

FENTURA FINANCIAL INC

Form 10-Q

August 14, 2008

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q**

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended **June 30, 2008**

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE EXCHANGE ACT
For the transition period from _____ to _____

Commission file number 000-23550

Fentura Financial, Inc.

(Exact name of registrant as specified in its charter)

Michigan

38-2806518

(State or other jurisdiction of incorporation or organization)

(IRS Employee Identification No.)

175 N Leroy, P.O. Box 725, Fenton, Michigan 48430

(Address of Principal Executive Offices)

(810) 629-2263

(Registrant's telephone number)

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

(Do not check if a smaller reporting company)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: July 30, 2008

Class	Common Stock	Shares Outstanding	2,175,664
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<u>Section 1350 Certificate of the CFO</u>	

Table of Contents**PART I FINANCIAL INFORMATION****ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS****Fentura Financial, Inc.****Consolidated Balance Sheets**

	June 30, 2008	Dec 31, 2007
(000 s omitted except share data)	(unaudited)	
ASSETS		
Cash and due from banks	\$ 16,147	\$ 22,734
Federal funds sold	0	7,300
Total cash & cash equivalents	16,147	30,034
Securities-available for sale	58,028	71,792
Securities-held to maturity, (fair value of \$8,151 at June 30, 2008 and \$8,714 at December 31, 2007)	8,179	8,685
Total securities	66,207	80,477
Loans held for sale	448	1,655
Loans:		
Commercial	318,109	313,642
Real estate loans - construction	51,569	59,805
Real estate loans - mortgage	37,023	39,817
Consumer loans	58,155	58,139
Total loans	464,856	471,403
Less: Allowance for loan losses	(12,778)	(8,554)
Net loans	452,078	462,849
Bank Owned Life Insurance	7,150	7,042
Bank premises and equipment	19,307	20,101
Federal Home Loan Bank stock	2,032	2,032
Accrued interest receivable	2,506	2,813
Goodwill	7,955	7,955
Acquisition intangibles	377	485
Equity Investment	2,631	3,089
Other assets	9,069	9,487
Total Assets	\$ 585,907	\$ 628,019
LIABILITIES		
Deposits:		
Non-interest bearing deposits	\$ 78,867	\$ 75,148
Interest bearing deposits	426,605	468,355
Total deposits	505,472	543,503
Short term borrowings	3,458	649

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Federal Home Loan Bank Advances	14,007	11,030
Repurchase Agreements	0	5,000
Subordinated debentures	14,000	14,000
Accrued taxes, interest and other liabilities	2,471	4,341
Total liabilities	539,408	578,523
SHAREHOLDERS EQUITY		
Common stock no par value 2,175,184 shares issued (2,163,385 at Dec. 31, 2007)	42,695	42,478
Retained earnings	4,691	7,488
Accumulated other comprehensive income (loss)	(887)	(470)
Total shareholders equity	46,499	49,496
Total Liabilities and Shareholders Equity	\$ 585,907	\$ 628,019

See notes to consolidated financial statements.

Table of Contents**Fentura Financial, Inc.
Consolidated Statements of Income (Unaudited)**

	Three Months Ended June 30		Six Months Ended June 30	
	2008	2007	2008	2007
(000 s omitted except per share data)				
INTEREST INCOME				
Interest and fees on loans	\$ 7,457	\$ 8,917	\$ 15,561	\$ 17,564
Interest and dividends on securities:				
Taxable	565	801	1,193	1,718
Tax-exempt	151	180	268	395
Interest on federal funds sold	16	44	114	211
Total interest income	8,189	9,942	17,136	19,888
INTEREST EXPENSE				
Deposits	3,285	3,990	7,312	7,951
Borrowings	439	560	935	1,145
Total interest expense	3,724	4,550	8,247	9,096
NET INTEREST INCOME	4,465	5,392	8,889	10,792
Provision for loan losses	3,811	649	4,892	1,088
Net interest income after Provision for loan losses	654	4,743	3,997	9,704
NON-INTEREST INCOME				
Service charges on deposit accounts	715	836	1,489	1,687
Gain on sale of mortgage loans	100	119	218	203
Trust and investment services income	518	461	974	968
Other income and fees	220	612	430	1,035
Total non-interest income	1,553	2,028	3,111	3,893
NON-INTEREST EXPENSE				
Salaries and employee benefits	2,935	3,193	5,937	6,440
Occupancy	531	510	1,082	1,013
Furniture and equipment	536	534	1,030	1,059
Loan and collection	378	85	544	176
Advertising and promotional	145	159	249	271
Loss on security impairment	36	0	610	0
Other operating expenses	954	1,117	1,969	2,135
Total non-interest expense	5,515	5,598	11,421	11,094

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INCOME (LOSS) BEFORE TAXES	(3,308)	1,173	(4,313)	2,503
Federal income taxes/(benefit)	(1,140)	329	(1,516)	711
NET INCOME (LOSS)	\$ (2,168)	\$ 844	\$ (2,797)	\$ 1,792
Per share:				
Net income (loss) basic	\$ (1.00)	\$ 0.39	\$ (1.29)	\$ 0.83
Net income (loss) diluted	\$ (1.00)	\$ 0.39	\$ (1.29)	\$ 0.83
Cash Dividends declared	\$ 0.00	\$ 0.25	\$ 0.00	\$ 0.50

See notes to consolidated financial statements.

Table of Contents**Fentura Financial, Inc.****Consolidated Statements of Changes in Shareholders' Equity (Unaudited)**

(000 s omitted)	Six Months Ended	
	2008	2007
		June 30,
COMMON STOCK		
Balance, beginning of period	\$ 42,478	\$ 42,158
Issuance of shares under		
Director stock purchase plan & Dividend reinvestment program(11,799 and 14,677 shares)	213	458
Stock repurchase (0 and 3,784 shares)	0	(112)
Stock options exercised (0 and 295 shares)	0	6
Stock compensation expense	4	28
Balance, end of period	42,695	42,538
RETAINED EARNINGS		
Balance, beginning of period	7,488	10,118
Net income (loss)	(2,797)	1,792
Cash dividends declared	0	(1,083)
Balance, end of period	4,691	10,827
ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)		
Balance, beginning of period	(470)	(958)
Change in unrealized gain (loss) on securities available for sale, net of tax	(417)	(80)
Balance, end of period	(887)	(1,038)
TOTAL SHAREHOLDERS' EQUITY	\$ 46,499	\$ 52,327

See notes to consolidated financial statements.

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**Fentura Financial, Inc.
Consolidated Statements of Cash Flows (Unaudited)**

	Six Months Ended	
	June 30,	
(000 s omitted)	2008	2007

See notes to consolidated financial statements

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Table of Contents**Fentura Financial, Inc.
Consolidated Statements of Comprehensive Income (Unaudited)**

(000 s Omitted)	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Net Income (loss)	\$ (2,168)	\$ 844	\$ (2,797)	\$ 1,792
Other comprehensive income (loss), net of tax:				
Unrealized holding gains (losses) arising during period	(791)	(343)	(1,027)	(80)
Less: Impairment loss recognized during period	(36)	0	(610)	0
Other comprehensive income (loss)	(755)	(343)	(417)	(80)
Comprehensive income (loss)	\$ (2,923)	\$ 501	\$ (3,214)	\$ 1,712

Fentura Financial, Inc.**Notes to Consolidated Financial Statements (Unaudited)****Note 1 Basis of Presentation**

The consolidated financial statements at December 31, 2007 and June 30, 2008 include Fentura Financial, Inc. (the Corporation) and its wholly owned subsidiaries, The State Bank in Fenton, Michigan; Davison State Bank in Davison, Michigan; and West Michigan Community Bank in Hudsonville, Michigan (the Banks), as well as Fentura Mortgage Company, West Michigan Mortgage Company, LLC, and the other subsidiaries of the Banks. Intercompany transactions and balances are eliminated in consolidation.

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the six months ended June 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008. For further information, refer to the consolidated financial statements and footnotes thereto included in the Corporation s annual report on Form 10-K for the year ended December 31, 2007.

Reclassifications: Some items in the prior year financial statements were reclassified to conform to the current presentation.

Securities: Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Securities are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method without anticipating prepayments. Gains and losses on sales are based on the amortized cost of the security sold. Securities are written down to fair value when a decline in fair value is not temporary.

Declines in the fair value of securities below their cost that are other than temporary are reflected as realized losses. In estimating other-than-temporary losses, management considers: the length of time and extent the fair value has been less than cost, the financial condition and near term prospects of the issuer,

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and the Corporation's ability and intent to hold the security for a period sufficient to allow for any anticipated recovery in fair value.

Allowance for Loan Losses: The allowance for loan losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan losses and decreased by charge-offs less recoveries. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed.

A loan is impaired when full payment under the loan terms is not expected. Impairment is evaluated in total for smaller-balance loans of similar nature such as residential mortgage, consumer, and on an individual loan basis for other loans. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral.

Stock Option Plans

The Nonemployee Director Stock Option Plan provides for granting options to nonemployee directors to purchase the Corporation's common stock. No options have been granted in 2008. The purchase price of the shares is the fair market value at the date of the grant, and there is a three-year vesting period before options may be exercised. Options to acquire no more than 8,131 shares of stock may be granted under the Plan in any calendar year and options to acquire not more than 73,967 shares in the aggregate may be outstanding at any one time.

The Employee Stock Option Plan grants options to eligible employees to purchase the Corporation's common stock at or above, the fair market value of the stock at the date of the grant. Awards granted under this plan are limited to an aggregate of 86,936 shares. The administrator of the plan is a committee of directors. The administrator has the power to determine the number of options to be granted, the exercise price of the options and other terms of the options, subject to consistency with the terms of the Plan.

The fair value of each option award is estimated on the date of grant using a closed form option valuation (Black-Scholes) model that uses the assumptions noted in the table below. Expected volatilities are based on historical volatilities of the Corporation's common stock. The Corporation uses historical data to estimate option exercise and post-vesting termination behavior. (Employee and management options are tracked separately.) The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. Shares that are issued upon option exercise come from authorized but unissued shares.

The following table summarizes stock option activity:

	Number of	Weighted
	Options	Average
		Price
Options outstanding at December 31, 2007	40,228	\$ 29.74
Options forfeited 2008	(3,004)	\$ 30.35
Options outstanding at June 30, 2008	37,224	\$ 29.69

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Note 2 Adoption of New Accounting Standards

Fair Value Option and Fair Value Measurements

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This Statement establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an asset. The standard is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued Staff Position (FSP) 157-2, *Effective Date of FASB Statement No. 157*. This FSP delays the effective date of FAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The Corporation adopted the standard effective January 1, 2008 and applicable disclosures have been added to the Notes to Consolidated Financial Statements.

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. The standard provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The Corporation did not elect the fair value option for any financial assets or financial liabilities as of January 1, 2008, the effective date of the standard.

Note 3 Fair Value

Statement No. 157 establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing and asset or liability.

The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used to in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs).

Table of Contents**Assets and Liabilities Measured on a Recurring Basis**

Assets and liabilities measured at fair value on a recurring basis are summarized below:

(000 s omitted)	Fair Value Measurements at June 30, 2008 Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
June 30, 2008				

Assets:

Available for sale securities	\$58,028	\$ 11	\$ 56,046	\$ 1,971
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Level 1 assets are comprised of investments in other financial institutions, which are publicly traded on the open market.

Level 2 assets are comprised of available for sale securities including, U.S. Treasuries, Government Agencies and Municipal Securities.

Level 3 assets are comprised of investments in other financial institutions including DeNovo banks.

The table below presents a reconciliation and income statement classification of gains and losses for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the six month period ended June 30, 2008:

(000 s omitted)	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)		
	Asset	Liability	Total
Beginning balance, Jan. 1, 2008	\$ 2,721	\$ 0	\$ 2,721
Total gains or losses (realized / unrealized)			
Included in earnings			
Loss on security impairment	(610)	0	(610)
Included in other comprehensive income	(140)	0	(140)
Purchases, issuances, and settlements			
Transfers in and / or out of Level 3	0	0	0
Ending balance, June 30, 2008	\$ 1,971	\$ 0	\$ 1,971

Assets and Liabilities Measured on a Non-Recurring Basis

Assets and liabilities measured at fair value on a non-recurring basis are summarized below:

June 30,	Fair Value Measurements at June 30, 2008 Using Significant		
	Quoted Prices in Active Markets for	Other Observable Inputs	Significant Unobservable Inputs

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(000 s omitted)	2008	Identical Assets (Level 1)	(Level 2)	(Level 3)
Assets:				
Impaired loans	\$24,490 10	\$ 0	\$ 0	\$ 24,490

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The following represent impairment charges recognized during the period:

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of \$24,490,059, with a valuation allowance of \$5,333,881, resulting in an additional provision for loan losses of \$2,863,000 for the period. The fair values of these loans were determined primarily using independent appraisals and are adjusted for anticipated disposition costs.

Note 4 Securities

During the quarter ended June 30, 2008, the Corporation recognized a \$35,400 other-than-temporary impairment loss on one of its DeNovo bank investments. The 2008 year to date other-than-temporary impairment recognition on this investment totals \$609,800. This investment was in an unrealized loss position at December 31, 2007 and since such time; its unrealized loss has continued to increase. The book value of this investment was \$843,200 and its market value was 18.5% less at December 31, 2007. Throughout 2007 and into 2008, this institution, based in Michigan, has experienced credit quality deterioration. The institution experienced a net operating loss for 2007 and for the first half of 2008. The institution's second quarter performance results are not yet known. Our Corporation attempted to maintain an informed position regarding this institution's performance, and as a result of current and forward looking projections, has concluded that a recovery can no longer be forecasted, and accordingly, an other-than-temporary loss has been recorded.

Note 5 Allowance for Loan Losses

Activity in the allowance for loan losses for the six month period ended June 30, 2008 and 2007 is as follows (in thousands)

	2008	2007
Balance, beginning of year	\$ 8,554	\$ 6,692
Provision for loan losses	4,892	1,088
Loans charged off	(933)	(755)
Loan recoveries	265	149
Balance, end of period	\$ 12,778	\$ 7,174

Loan impairment is measured by estimating the expected future cash flows and discounting them at the respective effective interest rate or by valuing the underlying collateral. The recorded investment in these loans is as follows at June 30, 2008 and December 31, 2007 (in thousands):

	June 30, 2008	December 31, 2007
Period end loans not requiring allocation	\$ 11,068	\$ 11,197
Period end loans requiring allocation	26,968	18,186
	\$ 38,036	\$ 29,383

Amount of the allowance for loan losses allocated \$ 6,133 \$ 2,751
Loans for which the accrual of interest has been discontinued at June 30, 2008 and December 31, 2007 amounted to \$21,360,000 and \$13,056,000, respectively, and are included in the impaired loans above. Loans past due, greater than 90 days and still accruing interest, amounted to \$2,191,000 and \$54,000 at June 30, 2008 and December 31, 2007.

Table of Contents**Note 6 Earnings Per Common Share**

A reconciliation of the numerators and denominators used in the computation of basic earnings per common share and diluted earnings per common share is presented below. Earnings per common share are presented below for the three and six month periods ended June 30, 2008 and 2007:

(\$ in thousands except per share data)	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Basic Earnings Per Common Share:				
Numerator				
Net Income (loss)	\$ (2,168,000)	\$ 844,000	\$ (2,797,000)	\$ 1,792,000
Denominator				
Weighted average common shares Outstanding	2,172,177	2,162,599	2,169,692	2,160,016
Basic earnings (loss) per common share	\$ (1.00)	\$ 0.39	\$ (1.29)	\$ 0.83
Diluted Earnings Per Common Share:				
Numerator				
Net Income (loss)	\$ (2,168,000)	\$ 844,000	\$ (2,797,000)	\$ 1,792,000
Denominator				
Weighted average common shares Outstanding for basic earnings per Common share	2,172,177	2,162,599	2,169,692	2,160,016
Add: Dilutive effects of assumed exercises of stock options	0	3,068	0	3,281
Weighted average common shares and dilutive potential common shares outstanding	2,172,177	2,165,667	2,169,873	2,163,297
Diluted earnings (loss) per common share	\$ (1.00)	\$ 0.39	\$ (1.29)	\$ 0.83

Stock options for zero shares and 181 shares of common stock for the three and six month period ended June 30, 2008 and stock options for 17,596 shares and 17,607 shares of common stock for the three and six month period ended June 30, 2007 were not considered in computing diluted earnings per common share because they were antidilutive.

Note 7 Commitments and Contingencies

There are various contingent liabilities that are not reflected in the financial statements including claims and legal actions arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, the ultimate disposition of these matters is not expected to have a material effect on the Corporation's consolidated financial condition or results of operations.

Table of Contents**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Results of Operations**

Certain of the Corporation's accounting policies are important to the portrayal of the Corporation's financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Facts and circumstances, which could affect these judgments, include, but without limitation, changes in interest rates, in the performance of the economy or in the financial condition of borrowers. Management believes that its critical accounting policies include determining the allowance for loan losses and determining the fair value of securities and other financial instruments.

As indicated in the income statement, the net loss for the three months ended June 30, 2008 was (\$2,168,000) compared to net income of \$844,000 for the same period in 2007. Net interest income in the second quarter of 2008, was \$927 thousand below net interest income for the same quarter in 2007. This is primarily due to a 17.2% decrease in interest income from declining market rates and an increase in non-performing loans that were put on non-accrual during the second quarter. Additionally, a decrease in non-interest income and a modest decrease in non-interest expense for the second quarter of 2008 also contributed to the second quarter loss. The second quarter 2008 provision for loan losses was up \$3.2 million compared to second quarter of 2007. The increase in provision is due to declining market conditions which have negatively impacted borrower capacity to repay their obligations and declining property values. Management feels the provision is adequate and the allowance for loan losses has increased \$5,604,000 when comparing year to date June 30, 2008 to June 30, 2007.

The Corporation had an \$843,200 investment in a DeNovo institution carried as available for sale. At December 31, 2007, the estimated fair value of this investment was \$687,600. Late in the first quarter of 2008, the DeNovo made information available that indicated its financial losses were beyond start up losses expected from a DeNovo and management began to conduct a financial analysis. The unrealized loss had been recorded through other comprehensive income in accordance with available for sale security accounting. Management has continued to identify more information about the DeNovo and management has concluded that a recovery can no longer be forecasted, and accordingly, an other-than-temporary loss of \$574,400 was recognized through earnings in the first quarter of 2008 and the Corporation recorded another other-than-temporary loss of \$35,400 in the second quarter of 2008. We will continue to update our financial analysis of the \$233,400 remaining investment and future losses may be recorded if the DeNovo's condition declines further.

The banking industry uses standard performance indicators to help evaluate a banking institution's performance. Return on average assets is one of these indicators. For the three months ended June 30, 2008, the Corporation's return on average assets (annualized) was (1.45%) compared to 0.55% for the same period in 2007. For six months ended June 30, 2008, the Corporation's return on average assets (annualized) was (0.92%) compared to 0.58% for the same period in 2007. Net income (loss) per share - basic and diluted was (\$1.00) in the second quarter of 2008 compared to \$0.39 net income per share basic and diluted for the same period in 2007. Net income (loss) per share - basic and diluted was (\$1.29) for the six months ended June 30, 2008 compared to \$0.83 net income per share basic and diluted for the same period in 2007.

Table of Contents**Net Interest Income**

Net interest income and average balances and yields on major categories of interest-earning assets and interest-bearing liabilities for the six months ended June 30, 2008 and 2007 are summarized in Table 2. Table 3 summarizes net interest income, average balances and yields on major categories of interest-earning assets and interest-earning liabilities for the three months ended June 30, 2008 and 2007. The effects of changes in average interest rates and average balances are detailed in Table 1 below.

Table 1

(000 \$ OMITTED)	SIX MONTHS ENDED JUNE 30, 2008 COMPARED TO 2007 INCREASE (DECREASE) DUE TO		
	VOL	YIELD/ RATE	TOTAL
Taxable Securities	\$ (481)	\$ (48)	\$ (529)
Tax-Exempt Securities	(128)	(64)	(192)
Federal Funds Sold	(16)	(81)	(97)
Total Loans	473	(2,466)	(1,993)
Loans Held for Sale	(5)	(5)	(10)
Total Earning Assets	(157)	(2,664)	(2,821)
Interest Bearing Demand Deposits	(49)	(471)	(520)
Savings Deposits	(47)	(139)	(186)
Time CD s \$100,000 and Over	346	(45)	301
Other Time Deposits	(148)	(86)	(234)
Other Borrowings	(112)	(98)	(210)
Total Interest Bearing Liabilities	(10)	(839)	(849)
Net Interest Income	\$ (147)	\$ (1,825)	\$ (1,972)

As indicated in Table 1, during the six months ended June 30, 2008, net interest income decreased compared to the same period in 2007, resulting primarily from decreasing rates on loans. Deposit interest expense decreased, as management reacted by decreasing interest bearing liability rates to be aligned with market rates during the first six months of 2008 compared to the same period in 2007.

Net interest income (displayed with consideration of full tax equivalency), average balance sheet amounts, and the corresponding yields for the three months ended June 30, 2008 and 2007 are shown in Table 3. Net interest income for the three months ended June 30, 2008 was \$4,561,000, a decrease of \$944,000, or 17.1%, over the same period in 2007. Net interest margin decreased due to a rapid decrease in interest income which was partially offset by decreases in interest bearing deposits. However, the decrease in interest expense was limited by the maturity of time deposits and their ability to re-price. Management has re-priced deposits to be competitive in the respective markets.

Additionally, increases in non-accruing loans, to a total of \$23,651,000, have had a negative impact to interest income.

Loan pricing continues to be competitive. While management strives to acquire quality credits with favorable pricing, local competition has been driving loan pricing down to unfavorable levels. As a result, the Banks have opted not to acquire minimally priced loans. Management has also addressed credit quality issues during the second quarter of 2008. This will be discussed further in the Allowance and Provision for Loan Losses section.

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Management reviews economic forecasts and strategy on a monthly basis. Accordingly, the Corporation will continue to strategically manage the balance sheet structure in an effort to create stability in net interest income. The Corporation expects to continue to seek out new loan opportunities with a focus on sound credit quality.

As indicated in Table 2, for the six months ended June 30, 2008, the Corporation's net interest margin (with consideration of full tax equivalency) was 3.27% compared with 3.93% for the same period in 2007. This decrease is a result of declines in interest income which primarily was due to decreases in yields on loans. The decrease in interest income was partially due to an increase in loans placed into non-accrual status. Those decreases outpaced the repricing ability of interest bearing liabilities, due to the large proportion of time deposits.

As indicated in Table 3, for the three months ended June 30, 2008, the Corporation's net interest margin (with consideration of full tax equivalency) was 3.35% compared with 3.91% for the same period in 2007. This decrease is a result of declines in interest income, due to an increase in loans placed into non-accrual status, versus the re-pricing ability of interest bearing liabilities. This is partially due to the large proportion of time deposits and the movement of additional deposit dollars into jumbo CD's with a higher pooled rate than other interest bearing liabilities.

Average earning assets decreased 1.7% or approximately \$9,653,000 comparing the six months of 2008 to the same time period in 2007. Loans, the highest yielding component of earning assets, represented 84.7% of earning assets in 2008 compared to 80.6% in 2007. Average interest bearing liabilities decreased .88% or \$4,293,000 comparing the first six months of 2008 to the same time period in 2007. Non-interest bearing deposits amounted to 13.1% of average earning assets in the first six months of 2008 compared with 13.2% in the same time period of 2007. For the second quarter of 2008 compared to 2007, average earning assets decreased 3.1% or \$17,434,000. The largest decrease was in the investment securities portfolio, as the funds were used to fund loans and repay borrowings. Loans increased 1.9% or \$8,710,000 comparing the second quarter of 2008 to the second quarter of 2007. Loans represented 86.0% of earning assets in 2008 compared to 81.8% in 2007. Average interest bearing liabilities decreased \$13,855,000 or 2.8% comparing the second quarter of 2008 to 2007. Non-interest bearing liabilities were 13.6% of average earning assets for the second quarter of 2008 versus 13.4% in the second quarter of 2007.

Management continually monitors the Corporation's balance sheet in an effort to insulate net interest income from significant swings caused by interest rate volatility. If market rates change in 2008, corresponding changes in funding costs will be considered to avoid the potential negative impact on net interest income. The Corporation's policies in this regard are further discussed in the section titled Interest Rate Sensitivity Management.

Table of Contents**Table 2 Average Balance and Rates**

(000 s omitted)(Annualized)	SIX MONTHS ENDED June 30,					
	AVERAGE BALANCE	2008 INCOME/ EXPENSE	YIELD/ RATE	AVERAGE BALANCE	2007 INCOME/ EXPENSE	YIELD/ RATE
ASSETS						
Securities:						
U.S. Treasury and Government						
Agencies	\$ 54,088	\$ 1,128	4.19%	\$ 77,242	\$ 1,673	4.37%
State and Political (1)	15,369	406	5.31%	19,435	598	6.21%
Other	7,987	65	1.64%	4,881	49	2.02%
Total Securities	77,444	1,599	4.15%	101,558	2,320	4.61%
Fed Funds Sold	7,685	114	2.98%	8,244	211	5.16%
Loans:						
Commercial	370,267	12,232	6.64%	354,834	13,717	7.80%
Tax Free (1)	3,278	109	6.69%	3,748	121	6.52%
Real Estate-Mortgage	38,885	1,245	6.44%	36,259	1,223	6.80%
Consumer	57,944	1,970	6.84%	60,358	2,488	8.31%
Total loans	470,374	15,556	6.65%	455,199	17,549	7.77%
Allowance for Loan Losses	(9,100)			(6,843)		
Net Loans	461,274	15,556	6.78%	448,356	17,549	7.89%
Loans Held for Sale	1,444	42	5.85%	1,599	52	6.56%
TOTAL EARNING ASSETS	\$ 556,947	\$ 17,311	6.25%	\$ 566,600	\$ 20,132	7.17%
Cash Due from Banks	15,361			17,234		
All Other Assets	47,670			44,151		
TOTAL ASSETS	\$ 610,878			\$ 621,142		
LIABILITIES & SHAREHOLDERS EQUITY:						
Deposits:						
Interest bearing DDA	\$ 96,564	\$ 669	1.39%	\$ 100,091	\$ 1,189	2.40%
Savings Deposits	83,190	391	0.95%	89,820	577	1.30%
Time CD s \$100,000 and Over	150,553	3,642	4.86%	135,472	3,341	4.97%
Other Time CD s	119,657	2,610	4.39%	125,369	2,844	4.57%
Total Deposits	449,964	7,312	3.27%	450,752	7,951	3.56%
Other Borrowings	34,759	935	5.41%	38,264	1,145	6.03%
INTEREST BEARING LIABILITIES	\$ 484,723	\$ 8,247	3.42%	\$ 489,016	\$ 9,096	3.75%

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Non-Interest bearing DDA	73,003	74,830
All Other Liabilities	3,353	4,468
Shareholders Equity	49,799	52,828

TOTAL LIABILITIES & SHAREHOLDERS EQUITY	\$ 610,878	\$ 621,142
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Net Interest Rate Spread 2.83% 3.42%

Net Interest Income /Margin \$ 9,064 3.27% \$ 11,036 3.93%

(1) Presented on a fully taxable equivalent basis using a federal income tax rate of 34%.

Table of Contents**Table 3 Average Balance and Rates**

(000 s omitted)(Annualized)	THREE MONTHS ENDED June 30,					
	2008			2007		
	AVERAGE BALANCE	INCOME/ EXPENSE	YIELD/ RATE	AVERAGE BALANCE	INCOME/ EXPENSE	YIELD/ RATE
ASSETS						
Securities:						
U.S. Treasury and Government						
Agencies	\$ 50,780	\$ 532	4.21%	\$ 76,091	\$ 782	4.12%
State and Political (1)	15,355	229	5.99%	18,092	273	6.05%
Other	7,666	33	1.75%	5,365	20	1.50%
Total Securities	73,801	794	4.32%	99,548	1,075	4.33%
Fed Funds Sold	2,969	16	2.11%	3,366	44	5.24%
Loans:						
Commercial	369,877	5,854	6.37%	360,535	6,996	7.78%
Tax Free (1)	3,247	54	6.69%	3,686	59	6.43%
Real Estate-Mortgage	38,307	612	6.42%	36,303	628	6.94%
Consumer	57,813	941	6.55%	59,425	1,230	8.30%
Total loans	469,244	7,461	6.39%	459,949	8,913	7.77%
Allowance for Loan Losses	(9,421)			(6,950)		
Net Loans	459,823	7,461	6.53%	452,999	8,913	7.89%
Loans Held for Sale	916	14	5.93%	1,501	23	6.15%
TOTAL EARNING ASSETS	\$ 546,930	\$ 8,285	6.09%	\$ 564,364	\$ 10,055	7.15%
Cash Due from Banks	14,398			16,704		
All Other Assets	47,175			45,131		
TOTAL ASSETS	\$ 599,082			\$ 619,249		
LIABILITIES & SHAREHOLDERS EQUITY:						
Deposits:						
Interest bearing DDA	\$ 97,132	\$ 325	1.35%	\$ 100,345	\$ 600	2.39%
Savings Deposits	83,606	169	0.81%	89,038	290	1.31%
Time CD s \$100,000 and Over	138,635	1,635	4.74%	134,374	1,659	4.95%
Other Time CD s	116,576	1,156	3.99%	125,523	1,441	4.60%
Total Deposits	435,949	3,285	3.03%	449,280	3,990	3.56%
Other Borrowings	36,383	439	4.85%	36,907	560	6.09%
INTEREST BEARING LIABILITIES	\$ 472,332	\$ 3,724	3.17%	\$ 486,187	\$ 4,550	3.75%

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Non-Interest bearing DDA	74,166	75,714
All Other Liabilities	2,840	4,124
Shareholders Equity	49,744	53,224

TOTAL LIABILITIES & SHAREHOLDERS EQUITY	\$ 599,082	\$ 619,249
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Net Interest Rate Spread 2.92% 3.40%

Net Interest Income /Margin \$ 4,561 3.35% \$ 5,505 3.91%

(1) Presented on a fully taxable equivalent basis using a federal income tax rate of 34%.

Table of Contents**Allowance and Provision For Loan Losses**

The Corporation maintains formal policies and procedures to control and monitor credit risk. Management believes the allowance for loan losses is adequate to provide for probable incurred losses in the loan portfolio. While the Corporation's loan portfolio has no significant concentrations in any one industry or any exposure in foreign loans, the loan portfolio has a concentration connected with construction and land development loans. Specific strategies have been deployed to reduce the concentration level and limit exposure to this type of lending in the future. The Michigan economy, employment levels and other economic conditions in the Corporation's local markets may have a significant impact on the level of credit losses. Management continues to identify and devote attention to credits that are not performing as agreed. Of course, deterioration of economic conditions could have an impact on the Corporation's credit quality, which could impact the need for greater provision for loan losses and the level of the allowance for loan losses as a percentage of gross loans. Non-performing loans are discussed further in the section titled "Non-Performing Assets."

The allowance for loan losses reflects management's judgment as to the level considered appropriate to absorb probable losses in the loan portfolio. The Corporation's methodology in determining the adequacy of the allowance is based on ongoing quarterly assessments and relies on several key elements, which include specific allowances for identified problem loans and a formula-based risk-allocated allowance for the remainder of the portfolio. This includes a review of individual loans, size, and composition of the loan portfolio, historical loss experience, current economic conditions, financial condition of borrowers, the level and composition of non-performing loans, portfolio trends, estimated net charge-offs and other pertinent factors. While we consider the allowance for loan losses to be adequate based on information currently available, future adjustments to the allowance may be necessary due to changes in economic conditions, delinquencies, or loss rates. Although portions of the allowance have been allocated to various portfolio segments, the allowance is general in nature and is available for the portfolio in its entirety. At June 30, 2008, the allowance was \$12,778,000, or 2.75% of total loans compared to \$8,554,000, or 1.81%, at December 31, 2007, increasing the allowance \$4,224,000 during the first six months of 2008. Non-performing loan levels, discussed later, increased during the period and net charge-offs have decreased to \$422,000 during the second quarter of 2008 compared to \$437,000 during the second quarter of 2007. Management believes that the allowance is appropriate given identified risk in the loan portfolio based on asset quality.

Table 4 below summarizes loan losses and recoveries for the first six months of 2008 and 2007. During the first six months of 2008, the Corporation experienced net charge-offs of \$668,000 or .14% of gross loans compared with net charge-offs of \$606,000 or .13% of gross loans in the first six months of 2007. The provision for loan losses was \$4,892,000 in the first six months of 2008 and \$1,088,000 for the same time period in 2007. As a result of continuing credit quality deterioration, additional provision for loan losses was taken in the second quarter. During the second quarter of 2008, the provision for loan losses was \$3,811,000 compared to \$649,000 in the second quarter of 2007. A substantial portion of the increase in provision for loan losses in the second quarter can directly be attributed to twelve particular loans for which valuations of underlying collateral, which were received during the second quarter, were found to be inadequate. These inadequacies necessitated the Banks to provide additional specific reserves for those accounts. The sizeable increase in provision for loan losses was to provide specific reserves mainly for non-performing construction and land development loans and the continuing decline in the Michigan economy.

Table of Contents**Table 4 Analysis of the Allowance for Loan Losses**

(000 s omitted)	Six Months Ended June 30,	
	2008	2007
Balance at Beginning of Period	\$ 8,554	\$6,692
Charge-Offs:		
Commercial, Financial and Agriculture	(630)	(534)
Real Estate-Mortgage	(88)	(30)
Installment Loans to Individuals	(215)	(191)
Total Charge-Offs	(933)	(755)
Recoveries:		
Commercial, Financial and Agriculture	201	102
Real Estate-Mortgage	0	0
Installment Loans to Individuals	64	47
Total Recoveries	265	149
Net Charge-Offs	(668)	(606)
Provision for loan losses	4,892	1,088
Balance at End of Period	\$12,778	\$7,174