizes the composition of our loan portfolio for each of the five years ended December 31, 2004.

| | 2004 | | 2003 | | 2002 | | 2001 | | 2000 | |
|--|-------------------|---------------|-------------------|---------------|-------------------|---------------|------------------|---------------|------------------|---------------|
| | Amount | % of Total | Amount | % of Total | Amount | % of Total | Amount | % of Total | Amount | % of Total |
| (Dollars in thousands) | | | | | | | | | | |
| Real Estate: | | | | | | | | | | |
| Commercial | | | | | | | | | | |
| Owner occupied | \$ 54,323 | 19.4% | \$ 39,301 | 18.8% | \$ 22,653 | 15.1% | \$ 16,533 | 17.1% | \$ 5,589 | 12.0% |
| Nonowner occupied | 76,284 | 27.2% | 53,898 | 25.8% | 43,077 | 28.7% | 22,813 | 23.6% | 13,435 | 28.8% |
| Construction | 12,212 | 4.4% | 10,878 | 5.2% | 4,008 | 2.7% | 8,292 | 8.6% | 2,422 | 5.2% |
| Total commercial real estate | 142,819 | 51.0% | 104,077 | 49.8% | 69,738 | 46.5% | 47,638 | 49.3% | 21,446 | 46.0% |
| Consumer | | | | | | | | | | |
| Residential | 46,240 | 16.5% | 35,823 | 17.2% | 25,500 | 17.0% | 12,899 | 13.4% | 6,367 | 13.7% |
| Home equity | 35,085 | 12.5% | 24,278 | 11.6% | 18,069 | 12.1% | 8,937 | 9.3% | 4,695 | 10.1% |
| Construction | 5,938 | 2.1% | 4,365 | 2.1% | 4,200 | 2.8% | 3,972 | 4.1% | 1,971 | 4.2% |
| Total consumer real estate | 87,263 | 82.1% | 64,466 | 30.9% | 47,769 | 31.9% | 25,808 | 26.8% | 13,033 | 28.0% |
| Total real estate | 230,082 | 31.1% | 168,543 | 80.7% | 117,507 | 78.4% | 73,446 | 76.1% | 34,479 | 74.0% |
| Commercial business | 44,872 | 16.0% | 36,107 | 17.3% | 28,192 | 18.8% | 20,529 | 21.3% | 9,283 | 19.9% |
| Consumer - other | 6,035 | 2.1% | 4,662 | 2.2% | 4,591 | 3.1% | 2,813 | 2.9% | 2,971 | 6.4% |
| Deferred origination fees, net | (642) | (0.2)% | (530) | (0.2)% | (387) | (0.3)% | (256) | (.3)% | (108) | (0.3)% |
| Total gross loans, net of deferred fees | 280,347 | 100.0% | 208,782 | 100.0% | 149,903 | 100.0% | 96,532 | 100.0% | 46,625 | 100.0% |
| Less - allowance for loan losses | (3,717) | | (2,705) | | (1,824) | | (1,192) | | (600) | |
| Total loans, net | \$ 276,630 | | \$ 206,077 | | \$ 148,079 | | \$ 95,340 | | \$ 46,025 | |

Maturities and Sensitivity of Loans to Changes in Interest Rates

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

The following table summarizes the loan maturity distribution by type and related interest rate characteristics at December 31, 2004.

| | One year or less | After one but within five years | After five years | Total |
|----------------|------------------|---------------------------------|------------------|---------|
| (In thousands) | | | | |
| | \$ 36,665 | 147,199 | 28,058 | 211,922 |

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After one

| | | | | |
|--|-----------|---------|--------|------------|
| Real estate- mortgage | | | | |
| Real estate- construction | 6,093 | 8,560 | 3,507 | 18,160 |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| Total real estate | 42,758 | 155,759 | 31,565 | 230,082 |
| Commercial | 27,927 | 16,532 | 413 | 44,872 |
| Consumer- other | 3,328 | 2,367 | 340 | 6,035 |
| Deferred origination fees, net | (132) | (425) | (85) | (642) |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| Total gross loan, net of deferred fees | \$ 73,881 | 174,233 | 32,233 | 280,347 |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| Loans maturing - | | | | |
| after one year with | | | | |
| Fixed interest rates | | | | \$ 70,356 |
| Floating interest rates | | | | \$ 136,180 |

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Provision and Allowance for Loan Losses

We have established an allowance for loan losses through a provision for loan losses charged to expense on our statement of income. The allowance for loan losses represents an amount which we believe will be adequate to absorb probable losses on existing loans that may become uncollectible. Our judgment as to the adequacy of the allowance for loan losses is based on a number of assumptions about future events, which we believe to be reasonable, but which may or may not prove to be accurate. Our determination of the allowance for loan losses is based on evaluations of the collectibility of loans, including consideration of factors such as the balance of impaired loans, the quality, mix, and size of our overall loan portfolio, economic conditions that may affect the borrower's ability to repay, the amount and quality of collateral securing the loans, our historical loan loss experience, and a review of specific problem loans. We also consider subjective issues such as changes in the lending policies and procedures, changes in the local/national economy, changes in volume or type of credits, changes in volume/severity of problem loans, quality of loan review and board of director oversight, concentrations of credit, and peer group comparisons. Due to our limited operating history, the provision for loan losses has been made primarily as a result of our assessment of general loan loss risk compared to banks of similar size and maturity. Periodically, we adjust the amount of the allowance based on changing circumstances. We charge recognized losses to the allowance and add subsequent recoveries back to the allowance for loan losses. There can be no assurance that charge-offs of loans in future periods will not exceed the allowance for loan losses as estimated at any point in time or that provisions for loan losses will not be significant to a particular accounting period.

The following table summarizes the activity related to our allowance for loan losses for the five years ended December 31, 2004.

| | December 31, | | | | |
|--|------------------------|-------|-------|-------|-------|
| | 2004 | 2003 | 2002 | 2001 | 2000 |
| | (Dollars in thousands) | | | | |
| Balance, beginning of year | \$ 2,705 | 1,824 | 1,192 | 600 | - |
| Loans charged-off | (335) | (173) | (418) | (8) | - |
| Recoveries of loans previously charged-off | 37 | 4 | - | - | - |
| | <hr/> | <hr/> | <hr/> | <hr/> | <hr/> |
| Net loans charged-off | \$ (298) | (169) | (418) | (8) | - |
| Provision for loan losses | 1,310 | 1,050 | 1,050 | 600 | 600 |
| | <hr/> | <hr/> | <hr/> | <hr/> | <hr/> |
| Balance, end of year | \$ 3,717 | 2,705 | 1,824 | 1,192 | 600 |
| | <hr/> | <hr/> | <hr/> | <hr/> | <hr/> |
| Allowance for loan losses to gross loans | 1.33% | 1.30% | 1.22% | 1.24% | 1.29% |
| Net charge-offs to average loans | 0.12% | 0.10% | 0.34% | 0.01% | - |

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We do not allocate the allowance for loan losses to specific categories of loans. Instead, we evaluate the adequacy of the allowance for loan losses on an overall portfolio basis utilizing our credit grading system which we apply to each loan. We have retained an independent consultant to review the loan files on a test basis to confirm the grading of each loan.

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Nonperforming Assets

The following table shows the nonperforming assets, percentages of net charge-offs, and the related percentage of allowance for loan losses for the five years ended December 31, 2004.

| | 2004 | 2003 | 2002 | 2001 | 2000 |
|---|------------------------|-------|-------|-------|-------|
| | (Dollars in thousands) | | | | |
| Loans over 90 days past due | \$ 683 | 396 | 3 | 360 | - |
| Loans on nonaccrual: | | | | | |
| Mortgage | 339 | 150 | - | 360 | - |
| Commercial | 385 | 224 | 100 | - | - |
| Consumer | 14 | 70 | 13 | - | - |
| Total nonaccrual loans | 739 | 444 | 113 | 360 | - |
| Total of nonperforming loans | 739 | 444 | 113 | 360 | - |
| Other nonperforming assets | 28 | - | 525 | - | - |
| Total nonperforming assets | \$ 767 | 444 | 638 | 360 | - |
| Percentage of total assets | 0.27% | 0.19% | 0.37% | 0.30% | - |
| Percentage of nonperforming loans and assets to gross loans | 0.30% | 0.21% | 0.43% | 0.37% | - |
| Allowance for loan losses to gross loans | 1.33% | 1.30% | 1.22% | 1.24% | 1.29% |
| Net charge-offs to average loans | 0.12% | 0.10% | 0.34% | 0.01% | - |

At December 31, 2004 and December 31, 2003, the allowance for loan losses was \$3.7 million and \$2.7 million, respectively, or 1.33% and 1.30%, respectively, of outstanding loans. During the years ended December 31, 2004 and 2003, our net charged-off loans were \$298,505 and \$168,999, respectively.

At December 31, 2004, nonaccrual loans represented 0.27%. At December 31, 2004 and December 31, 2003, we had \$739,126 and \$443,939 of loans, respectively, on nonaccrual status. The increase in mortgage loans on nonaccrual status related primarily to one loan that was adequately secured by real estate. Generally, a loan is placed on nonaccrual status when it becomes 90 days past due as to principal or interest, or when we believe, after considering economic and business conditions and collection efforts, that the borrower's financial condition is such that collection of the loan is doubtful. A payment of interest on a loan that is classified as nonaccrual is recognized as income when received.

The amount of foregone interest income on the nonaccrual loans for the years ended December 31, 2004 and 2003 was approximately \$9,200 and \$6,100, respectively. The amount of interest income recorded in 2004 for loans that were on nonaccrual at December 31, 2004 was approximately \$10,000, and was approximately \$6,100 in 2003.

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Deposits and Other Interest-Bearing Liabilities

Our primary source of funds for loans and investments is our deposits, advances from the FHLB, and short-term repurchase agreements. National and local market trends over the past several years suggest that consumers have moved an increasing percentage of discretionary savings funds into investments such as annuities, stocks, and fixed income mutual funds. Accordingly, it has become more difficult to attract deposits. We have chosen to obtain a portion of our certificates of deposits from areas outside of our market. The deposits obtained outside of

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our market area generally have lower rates than rates being offered for certificates of deposits in our local market. We also utilize out-of-market deposits in certain instances to obtain longer-term deposits than are readily available in our local market. We anticipate that the amount of out-of-market deposits will decline after we open additional retail deposit offices. The amount of out-of-market deposits was \$77.3 million at December 31, 2004 and \$79.6 at December 31, 2003.

We anticipate being able to either renew or replace these out-of-market deposits when they mature, although we may not be able to replace them with deposits with the same terms or rates. Our loan-to-deposit ratio was 135%, 122%, and 124% at, December 31, 2004, 2003, and 2002, respectively.

The following table shows the average balance amounts and the average rates paid on deposits held by us for the years ended December 31, 2004, 2003, and 2002.

| | 2004 | | 2003 | | 2002 | |
|--------------------------------------|-------------------|--------------|-------------------|--------------|-------------------|--------------|
| | Amount | Rate | Amount | Rate | Amount | Rate |
| (Dollars in thousands) | | | | | | |
| Noninterest bearing demand deposits | \$ 15,081 | -% | \$ 14,852 | -% | \$ 11,001 | -% |
| Interest bearing demand deposits | 24,552 | 1.35% | 15,253 | 0.83% | 16,366 | 1.59% |
| Money market accounts | 41,892 | 1.49% | 21,029 | 0.61% | 22,019 | 1.39% |
| Savings accounts | 1,296 | .34% | 1,793 | 0.41% | 792 | 1.31% |
| Time deposits less than \$100,000 | 23,611 | 2.48% | 31,171 | 3.09% | 32,687 | 3.88% |
| Time deposits greater than \$100,000 | 75,809 | 2.67% | 59,414 | 2.59% | 39,159 | 3.36% |
| Total Deposits | \$ 182,241 | 1.96% | \$ 143,512 | 1.93% | \$ 122,024 | 2.59% |

Core deposits, which exclude time deposits of \$100,000 or more, provide a relatively stable funding source for our loan portfolio and other earning assets. Our core deposits were \$107.8 million, \$89.9 million, and \$82.7 million at December 31, 2004, December 31, 2003, and December 31, 2002, respectively.

All of our time deposits are certificates of deposits. The maturity distribution of our time deposits of \$100,000 or more at December 31, 2004 and 2003 is as follows:

| | 2004 | 2003 |
|------------------------------------|------------------|------------------|
| (Dollars in thousands) | | |
| Three months or less | \$ 19,328 | \$ 19,272 |
| Over three through six months | 14,050 | 16,416 |
| Over three through twelve months . | 21,302 | 24,983 |
| Over twelve months | 29,339 | 18,437 |
| Total | \$ 84,019 | \$ 79,108 |

The amount of time deposits over \$100,000 or more for the years ended December 31, 2004 and 2003 resulted from the utilization of deposits that were obtained outside of our primary market.

Capital Resources

Total shareholders equity was \$28.1 million at December 31, 2004 and \$11.2 million at December 31, 2003. The \$16.9 million increase between 2004 and 2003 primarily resulted from \$14.9 million net proceeds from the issuance of 920,000 shares of common stock, the \$2.0 million of net income earned during 2004, less a \$47,008 decrease in unrealized gain on investment securities, net of tax.

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The following table shows the return on average assets (net income divided by average total assets), return on average equity (net income divided by average equity), and equity to assets ratio (average equity divided by average total assets) for the three years ended December 31, 2004. Since our inception, we have not paid cash dividends.

| | 2004 | 2003 | 2002 |
|--------------------------|--------|-------|-------|
| Return on average assets | 0.73% | 0.52% | 0.51% |
| Return on average equity | 12.37% | 9.28% | 7.72% |
| Equity to assets ratio | 5.87% | 5.57% | 6.71% |

The Federal Reserve Board and bank regulatory agencies require bank holding companies and financial institutions to maintain capital at adequate levels based on a percentage of assets and off-balance sheet exposures, adjusted for risk weights ranging from 0% to 100%.

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

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

The following table sets forth the holding company's and the bank's various capital ratios at December 31, 2004, 2003, and 2002. For all periods, the bank was considered well-capitalized and the holding company met or exceeded its applicable regulatory capital requirements.

| | 2004 | | 2003 | | 2002 | |
|---------------------------|-----------------|-------|-----------------|-------|-----------------|-------|
| | Holding Company | Bank | Holding Company | Bank | Holding Company | Bank |
| Total risk-based capital | 14.6% | 13.7% | 10.2% | 10.1% | 8.6% | 10.3% |
| Tier 1 risk-based capital | 13.4% | 12.4% | 7.8% | 8.8% | 7.4% | 9.1% |
| Leverage capital | 11.0% | 10.2% | 6.1% | 7.7% | 6.1% | 7.5% |

Borrowings

The following table outlines our various sources of borrowed funds during the years ended December 31, 2004, 2003, and 2002, the amounts outstanding at the end of each period, at the maximum point for each component during the periods and on average for each period, and the average interest rate that we paid for each borrowing source. The maximum month-end balance represents the high indebtedness for each component of borrowed funds at any time during each of the periods shown.

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| | Ending Balance | Period-End Rate | Maximum Month-end Balance | Average for the Period Balance | Rate |
|---|----------------|-----------------|---------------------------|--------------------------------|-------|
| (Dollars in thousands) | | | | | |
| At or for the Year Ended December 31, 2004 | | | | | |
| Federal Home Loan Bank advances | \$ 60,660 | 2.82% | \$ 58,400 | \$ 54,515 | 2.21% |
| Securities sold under agreement to repurchase | 13,100 | 2.25% | 14,637 | 13,643 | 1.43% |
| Federal funds purchased | - | 2.44% | - | 332 | 1.46% |
| Correspondent bank line of credit | - | 4.40% | 3,000 | 1,214 | 3.38% |
| Junior subordinated debentures | 6,186 | 5.65% | 6,186 | 6,186 | 4.88% |

At or for the Year

Ended December 31, 2003

| | | | | | |
|---|-----------|-------|-----------|-----------|-------|
| Federal Home Loan Bank advances | \$ 32,500 | 2.00% | \$ 40,000 | \$ 27,569 | 2.14% |
| Securities sold under agreement to repurchase | 9,297 | 1.12% | 9,865 | 5,689 | 1.23% |
| Federal funds purchased | - | 1.40% | 1,556 | 450 | 1.56% |
| Correspondent bank line of credit | - | 3.12% | 3,000 | 1,332 | 3.23% |
| Junior subordinated debentures | 6,186 | 4.56% | 6,186 | 3,107 | 4.54% |

At or for the Year**Ended December 31, 2002**

| | | | | | |
|---|-----------|-------|-----------|----------|-------|
| Federal Home Loan Bank advances | \$ 13,000 | 2.35% | \$ 13,000 | \$ 7,090 | 3.05% |
| Securities sold under agreement to repurchase | 7,892 | 1.38% | 7,892 | 4,349 | 1.93% |
| Federal funds purchased | 1,215 | 1.65% | 1,215 | 411 | 1.95% |
| Correspondent bank line of credit | 2,500 | 3.00% | 2,500 | 702 | 3.42% |

Effect of Inflation and Changing Prices

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

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

Off-Balance Sheet Risk

Commitments to extend credit are agreements to lend to a client as long as the client has not violated any material condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of a fee. At December 31, 2004, unfunded commitments to extend credit were \$51.6 million, of which \$17.6 million was at fixed rates and \$34.0 million was at variable rates. A significant portion of the unfunded commitments related to consumer equity lines of credit. Based on historical experience, we anticipate that a significant portion of these lines of credit will not be funded. We evaluate each client's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by us upon extension of credit, is based on our credit evaluation of the borrower. The type of collateral varies but may include accounts receivable, inventory, property, plant and equipment, and commercial and residential real estate.

At December 31, 2004, there was a \$2.5 million commitment under a letter of credit. The credit risk and collateral involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to

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clients. Since most of the letters of credit are expected to expire without being drawn upon, they do not necessarily represent future cash requirements.

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

Market Risk

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

We actively monitor and manage our interest rate risk exposure principally by measuring our interest sensitivity gap, which is the positive or negative dollar difference between assets and liabilities that are subject to interest rate repricing within a given period of time. Interest rate sensitivity can be managed by repricing assets or liabilities, selling securities available for sale, replacing an asset or liability at maturity, or adjusting the interest rate during the life of an asset or liability. Managing the amount of assets and liabilities repricing in this same time interval

helps to hedge the risk and minimize the impact on net interest income of rising or falling interest rates. We generally would benefit from increasing market rates of interest when we have an asset-sensitive gap position and generally would benefit from decreasing market rates of interest when we are liability-sensitive.

Approximately 66.5% of our loans were variable rate loans at December 31, 2004 and we were asset sensitive during most of the year ended December 31, 2004. As of December 31, 2004, we expect to be asset sensitive for the first three months, then we expect to be liability sensitive for the following nine months because substantially all of our variable rate loans repriced within the first three months of the year but a majority of our deposits will reprice over a 12-month period. The ratio of cumulative gap to total earning assets after 12 months was 1.5% because \$4.6 million more assets will reprice in a 12 month period than liabilities. However, our gap analysis is not a precise indicator of our interest sensitivity position. The analysis presents only a static view of the timing of maturities and repricing opportunities, without taking into consideration that changes in interest rates do not affect all assets and liabilities equally. For example, rates paid on a substantial portion of core deposits may change contractually within a relatively short time frame, but those rates are viewed by us as significantly less interest-sensitive than market-based rates such as those paid on noncore deposits. Net interest income may be affected by other significant factors in a given interest rate environment, including changes in the volume and mix of interest-earning assets and interest-bearing liabilities.

Liquidity and Interest Rate Sensitivity

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

At December 31, 2004 and 2003, our liquid assets amounted to \$5.3 million and \$6.9 million, or 1.7% and 3.0% of total assets, respectively. Our investment securities at December 31, 2004 and 2003 amounted to \$29.2 million and \$15.8 million, or 9.2% and 6.8% of total assets, respectively. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. However, substantially all of these securities are pledged against outstanding debt. Therefore, the related debt would need to be repaid prior to the securities being sold in order for these securities to be converted to cash.

Our ability to maintain and expand our deposit base and borrowing capabilities serves as our primary source of liquidity. We plan to meet our future cash needs through the liquidation of temporary investments and the generation of deposits. In addition, we will receive cash upon the maturity and sale of loans and the maturity of investment securities. During most of 2003 and 2004, as a result of historically low rates that were being earned on short-term liquidity investments, we chose to maintain a lower than normal level of short-term liquidity securities. In addition, we maintain two federal funds purchased lines of credit with correspondent banks totaling \$13.0 million. We are also a member of

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the Federal Home Loan Bank of Atlanta, from which applications for borrowings can be made for leverage purposes. The FHLB requires that securities, qualifying mortgage loans, and stock of the FHLB owned by the bank be pledged to secure any advances from the FHLB. The unused borrowing capacity currently available from the FHLB at December 31, 2004 was \$25.0 million, assuming that the bank's \$3.2 million investment in FHLB stock, as well as qualifying mortgages, would be available to secure any future borrowings.

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

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

The following table sets forth information regarding our rate sensitivity, as of December 31, 2004, at each of the time intervals. The information in the table may not be indicative of our rate sensitivity position at other points in time. In addition, the maturity distribution indicated in the table may differ from the contractual maturities of the earning assets and interest-bearing liabilities presented due to consideration of prepayment speeds under various interest rate change scenarios in the application of the interest rate sensitivity methods described above.

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| | Within three months | After three but within twelve months | After one but within five years | After five years | Total |
|---|---------------------------|--|---------------------------------------|------------------------|-------------------|
| (In thousands) | | | | | |
| Interest-earning assets: | | | | | |
| Federal funds sold | \$ 1,394 | \$ - | \$ - | \$ - | \$ 1,394 |
| Investment securities | 1,572 | 4,716 | 15,511 | 3,500 | 25,299 |
| Loans | 196,066 | 10,374 | 54,704 | 19,105 | 280,249 |
| Total earning assets | \$ 199,032 | \$ 15,090 | \$ 70,215 | \$ 22,605 | \$ 306,942 |
| Interest-bearing liabilities: | | | | | |
| Money market and NOW | \$ 87,081 | \$ - | \$ - | \$ - | \$ 87,081 |
| Regular savings | 1,244 | - | - | - | 1,244 |
| Time deposits | 23,369 | 39,845 | 29,927 | 5,834 | 98,986 |
| Repurchase agreements | 13,100 | - | - | - | 13,100 |
| FHLB advances | 30,660 | 8,000 | 5,000 | 17,000 | 60,660 |
| Junior subordinated debentures | 6,186 | - | - | - | 6,186 |
| Total interest-bearing liabilities | \$ 161,640 | \$ 47,845 | \$ 34,927 | \$ 22,834 | \$ 267,246 |
| Period gap | \$ 37,392 | \$ (32,755) | \$ 35,288 | \$ (229) | |
| Cumulative gap | 37,392 | 4,637 | 39,925 | 39,696 | |
| Ratio of cumulative gap total assets total assets | 12.2% | 1.5% | 13.0% | 12.9% | |

Accounting, Reporting, and Regulatory Matters

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS No. 123(R)). SFAS No. 123(R) will require companies to measure all employee stock-based compensation awards using a fair value method and record such expense in its financial statements. In addition, the adoption of SFAS No. 123(R) requires additional accounting and disclosure related to the income tax and cash flow effects resulting from share-based payment arrangements. SFAS No. 123(R) is effective for the company beginning as of the quarter ending March 31, 2006.

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The Company is currently evaluating the impact that the adoption of SFAS No. 123(R) will have on its financial position, results of operations and cash flows. The company is in the process of determining the effect of adoption which will be recognized in the statement of income.

In January 2004, the FASB issued FIN No. 46, Consolidation of Variable Interest Entities. FIN No. 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns, or both. FIN No. 46 also requires disclosures about variable interest entities that a company is not required to consolidate, but in which it has a significant variable interest. FIN No. 46 provides guidance for determining whether an entity qualifies as a variable interest entity by considering, among other considerations, whether the entity lacks sufficient equity or its equity holders lack adequate decision-making ability. The consolidation requirements of FIN No. 46 apply immediately to variable interest entities created after January 31, 2004. The consolidation requirements apply to existing entities in the first fiscal year or interim period beginning after June 15, 2004. Certain of the disclosure requirements apply in all financial statements issued after January 31, 2004, regardless of when the variable interest entity was established. The adoption of FIN No. 46 will not have a material effect on the Company's financial position or results of operations. As a result of adoption of FIN No. 46, the Company deconsolidated the Trust for periods ended December 31, 2004, and has restated the periods ended December 31, 2004 to reflect the deconsolidation.

In November 2003, the Emerging Issues Task Force (EITF) reached a consensus that certain quantitative and qualitative disclosures should be required for debt and marketable equity securities classified as available for sale or held to maturity under SFAS No. 115 and SFAS No. 124 that are impaired at the balance sheet date but for which other-than-temporary impairment has not been recognized. Accordingly the EITF issued EITF No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. This issue addresses the meaning of other-than-temporary impairment and its application to investments classified as either available for sale or held to maturity under SFAS No. 115 and provides guidance on quantitative and qualitative disclosures. The disclosure requirements of EITF No. 03-1 are effective for annual financial statements for fiscal years ending after June 15, 2004. The effective date for the measurement and recognition guidance of EITF No. 03-1 has been delayed. The FASB staff has issued a proposed Board-directed FASB Staff Position (FSP), FSP EITF 03-1-a, Implementation

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Guidance for the Application of Paragraph 16 of Issue No. 03-1. The proposed FSP would provide implementation guidance with respect to debt securities that are impaired solely due to interest rates and/or sector spreads and analyzed for other-than-temporary impairment under the measurement and recognition requirements of EITF No. 03-1. The delay of the effective date for the measurement and recognition requirements of EITF No. 03-1 will be superseded concurrent with the final issuance of FSP EITF 03-1-a. Adopting the disclosure provisions of EITF No. 03-1 did not have any impact on the Company's financial position or results of operations.

In March 2004, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 105, Application of Accounting Principles to Loan commitments, to inform registrants of the Staff's view that the fair value of the recorded loan commitments should not consider the expected future cash flows related to the associated servicing of the future loan. The provisions of SAB No. 105 must be applied to loan commitments accounted for as derivatives that are entered into after March 31, 2004. The Staff will not object to the application of existing accounting practices to loan commitments accounted for as derivatives that are entered into on or before March 31, 2004, with appropriate disclosures. The Company adopted the provisions of SAB No. 105 on April 1, 2004. The adoption of SAB No. 105 did not have a material impact on the Company's financial condition or results of operations.

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

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Item 7. Financial Statements

INDEX TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Directors
Greenville First Bancshares, Inc. and Subsidiary
Greenville, South Carolina

We have audited the accompanying consolidated balance sheets of **Greenville First Bancshares, Inc. and Subsidiary** as of December 31, 2004 and 2003 and the related consolidated statements of income, shareholders' equity and comprehensive income, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of **Greenville First Bancshares, Inc. and Subsidiary** as of December 31, 2004 and 2003 and the results of their operations and their cash flows for the years ended in conformity with accounting principles generally accepted in the United States of America.

/s/ Elliott Davis, LLC
 Elliott Davis, LLC
 Greenville, South Carolina
 February 11, 2005

**GREENVILLE FIRST BANCSHARES, INC. AND SUBSIDIARY
 CONSOLIDATED BALANCE SHEETS**

| | <u>December 31,</u> | |
|--|-----------------------|-----------------------|
| | <u>2004</u> | <u>2003</u> |
| Assets | | |
| Cash and due from banks | \$ 3,943,877 | \$ 4,104,697 |
| Federal funds sold | 1,394,459 | 2,842,594 |
| Investment securities available for sale | 12,159,674 | 3,628,996 |
| Investment securities held to maturity- (fair value \$13,088,613 and \$9,761,305) | 13,138,697 | 9,834,324 |
| Other investments, at cost | 3,863,850 | 2,296,150 |
| Loans, net | 276,630,484 | 206,076,833 |
| Accrued interest | 1,145,810 | 756,905 |
| Property and equipment, net | 2,013,995 | 824,259 |
| Other real estate owned | 28,000 | - |
| Other assets | 1,492,352 | 476,463 |
| | <u>315,811,198</u> | <u>230,841,221</u> |
| Total assets | \$ 315,811,198 | \$ 230,841,221 |
| Liabilities | | |
| Deposits | \$ 204,864,142 | \$ 168,963,595 |
| Official checks outstanding | 1,384,480 | 1,575,357 |
| Federal funds purchased and repurchase agreements | 13,099,999 | 9,296,999 |
| Federal Home Loan Bank advances | 60,660,000 | 32,500,000 |
| Junior subordinate debentures | 6,186,000 | 6,186,000 |
| Accrued interest payable | 620,014 | 572,272 |
| Accounts payable and accrued expenses | 917,975 | 560,030 |
| | <u>287,732,610</u> | <u>219,654,253</u> |
| Total liabilities | 287,732,610 | 219,654,253 |
| Commitments and contingencies - notes 13 and 16 | | |
| Shareholders' equity | | |
| Preferred stock, par value \$.01 per share, 10,000,000 shares authorized, no shares issued | - | - |
| Common stock, par value \$.01 Authorized, 10,000,000 shares. Issued and outstanding 2,647,994 and 1,724,994 at December 31, 2004 and December 31, 2003, respectively | 26,480 | 17,250 |
| Additional paid-in capital | 25,546,259 | 10,629,450 |
| Accumulated other comprehensive income | 49,989 | 96,997 |
| Retained earnings | 2,455,860 | 443,271 |
| | <u>28,078,588</u> | <u>11,186,968</u> |
| Total shareholders' equity | 28,078,588 | 11,186,968 |
| Total liabilities and shareholders' equity | <u>\$ 315,811,198</u> | <u>\$ 230,841,221</u> |

See notes to consolidated financial statements that are an integral part of these consolidated statements.

GREENVILLE FIRST BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME

| | For the years ended December 31, | |
|---|-------------------------------------|--------------|
| | 2004 | 2003 |
| Interest income | | |
| Loans | \$ 12,975,296 | \$ 9,186,378 |
| Investment securities | 966,653 | 517,005 |
| Federal funds sold | 22,751 | 18,171 |
| | <hr/> | <hr/> |
| Total interest income | 13,964,700 | 9,721,554 |
| | <hr/> | <hr/> |
| Interest expense | | |
| Deposits | 3,570,263 | 2,766,951 |
| Borrowings | 1,746,294 | 850,989 |
| | <hr/> | <hr/> |
| Total interest expense | 5,316,557 | 3,617,940 |
| | <hr/> | <hr/> |
| Net interest income | 8,648,143 | 6,103,614 |
| Provision for loan losses | 1,310,000 | 1,050,000 |
| | <hr/> | <hr/> |
| Net interest income after provision for loan losses | 7,338,143 | 5,053,614 |
| | <hr/> | <hr/> |
| Noninterest income | | |
| Loan fee income | \$ 146,986 | \$ 183,932 |
| Service fees on deposit accounts | 296,100 | 251,938 |
| Write-down of real estate owned | (2,725) | (253,699) |
| Other income | 321,102 | 239,513 |
| | <hr/> | <hr/> |
| Total noninterest income | 761,463 | 421,684 |
| | <hr/> | <hr/> |
| Noninterest expenses | | |
| Compensation and benefits | 2,497,445 | 1,983,204 |
| Professional fees | 213,168 | 175,126 |
| Marketing | 292,043 | 159,486 |
| Insurance | 128,978 | 110,219 |
| Occupancy | 603,033 | 587,992 |
| Data processing and related costs | 813,097 | 625,779 |
| Telephone | 32,216 | 22,097 |
| Other | 273,315 | 188,946 |
| | <hr/> | <hr/> |
| Total noninterest expenses | 4,853,295 | 3,852,849 |
| | <hr/> | <hr/> |
| Income before income taxes expense | 3,246,311 | 1,622,449 |
| | <hr/> | <hr/> |
| Income tax expense | 1,233,722 | 616,534 |
| | <hr/> | <hr/> |
| Net income | \$ 2,012,589 | \$ 1,005,915 |
| | <hr/> | <hr/> |
| Earnings per common share: | | |
| Basic | \$ 1.02 | \$.58 |

| | For the years ended | |
|---|-----------------------------|-----------------------------|
| | <u> </u> | <u> </u> |
| Diluted | \$.90 | \$.53 |
| Weighted average common shares outstanding | | |
| Basic | 1,972,087 | 1,724,994 |
| Diluted | 2,239,702 | 1,881,129 |

See notes to consolidated financial statements that are an integral part of these consolidated statements.

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GREENVILLE FIRST BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
AND COMPREHENSIVE INCOME (LOSS)
FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

| | Common stock | | Additional | Accumulated | Retained | Total |
|---|-------------------|-------------------|------------------|------------------------|--------------------|-----------------|
| | Shares | Amount | paid-in | other | earnings | shareholders' |
| | <u> </u> | <u> </u> | <u> capital</u> | <u> comprehensive</u> | <u> (deficit)</u> | <u> equity</u> |
| December 31, 2002 | 1,150,000 | \$ 11,500 | \$ 10,635,200 | \$ 147,733 | \$ (562,644) | \$ 10,231,789 |
| Net income | - | - | - | - | 1,005,915 | 1,005,915 |
| Stock split - 3 for 2 | 574,994 | 5,750 | (5,750) | | | |
| Comprehensive loss, net of tax - Unrealized holding loss on securities available for sale | | | | (50,736) | | (50,736) |
| Comprehensive income | - | - | - | - | - | 955,179 |
| December 31, 2003 | 1,724,994 | 17,250 | 10,629,450 | 96,997 | 443,271 | 11,186,968 |
| Net income | - | - | - | - | 2,012,589 | 2,012,589 |
| Comprehensive loss, net of tax - Unrealized holding loss on securities available for sale | - | - | - | (47,008) | - | (47,008) |
| Comprehensive income | - | - | - | - | - | 1,965,581 |
| Proceeds from sale of Common stock, net | 920,000 | 9,200 | 14,896,829 | - | - | 14,906,029 |
| Exercise of warrants | 3,000 | 30 | 19,980 | - | - | 20,010 |
| December 31, 2004 | 2,647,994 | \$ 26,480 | \$ 25,546,259 | \$ 49,989 | \$ 2,455,860 | \$ 28,078,588 |

See notes to consolidated financial statements that are an integral part of these consolidated statements.

GREENVILLE FIRST BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | For the years ended December 31, | |
|---|---|---------------------|
| | 2004 | 2003 |
| Operating activities | | |
| Net income | \$ 2,012,589 | \$ 1,005,915 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Provision for loan losses | 1,310,000 | 1,050,000 |
| Depreciation and other amortization | 163,738 | 162,618 |
| Write-down of real estate owned | 2,725 | 253,699 |
| Accretion and amortization of securities discounts and premium, net | 94,394 | 94,773 |
| Increase in deferred taxes asset | (244,837) | (654,653) |
| Decrease (increase) in other assets, net | (1,162,682) | 692,079 |
| Increase in other liabilities, net | 239,027 | 778,194 |
| | 2,414,954 | 3,382,625 |
| Net cash provided by operating activities | | |
| Investing activities | | |
| Increase (decrease) in cash realized from: | | |
| Origination of loans, net | (72,169,136) | (59,047,821) |
| Purchase of property and equipment | (1,353,474) | (200,935) |
| Purchase of investment securities: | | |
| Available for sale | (9,983,843) | - |
| Held to maturity | (5,585,719) | (10,158,438) |
| Other investments | (4,575,000) | (2,971,150) |
| Payments and maturity of investment securities: | | |
| Available for sale | 1,340,037 | 10,103,883 |
| Held to maturity | 2,228,854 | 1,011,777 |
| Other investments | 3,007,300 | 1,580,000 |
| Proceeds from sale of real estate acquired in settlement of loans | 277,486 | - |
| | (86,813,495) | (59,682,684) |
| Net cash used for investing activities | | |
| Financing activities | | |
| Increase in deposits, net | 35,900,547 | 35,400,325 |
| Increase in short-term borrowings | 3,803,000 | 189,999 |
| Decrease in other borrowings | - | (2,500,000) |
| Proceeds from issuance of junior subordinate debentures | - | 6,186,000 |
| Increase in Federal Home Loan Bank advances | 28,160,000 | 19,500,000 |
| Proceeds from sale of common stock, net | 14,906,029 | - |
| Proceeds from the exercise of stock warrants | 20,010 | - |
| | 82,789,586 | 58,776,324 |
| Net cash provided by financing activities | | |
| Net increase (decrease) in cash and cash equivalents | (1,608,955) | 2,476,265 |
| Cash and cash equivalents at beginning of the year | 6,947,291 | 4,471,026 |
| Cash and cash equivalents at end of the year | \$ 5,338,336 | \$ 6,947,291 |

| | For the years ended | |
|--|-----------------------------|-----------------------------|
| Supplemental information | | |
| Cash paid for | | |
| Interest | \$ 5,268,815 | \$ 3,651,740 |
| | <u> </u> | <u> </u> |
| Income taxes | \$ 2,148,425 | \$ 580,040 |
| | <u> </u> | <u> </u> |
| Schedule of non-cash transactions | | |
| Foreclosure of real estate | \$ 308,210 | \$ -- |
| | <u> </u> | <u> </u> |
| Unrealized loss on securities, net of income taxes | \$ 47,008 | \$ 50,736 |
| | <u> </u> | <u> </u> |

See notes to consolidated financial statements that are an integral part of these consolidated statements.

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

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ACTIVITIES

Greenville First Bancshares, Inc. (the Company) is a South Carolina corporation that owns all of the capital stock of Greenville First Bank, N.A. (the bank) and all of the stock of Greenville First Statutory Trust I (the Trust). The bank is a national bank organized under the laws of the United States located in Greenville County, South Carolina. The bank is primarily engaged in the business of accepting demand deposits and savings deposits insured by the Federal Deposit Insurance Corporation, and providing commercial, consumer and mortgage loans to the general public. The Trust is a special purpose subsidiary organized for the sole purpose of issuing trust preferred securities.

On October 26, 1999, the Company sold 1,100,000 shares of its common stock at \$10 per share and on November 30, 1999 sold 50,000 additional shares for a total of 1,150,000 shares (1,724,994 after adjustment of 3 for 2 stock split). The offering raised approximately \$10.6 million, net of underwriting discounts, commissions and offering expenses.

On June 26, 2003, the Trust offered and sold \$6,000,000 of floating rate securities. The Company received the proceeds from the issuance of these securities and has reflected the obligation resulting from the receipt of the proceeds as junior subordinate debentures in the balance sheets.

On November 17, 2003, shareholders of record as of November 3, 2003, received one additional share of stock for every two shares of stock owned prior to the 3 for 2 stock split. All fractional shares were paid in cash. The earnings per share amounts for all periods shown have been adjusted to reflect the 3 for 2 split.

On September 24, 2004, the Company sold 800,000 shares of its common stock and on October 15, 2004 sold 120,000 additional shares for a total of 920,000 shares. All shares were sold at \$17.875 per share. The offering raised approximately \$14.9 million, net of underwriting discounts, commissions and offering expenses.

The following is a description of the more significant accounting and reporting policies that the Company follows in preparing and presenting consolidated financial statements.

Basis of presentation

The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, Greenville First Bank, N.A. In consolidation, all significant intercompany transactions have been eliminated. The accounting and reporting policies conform to accounting principles generally accepted in the United States of America. In accordance with guidance issued by the Financial Accounting Standards Board (FASB) in Interpretation number 46, the operations of the Trust have not been consolidated in these financial statements.

Estimates

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

Risks and uncertainties

In the normal course of its business the Company encounters two significant types of risks: economic and regulatory. There are three main components of economic risk: interest rate risk, credit risk and market risk. The Company is subject to interest rate risk to the degree that its interest-bearing liabilities mature or reprice at different speeds, or on different bases, than its interest-earning assets. Credit risk is the risk of default within the Company's loan portfolio that results from borrowers' inability or unwillingness to make contractually required payments. Market risk reflects changes in the value of collateral underlying loans receivable and the valuation of real estate held by the Company.

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NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ACTIVITIES, Continued

The Company is subject to the regulations of various governmental agencies. These regulations can and do change significantly from period to period. The Company also undergoes periodic examinations by the regulatory agencies, which may subject it to changes with respect to valuation of assets, amount of required loss allowance and operating restrictions resulting from the regulators' judgments based on information available to them at the time of their examinations. The bank makes loans to individuals and businesses in and around Upstate South Carolina for various personal and commercial purposes. The Bank has a diversified loan portfolio. Borrowers' ability to repay their loans is not dependent upon any specific economic sector.

Investment securities

The Company accounts for investment securities in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities. The statement requires investments in equity and debt securities to be classified into three categories:

1. *Available for sale securities:* These are securities that are not classified as either held to maturity or as trading securities. These securities are reported at fair market value. Unrealized gains and losses are reported, net of income taxes, as separate components of shareholders' equity (accumulated other comprehensive income).
2. *Held to maturity securities:* These are investment securities that the Company has the ability and intent to hold until maturity. These securities are stated at cost, adjusted for amortization of premiums and the accretion of discounts.
3. *Trading securities:* These are securities that are bought and held principally for the purpose of selling in the near future. Trading securities are reported at fair market value, and related unrealized gains and losses are recognized in the income statement. The Company has no trading securities.

Gains or losses on dispositions of investment securities are based on the differences between the net proceeds and the adjusted carrying amount of the securities sold, using the specific identification method. Premiums and discounts are amortized or accrued into interest income by a method that approximates a level yield.

Other investments

The Bank, as a member institution, is required to own stock investments in the Federal Home Loan Bank of Atlanta and the Federal Reserve Bank. The stock is generally pledged against any borrowings from these institutions. No ready market exists for the stock and it has no quoted market value. However, redemption of these stocks has historically been at par value. Other investments also include an \$186,000 investment in the Trust.

Loans, interest and fee income on loans

Loans are stated at the principal balance outstanding. Unamortized net loan fees and the allowance for possible loan losses are deducted from total loans on the balance sheet. Interest income is recognized over the term of the loan based on the principal amount outstanding. The net of loan origination fees received and direct costs incurred in the origination of loans is deferred and amortized to interest income over the contractual life of the loans adjusted for actual principal prepayments using a method approximating the interest method.

Loans are generally placed on non-accrual status when principal or interest becomes ninety days past due, or when payment in full is not anticipated. When a loan is placed on non-accrual status, interest accrued but not received is generally reversed against interest income. Cash receipts on non-accrual loans are not recorded as interest income, but are used to reduce principal.

Allowance for loan losses

The provision for loan losses charged to operating expenses reflects the amount deemed appropriate by management to establish an adequate reserve to meet the present and foreseeable risk characteristics of the current loan portfolio. Management's judgment is based on periodic and regular evaluation of individual loans, the overall risk characteristics of the various portfolio segments, past experience with losses and prevailing and anticipated economic conditions. Loans that are determined to be uncollectable are charged against the allowance. Provisions for loan losses and recoveries on loans previously charged off are added to the allowance.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ACTIVITIES, Continued

Impaired loans

The Bank accounts for impaired loans in accordance with SFAS No. 114, "Accounting by Creditors for Impairment of a Loan". This statement requires that all lenders value loans at the loan's fair value if it is probable that the lender will be unable to collect all amounts due according to the terms of the loan agreement. Fair value may be determined based upon the present value of expected cash flows, market price of the loan, if available, or value of the underlying collateral. Expected cash flows are required to be discounted at the loan's effective interest rate. SFAS No. 114 was amended by SFAS No. 118 to allow a lender to use existing methods for recognizing interest income on an impaired loan and by requiring additional disclosures about how a creditor recognizes interest income on an impaired loan.

Under SFAS No. 114, as amended by SFAS No. 118, when the ultimate collectibility of an impaired loan's principal is in doubt, wholly or partially, all cash receipts are applied to principal. Once the reported principal balance has been reduced to zero, future cash receipts are applied to interest income, to the extent that any interest has been foregone. Further cash receipts are recorded as recoveries of any amounts previously charged off. When this doubt does not exist, cash receipts are applied under the contractual terms of the loan agreement first to interest income then to principal.

A loan is also considered impaired if its terms are modified in a troubled debt restructuring. For these accruing impaired loans, cash receipts are typically applied to principal and interest receivable in accordance with the terms of the restructured loan agreement. Interest income is recognized on these loans using the accrual method of accounting.

Non-performing assets

Non-performing assets include real estate acquired through foreclosure or deed taken in lieu of foreclosure, and loans on non-accrual status. Loans are placed on non-accrual status when, in the opinion of management, the collection of additional interest is questionable. Thereafter no interest is taken into income unless received in cash or until such time as the borrower demonstrates the ability to pay principal and interest.

Real estate acquired in settlement of loans

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

Property and equipment

Property and equipment are stated at cost. Major repairs are charged to operations, while major improvements are capitalized. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets. Upon retirement, sale, or other disposition of property and equipment, the cost and accumulated depreciation are eliminated from the accounts, and gain or loss is included in income from operations.

Construction in progress is stated at cost, which includes the cost of construction and other direct costs attributable to the construction. No provision for depreciation is made on construction in progress until such time as the relevant assets are completed and put into use.

Securities sold under agreements to repurchase

The Bank enters into sales of securities under agreements to repurchase. Fixed-coupon repurchase agreements are treated as financing,

with the obligation to repurchase securities sold being reflected as a liability and the securities underlying the agreements remaining as assets.

Advertising and public relations expense

Advertising, promotional and other business development costs are generally expensed as incurred. External costs incurred in producing media advertising are expensed the first time the advertising takes place. External costs relating to direct mailing costs are expensed in the period in which the direct mailings are sent.

NOTE 1 -SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ACTIVITIES, Continued

Income taxes

The financial statements have been prepared on the accrual basis. When income and expenses are recognized in different periods for financial reporting purposes versus for the purposes of computing income taxes currently payable, deferred taxes are provided on such temporary differences. The Company accounts for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes. Under SFAS No. 109, deferred tax assets and liabilities are recognized for the expected future tax consequences of events that have been recognized in the consolidated financial statements or tax returns. Deferred tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be realized or settled.

Stock based compensation

The Company has a stock-based employee compensation plan that is further described in Note 18. The Company accounts for the plan under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. No stock-based employee compensation cost is reflected in net income, as all stock options granted under these plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation. The 2003 amounts have been restated for the 3 for 2 stock split.

| | For the years ended December 31, | |
|---|----------------------------------|--------------|
| | 2004 | 2003 |
| Net income, as reported | \$ 2,012,589 | \$ 1,005,915 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (82,876) | (78,452) |
| Pro forma net income | \$ 1,929,713 | \$ 927,463 |
| Earnings per common share: | | |
| Basic - as reported | \$ 1.02 | \$.58 |
| Basic - pro forma | \$.98 | \$.54 |
| Diluted - as reported | \$.90 | \$.53 |
| Diluted - pro forma | \$.86 | \$.49 |

The fair market value of the option grant is estimated on the date of grant using the Black-Scholes option-pricing model. The following assumptions were used for grants: expected volatility of 10% for 2004 and 2003, risk-free interest rate of 3.00% for 2004 and 2003, respectively, and expected lives of the options 10 years and the assumed dividend rate was zero.

Statement of cash flows

For purposes of reporting cash flows, cash and cash equivalents are defined as those amounts included in the balance sheet captions Cash and Due from Banks and Federal Funds Sold. Cash and cash equivalents have an original maturity of three months or less.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ACTIVITIES, Continued**Reclassifications**

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

Earnings per common share

The following schedule reconciles the numerators and denominators of the basic and diluted earnings per share computations for the years ended December 31, 2004 and 2003. Dilutive common shares arise from the potentially dilutive effect of the Company's stock options and warrants that are outstanding. The assumed conversion of stock options and warrants can create a difference between basic and dilutive net income per common share. The 2003 numbers of shares and the earnings per share have been adjusted for the 3 for 2 stock split.

| | For the years ended December 31, | |
|-----------------------------------|---|--------------|
| | 2004 | 2003 |
| Basic Earnings Per Share | | |
| Average common shares | 1,972,087 | \$ 1,724,994 |
| Net income | \$ 2,012,589 | \$ 1,005,915 |
| Earnings per share | \$ 1.02 | \$.58 |
| Diluted Earnings Per Share | | |
| Average common shares outstanding | 1,972,087 | 1,724,994 |
| Average dilutive common shares | 267,615 | 156,135 |
| Adjusted average common shares | 2,239,702 | 1,881,129 |
| Net income | \$ 2,012,589 | \$ 1,005,915 |
| Earnings per share | \$.90 | \$.53 |

Recently issued accounting pronouncements

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

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS No. 123(R)). SFAS No. 123(R) will require companies to measure all employee stock-based compensation awards using a fair value method and record such expense in its financial statements. In addition, the adoption of SFAS No. 123(R) requires additional accounting and disclosure related to the income tax and cash flow effects resulting from share-based payment arrangements. SFAS No. 123(R) is effective for the company beginning as of the quarter ending March 31, 2006. The Company is currently evaluating the impact that the adoption of SFAS No. 123(R) will have on its financial position, results of operations and cash flows. The company is in the process of determining the effect of adoption which will be recognized in the statement of income.

In January 2004, the FASB issued FIN No. 46, Consolidation of Variable Interest Entities. FIN No. 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns, or both. FIN No. 46 also requires disclosures about variable interest entities that a company is not required to consolidate, but in which it has a significant variable interest. FIN No. 46 provides guidance for determining whether an entity qualifies as a variable interest entity by considering, among other considerations, whether the entity lacks sufficient equity or its equity holders lack adequate decision-making ability. The consolidation requirements of FIN No. 46 apply immediately to variable interest entities created after January 31, 2004. The consolidation requirements apply to existing entities in the first fiscal year or interim period beginning after June 15, 2004. Certain of the disclosure requirements apply in all financial statements issued after January 31, 2004, regardless of when the variable interest entity was established. The adoption of FIN No. 46 will not have a material effect on the Company's financial position or results of operations. As a result of adoption of FIN No. 46, the Company deconsolidated the Trust for periods ended December 31, 2004, and has restated the periods ended December 31, 2004 to reflect the deconsolidation.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ACTIVITIES, Continued

In November 2003, the Emerging Issues Task Force (EITF) reached a consensus that certain quantitative and qualitative disclosures should be required for debt and marketable equity securities classified as available for sale or held to maturity under SFAS No. 115 and SFAS No. 124

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that are impaired at the balance sheet date but for which other-than-temporary impairment has not been recognized. Accordingly the EITF issued EITF No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. This issue addresses the meaning of other-than-temporary impairment and its application to investments classified as either available for sale or held to maturity under SFAS No. 115 and provides guidance on quantitative and qualitative disclosures. The disclosure requirements of EITF No. 03-1 are effective for annual financial statements for fiscal years ending after June 15, 2004. The effective date for the measurement and recognition guidance of EITF No. 03-1 has been delayed. The FASB staff has issued a proposed Board-directed FASB Staff Position (FSP), FSP EITF 03-1-a, Implementation Guidance for the Application of Paragraph 16 of Issue No. 03-1. The proposed FSP would provide implementation guidance with respect to debt securities that are impaired solely due to interest rates and/or sector spreads and analyzed for other-than-temporary impairment under the measurement and recognition requirements of EITF No. 03-1. The delay of the effective date for the measurement and recognition requirements of EITF No. 03-1 will be superseded concurrent with the final issuance of FSP EITF 03-1-a. Adopting the disclosure provisions of EITF No. 03-1 did not have any impact on the Company's financial position or results of operations.

In March 2004, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 105, Application of Accounting Principles to Loan commitments, to inform registrants of the Staff's view that the fair value of the recorded loan commitments should not consider the expected future cash flows related to the associated servicing of the future loan. The provisions of SAB No. 105 must be applied to loan commitments accounted for as derivatives that are entered into after March 31, 2004. The Staff will not object to the application of existing accounting practices to loan commitments accounted for as derivatives that are entered into on or before March 31, 2004, with appropriate disclosures. The Company adopted the provisions of SAB No. 105 on April 1, 2004. The adoption of SAB No. 105 did not have a material impact on the Company's financial condition or results of operations.

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

NOTE 2 RESTRICTIONS ON CASH AND DUE FROM BANKS

The Bank is required to maintain average cash reserve balances, computed by applying prescribed percentages to its various types of deposits, either at the bank or on deposit with the Federal Reserve Bank. At December 31, 2004 and 2003, the bank had \$1,019,060 and \$766,185, respectively on deposit with the Federal Reserve Bank to meet this requirement.

NOTE 3 FEDERAL FUNDS SOLD

The Bank's cash reserves in excess of the required amounts to be held by the Federal Reserve Bank (Note 2) may be lent to other banks on a daily basis. At December 31, 2004 and 2003, federal funds sold amounted to \$1,394,459 and \$2,842,594, respectively.

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NOTE 4 INVESTMENT SECURITIES

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

| | December 31, 2004 | | | |
|------------------|----------------------|------------------|-------------|----------------------|
| | Amortized Cost | Gross Unrealized | | Fair Value |
| | | Gains | Losses | |
| Federal agencies | \$ 1,013,803 | \$ 39,322 | \$ - | \$ 1,053,125 |
| Mortgage-backed | 11,070,132 | 36,417 | - | 11,106,549 |
| | \$ 12,083,935 | \$ 75,739 | \$ - | \$ 12,159,674 |
| | December 31, 2003 | | | |
| | Amortized Cost | Gross Unrealized | | Fair Value |
| | | Gains | Losses | |

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December 31, 2003

| Federal agencies | \$ 1,022,311 | \$ 76,127 | \$ - | \$ 1,098,438 |
|-----------------------------|---------------------|-------------------|-------------|---------------------|
| Mortgage-backed | 2,459,720 | 70,838 | - | 2,530,558 |
| Total investment securities | \$ 3,482,031 | \$ 146,965 | \$ - | \$ 3,628,996 |

At December 31, 2004, each of the investment securities available for sale had individual unrealized gains.

The amortized costs and fair values of investment securities available for sale at December 31, 2004 and 2003, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because issuers have the right to prepay the obligations.

| | December 31, 2004 | | December 31, 2003 | |
|------------------------------------|----------------------|----------------------|---------------------|---------------------|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Due after one through three years | \$ 1,013,803 | \$ 1,053,125 | \$ 1,022,311 | \$ 1,098,438 |
| Due after three through five years | - | - | - | - |
| Due after five through ten year | 1,679,258 | 1,707,784 | 2,459,720 | 2,530,558 |
| Due after ten years | 9,390,874 | 9,398,765 | - | - |
| Total investment securities | \$ 12,083,935 | \$ 12,159,674 | \$ 3,482,031 | \$ 3,628,996 |

At December 31, 2004, the Company's held-to-maturity portfolio totaled \$13,138,697 and is recorded at amortized cost. The portfolio includes two FNMA and one FHLMC mortgage-backed security. The first FNMA security has a balance of \$7,602,508 with a 2023 maturity. The second FNMA security has a balance of \$758,454 with a maturity of 2013. The two FNMA securities were purchased in July of 2003 and had a fair value at December 31, 2004, of \$8,349,710 with a net unrealized loss totaling \$11,252 at December 31, 2004. The FHLMC security has a balance of \$4,777,735 with a 2018 maturity. The FHLMC security was purchased in January 2004 and had a fair value at December 31, 2004 of \$4,738,903 with an unrealized loss totaling \$38,832. The Company believes, based on industry analyst reports and credit ratings that the deterioration in value is attributed to changes in market interest rates and not in the credit quality of the issuer and therefore, these losses are not considered other-than-temporary. The company has the ability and intent to hold these securities until such time as the value recovers or the securities mature. At December 31, 2003, the Company's held-to-maturity portfolio totaled \$9,834,324 and is recorded at amortized cost. The portfolio includes two FNMA mortgage-backed securities. The first security has a balance of \$8,871,418 with a 2023 maturity. The second security has a balance of \$962,906 with a maturity of 2013. The two securities were purchased in July of 2003 and had an unrealized loss totaling \$73,019 at December 31, 2003.

Other investments totaled \$3,863,850 and \$2,296,150 at December 31, 2004 and 2003, respectively. Other investments at December 31, 2004, consisted of Federal Reserve Bank stock with a cost of \$485,150, Federal Home Loan Bank stock with a cost of \$3,192,700, and an investment in the Trust of \$186,000. At December 31, 2003, the company owned Federal Reserve Bank stock with a cost of \$485,150, Federal Home Loan Bank stock with a cost of \$1,625,000, and an investment in the Trust of \$186,000.

No investment securities were sold in 2004 or 2003. Accordingly, no gains or losses were recorded. Included in the investment portfolios at December 31, 2004, are mortgage-backed securities issued by the Federal National Mortgage Association totaling \$17,751,836. At December 31, 2004 and 2003 \$17,020,372 and \$9,932,763, respectively, of securities were pledged as collateral for Advances from the Federal Home Loan Bank or repurchase agreements from brokers.

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NOTE 5 LOANS

The composition of net loans by major loan categories is as follows:

December 31,

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| | December 31, | |
|--------------------------------|-----------------------|-----------------------|
| | 2004 | 2003 |
| Real estate: | | |
| Commercial | | |
| Owner occupied | \$ 54,323,486 | \$ 39,300,648 |
| Non-owner occupied | 76,284,002 | 53,898,628 |
| Construction | 12,211,605 | 10,878,152 |
| | <u>142,819,093</u> | <u>104,077,428</u> |
| Consumer: | | |
| Residential | 46,240,388 | 35,822,608 |
| Home equity | 35,084,921 | 24,278,245 |
| Construction | 5,937,489 | 4,365,041 |
| | <u>87,262,798</u> | <u>64,465,894</u> |
| Total real estate loans | 230,081,891 | 168,543,322 |
| Commercial business | 44,871,612 | 36,106,814 |
| Consumer-other | 6,034,980 | 4,661,929 |
| Deferred origination fees, net | (641,354) | (530,082) |
| | <u>280,347,129</u> | <u>208,781,983</u> |
| Gross loans | 280,347,129 | 208,781,983 |
| Less allowance for loan losses | (3,716,645) | (2,705,150) |
| | <u>276,630,484</u> | <u>206,076,833</u> |
| Loans, net | \$ 276,630,484 | \$ 206,076,833 |

At December 31, 2004 and 2003, there was \$739,126 and \$443,939, respectively of loans classified as non-accruing loans. Foregone interest income on the non-accrual loans in 2004 was approximately \$9,200 and was approximately \$6,100 in 2003.

At December 31, 2004, certain of the Bank's first mortgage loans were pledged as collateral for advances from the Federal Home Loan Bank of Atlanta, as set forth in Note 9.

The composition of gross loans by rate type is as follows:

| | December 31, | |
|---------------------|-----------------------|-----------------------|
| | 2004 | 2003 |
| Variable rate loans | \$ 186,486,910 | \$ 143,241,945 |
| Fixed rate loans | 93,860,219 | 65,540,038 |
| | <u>\$ 280,347,129</u> | <u>\$ 208,781,983</u> |

The allowance for loan losses is available to absorb future loan charge-offs. The allowance is increased by provisions charged to operating income and by recoveries of loans that were previously written-off. The allowance is decreased by the aggregate loan balances, if any, that were deemed uncollectible during the year.

Activity within the allowance for loan losses account follows:

For the years ended
December 31,

| 2004 | 2003 |
|------|------|
|------|------|

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| | For the years ended | |
|--|-----------------------------|-----------------------------|
| Balance beginning of year | \$ 2,705,150 | \$ 1,824,149 |
| Recoveries of loans previously charged-off against the allowance | 36,423 | 3,647 |
| Provision for loan losses | 1,310,000 | 1,050,000 |
| Loans charged-off against the allowance | (334,928) | (172,646) |
| | <u> </u> | <u> </u> |
| Balance, end of year | <u>\$ 3,716,645</u> | <u>\$ 2,705,150</u> |

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NOTE 6 PROPERTY AND EQUIPMENT

Property and equipment are stated at cost less accumulated depreciation. Components of property and equipment included in the consolidated balance sheets are as follows:

| | December 31, | |
|------------------------------|-----------------------------|-----------------------------|
| | <u>2004</u> | <u>2003</u> |
| Land | \$ 422,000 | \$ - |
| Leasehold improvements | 450,090 | 428,875 |
| Furniture and equipment | 1,030,264 | 844,549 |
| Software | 216,255 | 168,163 |
| Construction in process | 663,527 | - |
| | 2,782,136 | 1,441,587 |
| Accumulated depreciation | (768,141) | (617,328) |
| | <u> </u> | <u> </u> |
| Total property and equipment | <u>\$ 2,013,995</u> | <u>\$ 824,259</u> |

The Company's main office building is leased for twenty years (see note 13). The construction in process relates the cost as of December 31, 2004 of building a branch office.

Depreciation expense for the years ended December 31, 2004 and 2003 was \$163,738 and \$162,618, respectively. Depreciation is charged to operations over the estimated useful lives of the assets. The estimated useful lives and methods of depreciation for the principal items follow:

| <u>Type of Asset</u> | <u>Life in Years</u> | <u>Depreciation Method</u> |
|-------------------------|----------------------|----------------------------|
| Software | 3 | Straight-line |
| Furniture and equipment | 5 to 7 | Straight-line |
| Leasehold improvements | 5 to 15 | Straight-line |

NOTE 7 DEPOSITS

The following is a detail of the deposit accounts:

| | December 31, | |
|---------------------------|------------------------------|------------------------------|
| | <u>2004</u> | <u>2003</u> |
| Non-interest bearing | \$ 17,553,036 | \$ 16,329,095 |
| Interest bearing: | | |
| NOW accounts | 31,433,208 | 17,455,460 |
| Money market accounts | 55,647,710 | 24,769,077 |
| Savings | 1,244,015 | 1,588,652 |
| Time, less than \$100,000 | 14,967,414 | 29,713,733 |
| Time, \$100,000 and over | 84,018,759 | 79,107,578 |
| | <u> </u> | <u> </u> |
| Total deposits | <u>\$ 204,864,142</u> | <u>\$ 168,963,595</u> |

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At December 31, 2004 and 2003, the bank had approximately \$77.3 million and \$79.6 million of time deposits that were obtained outside of the bank's primary market. Interest expense on time deposits greater than \$100,000 was \$1,860,382 and \$1,437,722 in the years ended December 31, 2004 and 2003, respectively.

At December 31, 2004 the scheduled maturities of certificates of deposit are as follows:

| | |
|----------------|----------------------|
| 2005 | \$ 65,398,890 |
| 2006 | 8,929,501 |
| 2007 | 9,988,148 |
| 2007 and after | 14,669,634 |
| | \$ 98,986,173 |

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NOTE 8 FEDERAL FUNDS PURCHASED AND REPURCHASE AGREEMENTS

At December 31, 2004 the bank had sold \$13,099,999 of securities under agreements to repurchase with brokers with a weighted rate of 2.25% that mature in less than 90 days. These agreements were secured with approximately \$13,200,000 of investment securities. The securities, under agreement to repurchase, averaged \$13,643,285 during 2004, with \$14,637,000 being the maximum amount outstanding at any month-end. The average rate paid in 2004 was 1.43%.

At December 31, 2003 the bank had sold \$9,296,999 of securities under agreements to repurchase with brokers with a weighted rate of 1.12% that mature in less than 90 days. These agreements are secured with approximately \$9,800,000 of investment securities. The securities, under agreement to repurchase, averaged \$5,689,259 during 2003, with \$9,865,000 being the maximum amount outstanding at any month-end. The average rate paid in 2003 was 1.23%.

NOTE 9 FEDERAL HOME LOAN BANK ADVANCES

At December 31, 2004 the bank had \$60,660,000 of advances from the FHLB. These advances are secured with approximately \$91,536,000 of first mortgage loans and stock in the FHLB. Listed below is a summary of the terms and maturities of the advances:

| Amount | Rate | Maturity | Repricing Date |
|---------------|-------|------------------|------------------|
| \$ 18,160,000 | 2.44% | October 1, 2005 | Daily |
| 7,500,000 | 2.46% | March 10, 2006 | March 10, 2005 |
| 5,000,000 | 1.78% | May 14, 2007 | May 15, 2005 |
| 10,000,000 | 2.84% | October 7, 2009 | October 10, 2006 |
| 5,000,000 | 2.07% | October 15, 2007 | January 15, 2005 |
| 3,000,000 | 4.83% | August 24, 2011 | August 24, 2006 |
| 5,000,000 | 3.36% | January 30, 2013 | January 30, 2008 |
| 7,000,000 | 4.21% | May 14, 2014 | May 14, 2009 |

\$ 60,660,000

At December 31, 2003 the bank had \$32,500,000 of advances from the FHLB. These advances are secured with approximately \$99,800,000 of first mortgage loans and stock in the FHLB. Listed below is a summary of the terms and maturities of the advances:

| Amount | Rate | Maturity | Repricing Date |
|--------------|-------|------------------|------------------|
| \$ 5,000,000 | 1.63% | July 16, 2004 | April 16, 2004 |
| 7,000,000 | 1.15% | October 1, 2004 | Daily |
| 7,500,000 | 1.21% | March 10, 2006 | March 10, 2004 |
| 5,000,000 | 1.56% | October 15, 2007 | April 15, 2004 |
| 3,000,000 | 4.86% | August 24, 2011 | August 24, 2006 |
| 5,000,000 | 3.36% | January 30, 2013 | January 30, 2008 |

\$ 32,500,000

NOTE 10 NOTE PAYABLE

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At December 31, 2004 and 2003, the Company had an unused revolving line of credit in the amount of \$4,500,000 and \$3,500,000, respectively, with another bank with a maturity of March 20, 2005. The Company has utilized this line of credit in the past to provide proceeds to increase the capital investment in the Company's wholly-owned bank. The line of credit bears interest at the 30 day LIBOR rate plus 2.00%, which at December 31, 2004 was 4.40%. The Company has pledged all of the stock of the Bank as collateral for this line of credit. The line of credit agreement contains various covenants related to net income and asset quality. As of December 31, 2004, the Company believes it was in compliance with all covenants. The Company anticipates renewing this line of credit.

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NOTE 11 JUNIOR SUBORDINATE DEBENTURES

On June 26, 2003, Greenville First Statutory Trust I, (a non-consolidated subsidiary) issued \$6.0 million floating rate trust preferred securities with a maturity of June 26, 2033. The rate is adjusted quarterly and was 5.65% at December 31, 2004. In accordance with the revised FIN 46, the Trust has not been consolidated in these financial statements. The Company received from the Trust the \$6.0 million proceeds from the issuance of the securities and the \$186,000 initial proceeds from the capital investment in the Trust, and accordingly has shown the funds due to the Trust as \$6,186,000 junior subordinated debentures. The current regulatory rules allow certain amounts of junior subordinated debentures to be included in the calculation of regulatory capital. The debenture issuance cost, net of accumulated amortization, totaled \$153,000 at December 31, 2004 and is included in other assets on the consolidated balance sheet. Amortization of debt issuance costs totaled \$18,000 and \$9,000 for the years ended December 31, 2004 and 2003, respectively, and are included in other borrowings interest expense.

NOTE 12 UNUSED LINES OF CREDIT

At December 31, 2004, the Bank had two unused lines of credit to purchase federal funds that totaled \$13,000,000. The lines of credit are available on a one to seven day basis for general corporate purposes of the Bank. The lender has reserved the right to withdraw the line at their option. The Bank has an additional line of credit with the Federal Home Loan Bank to borrow funds, subject to a pledge of qualified collateral. The Bank has collateral that would support approximately \$25,000,000 in additional borrowings.

NOTE 13 COMMITMENTS AND CONTINGENCIES

The Company has entered into an employment agreement with its president and chief executive officer that includes a three year compensation term, annual bonus, incentive program, stock option plan and a one-year non-compete agreement upon termination. The Company has also entered into an employment agreement with its three executive vice presidents that includes a two year compensation term, annual bonus, incentive program, stock option plan and a one-year non-compete agreement upon termination. The total estimated aggregate commitment is approximately \$600,000.

The Company has entered into an agreement with a data processor with a remaining term of five years to provide ATM services, item processing and general ledger processing. Components of this contract include monthly charges of approximately \$23,000.

The Bank may become party to litigation and claims in the normal course of business. As of December 31, 2004, management believes there is no material litigation pending.

The Bank has a twenty-year lease on its main office building that began in January 2001. The monthly rent for the year 2004 is \$32,339. The Bank also has a lease on land to be used for a future branch site. The monthly rent of \$4,804 is expected to begin in September of 2005, at the time the branch is completed. Both leases provide for annual lease rate escalations based on cost of living adjustments.

Future minimum lease payments under these operating leases are summarized as follows:

| | |
|------------------------------------|---------------------|
| For the year ended December 31, | |
| 2005 | \$ 409,777 |
| 2006 | 418,545 |
| 2007 | 427,531 |
| 2008 | 436,741 |
| 2009 | 446,180 |
| Thereafter* | 6,027,184 |
| | <hr/> |
| | \$ 8,165,958 |
| | <hr/> |

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*Amount is estimated based on an increase of 2.49 percent per year. Actual lease will be adjusted annually by the cost of living index as stated in the Consumer Price Index.

The bank has a commitment related to the cost of construction of two branch offices. The bank has incurred \$663,527 as of December 31, 2004. The remaining unpaid commitment on the first office is approximately \$50,000. The unpaid balance on the second office is approximately \$650,000.

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NOTE 14 INCOME TAXES

The components of income tax expense for the years ended December 31, 2004 and 2003 were as follows:

| | December 31, | |
|---|--------------|------------|
| | 2004 | 2003 |
| Current income taxes: | | |
| Federal | \$ 1,383,364 | \$ 918,080 |
| State | 106,000 | 53,548 |
| | 1,489,364 | 971,628 |
| Total current tax expense | | |
| Deferred income tax benefit and change in valuation allowance | (255,642) | (355,094) |
| | \$ 1,233,722 | \$ 616,534 |

The following is a summary of the items that caused recorded income taxes to differ from taxes computed using the statutory tax rate:

| | For the years ended December 31, | |
|-------------------------------|-------------------------------------|------------|
| | 2004 | 2003 |
| Effect of state income taxes | \$ 1,103,746 | \$ 551,633 |
| Change in valuation allowance | 106,000 | 53,548 |
| Other | - | (16,123) |
| | 23,976 | 27,476 |
| | \$ 1,233,722 | \$ 616,534 |

The components of the deferred tax assets and liabilities are as follows:

| | December 31, | |
|---------------------------|--------------|------------|
| | 2004 | 2003 |
| Deferred tax assets: | | |
| Allowance for loan losses | \$ 1,104,641 | \$ 763,514 |
| Net deferred loan fees | 218,060 | 180,228 |
| Other | 13,858 | 52,213 |
| | 1,336,559 | 995,955 |
| Valuation allowance | (63,877) | (63,877) |
| | 1,272,682 | 932,078 |
| Deferred tax liabilities: | | |

| | <u>December 31,</u> | |
|--|----------------------------|--------------------------|
| Unrealized gain on securities available for sale | \$ 25,751 | \$ 49,968 |
| Premise and equipment | 103,939 | 50,886 |
| Other | 126,093 | 94,184 |
| | <u>255,783</u> | <u>195,038</u> |
| Net deferred tax asset | <u>\$ 1,016,899</u> | <u>\$ 737,040</u> |

The net of current taxes payable and net deferred tax assets are included in other assets.

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NOTE 15 RELATED PARTY TRANSACTIONS

Certain directors, executive officers, and companies with which they are affiliated, are clients of and have banking transactions with the Bank in the ordinary course of business. These loans were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable arms-length transactions.

A summary of loan transactions with directors, including their affiliates and executive officers is as follows:

| | <u>For the years ended December 31,</u> | |
|----------------------------|---|----------------------------|
| | <u>2004</u> | <u>2003</u> |
| Balance, beginning of year | \$ 4,983,535 | \$ 2,828,958 |
| New loans | 12,035,257 | 7,485,973 |
| Less loan payments | (9,505,536) | (5,331,396) |
| Balance, end of year | <u>\$ 7,513,256</u> | <u>\$ 4,983,535</u> |

Deposits by officers and directors and their related interests at December 31, 2004 and 2003, were \$894,149 and \$700,052, respectively.

The Bank has a lease on its main office building with a director of the bank that began in 2001. The lease has a remaining term of sixteen years, with monthly payments in 2004 of \$32,339. The Bank also has a land lease with a director on property to be used for a future branch site, with monthly payments of \$4,804. The Bank is of the opinion that the lease payments represent market costs that could have been obtained in similar arms length transactions.

NOTE 16 FINANCIAL INSTRUMENTS WITH OFF BALANCE SHEET RISK

In the ordinary course of business, and to meet the financing needs of its customers, the Company is a party to various financial instruments with off balance sheet risk. These financial instruments, which include commitments to extend credit and standby letters of credit, involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the balance sheets. The contract amount of those instruments reflects the extent of involvement the Company has in particular classes of financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amounts of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on balance sheet instruments.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any material condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of a fee. At December 31, 2004, unfunded commitments to extend credit were approximately \$51,644,000, of which \$17,559,000 is at fixed rates and \$34,085,000 is at variable rates. The Company evaluates each customer's credit-worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the borrower. Collateral varies but may include accounts receivable, inventory, property, plant and equipment, and commercial and residential real estate.

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At December 31, 2004, there was a \$2,463,000 commitment under a letter of credit. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral varies but may include accounts receivable, inventory, equipment, marketable securities and property. Since most of the letters of credit are expected to expire without being drawn upon, they do not necessarily represent future cash requirements. The fair value of off balance sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties credit standing. The total fair value of such instruments is not material.

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NOTE 17 EMPLOYEE BENEFIT PLAN

On January 1, 2000, the Company adopted the Greenville First Bancshares, Inc. Profit Sharing and 401(k) Plan for the benefit of all eligible employees. The Company contributes to the Plan annually upon approval by the Board of Directors. Contributions made to the Plan in 2004 and 2003 amounted to \$57,000 and \$53,000, respectively.

NOTE 18 STOCK OPTIONS AND WARRANTS

On March 21, 2000, the Company adopted a stock option plan for the benefit of the directors, officers and employees. The Board may grant up to 258,750 options (adjusted for 3 for 2 stock split) at an option price per share not less than the fair market value on the date of grant. The options granted to officers and employees vest either at 20 percent over five years or 33 percent over three years and expire 10 years from the grant date.

A summary of the status of the plan and changes for the years ended December 31, are presented below:

| | 2004 | | 2003 | |
|----------------------------------|----------------|--|----------------|--|
| | Shares | Weighted average exercise price | Shares | Weighted average exercise price |
| Outstanding at beginning of year | 227,250 | \$ 6.98 | 186,750 | \$ 6.75 |
| Granted | 25,000 | 8.66 | 40,500 | 8.66 |
| Exercised | - | - | - | - |
| Forfeited or | - | - | - | - |
| | 252,250 | \$ 7.15 | 227,250 | \$ 6.98 |
| Options exercisable at year-end | 165,188 | | 133,000 | |
| Shares available for grant | 6,500 | | 31,500 | |

Upon completion of the 1999 stock offering, the Company issued warrants to each of its organizers to purchase up to an additional 194,925 shares (adjusted for 3 for 2 stock split) of common stock at \$6.67 per share. These warrants vested over a three-year period, are exercisable at December 31, 2004 and expire on October 27, 2009.

NOTE 19 COMMON STOCK AND EARNINGS PER SHARE

SFAS No. 128, Earnings per Share requires that the Company present basic and diluted net earnings per common share. The assumed conversion of stock options and warrants can create a difference between basic and diluted net earnings per common share. The weighted average number of common shares outstanding for basic earnings in 2004 was 1,972,087, and the weighted average number of common shares assumed outstanding in 2004 for diluted earnings per common share was 2,239,702. The weighted average number of common shares outstanding for basic earnings in 2003 adjusted for the 3 for 2 stock split was 1,724,994, and the weighted average number of common shares assumed outstanding in 2003 for diluted earnings per common share was 1,881,129.

NOTE 20 DIVIDENDS

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There are no current plans to initiate payment of cash dividends and future dividend policy will depend on the Bank's and the Company's earnings, capital requirements, financial condition and other factors considered relevant by the Company's Board of Directors. The Bank is restricted in its ability to pay dividends under the national banking laws and regulations of the OCC. Generally, these restrictions require the Bank to pay dividends derived solely from net profits. Moreover, OCC prior approval is required if dividends declared in any calendar year exceed the Bank's net profit for that year combined with its retained net profits for the preceding two years.

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NOTE 21 REGULATORY MATTERS

The Company and the Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company and Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the assets, liabilities, and certain off balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and Bank to maintain minimum amounts and ratios (set forth in the table below) of Total and Tier 1 capital to risk-weighted assets, and of Tier 1 capital to average assets. Management believes, as of December 31, 2004, that the Company and Bank meet all capital adequacy requirements to which it is subject.

As of December 31, 2004, the most recent notification of the Office of the Comptroller of the Currency categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events, since that notification that management believes have changed the Bank's category. The Company's and Bank's actual capital amounts and ratios and minimum regulatory amounts and ratios are presented as follows:

| | Actual | | For capital adequacy purposes Minimum | | To be well capitalized under prompt corrective action provisions Minimum | |
|--|--------------------|-------|---|-------|--|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| | (amounts in \$000) | | | | | |
| As of December 31, 2004 | | | | | | |
| <i>The Company</i> | | | | | | |
| Total Capital (to risk weighted assets) | \$ 37,218 | 14.6% | \$ 20,365 | 8.0% | \$ 25,456 | 10.0% |
| Tier 1 Capital (to risk weighted assets) | 34,029 | 13.4 | 10,182 | 4.0 | 15,273 | 6.0 |
| Tier 1 Capital (to average assets) | 34,029 | 11.0 | 12,381 | 4.0 | 15,476 | 5.0 |
| <i>The Bank</i> | | | | | | |
| Total Capital (to risk weighted assets) | \$ 34,832 | 13.7% | \$ 20,365 | 8.0% | \$ 25,456 | 10.0% |
| Tier 1 Capital (to risk weighted assets) | 31,643 | 12.4 | 10,182 | 4.0 | 15,273 | 6.0 |
| Tier 1 Capital (to average assets) | 31,643 | 10.2 | 12,381 | 4.0 | 15,476 | 5.0 |
| As of December 31, 2003 | | | | | | |
| <i>The Company</i> | | | | | | |
| Total Capital (to risk weighted assets) | \$ 19,470 | 10.2% | \$ 15,206 | 8.0% | \$ 19,008 | 10.0% |
| Tier 1 Capital (to risk weighted assets) | 14,787 | 7.8 | 7,603 | 4.0 | 11,405 | 6.0 |
| Tier 1 Capital (to average assets) | 14,787 | 6.1 | 8,779 | 4.0 | 10,973 | 5.0 |
| <i>The Bank</i> | | | | | | |
| Total Capital (to risk weighted assets) | \$ 19,176 | 10.1% | \$ 15,206 | 8.0% | \$ 19,008 | 10.0% |
| Tier 1 Capital (to risk weighted assets) | 16,796 | 8.8 | 7,603 | 4.0 | 11,405 | 6.0 |
| Tier 1 Capital (to average assets) | 16,796 | 7.7 | 8,779 | 4.0 | 10,973 | 5.0 |

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NOTE 22 SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

Following is a summary of operations by quarter:

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| 2004 | Quarters ended | | | |
|--|----------------|--------------|--------------|--------------|
| | March 31 | June 30 | September 30 | December 31 |
| Interest income | \$ 2,967,320 | \$ 3,175,615 | \$ 3,635,254 | \$ 4,186,511 |
| Interest expense | 1,034,335 | 1,215,170 | 1,444,123 | 1,622,929 |
| Net interest income | 1,932,985 | 1,960,445 | 2,191,131 | 2,563,582 |
| Provision for loan losses | 350,000 | 300,000 | 375,000 | 285,000 |
| Noninterest income | 162,323 | 200,577 | 184,421 | 214,142 |
| Noninterest expenses | 1,119,582 | 1,193,514 | 1,182,770 | 1,357,429 |
| Income before provision for income taxes | 625,726 | 667,508 | 817,782 | 1,135,295 |
| Income tax expense | 237,776 | 253,657 | 310,876 | 431,413 |
| Net income | \$ 387,950 | \$ 413,851 | \$ 506,906 | \$ 703,882 |
| Earnings per share | | | | |
| Basic | \$.22 | \$.24 | \$.28 | \$.27 |
| Diluted | \$.19 | \$.21 | \$.25 | \$.24 |
| Weighted average common shares | | | | |
| Basic | 1,725,494 | 1,725,494 | 1,788,864 | 2,648,494 |
| Diluted | 2,007,634 | 1,988,584 | 2,044,963 | 2,915,606 |

| 2003 | Quarters ended | | | |
|--|----------------|--------------|--------------|--------------|
| | March 31 | June 30 | September 30 | December 31 |
| Interest income | \$ 2,231,029 | \$ 2,287,402 | \$ 2,495,104 | \$ 2,708,019 |
| Interest expense | 891,950 | 860,820 | 932,385 | 932,785 |
| Net interest income | 1,339,079 | 1,426,582 | 1,562,719 | 1,775,234 |
| Provision for loan losses | 300,000 | 200,000 | 250,000 | 300,000 |
| Noninterest income | 147,153 | 83,954 | 115,318 | 75,259 |
| Noninterest expenses | 916,998 | 940,447 | 996,614 | 998,790 |
| Income before provision for income taxes | 269,234 | 370,089 | 431,423 | 551,703 |
| Income tax expense | 102,307 | 140,634 | 163,941 | 209,652 |
| Net income | \$ 166,927 | \$ 229,455 | \$ 267,482 | \$ 342,051 |
| Earnings per share | | | | |
| Basic | \$.10 | \$.13 | \$.16 | \$.20 |
| Diluted | \$.09 | \$.12 | \$.14 | \$.18 |
| Weighted average common shares | | | | |
| Basic | 1,724,994 | 1,724,994 | 1,724,994 | 1,724,994 |
| Diluted | 1,834,053 | 1,886,399 | 1,903,130 | 1,899,969 |

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NOTE 23 FAIR VALUE OF FINANCIAL INSTRUMENTS

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SFAS No. 107, Disclosures about Fair Value of Financial Instruments requires disclosure of fair value information, whether or not recognized in the consolidated balance sheets, when it is practical to estimate the fair value. SFAS No. 107 defines a financial instrument as cash, evidence of an ownership interest in an entity or contractual obligations which require the exchange of cash or other financial instruments. Certain items are specifically excluded from the disclosure requirements, including the Company's common stock, premises and equipment and other assets and liabilities.

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

Securities are valued using quoted fair market prices. Fair value for the Company's off-balance sheet financial instruments is based on the discounted present value of the estimated future cash flows.

Fair value for variable rate loans and borrowings that reprice frequently and for loans that mature in less than one year is based on the carrying value. Fair value for fixed rate mortgage loans, personal loans and all other loans (primarily commercial) maturing after one year is based on the discounted present value of the estimated future cash flows. Discount rates used in these computations approximate the rates currently offered for similar loans of comparable terms and credit quality.

Fair value for demand deposit accounts and interest-bearing accounts with no fixed maturity date is equal to the carrying value. Certificate of deposit accounts and FHLB advances with a maturity within one year are valued at their carrying value. The fair value of certificate of deposit accounts and FHLB advances with a maturity after one year are estimated by discounting cash flows from expected maturities using current interest rates on similar instruments.

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

The estimated fair values of the Company's financial instruments at December 31, 2004 and 2003 are as follows:

| | 2004 | | 2003 | |
|---|--------------------|---------------|--------------------|---------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial Assets: | | | | |
| Cash and due from banks | \$ 3,943,877 | \$ 3,943,877 | \$ 4,104,697 | \$ 4,104,697 |
| Federal funds sold | 1,394,459 | 1,394,459 | 2,842,594 | 2,842,594 |
| Investment securities available for sale | 12,159,674 | 12,159,674 | 3,628,996 | 3,628,996 |
| Investment securities held to maturity | 13,138,697 | 13,088,613 | 9,834,324 | 9,761,305 |
| Other investments | 3,863,850 | 3,863,850 | 2,296,150 | 2,296,150 |
| Loans, net | 276,630,484 | 278,400,000 | 206,076,833 | 208,638,000 |
| Financial Liabilities: | | | | |
| Deposits | 204,864,142 | 205,000,000 | 168,963,595 | 169,400,000 |
| Official checks outstanding | 1,384,480 | 1,384,480 | 1,575,357 | 1,575,357 |
| Federal funds purchased and repurchase agreements | 13,099,999 | 13,099,999 | 9,296,999 | 9,296,999 |
| Junior subordinate debentures | 6,186,000 | 6,186,000 | 6,186,000 | 6,186,000 |
| Federal Home Loan Bank advances | 60,660,000 | 60,916,000 | 32,500,000 | 33,000,000 |

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NOTE 24 PARENT COMPANY FINANCIAL INFORMATION

Following is condensed financial information of Greenville First Bancshares, Inc. (parent company only):

Condensed Balance Sheets

December 31,

| 2004 | 2003 |
|------|------|
|------|------|

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| | <u>December 31,</u> | |
|---|-----------------------------|-----------------------------|
| Assets | | |
| Cash and cash equivalents | \$ 2,249,411 | \$ 136,932 |
| Investment in subsidiaries | 31,878,987 | 17,079,756 |
| Other assets | 153,000 | 171,000 |
| | <u> </u> | <u> </u> |
| Total assets | \$ 34,281,398 | \$ 17,387,688 |
| | <u> </u> | <u> </u> |
| Liabilities and Shareholders' Equity | | |
| Accounts payable and accrued expenses | \$ 16,810 | \$ 14,720 |
| Junior Subordinate debentures | 6,186,000 | 6,186,000 |
| Shareholders' equity | 28,078,588 | 11,186,968 |
| | <u> </u> | <u> </u> |
| Total liabilities and shareholders' equity | \$ 34,281,398 | \$ 17,387,688 |
| | <u> </u> | <u> </u> |

Condensed Statements of Income

| | <u>For the years ended December 31,</u> | |
|---|---|-----------------------------|
| | <u>2004</u> | <u>2003</u> |
| Revenues | | |
| Interest income | \$ 5,150 | \$ 1,196 |
| Expenses | | |
| Interest expense | 338,801 | 183,666 |
| | <u> </u> | <u> </u> |
| Loss before equity in undistributed net income of subsidiaries | (333,651) | (182,470) |
| Equity in undistributed net income of subsidiaries | 2,346,240 | 1,188,385 |
| | <u> </u> | <u> </u> |
| Net income | \$ 2,012,589 | \$ 1,005,915 |
| | <u> </u> | <u> </u> |

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NOTE 24 PARENT COMPANY FINANCIAL INFORMATION, Continued

Condensed Statements of Cash Flows

| | <u>For the years ended December 31,</u> | |
|---|---|--------------|
| | <u>2004</u> | <u>2003</u> |
| Operating activities | | |
| Net income | \$ 2,012,589 | \$ 1,005,915 |
| Adjustments to reconcile net income to net cash used in operating activities | | |
| Equity in undistributed net income of subsidiaries | | (1,188,385) |
| Decrease (Increase) in other assets | 18,000 | (171,000) |
| Increase in accounts payable and accrued expenses | 2,091 | 13,350 |

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| | For the years ended | |
|--|---------------------|-------------------|
| | 2005 | 2004 |
| Net cash used in operating activities | (313,560) | (340,120) |
| Investing activities | | |
| Investment in subsidiaries | (12,500,000) | (3,386,000) |
| Net cash used for investing activities | (12,500,000) | (3,386,000) |
| Financing activities | | |
| Proceeds from note payable | 3,000,000 | 500,000 |
| Repayment of note payable | (3,000,000) | (3,000,000) |
| Proceeds from junior subordinate debentures | - | 6,186,000 |
| Proceeds from sale of common stock, net | 14,906,029 | - |
| Proceeds from the exercise of stock warrants | 20,010 | - |
| Net cash provide by financing activities | 14,926,039 | 3,686,000 |
| Net increase (decrease) in cash and cash equivalents | 2,112,479 | (40,120) |
| Cash and cash equivalents, beginning of year | 136,932 | 177,052 |
| Cash and cash equivalents, end of year | \$ 2,249,411 | \$ 136,932 |

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Item 8. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 8A. Controls and Procedures

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as defined in Exchange Act Rule 13a-15(e). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our current disclosure controls and procedures are effective as of December 31, 2004. There have been no significant changes in our internal controls over financial reporting during the fourth fiscal quarter ended December 31, 2004 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

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

Item 9. Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act

In response to this Item, this information is contained in our Proxy Statement for the Annual Meeting of Shareholders to be held on May 17, 2005 and is incorporated herein by reference.

Item 10. Executive Compensation

In response to this Item, this information is contained in our Proxy Statement for the Annual Meeting of Shareholders to be held on May 17, 2005 and is incorporated herein by reference.

Item 11. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

In response to this Item, the information required by Item 201(d) is contained in Item 5 of this report. In response to this Item, this information is contained in our Proxy Statement for the Annual Meeting of Shareholders to be held on May 17, 2005 and is incorporated herein by reference.

Item 12. Certain Relationships and Related Transactions

The information is contained in our Proxy Statement for the Annual Meeting of Shareholders to be held on May 17, 2005 is incorporated herein by reference.

Item 13. Exhibits

- 3.1 Articles of Incorporation, as amended (incorporated by reference to Exhibit 3.1 of the Registration Statement on Form SB-2, File No. 333-83851).
- 3.2 Bylaws (incorporated by reference to Exhibit 3.2 of the Registration Statement on Form SB-2, File No. 333-83851).
- 4.1 See Exhibits 3.1 and 3.2 for provisions in Greenville First Bancshares' s Articles of Incorporation and Bylaws defining the rights of holders of the common stock (incorporated by reference to Exhibit 4.1 of the Registration Statement on Form SB-2, File No. 333-83851).
- 4.2 Form of certificate of common stock (incorporated by reference to Exhibit 4.2 of the Registration Statement on Form SB-2, File No. 333-83851).
- 10.1 Employment Agreement dated July 27, 1999 between Greenville First Bancshares and Art Seaver (incorporated by reference to Exhibit 10.1 of the Registration Statement on Form SB-2, File No.333-83851).*

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- 10.2 Lease Agreement incorporated by reference between Greenville First Bank and Halton Properties, LLC, formerly Cothran Properties, LLC (incorporated by reference to Exhibit 10.2 of Form 10-K filed on March 28, 2000).
 - 10.3 Data Processing Services Agreement dated June 28, 1999 between Greenville First Bancshares and the Intercept Group (incorporated by reference to Exhibit 10.3 of the Registration Statement on Form SB-2, File No. 333-83851).
 - 10.4 Form of Stock Warrant Agreement (incorporated by reference to Exhibit 10.4 of the Registration Statement on Form SB-2, File No. 333-83851).*
 - 10.5 2000 Greenville First Bancshares, Inc. Stock Incentive Plan and Form of Option Agreement (incorporated by reference to Exhibit 10.7 to the Company' s Form 10-QSB for the period ended March 31, 2000).
 - 10.6 Employment Agreement dated April 1, 2004 between Greenville First Bank, N.A., Greenville First Bancshares, Inc., and James M. Austin, III (incorporated by reference to Exhibit 10.1 to the Company' s Form 10-QSB for the period ended June 30, 2004).
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 - 10.11 Sublease Agreement between Greenville First Bank, N.A. and Augusta Road Holdings, LLC dated February 26, 2004 (incorporated by reference to Exhibit 10.6 to the Company' s Form 10-QSB for the period ended June 30, 2004).
 - 21 Subsidiaries of our company

- 24 Power of Attorney (contained herein as part of the signature pages).
- 31.1 Rule 13a-14(a) Certification of the Chief Executive Officer.
- 31.2 Rule 13a-14(a) Certification of the Chief Financial Officer.
- 32 32 Section 1350 Certifications.

* Management contract or compensatory plan or arrangement required to be filed as an Exhibit to this Annual Report on Form 10-KSB.

Item 14 Principal Accountant Fees and Services

In response to this item, this information is contained our Proxy Statement for the Annual Meeting of Shareholders to be held on May 17, 2005.

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SIGNATURES

In accordance with Section 13 or 15(d) of the Securities Exchange Act of 1934 (the Exchange Act), the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

GREENVILLE FIRST BANCSHARES, INC.

Date: March 15, 2005

/s/ R. Arthur Seaver, Jr.
 R. Arthur Seaver, Jr.
 President and Chief Executive Officer

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints R. Arthur Seaver, Jr., his true and lawful attorney-in-fact and agent, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-KSB, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto attorney-in-fact and agent full power and authority to do and perform each and every act and thing requisite or necessary to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that attorney-in-fact and agent, or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant in the capacities and on the dates indicated.

| <u>Signature</u> | <u>Title</u> | <u>Date</u> |
|---|---|----------------|
| <u>/s/ James M. Austin</u> James M. Austin | Chief Financial Officer, Principal Financial and Accounting Officer | March 15, 2005 |
| <u>Andrew B. Cajka</u> Andrew B. Cajka | Director | March 15, 2005 |
| <u>/s/ Mark A. Cothran</u> Mark A. Cothran | Director | March 15, 2005 |

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| | | |
|--------------------------------|----------|----------------|
| <u>/s/ Leighton M. Cabbage</u> | Director | March 15, 2005 |
| Leighton M. Cabbage | | |
| <u>/s/ David G. Ellison</u> | Director | March 15, 2005 |
| David G. Ellison | | |
| <u>/s/ Anne S. Ellefson</u> | Director | March 15, 2005 |
| Anne S. Ellefson | | |

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|--|--|----------------|
| <u>/s/ Tecumseh Hooper, Jr.</u> | Director | March 15, 2005 |
| Tecumseh Hooper, Jr. | | |
| <u>/s/ Rudolph G. Johnstone, III, MD</u> | Director | March 15, 2005 |
| Rudolph G. Johnstone, III, MD | | |
| <u>/s/ Keith J. Marrero</u> | Director | March 15, 2005 |
| Keith J. Marrero | | |
| <u>/s/ James B. Orders</u> | Director, Chairman | March 15, 2005 |
| James B. Orders | | |
| <u>/s/ William B. Sturgis</u> | Director | March 15, 2005 |
| William B. Sturgis | | |
| <u>/s/ R. Arthur Seaver, Jr.</u> | Director, Chief Executive Officer and President (<i>principal executive officer</i>) | March 15, 2005 |
| R. Arthur Seaver, Jr. | | |
| <u>/s/ Fred Gilmer, Jr.</u> | Director, Senior Vice- President | March 15, 2005 |
| Fred Gilmer, Jr. | | |

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EXHIBIT INDEX

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