1ST STATE BANCORP INC
Form 10-Q
February 13, 2001

U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2000

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: 0-25859

1ST STATE BANCORP, INC.

(Exact Name of Registrant as Specified in Its Charter)

VIRGINIA	56-2130744
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
445 S. MAIN STREET, BURLINGTON, NORTH CAROLINA	27215
(Address of Principal Executive Offices)	(Zip Code)

Registrant' s Telephone Number, Including Area Code (336) 227-8861

N/A

Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No

As of February 2, 2000, the issuer had 3,289,607 shares of common stock issued and outstanding.

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1ST STATE BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 2000 AND SEPTEMBER 30, 2000

(IN THOUSANDS)

	AT DECEMBER 31, 2000 (Unaudited)	A SEPT 2
ASSETS		
Cash and cash equivalents	$ 20,776	
Investment securities:		
Held to maturity (fair value of $66,131 and $65,173 at December 31, 2000 and September 30, 2000, respectively)	66,705	
Available for sale (cost of $9,961 and $10,019 at December 31, 2000 and September 30, 2000, respectively)	9,864	
Loans held for sale, at lower of cost or fair value	3,753	
Loans receivable (net of allowance for loan losses of $3,564 and $3,536 at December 31, 2000 and September 30, 2000, respectively)	229,785	
Federal Home Loan Bank stock, at cost	1,650	
Premises and equipment	8,709	
Accrued interest receivable	2,563	
Other assets	3,343	
Total assets	$347,148	
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Deposit accounts	$258,070	
Advances from Federal Home Loan Bank	25,000	
Advance payments by borrowers for property taxes and insurance	354	
Dividend payable	263	
Other liabilities	3,166	
Total liabilities	286,853	
Stockholders' Equity:		
Preferred stock, $0.01 par value, 1,000,000 shares authorized; none issued	--	
Common stock, $0.01 par value, 7,000,000 shares authorized; 3,289,607 shares issued and outstanding	33	
Additional paid-in capital	35,579	
Unearned ESOP shares	(4,813)	
Unearned compensation - management recognition plan	(1,101)	
Deferred compensation	2,928	
Treasury stock for deferred compensation	(2,928)	
Retained income - substantially restricted	30,659	
Accumulated other comprehensive loss - net unrealized loss on investment securities available for sale	(62)	
Total stockholders' equity	60,295	
Total liabilities and stockholders' equity	$347,148	

See accompanying notes to the consolidated financial statements.

1ST STATE BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

FOR THE THREE MONTHS ENDED DECEMBER 31, 2000 AND 1999

(IN THOUSANDS, EXCEPT PER SHARE DATA)

(UNAUDITED)

	FOR THE THREE MONTHS EN DECEMBER 31,	
	2000	19
Interest income:		
Interest and fees on loans	$ 5,090	4,3
Interest and dividends on investments	1,217	1,4
Overnight deposits	203	
Total interest income	6,510	5,9
Interest expense:		
Deposit accounts	2,977	2,3
Borrowings	303	3
Total interest expense	3,280	2,6
Net interest income	3,230	3,2
Provision for loan losses	60	
Net interest income after provision for loan losses	3,170	3,2
Other income:		
Service fees on loans sold	20	
Customer service fees	156	1
Commissions from sales of annuities and mutual funds	111	
Mortgage banking income (loss), net	128	(
Other	42	
Total other income	457	2
Operating expenses:		
Compensation and related benefits	1,543	1,1
Occupancy and equipment	277	2
Deposit insurance premiums	12	
Other expenses	411	2
Total operating expenses	2,243	1,7
Income before income taxes	1,384	1,6
Income taxes	483	5

Net income	$ 901	1,0
	=========	=====
Earnings per share:		
Basic	$ 0.30	$ 0.
Diluted	$ 0.29	$ 0.

See accompanying notes to the consolidated financial statements.

1ST STATE BANCORP, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME
FOR THE THREE MONTHS ENDED DECEMBER 31, 2000 AND 1999
(UNAUDITED)
(IN THOUSANDS)

	COMMON STOCK	ADDITIONAL PAID-IN CAPITAL
Balance at September 30, 1999	$ 32	49,216
Comprehensive income:		
Net income	--	--
Other comprehensive income-unrealized loss on securities available-for-sale net of income taxes of $45	--	--
Total comprehensive income		
Release of ESOP shares	--	2
Deferred compensation	--	--
Treasury stock held for deferred compensation	--	--
Cash dividend declared	--	--
Cash dividend on unallocated ESOP shares	--	--
	----	------
Balance at December 31, 1999	$ 32	49,218
	====	======
Balance at September 30, 2000	$ 33	35,587
Comprehensive income:		
Net income	--	--
Other comprehensive income-unrealized loss on securities available-for-sale net of income taxes of $68	--	--
Total comprehensive income		
Release of ESOP shares	--	(8)
Deferred compensation	--	--
Treasury stock held for deferred compensation	--	--

MRP share amortization	--	--
Cash dividend declared	--	--
Cash dividend on unallocated ESOP shares	--	--
Balance at December 31, 2000	$ 33	35,579

	DEFERRED COMPENSATION	TREASURY STOCK FOR DEFERRED COMPENSATION	RETAINED INCOME	OTHE COMPRE INCOME
Balance at September 30, 1999	2,373	(2,373)	26,960	(123
Comprehensive income:				
Net income	--	--	1,092	--
Other comprehensive income-unrealized loss on securities available-for-sale net of income taxes of $45	--	--	--	(67
Total comprehensive income				
Release of ESOP shares	--	--	--	--
Deferred compensation	217	--	--	--
Treasury stock held for deferred compensation	--	(217)	--	--
Cash dividend declared	--	--	(253)	--
Cash dividend on unallocated ESOP shares	--	--	18	--
Balance at December 31, 1999	2,590	(2,590)	27,817	(190
Balance at September 30, 2000	2,679	(2,679)	29,999	(164
Comprehensive income:				
Net income	--	--	901	--
Other comprehensive income-unrealized loss on securities available-for-sale net of income taxes of $68	--	--	--	102
Total comprehensive income				
Release of ESOP shares	--	--	--	--
Deferred compensation	249	--	--	--
Treasury stock held for deferred compensation	--	(249)	--	--
MRP share amortization	--	--	--	--
Cash dividend declared	--	--	(263)	--
Cash dividend on unallocated ESOP shares	--	--	22	--
Balance at December 31, 2000	2,928	(2,928)	30,659	(62

See accompanying notes to the consolidated financial statements.

1ST STATE BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE THREE MONTHS ENDED DECEMBER 31, 2000 AND 1999

(UNAUDITED)

(IN THOUSANDS)

	FOR THE THREE MONTHS EN DECEMBER 31,	
	2000	19
Cash flows from operating activities:		
Net income	$ 901	$ 1,
Adjustment to reconcile net income to net cash provided by (used in) operating activities:		
Provision for loan losses	60	
Depreciation	146	
Deferred tax expense	(38)	
Amortization of premiums and discounts, net	(5)	
Release of ESOP shares	129	
Vesting of MRP shares	263	
Loan origination fees and unearned discounts deferred, net of current amortization	44	
Net loss on sale of loans	63	
Proceeds from loans held for sale	6,195	2,
Originations of loans held for sale	(5,164)	(3,
Decrease (increase) in other assets	111	
Decrease in accrued interest receivable	90	
Decrease in other liabilities	(1,326)	(2,
Net cash provided by (used in) operating activities	1,469	(1,
Cash flows from investing activities:		
Purchase of FHLB stock	--	(
Purchases of investment securities held to maturity	--	(1,
Proceeds from maturities of investment securities available for sale	60	1,
Proceeds from maturities of investment securities held to maturity	530	2,
Net increase in loans receivable	(5,608)	(6,
Purchases of premises and equipment	(402)	
Net cash used in investing activities	(5,420)	(6,

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1ST STATE BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS - CONTINUED

FOR THE THREE MONTHS ENDED DECEMBER 31, 2000 AND 1999

(UNAUDITED)

(IN THOUSANDS)

	FOR THE THREE MONTHS EN DECEMBER 31,	
	2000	19
Cash flows from financing activities:		
Net increase (decrease) in deposits	$ 3,665	$ (5,
Advances from the Federal Home Loan Bank	5,000	11,
Repayments of advances from Federal Home Loan Bank	--	(2,
Return of capital dividend payment	(17,007)	
Dividends paid on common stock	(241)	(
Increase in advance payments by borrowers for property taxes and insurance	203	
Net cash provided by (used in) financing activities	(8,380)	3,
Net decrease in cash and cash equivalents	(12,331)	(3,
Cash and cash equivalents at beginning of period	33,107	15,
Cash and cash equivalents at end of period	$ 20,776	$ 11,
Payments are shown below for the following:		
Interest	$ 3,342	$ 2,
Income taxes	$ 27	$
Noncash investing and financing activities:		
Deferred compensation to be settled in Company's stock	$ 249	$
Unrealized gains (losses) on investment securities available for sale	$ 170	$ (
Cash dividends declared but not paid	$ 241	$
Cash dividends on unallocated ESOP and MRP shares	$ 22	$
Transfer from loans held for sale to loans receivable	$ 686	$

See accompanying notes to consolidated financial statements.

1ST STATE BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2000 (UNAUDITED) AND SEPTEMBER 30, 2000

NOTE 1. NATURE OF BUSINESS

1st State Bancorp, Inc. (the "Company") was incorporated under the laws of the Commonwealth of Virginia for the purpose of becoming the holding company for 1st State Bank (the "Bank") in connection with the Bank's conversion from a North Carolina-chartered mutual savings bank to a North Carolina-chartered stock savings bank (the "Converted Bank") pursuant to its Plan of Conversion (the "Stock Conversion"). Upon completion of the Stock Conversion, the Bank converted from a North Carolina-chartered stock savings bank to a North Carolina commercial bank (the "Bank Conversion"), retaining the name 1st State Bank (the "Commercial Bank"), and the Commercial Bank succeeded to all of the assets and liabilities of the Converted Bank. The Stock Conversion and the Bank Conversion were consummated on April 23, 1999. The common stock of the Company began trading on the Nasdaq National Market System under the symbol "FSBC" on April 26, 1999.

NOTE 2. BASIS OF PRESENTATION

The accompanying consolidated financial statements (which are unaudited, except for the consolidated balance sheet at September 30, 2000, which is derived from the September 30, 2000 audited consolidated financial statements) have been prepared in accordance with generally accepted accounting principles for interim financial information and with the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (none of which were other than normal recurring accruals) necessary for a fair presentation of the financial position and results of operations for the periods presented have been included.

The results of operations for the three month period ended December 31, 2000 are not necessarily indicative of the results of operations that may be expected for the year ended September 30, 2001. The preparation of consolidated financial statements in accordance with generally accepted accounting principles requires management to make certain estimates. These amounts may be revised in future periods because of changes in the facts and circumstances underlying their estimation.

NOTE 3. EARNINGS PER SHARE

The Company's earnings per share for the three month period ended December 31, 2000 is based on basic and diluted weighted average shares of 3,007,030 and 3,152,285,respectively, of common stock outstanding, excluding ESOP and MRP benefit plan shares not committed to be released or granted. For the three month period ended December 31, 1999, both basic and diluted weighted average shares were 2,935,902.

	2000	1
Average shares outstanding, excluding MRP shares	3,163,125	3,
Add: weighted average vested MRP shares issued	42,163	
Less: weighted average unallocated ESOP shares	(198,258)	(
	---------	--

Basic shares for earnings per share	3,007,030	2,
Add: unvested MRP shares	84,319	
Add: potential common stock pursuant to stock option plan (See Note 7)	60,936	
Dilutive shares for earnings per share	3,152,285	2,

NOTE 4. EMPLOYEE STOCK OWNERSHIP PLAN ("ESOP")

The Company sponsors an employee stock ownership plan (the "ESOP") whereby an aggregate number of shares amounting to 253,050 or 8% of the stock issued in the conversion was purchased for future allocation to employees. The ESOP was funded by an 11 year term loan from the Company in the amount of $4,899,000. The loan is secured by the shares of stock

purchased by the ESOP. During the three months ended December 31, 2000 and 1999, 7,097 and 7,331 shares of stock were committed to be released and approximately $129,000 and $144,000 of compensation expense was recognized, respectively.

NOTE 5. DEFERRED COMPENSATION

Directors and certain executive officers participate in a deferred compensation plan, which was approved by the Board of Directors on September 24, 1997. This plan generally provides for fixed payments beginning after the participant retires. Each participant is fully vested in his account balance under the plan. Directors may elect to defer their directors' fees and executive officers may elect to defer 25% of their salary and 100% of bonus compensation.

Prior to the Conversion, amounts deferred by each participant accumulated interest at a rate equal to the highest rate of interest paid on the Bank's one-year certificates of deposit. In connection with the Conversion, participants in the plan were given the opportunity to prospectively elect to have their deferred compensation balance earn a rate of return equal to the total return of the Company's stock. All participants elected this option concurrent with the Conversion, so the Company purchases its common stock to fund this obligation. Refer to the Company's notes to consolidated financial statements, incorporated by reference in the Company's 2000 Annual Report on Form 10-K for a discussion of the Company's accounting policy with respect to this deferred compensation plan and the related treasury stock purchased by the Company to fund this obligation.

The expense related to this plan for the three months ended December 31, 2000 and 1999 was $68,000 and $39,000, respectively. This expense is included in compensation expense.

NOTE 6. MANAGEMENT RECOGNITION PLAN

The Company has a Management Recognition Plan ("MRP") which serves as a means of providing existing directors and officers of the bank with an ownership interest in the company. On June 6, 2000, restricted stock awards of 126,482 shares were granted. The shares awarded under the MRP were issued from authorized but unissued shares of common stock at no cost to the recipients. The shares vest at a rate of 33 1/3% per year with a one-third immediate vest on the date of the grant. Compensation expense of $263,000 associated with the MRP was recorded during the quarter ended December 31, 2000.

NOTE 7. STOCK OPTION AND INCENTIVE PLAN

On June 6, 2000 the Company's stockholders approved the 1st State Bancorp, Inc. 2000 Stock Option and Incentive Plan (the "Plan"). The purpose of this plan is to advance the interests of the Company through providing select key employees and directors of the Bank with the opportunity to acquire shares. By encouraging such stock ownership, the Company seeks to attract, retain and motivate the best available personnel for positions of substantial responsibility and to provide incentives to the key employees and directors. Under the Plan, the Company granted 316,312 options to purchase its $0.01 par value common stock in fiscal year 2000. The exercise price per share is equal to the fair market value per share on the date of the grant of the stock.

NOTE 8. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

In June 1998 the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Certain Hedging Activities." In June 1999 the FASB issued SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities, an Amendment of SFAS 133." SFAS No. 133 and SFAS No. 138 require that all derivative instruments be recorded on the balance sheet at their respective fair values. Changes in the fair values of those derivatives will be reported in earnings or other comprehensive income depending on the use of the derivative and whether the derivative qualifies for hedge accounting. SFAS No. 133 and SFAS No. 138 are effective for all fiscal quarters of all fiscal years beginning after June 30, 2000; the Company adopted SFAS No. 133, as amended by SFAS No. 138, on October 1, 2000.

On October 1, 2000, the Company had no embedded derivative instruments requiring separate accounting treatment and had identified fixed rate conforming loan commitments as its only freestanding derivative instrument. The Company does not currently engage in hedging activities. The commitments to originate fixed rate conforming loans totaled $664,000 and $ 1,114,000 at December 31, 2000 and October 1, 2000, respectively. The fair value of these commitments was less than $ 5,000 on these dates and therefore the adoption of SFAS 133 on October 1, 2000 as well as the impact of applying SFAS 133 at December 31, 2000 was not material to the Company's consolidated financial statements.

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

FORWARD-LOOKING STATEMENTS

When used in this Form 10-Q, the words or phrases "will likely result," "are expected to," "will continue," "is anticipated," "estimate," "project" or similar expressions are intended to identify "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements are subject to certain risks and uncertainties including changes in economic conditions in our market area, changes in policies by regulatory agencies, fluctuations in interest rates, demand for loans in our market area, and competition that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. We wish to caution you not to place undue reliance on any such forward-looking statements, which speak only as of the date made. We wish to advise you that the factors listed above could affect our financial performance and could cause our actual results for future periods to differ materially from any opinions or statements expressed with respect to future periods in any current statements.

We do not undertake, and specifically disclaim any obligation, to publicly release the result of any revisions which may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

COMPARISON OF FINANCIAL CONDITION AT DECEMBER 31, 2000 AND SEPTEMBER 30, 2000

Total assets decreased by $8.4 million or 2.4% from $355.5 million at September 30, 2000 to $347.1 million at December 31, 2000. This decrease was largely a result of the $17.0 million return of capital dividend which was paid to stockholders on October 2, 2000.

Cash and cash equivalents decreased $12.3 million, or 37.2%, from $33.1 million at September 30, 2000 to $20.8 million at December 31, 2000. The decrease in cash and cash equivalents resulted primarily from the payment of the $17.0 million return of capital dividend on October 2, 2000. This decrease was partially offset by an increase in cash and cash equivalents from an increase of $5.0 million in borrowed money. Investment securities, both available for sale and held to maturity, were relatively unchanged. Investments decreased a combined total of $400,000, or 0.5%, from $77.0 million at September 30, 2000 to $76.6 million at December 31, 2000.

Loans receivable, net increased by $6.2 million, or 2.8%, from $223.6 million at September 30, 2000 to $229.8 million at December 31, 2000. This increase was offset somewhat by a $1.7 million decrease in loans held for sale. Loans held for sale decreased 30.9% from $5.5 million at September 30, 2000 to $3.8 million at December 31, 2000. Commercial loans increased $6.0 million, or 14.0%, compared to September 30, 2000 levels reflecting current loan demand. Interest rates declined during the quarter and we sold more of our mortgage production. We continue to emphasize commercial, commercial real estate, consumer loans and equity lines of credit that carry variable rates and/or short term maturities.

Stockholders' equity increased by $1.1 million from $59.2 million at September 30, 2000 to $60.3 million at December 31, 2000 as a result of net income of $901,000, release of ESOP shares of $129,000, vesting of MRP shares of $195,000, and a decrease in unrealized losses on available for sale securities of $102,000. These increases were offset by dividends declared of $241,000.

COMPARISON OF OPERATING RESULTS FOR THE THREE MONTHS ENDED DECEMBER 31, 2000 AND 1999

Net Income. We recorded net income of $901,000 for the quarter ended December 31, 2000, as compared to $1,092,000 for the quarter ended December 31, 1999, representing a decrease of $191,000, or 17.5%. For the three months ended December 31, 2000 basic and diluted earnings per share were $0.30 and $0.29, respectively. The Company reported basic and diluted earnings per share for the quarter ended December 31, 1999 of $0.37 per share. The decrease in net income resulted primarily from decreased net interest income and increased operating expenses that were offset partially by increased other income and decreased income taxes. The decline in net interest income resulted from the impact of the decline in cash equivalents used to fund the special return on capital dividend of $17.0 million, which was paid on October 2, 2000 and decreased net interest margins. The return of capital dividend decreased the ratio of average interest-earning assets to average interest-bearing liabilities from 126.2% for the three months ended December 31, 1999 to 121.0% for the three months ended December 31, 2000.

Net Interest Income. Net interest income, the difference between interest earned on loans and investments and interest paid on interest-bearing liabilities, decreased by $36,000 or 1.1% for the three months ended December 31, 2000, compared to the same quarter in the prior year. This decrease reflects a $554,000 increase in interest income that was more than offset by the $590,000

increase in total interest expense. The average net interest margin decreased 15 basis points from 4.16% for the three months ended December 31, 1999 to 4.01% for the quarter ended December 31, 2000.

Interest Income. The increase in interest income for the three months ended December 31, 2000 was due to an increase of $8.6 million in average interest-earning assets compared to the same quarter in the prior year and an increase in yield on interest-earning assets of 0.49% from 7.59% for the three months ended December 31, 1999 to 8.08% for the three months ended December 31, 2000. The increased volume of average interest-earning assets increased interest income by approximately $250,000 and the increased yield increased interest income by approximately $304,000. An increase in average loans outstanding of $20.4 million coupled with an increase in average interest-bearing overnight funds of $5.5 million increased interest-earning assets for the quarter compared to the prior year. These increases were offset in part by a decrease in average investments of $17.3 million. Average investments decreased to provide cash to pay the special return of capital dividend.

Interest Expense. Interest expense increased in the three months ended December 31, 2000 due to an increase in average interest-bearing liabilities of $17.7 million and an increase in the cost of interest-bearing liabilities of 60 basis points from 4.33% for the three months ended December 31, 1999 to 4.93% for the three months ended December 31, 2000. Average deposits increased by $21.6 million while average FHLB advances decreased $3.9 million for the three months ended December 31, 2000 compared to the same quarter in the prior year. The increase in average interest-bearing liabilities increased interest expense by approximately $183,000 while the increase in the average cost of interest-bearing liabilities increased interest expense by approximately $407,000.

The following table presents average balances and average rates earned/paid by the Company for the quarter ended December 31, 2000 compared to the quarter ended December 31, 1999.

	THREE MONTHS ENDED DECEMBER 31, 2000			
			DOLLARS IN THOUSANDS	
	AVERAGE BALANCE	INTEREST	YIELD/ COST	AVE BAL
Assets:				
Loans receivable (1)	231,424	5,090	8.80%	21
Investment securities (2)	78,560	1,217	6.20	9
Interest-bearing overnight deposits	12,340	203	6.58	
Total interest-earning assets	322,324	6,510	8.08	31
Non interest-earning assets	21,881			2
Total assets	344,205			33
Liabilities and stockholders' equity:				

Deposits	244,755	2,977	4.87%	22
FHLB advances	21,630	303	5.60	2
Total interest-earning liabilities	266,385	3,280	4.93	24
Non interest-earning liabilities	17,995			1
Total liabilities	284,380			26
Stockholders' equity	59,825			7
Total liabilities and stockholders' equity	344,205			33
Net interest income		3,230		
Interest rate spread			3.15%	
Net interest margin (3)			4.01%	
Ratio of average interest-earning assets to average interest-bearing liabilities			121.00%	

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Provision for Loan Losses. The provision for loan losses is charged to earnings to maintain the total allowance for loan losses at a level considered adequate to absorb estimated probable losses inherent in the loan portfolio based on existing loan levels and types of loans outstanding, nonperforming loans, prior loan loss experience, general economic conditions and other factors. Provisions for loan losses totaled $60,000 for both the three months ended December 31, 2000 and 1999.

Other Income. Other income increased $250,000, or 120.8%, from $207,000 for the quarter ended December 31 1999 to $457,000 for the quarter ended December 31, 2000. Mortgage banking income, net increased $211,000 from a loss of $83,000 for the quarter ended December 31, 1999 to income of $128,000 for the quarter ended December 31, 2000. During the quarter ended December 31, 2000, we sold fixed-rate mortgage loans held for sale of $6.2 million and recognized a $108,000 gain on the sale. The Bank was also able to record a nominal recovery on its lower of cost or fair value valuation reserve on loans held for sale of $20,000. During the quarter ended December 31, 1999, we sold fixed-rate mortgage loans held for sale of $2.5 million and recognized a gain of $36,000 from the sale of these loans; however, the increase in interest rates during this quarter required a $119,000 charge to earnings to record the loans held for sale to the lower of cost or fair value. Customer service fees increased $15,000, or 10.6% from $141,000 for the quarter ended December 31, 1999 to $156,000 for the quarter ended December 31, 2000. This increase results primarily from growth in the number of transaction accounts. In addition, during the quarter ended December 31, 2000, commissions from sales of annuities and mutual funds increased $31,000 or 38.8% from $80,000 for the quarter ended December 31, 1999 to $111,000 for the quarter ended December 31, 2000. The increase resulted from a slightly higher volume of sales of annuities and mutual fund products.

Operating Expenses. Total operating expenses were $2.2 million for the quarter ended December 31, 2000, an increase of $500,000, or 29.4% over the $1.7 million recorded for the three months ended December 31, 1999. Compensation and related benefits expense increased $300,000, or 25.0% from $1.2 million for the quarter ended December 31, 1999 to $1.5 million for the quarter ended December 31, 2000. This increase was primarily the result of the MRP expense of $263,000 for the quarter ended December 31, 2000, which was not present in 1999. The increases in other categories of operating expenses generally are attributable to the growth of the Company including the operating expenses associated with the Bank's seventh branch, which opened on September 27, 2000. We expect that other operating expenses will continue to increase in subsequent periods as a result of increased cost associated with operating a public company.

Income Tax Expense. Income tax expense decreased $94,000 from tax expense of $577,000 for the quarter ended December 31, 1999 to $483,000 for the quarter ended December 31, 2000. The decrease resulted from a $285,000 decrease in income before income taxes. The effective tax rates were 34.9% and 34.6% for the quarters ended December 31, 2000 and 1999, respectively.

ASSET QUALITY

At December 31, 2000, we had approximately $3.0 million of loans in nonaccrual status as compared with $2.9 million at September 30, 2000. At December 31, 2000 and September 30, 2000, impaired loans totaled $2.5 million and $2.6 million, respectively, as defined by Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan." The impaired loans result from two unrelated loan customers, both of which have loans secured by commercial real estate properties in Alamance County. At December 31, 2000, all of the $2.5 million of impaired loans is on non-accrual status, and their related reserve for loan losses totaled $245,000. There was no impact on the provision as management had already anticipated the loans' performance in setting the allowance for loan losses in previous periods. The average carrying value of impaired loans was $2.7 million during the three months ended December 31, 2000. No interest income was recognized on these impaired loans during the three months ended December 31, 2000. All amounts received on these impaired loans have been recorded as a reduction of the principal balance of the loan. The Bank's net chargeoffs for the three months ended December 31, 2000 and 1999 were $32,000 and $1,000, respectively. The allowance for loan losses was $3.6 million or 1.53% of outstanding loans at December 31, 2000. This compares to 1.56 % at September 30, 2000 and 1.71% at December 31, 1999.

LIQUIDITY AND CAPITAL RESOURCES

The Bank must meet certain liquidity requirements established by the State of North Carolina Office of the Commissioner of Banks (the "Commissioner"). At December 31, 2000, the Bank's liquidity ratio exceeded such requirements. Liquidity generally refers to the Bank's ability to generate adequate amounts of funds to meet its cash needs. Adequate liquidity guarantees

that sufficient funds are available to meet deposit withdrawals, fund loan commitments, maintain adequate reserve requirements, pay operating expenses, provide funds for debt service, pay dividends to stockholders and meet other general commitments.

Our primary sources of funds are deposits, principal and interest payments on loans, proceeds from the sale of loans, and to a lesser extent, advances from the FHLB of Atlanta. While maturities and scheduled amortization of loans are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and local competition.

Our most liquid assets are cash and cash equivalents. The levels of these assets are dependent on our operating, financing, lending and investing activities during any given period. At December 31, 2000, cash and cash equivalents totaled $20.8 million. We have other sources of liquidity should we need additional funds. During the three months ended December 31, 2000 and 1999, we sold loans totaling $6.2 million and $2.5 million, respectively. Additional sources of funds include FHLB of Atlanta advances. Other sources of liquidity include loans and investment securities designated as available for sale, which totaled $13.6 million at December 31, 2000.

We anticipate that we will have sufficient funds available to meet our current commitments. At December 31, 2000, we had $5.9 million in commitments to originate new loans, $56.2 million in unfunded commitments to extend credit under existing equity lines and commercial lines of credit and $1.8 million in standby letters of credit. At December 31, 2000, certificates of deposit, which are scheduled to mature within one year, totaled $132.1 million. We believe that a significant portion of such deposits will remain with us.

The FDIC requires the Bank to meet a minimum leverage capital requirement of Tier I capital to assets ratio of 4%. The FDIC also requires the Bank to meet a ratio of total capital to risk-weighted assets of 8%, of which 4% must be in the form of Tier I capital. The Commissioner requires the Bank at all times to maintain certain minimum capital levels. The Bank was in compliance with all capital requirements of the FDIC and the Commissioner at December 31, 2000 and is deemed to be "well capitalized."

The Federal Reserve also mandates capital requirements on all bank holding companies, including 1st State Bancorp, Inc. These capital requirements are similar to those imposed by the FDIC on the Bank. At December 31, 2000, the Company was in compliance with the capital requirements of the Federal Reserve.

ACCOUNTING ISSUES

In June 1998 the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Certain Hedging Activities." In June 1999 the FASB issued SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities, an Amendment of SFAS 133." SFAS No. 133 and SFAS No. 138 require that all derivative instruments be recorded on the balance sheet at their respective fair values. Changes in the fair values of those derivatives will be reported in earnings or other comprehensive income depending on the use of the derivative and whether the derivative qualifies for hedge accounting. SFAS No. 133 and SFAS No. 138 are effective for all fiscal quarters of all fiscal years beginning after June 30, 2000; the Company adopted SFAS No. 133, as amended by SFAS No. 138, on October 1, 2000.

On October 1, 2000, the Company had no embedded derivative instruments requiring separate accounting treatment and had identified fixed rate conforming loan commitments as its only freestanding derivative instrument. The Company does not currently engage in hedging activities. The commitments to originate fixed rate conforming loans totaled $664,000 and $ 1,114,000 at December 31, 2000 and October 1, 2000, respectively. The fair value of these commitments was less than $ 5,000 on these dates and therefore the adoption of SFAS 133 on October 1, 2000 as well as the impact of applying SFAS 133 at December 31, 2000 was not material to the Company's consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company monitors whether material changes in market risk have occurred since September 30, 2000. The Company does not believe that any material adverse changes in market risk exposures occurred since September 30, 2000.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

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

None

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a.) Exhibits. None.

(b.) Reports on Form 8-K. During the quarter ended December 31, 2000, the registrant did not file any current reports on Form 8-K.

SIGNATURES

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

1ST STATE BANCORP, INC.

Date: February 7, 2001

/s/ James C. McGill
James C. McGill
President and Chief Executive Officer
(Principal Executive Officer)

Date: February 7, 2001

/s/ A. Christine Baker
A. Christine Baker
Executive Vice President
Treasurer and Secretary
(Principal Financial and Accounting Officer)