

MID-STATE BANCSHARES
Form 10-Q
November 12, 2003

**United States
Securities and Exchange Commission**

Washington, D.C. 20429

FORM 10-Q

ý **Quarterly report under Section 13 or 15(d) of the Securities Exchange
Act of 1934**
for the quarterly period ended September 30, 2003.

o **Transition report under Section 13 or 15(d) of the Securities Exchange
Act of 1934**
for the transition period from N/A to N/A

Commission File Number 000-23925

MID-STATE BANCSHARES

(Exact name of registrant as specified in its charter)

California

(State or Other Jurisdiction of
Incorporation or Organization)

77-0442667

(I.R.S. Employer Identification No.)

1026 Grand Ave. Arroyo Grande, CA

(Address of Principal Executive Offices)

93420-0580

(Zip Code)

Issuer's Telephone Number: **(805) 473-7700**

Securities to be registered under Section 12(b) of the Act: **None**

Securities to be registered under Section 12(g) of the Act:

Common Stock, no par value

(Title of class)

Check whether the Company (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or 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.

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Yes No

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of November 5, 2003, the aggregate market value of the common stock held by non-affiliates of the Company was: \$562,070,832.

Number of shares of common stock of the Company outstanding as of November 5, 2003: 23,635,333 shares.

Mid-State Bancshares

September 30, 2003

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PART I - FINANCIAL INFORMATION

Item 1 - Financial Statements

Mid-State Bancshares
Consolidated Statements of Financial Position
 (Interim Periods Unaudited - figures in 000 s)

	Sept. 30, 2003	Dec. 31, 2002	Sept. 30, 2002
ASSETS			
Cash and Due From Banks	\$ 109,469	\$ 128,036	\$ 110,454
Fed Funds Sold	85,300	16,500	5,000
Securities Available For Sale	682,441	608,983	632,124
Loans Held for Sale	42,075	22,560	3,760
Loans, net of unearned income	1,091,113	1,087,551	1,106,184
Allowance for Loan Losses	(16,871)	(17,370)	(17,465)
Net Loans	1,074,242	1,070,181	1,088,719
Premises and Equipment, Net	25,709	25,342	24,555
Accrued Interest Receivable	12,254	11,689	13,700
Other Real Estate Owned	3,279		
Goodwill	33,448	33,448	33,448
Other Intangibles	8,769	8,816	8,806
Other Assets	9,163	9,185	7,456
Total Assets	\$ 2,086,149	\$ 1,934,740	\$ 1,928,022
LIABILITIES AND EQUITY			
Non Interest Bearing Demand	\$ 436,565	\$ 390,212	\$ 391,350
NOW Accounts, Money Market and Savings Deposits	965,821	863,142	842,791
Time Deposits Under \$100	236,275	249,792	253,391
Time Deposits \$100 or more	156,131	149,801	151,805
Total Deposits	1,794,792	1,652,947	1,639,337
Other Borrowings	7,907	10,973	11,573
Allowance for Losses Unfunded Commitments	1,862	1,771	1,687
Accrued Interest Payable and Other Liabilities	20,767	14,914	23,515
Total Liabilities	1,825,328	1,680,605	1,676,112
Commitments and Contingencies			
Shareholders' Equity:			
Common Stock and Surplus (Shares Outstanding of 23,191, 23,697 and 23,839, respectively)	67,424	77,588	80,098
Retained Earnings	179,448	163,309	157,200
Accumulated Other Comprehensive Income, Net	13,949	13,238	14,612

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<i>Total Equity</i>		260,821		254,135		251,910
<i>Total Liabilities and Equity</i>	\$	2,086,149	\$	1,934,740	\$	1,928,022

Mid-State Bancshares
Consolidated Statements of Income
(Unaudited - figures in 000 s except earnings per share data)

	Three Month Period Ended Sept. 30,		Nine Month Period Ended Sept. 30,	
	2003	2002	2003	2002
Interest Income:				
Interest and fees on loans	\$ 20,574	\$ 20,771	\$ 60,461	\$ 64,307
Interest on investment securities -				
U.S. Treasury securities	253	296	612	1,068
U.S. Government agencies and corporations	2,062	2,579	6,453	6,383
Obligations of states and political sub-divisions and other securities	3,491	3,175	10,585	9,454
Interest on fed funds sold and other	263	343	604	1,013
Total Interest Income	26,643	27,164	78,715	82,225
Interest Expense:				
Interest on NOW, money market and savings	497	1,364	1,997	3,867
Interest on time deposits less than \$100	1,034	1,694	3,540	5,811
Interest on time deposits of \$100 or more	585	907	1,908	3,137
Interest other	41	56	114	163
Total Interest Expense	2,157	4,021	7,559	12,978
Net Interest Income before provision	24,486	23,143	71,156	69,247
Less: Provision for loan losses		-	260	600
Net Interest Income after provision	24,486	23,143	70,896	68,647
Other Operating Income:				
Service charges and fees	2,271	2,155	6,835	6,584
Commissions, fees and other service charges	3,511	3,203	9,996	8,970
Gains on sale of securities	14	21	43	12
Gain on sale of loans held for sale	1,032	243	2,992	390
Other non-interest income	1,010	172	2,370	1,566
Total Other Operating Income	7,838	5,794	22,236	17,522
Other Operating Expense:				
Salaries and employee benefits	9,606	9,122	28,465	27,634
Occupancy and furniture	3,017	2,873	8,649	8,277
Other operating expenses	5,966	5,891	17,876	17,193
Total Other Operating Expense	18,589	17,886	54,990	53,104
Income Before Taxes	13,735	11,051	38,142	33,065
Provision for income taxes	4,760	3,965	13,364	11,925
Net Income	\$ 8,975	\$ 7,086	\$ 24,778	\$ 21,140
Earnings per share:				
basic	\$ 0.39	\$ 0.30	\$ 1.06	\$ 0.88
diluted	\$ 0.37	\$ 0.29	\$ 1.01	\$ 0.85
Dividends per share	\$ 0.13	\$ 0.10	\$ 0.37	\$ 0.30

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Average shares used in earnings per share calculations:

basic	23,287	23,924	23,441	24,026
diluted	24,350	24,815	24,487	24,860

Mid-State Bancshares
Consolidated Statements of Comprehensive Income
(Unaudited - figures in 000 s)

	Three Month Period Ended Sept. 30,		Nine Month Period Ended Sept. 30,	
	2003	2002	2003	2002
Net Income	\$ 8,975	\$ 7,086	\$ 24,778	\$ 21,140
Other Comprehensive (Loss) Income Before Taxes:				
Unrealized (losses) gains on securities available for sale:				
Unrealized holding (losses) gains arising during period	(5,579)	9,301	1,228	13,662
Reclassification adjustment for gains included in net income	(14)	(21)	(43)	(12)
Other comprehensive (loss) income, before tax	(5,593)	9,280	1,185	13,650
Income tax (credit) expense related to items in comprehensive income	(2,237)	3,712	474	5,460
Other Comprehensive (Loss) Income, Net of Taxes	(3,356)	5,568	711	8,190
Comprehensive Income	\$ 5,619	\$ 12,654	\$ 25,489	\$ 29,330

Mid-State Bancshares
Consolidated Statements of Cash Flows
(Unaudited - figures in 000 s)

	Nine Month Period Ended Sept. 30,	
	2003	2002
OPERATING ACTIVITIES		
Net Income	\$ 24,778	\$ 21,140
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for credit losses	260	600
Depreciation and amortization	3,376	3,277
Net amortization of prem./discounts-investments	2,891	2,863
Impairment of investment in real estate	91	
Gain on sale of loans held for sale	(2,992)	(390)
Net (increase) decrease in loans held for sale	(16,523)	9,844
Change in deferred loan fees	197	(32)
Changes in assets and liabilities:		
Accrued interest receivable	(565)	(2,640)
Other intangibles, net	47	488
Other assets, net	(691)	(6,337)
Other liabilities	5,944	7,969
Net cash provided by operating activities	16,813	36,782

INVESTING ACTIVITIES

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Proceeds from sales and maturities of investments	128,074	73,280
Purchases of investments	(203,238)	(243,272)
Net (Increase) decrease in loans	(7,797)	37,583
Receipt from investments in real estate	148	33
Purchases of premises and equipment, net	(3,743)	(1,981)
Net cash used in investing activities	(86,556)	(134,357)
FINANCING ACTIVITIES		
Increase in deposits	141,845	55,171
Decrease in other borrowings	(3,066)	(6,141)
Exercise of stock options	1,686	792
Cash dividends paid	(8,639)	(7,197)
Retirement of company stock	(11,850)	(5,566)
Net cash provided by financing activities	119,976	37,059
Increase (decrease) in cash and cash equivalents	50,233	(60,516)
Cash and cash equivalents, beginning of period	144,536	175,970
Cash and cash equivalents, end of period	\$ 194,769	\$ 115,454
Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	\$ 7,671	\$ 13,364
Cash paid during the period for taxes on income	13,636	9,500
Non-cash disclosure of Investing Activities:		
Transfer of Loans to Other Real Estate Owned	3,279	0

Mid-State Bancshares
Notes to Consolidated Financial Statements
(Information with respect to interim periods is unaudited)

NOTE A - BASIS OF PRESENTATION AND MANAGEMENT REPRESENTATION

The accompanying consolidated financial statements include the accounts of Mid-State Bancshares and its wholly owned subsidiary Mid-State Bank & Trust and the Bank's subsidiaries, MSB Properties and Mid Coast Land Company (collectively the Company, Bank or Mid-State). All significant inter-company transactions have been eliminated in consolidation. These consolidated financial statements should be read in conjunction with the Form 10-K Annual Report for the year ended December 31, 2002 of Mid-State Bancshares. A summary of the Company's significant accounting policies is set forth in the Notes to Consolidated Financial Statements contained therein.

These consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States on a basis consistent with the accounting policies reflected in the audited consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2002. They do not, however, include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments including normal recurring accruals considered necessary for a fair presentation have been included. Operating results for the interim periods presented are not necessarily indicative of the results that may be expected for any other interim period or for the year as a whole.

NOTE B - EARNINGS PER SHARE

The following is a reconciliation of net income and shares outstanding to the income and number of shares used to compute Earnings Per Share (EPS). Figures are in thousands, except earnings per share data.

	Three Month Period Ended Sept. 30, 2003			Three Month Period Ended Sept. 30, 2002		
	Earnings	Shares	EPS	Earnings	Shares	EPS
Basic Earnings Per Share:						
Income available to Common Shareholders	\$ 8,975	23,287	\$ 0.39	\$ 7,086	23,924	\$ 0.30
Effect of dilutive securities:						
Stock Options		1,063			891	
Diluted Earnings Per Share:						
Income available to Common Shareholders	\$ 8,975	24,350	\$ 0.37	\$ 7,086	24,815	\$ 0.29

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	Nine Month Period Ended Sept. 30, 2003			Nine Month Period Ended Sept. 30, 2002		
	Earnings	Shares	EPS	Earnings	Shares	EPS
Basic Earnings Per Share:						
Income available to Common Shareholders	\$ 24,778	23,441	\$ 1.06	\$ 21,140	24,026	\$ 0.88
Effect of dilutive securities:						
Stock Options		1,046			834	
Diluted Earnings Per Share:						
Income available to Common Shareholders	\$ 24,778	24,487	\$ 1.01	\$ 21,140	24,860	\$ 0.85

NOTE C RECENT ACCOUNTING PRONOUNCEMENTS

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In January of 2003, the FASB issued FIN No. 46, *Consolidation of Variable Interest Entities*. FIN No. 46 addresses consolidation by business enterprises of variable interest entities, which have one or both of the following characteristics: i) the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, which is provided through other interests that will absorb some or all of the expected losses of the entity; and ii) the equity investors lack an essential characteristic of a controlling financial interest. FIN No. 46 was initially effective for all financial statements issued on or after February 1, 2003, but subsequently the adoption date was deferred to January 1, 2004. The adoption of FIN No. 46 is not expected to have a material impact on the Company's results of operations and financial position.

The FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* in May of 2003. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. SFAS No. 150 was effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS No. 150 did not have a material impact on the Company's results of operations and financial position.

The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* in June of 2002. SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities. SFAS No. 146 was effective for exit or disposal activities initiated after December 31, 2002, with early adoption permitted. The adoption of SFAS No. 146 did not have a material impact on the Company's results of operations and financial position.

In November of 2002, the FASB issued FASB Interpretation (FIN) No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. FIN No. 45 clarifies the requirements relating to the guarantor's accounting for, and disclosure of, the issuance of certain types of guarantees. The disclosure provisions of FIN No. 45 were effective for financial statements of periods

ended after December 15, 2002. The provisions for initial recognition and measurement are effective on a prospective basis for guarantees that are issued or modified after December 31, 2002. Adoption did not have a material impact on the Company's results of operations and financial position.

The FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure in December of 2002. SFAS No. 148 amends SFAS No. 123, Accounting for Stock-Based Compensation to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123. SFAS No. 148 was effective for fiscal years ending after December 15, 2002. The Company adopted SFAS No. 148 on December 15, 2002 and adoption did not have a material impact on its results of operations and financial position. The effect of SFAS No. 148 is displayed in Note E below.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133. SFAS 149 is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. The guidance should be applied prospectively. The adoption of SFAS 149 did not have a material impact on the Company's results of operations and financial position.

NOTE D OTHER INTANGIBLE ASSETS

The following is a summary of the Company's other intangible assets. Figures are in thousands.

	Gross Amount	Sept. 30, 2003 Accumulated Amortization	Net Carrying Amount	Gross Amount	Sept. 30, 2002 Accumulated Amortization	Net Carrying Amount
Core Deposit Intangible	\$ 8,869	\$ (2,171)	\$ 6,698	\$ 8,869	\$ (1,100)	\$ 7,769
Originated Mortgage Servicing Rights	3,425	(1,354)	2,071	1,633	(596)	1,037
Total Other Intangible Assets	\$ 12,294	\$ (3,525)	\$ 8,769	\$ 10,502	\$ (1,696)	\$ 8,806

	Gross Amount	Dec. 31, 2002 Accumulated Amortization	Net Carrying Amount
Core Deposit Intangible	\$ 8,869	\$ (1,368)	\$ 7,501
Originated Mortgage Servicing Rights	2,063	(748)	1,315

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Total Other Intangible Assets	\$	10,932	\$	(2,116)	\$	8,816
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Aggregate Amortization Expense of Other Intangible Assets (\$ in 000 s):

	Three Month Period Ended Sept. 30,		Nine Month Period Ended Sept. 30,	
	2003	2002	2003	2002
Amortization of Core Deposit Intangible	\$ 268	\$ 268	\$ 804	\$ 804
Amortization of Originated Mortgage Servicing Rights	317	77	606	156
Total aggregate amortization expense	\$ 585	\$ 345	\$ 1,410	\$ 960

The projected amortization expense for intangible assets, including the acquisition highlighted in Note F below, is approximately \$2.2 million per year over the next five years. These charges are included in other operating expense on the Consolidated Statements of Income.

NOTE E STOCK OPTIONS

At September 30, 2003, the Company had one stock option plan which is described more fully in Note 15 in the Company's 2002 Annual Report on form 10-K. The Company accounts for stock options using the intrinsic value method under the provisions of Accounting Principles Board (APB) Opinion No. 25 and provides proforma net income and proforma earnings per share disclosures for employee stock option grants as if the fair-value-based method, defined in SFAS No. 123, Accounting for Stock-Based Compensation, had been applied. Had the Company determined compensation cost based on the fair value at the grant date for its stock options under SFAS No. 123, the Company's net income would have been reduced to the pro forma amounts indicated below for the three and nine month periods ended September 30:

(dollars in 000 s except per share amounts)	Three Month Period Ended Sept. 30,		Nine Month Period Ended Sept. 30,	
	2003	2002	2003	2002
Net income, as reported	\$ 8,975	\$ 7,086	\$ 24,778	\$ 21,140
Deduct: Total stock-based compensation expense determined under the fair value based method for all awards, net of related taxes	(395)	(356)	(1,186)	(1,068)
Proforma net income	\$ 8,580	\$ 6,730	\$ 23,592	\$ 20,072
Basic income per share, as reported	\$ 0.39	\$ 0.30	\$ 1.06	\$ 0.88
Proforma basic income per share	\$ 0.37	\$ 0.28	\$ 1.01	\$ 0.84
Diluted income per share, as reported	\$ 0.37	\$ 0.29	\$ 1.01	\$ 0.85
Proforma diluted income per share	\$ 0.35	\$ 0.27	\$ 0.96	\$ 0.81

NOTE F SUBSEQUENT EVENT: MERGER OF MID-STATE BANCSHARES AND OJAI VALLEY BANK

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On June 30, 2003, the Company signed a definitive agreement (the Agreement) to acquire Ojai Valley Bank through merger, subject to the approval of banking regulators and shareholders of Ojai Valley Bank. The Agreement provided Ojai Valley Bank shareholders with an election to choose Mid-State Bancshares common

stock, cash, or a combination of Mid-State Bancshares common stock and cash that was subject to potential adjustments. Adjustments were then made based on changes in the price of Mid-State Bancshares stock preceding the effective date of the transaction and the necessary pro ration of the stock selections made by Ojai Valley Bank shareholders. Half of the consideration provided was in the form of Mid-State Bancshares stock with the balance being in cash. The transaction closed on October 31, 2003 and is expected to be accretive to earnings in the year 2004. The total consideration was valued at approximately \$23.7 million. The merger was structured to be tax-free for the stock portion of the consideration.

Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations

Selected Financial Data - Summary. The following table provides certain selected consolidated financial data as of and for the three and nine month periods ended September 30, 2003 and 2002 (unaudited).

Consolidated Financial Data - Mid-State Bancshares

(Unaudited in thousands, except per share data)	Quarter Ended		Year-to-Date	
	Sept. 30, 2003	Sept. 30, 2002	Sept. 30, 2003	Sept. 30, 2002
Interest Income (not taxable equivalent)	\$ 26,643	\$ 27,164	\$ 78,715	\$ 82,225
Interest Expense	2,157	4,021	7,559	12,978
Net Interest Income	24,486	23,143	71,156	69,247
Provision for Loan Losses			260	600
Net Interest Income after provision for loan losses	24,486	23,143	70,896	68,647
Non-interest income	7,838	5,794	22,236	17,522
Non-interest expense	18,589	17,886	54,990	53,104
Income before income taxes	13,735	11,051	38,142	33,065
Provision for income taxes	4,760	3,965	13,364	11,925
Net Income	\$ 8,975	\$ 7,086	\$ 24,778	\$ 21,140
Per share:				
Net Income - basic	\$ 0.39	\$ 0.30	\$ 1.06	\$ 0.88
Net Income - diluted	\$ 0.37	\$ 0.29	\$ 1.01	\$ 0.85
Weighted avg. shares used in Basic E.P.S. calculation	23,287	23,924	23,441	24,026
Weighted avg. shares used in Diluted E.P.S. calculation	24,350	24,815	24,487	24,860
Cash dividends	\$ 0.13	\$ 0.10	\$ 0.37	\$ 0.30
Book value at period-end			\$ 11.25	\$ 10.57
Tangible book value at period end			\$ 9.43	\$ 8.79
Ending Shares			23,191	23,839
Financial Ratios				
Return on assets	1.72%	1.47%	1.65%	1.51%
Return on tangible assets	1.76%	1.50%	1.69%	1.54%
Return on equity	13.61%	11.31%	12.77%	11.69%
Return on tangible equity	16.22%	13.63%	15.25%	14.18%
Net interest margin (not taxable equivalent)	5.14%	5.28%	5.23%	5.43%
Net interest margin (taxable equivalent yield)	5.53%	5.61%	5.63%	5.74%
Net loan losses to avg. loans	0.38%	0.62%	0.09%	0.25%
Efficiency ratio	57.5%	62.3%	58.9%	61.4%

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Period Averages

Total Assets	\$	2,069,078	\$	1,914,466	\$	2,002,806	\$	1,877,434
Total Tangible Assets		2,026,932		1,872,173		1,960,666		1,834,976
Total Loans (includes loans held for sale)		1,140,493		1,081,936		1,129,684		1,112,715
Total Earning Assets		1,889,499		1,739,554		1,818,879		1,705,685
Total Deposits		1,787,933		1,641,953		1,724,251		1,610,677
Common Equity		261,692		248,608		259,408		241,725
Common Tangible Equity		219,546		206,315		217,268		199,267

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(Unaudited in thousands)	Sept. 30, 2003		Sept. 30, 2002	
Balance Sheet - At Period-End				
Cash and due from banks	\$	109,469	\$	110,454
Investments and Fed Funds Sold		767,741		637,124
Loans held for sale		42,075		3,760
Loans, net of deferred fees, before allowance for loan losses		1,091,113		1,106,184
Allowance for Loan Losses		(16,871)		(17,465)
Goodwill and other intangibles		42,217		42,254
Other assets		50,405		45,711
Total Assets	\$	2,086,149	\$	1,928,022
Non-interest bearing deposits	\$	436,565	\$	391,350
Interest bearing deposits		1,358,227		1,247,987
Other borrowings		7,907		11,573
Allowance for losses - unfunded commitments		1,862		1,687
Other liabilities		20,767		23,515
Shareholders' equity		260,821		251,910
Total Liabilities and Shareholders' equity	\$	2,086,149	\$	1,928,022
Asset Quality & Capital - At Period-End				
Non-accrual loans	\$	12,562	\$	10,729
Loans past due 90 days or more				4
Other real estate owned		3,279		
Total non-performing assets	\$	15,841	\$	10,733
Allowance for losses to loans, gross (1)		1.7%		1.7%
Non-accrual loans to total loans, gross		1.2%		1.0%
Non-performing assets to total assets		0.8%		0.6%
Allowance for losses to non performing loans (1)		149.1%		178.4%
Equity to average assets (leverage ratio)		10.2%		10.5%
Tier One capital to risk-adjusted assets		14.7%		14.5%
Total capital to risk-adjusted assets		16.0%		15.7%

(1) Includes allowance for loan losses and allowance for losses - unfunded commitments

Performance Summary. The Company posted net income of \$9.0 million for the three months ended September 30, 2003 compared to \$7.1 million in the like 2002 period. These earnings represent an annualized return on assets of 1.72% and 1.47%, respectively. The annualized return on equity was 13.61% for the third quarter of 2003 compared to 11.31% in the third quarter of 2002. On a per share basis, diluted earnings per share were \$0.37 in the 2003 period compared to \$0.29 in the like quarter of 2002.

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For the nine months year-to-date, the Company posted net income of \$24.8 million compared to \$21.1 million earned in the like 2002 period. Diluted earnings per share were \$1.01 in the first nine months of 2003 compared to \$0.85 in the like period one year earlier. These earnings represent an annualized return on assets of 1.65% and 1.51%, respectively, for the comparable 2003 and 2002 periods. The annualized return on equity was 12.77% for the first nine months of 2003 compared to 11.69% in the first nine months of 2002.

Both the three month and nine month results benefited from increases in its mortgage banking operation compared to the results in 2002. The decline in interest rates helped to increase the volume of loans originated and corresponding fees earned from the sale of those loans into the secondary market. Additionally, the Company began selling late in 2002 those mortgage loans for forward delivery on longer terms (up to 90 days), thereby

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earning interest on those assets for a longer period of time than what it had done historically. These two factors, coupled with normal growth of the balance sheet, explain the majority of the increase in the Company's 2003 earnings for both the quarter and year-to-date compared to 2002.

Net Interest Income. The following table delineates the impacts of changes in the volume of earning assets, changes in the volume of interest bearing liabilities, and changes in interest rates on net interest income for the three month period ended September 30, 2003 and 2002.

Dollars in 000 s	3 Months Ended Sept. 30, 2003			3 Months Ended Sept. 30, 2002			2003 Compared to 2002 Composition of Change		
	Average Balance	Interest Income / Expense	Average Yield / Rate	Average Balance	Interest Income / Expense	Average Yield / Rate	Change Due To:		Total Change
							Volume	Rate	
EARNING ASSETS:									
Loans	\$ 1,140,493	\$ 20,574	7.16%	\$ 1,081,936	\$ 20,771	7.62%	\$ 1,090	\$ (1,287)	\$ (197)
Investment Securities	626,614	5,806	3.68%	573,403	6,050	4.19%	527	(771)	(244)
Fed Funds, Other	122,392	263	0.85%	84,215	343	1.62%	119	(199)	(80)
TOTAL EARNING ASSETS	1,889,499	26,643	5.59%	1,739,554	27,164	6.20%	1,736	(2,257)	(521)
INTEREST BEARING LIABILITIES:									
NOW, Savings, and Money Market Accounts	951,724	497	0.21%	840,885	1,364	0.64%	119	(986)	(867)
Time Deposits	396,014	1,619	1.62%	410,557	2,601	2.51%	(76)	(906)	(982)
Interest Bearing Deposits	1,347,738	2,116	0.62%	1,251,442	3,965	1.27%	43	(1,892)	(1,849)
Other Borrowings	5,596	41	2.84%	8,035	56	2.77%	(16)	1	(15)
TOTAL INTEREST BEARING LIABILITIES	1,353,334	2,157	0.63%	1,259,477	4,021	1.27%	27	(1,891)	(1,864)
NET INTEREST INCOME	\$ 1,889,499	\$ 24,486	5.14%	\$ 1,739,554	\$ 23,143	5.28%	\$ 1,709	\$ (366)	\$ 1,343

Mid-State's annualized yield on interest earning assets was 5.59% for the third quarter of 2003 (5.99% on a taxable equivalent basis) compared to 6.20% in the like 2002 period (6.52% on a taxable equivalent basis). The decrease in yield is related to the general decline in interest rates. The Prime Rate, to which many of the Bank's loans are tied, averaged 4.00% in the third quarter of 2003 compared to 4.75% in the like period of 2002. Annualized interest expense also decreased from 1.27% in the three months ended September 2002 to 0.63% in the comparable 2003 period. This too reflected the general decline in interest rates.

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Overall, Mid-State's annualized Net Interest Income, expressed as a percent of earning assets, decreased from 5.28% for the third quarter of 2002 (5.61% on a taxable equivalent basis) to 5.14% in the comparable 2003 period (5.53% on a taxable equivalent basis). Annualized Net Interest Income as a percent of average total assets declined from 4.80% in the third quarter of 2002 (5.08% taxable equivalent) to 4.70% in the comparable 2003 period (5.05% taxable equivalent). In comparing the third quarter of 2003 to the third quarter of 2002, average earnings assets increased from \$1,739.6 million one year ago to \$1,889.5 million and average deposits increased from \$1,251.4 million one year ago to \$1,347.7 million. The combination of the increase in earning assets and the impact of the decline in interest rates on deposits offset the negative impact of the decline in interest rates on interest income and allowed the Company to show a modest increase in net interest income of \$1.3 million over the comparable quarters.

The following table presents a similar analysis of changes in interest income and expense for the nine month period ended September 30, 2003 and 2002.

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Dollars in 000 s	9 months ended Sept. 30, 2003			9 months ended Sept. 30 2002			2003 Compared to 2002 Composition of Change		
	Average Balance	Interest Income / Expense	Average Yield / Rate	Average Balance	Interest Income / Expense	Average Yield / Rate	Change Due To:		Total Change
							Volume	Rate	
<i>EARNING ASSETS:</i>									
Loans	\$ 1,129,684	\$ 60,461	7.16%	\$ 1,112,715	\$ 64,307	7.73%	\$ 626	\$ (4,472)	\$ (3,846)
Investment Securities	608,510	17,650	3.88%	507,699	16,905	4.45%	2,082	(1,337)	745
Fed Funds, Other	80,685	604	1.00%	85,271	1,013	1.59%	(29)	(380)	(409)
TOTAL EARNING ASSETS	1,818,879	78,715	5.79%	1,705,685	82,225	6.45%	2,679	(6,188)	(3,510)
<i>INTEREST BEARING LIABILITIES:</i>									
NOW, Savings, and Money Market Accounts	915,261	1,997	0.29%	813,211	3,867	0.64%	235	(2,105)	(1,870)
Time Deposits	398,312	5,448	1.83%	424,193	8,948	2.82%	(298)	(3,202)	(3,500)
Interest Bearing Deposits	1,313,573	7,445	0.76%	1,237,404	12,815	1.38%	(64)	(5,306)	(5,370)
Other Borrowings	4,422	114	3.42%	8,086	163	2.70%	(55)	6	(49)
TOTAL INTEREST BEARING LIABILITIES	1,317,995	7,559	0.77%	1,245,490	12,978	1.39%	(118)	(5,301)	(5,419)
NET INTEREST INCOME	\$ 1,818,878	\$ 71,156	5.23%	\$ 1,705,685	\$ 69,247	5.43%	\$ 2,797	\$ (888)	\$ 1,909

Mid-State's year-to-date annualized yield on interest earning assets was 5.79% for the first nine months of 2003 (6.18% on a taxable equivalent basis) compared to 6.45% in the like 2002 period (6.76% on a taxable equivalent basis). The decrease in yield is related to the general decline in interest rates. The Prime Rate, to which many of the Bank's loans are tied, averaged 4.16% in the first nine months of 2003 compared to 4.75% in the like period of 2002. Annualized interest expense also decreased from 1.38% in the first nine months of 2002 to 0.76% in the comparable 2003 period.

Overall, Mid-State's annualized Net Interest Income, expressed as a percent of earning assets, decreased from 5.43% for the first nine month period of 2002 (5.74% on a taxable equivalent basis) to 5.23% in the comparable 2003 period (5.63% on a taxable equivalent basis). Annualized Net Interest Income as a percent of average total assets declined from 4.93% in the first nine months of 2002 (5.21% taxable equivalent) to 4.75% in the comparable 2003 period (5.11% taxable equivalent). Average earnings assets for the nine months ended September 30, 2003 increased from the like 2002 period (\$1,818.9 million compared to \$1,705.7 million). The combination of the increase in earning assets and the impact of the decline in interest rates on deposits offset the negative impact of the decline in interest rates on interest income and allowed the Company to show a modest increase in net interest income of \$1.9 million over the comparable nine month periods.

It should also be noted that for both the three month and nine month periods ended September 30, 2003, while there was growth in net interest income over 2002, the mix of earning assets had changed somewhat from the same periods of 2002. Lower yielding investments and fed funds sold had a larger growth rate than loans across the comparable periods, thus also tending to reduce the net interest margins for the 2003 periods compared to the 2002 periods.

Provision and Allowance for Loan Losses. Mid-State did not make a provision for loan losses in the third quarter of either 2003 and 2002. During the nine months ended September 30, 2003 provision for loan losses totaled \$260 thousand, declining from \$600 thousand in the like 2002 period.

Management continues to believe that the allowances for loan losses and the allowance for losses - unfunded commitments, which collectively stand at 1.7% of total loans at September 30, 2003, are adequate to cover

inherent losses. The \$18.7 million total allowance for credit losses is approximately 149% of the level of non performing loans which stands at \$12.6 million compared to \$10.7 million one year earlier. The level of non performing loans is centered in two lending relationships secured by real estate which total \$10.1 million at September 30, 2003. One year earlier, just one of those two relationships were on non accrual totaling \$8.0 million. The two troubled lending relationships described above had totaled \$14.5 million at June 30, 2003. During the third quarter, the Company incurred a partial charge-off totaling \$1.1 million as it initiated foreclosure on the property securing one of these loans and the remaining balance of \$3.3 million on that loan was transferred to Other Real Estate Owned. In this way, the non performing loans represented by these two lending relationships was reduced to \$10.1 million from the \$14.5 million level of June 30, 2003, although the Bank's overall exposure only decreased by the \$1.1 million charge-off. Management believes that the Other Real Estate Owned now held on the balance sheet is appropriately stated given its fair value and allowing for costs of sale.

Management has determined that its reserve requirement allocated to its troubled loans, and held in the general loan loss reserve, are sufficient to offset potential losses, if any, arising from less than full recovery of the loans from the supporting collateral. Non performing loans consist of loans on non-accrual and accruing loans 90 days or more past due. While continuing efforts are made to improve overall asset quality, Management is unable to estimate with certainty, how and under what terms, problem assets will be resolved.

Changes in the allowance for loan losses (in thousands) for the periods ended September 30, 2003 and 2002 are as follows:

	Three Months Ended Sept. 30,		Nine Months Ended Sept. 30,	
	2003	2002	2003	2002
Balance at beginning of period:				
Allowance for loan losses	\$ 17,963	\$ 19,160	\$ 17,370	\$ 19,073
Allowance for losses-unfunded commitments	1,812	1,687	1,771	1,586
Total allowances for losses at beginning of period	19,775	20,847	19,141	\$ 20,659
Additions to the allowances charged to expense	50		91	
Additions to the allowances charged to provision			260	600
Loans charged off	(1,404)	(1,882)	(1,645)	(2,669)
Recoveries of loans previously charged-off	312	187	886	562
Total allowances for losses at end of period	\$ 18,733	\$ 19,152	\$ 18,733	\$ 19,152
Allowance for loan losses	\$ 16,871	\$ 17,465	\$ 16,871	\$ 17,465
Allowance for losses-unfunded commitments	1,862	1,687	1,862	1,687
Total allowance for credit losses	\$ 18,733	\$ 19,152	\$ 18,733	\$ 19,152

At September 30, 2003, the recorded investments in loans, which have been identified as impaired loans, totaled \$23,219,000. Of this amount, \$12,893,000 related to loans with no valuation allowance and \$10,326,000 related to loans with a corresponding valuation allowance of \$2,217,000. Impaired loans totaled \$11,843,000 at September 30, 2002. Of that amount, \$9,814,000 related to loans with no valuation allowance and \$2,029,000 related to loans with a corresponding valuation allowance of \$431,000. The valuation allowance for impaired loans is included within the general allowance shown above and netted against loans on the consolidated statements of financial position. For the quarter ended September, 2003, the average recorded investment in impaired loans was \$19,131,000 compared to \$12,959,000 in the 2002 period. A loan is identified as impaired when it is probable that interest and principal will not be collected according to the contractual terms of the loan agreement.

Non-interest Income. Non-interest income for the first nine months of 2003 was \$22.2 million, up from \$17.5 million earned in the 2002 period, an increase of 26.9%. An increase in the Company's gain on sale of loans of \$2.6 million accounted for the largest portion of the increase, reflecting an increase in the volume of loans originated in response to an increase in refinance activity in its mortgage banking operation. Other commissions, fees and service charges increased by \$1.0 million which was primarily the result of increases in ATM and Debit card fees collected along with increases from trust department fee income and letters of credit commissions. Other non-interest income increased \$0.8 million reflecting a one-time gain on the sale of Bank property of \$273 thousand and \$470 thousand of on-going commissions on the sale of property formerly owned by Mid Coast Land Company. Service charge income also increased \$251 thousand across the comparable periods.

For the three months ended September 30, 2003, non-interest income rose \$2.0 million from \$5.8 million in the third quarter of 2002 to \$7.8 million in the comparable 2003 period. An increase in the Company's gain on sale of loans of \$0.8 million accounted for a portion of the increase, reflecting an increase in the volume of loans originated in response to an increase in refinance activity in its mortgage banking operation. Other commissions, fees and service charges increased by \$0.3 million, the result of increases in ATM and Debit card fees collected along with increases from trust department fee income and letters of credit commissions. Other non-interest income increased \$0.8 million reflecting a one-time gain on the sale of Bank property of \$273 thousand and \$280 thousand of on-going commissions on the sale of property formerly owned by Mid Coast Land Company.

It should be noted that the increase in the gain on sale of loans held for sale throughout 2003 is in large part a result of the increased loan demand for single family residential mortgages which the Company has originated and sold. This activity represents predominantly refinance activity in the low interest rate environment prevalent in 2003. If rates rise into 2004, this source of income may diminish in the coming quarters.

Non-interest Expense. Non-interest expense for the first nine months of 2003 was \$55.0 million. This compares to \$53.1 million in the comparable 2002 period, an increase of \$1.9 million. Increases in salaries and benefits accounted for \$831 thousand of the increase (salary expense increased by \$237 thousand while benefit costs, especially for health care, workers compensation premiums and incentive compensation, increased \$594 thousand, a trend being experienced by most employers). Occupancy costs increased \$372 thousand reflecting normal operating expense increases. All other operating expenses increased \$684 thousand. Included in other operating expenses were increases of \$771 thousand in professional services, \$545 thousand of amortization of originated mortgage servicing rights, \$121 thousand of increases in general insurance costs and \$91 thousand of provision for losses on unfunded commitments. These increases were offset by a decrease in merchant service processing fees of \$829 thousand.

In comparing the third quarter of 2003 with the third quarter of 2002, non-interest expense increased \$703 thousand from \$17.9 million to \$18.6 million. This increase was primarily the result of increases in salaries and benefits of \$484 thousand. Occupancy and furniture accounted for \$144 thousand of the increase. And all other categories of expense showed a net \$75 thousand increase.

Efficiency Ratio. The Company's efficiency ratio (defined as the ratio of non-interest expense to the sum of net interest income plus non interest income) has improved in 2003 to the comparable 2002 periods. For the three months ended September 30, 2003, the ratio was 57.5% compared to 61.8% in the year ago period. Similarly, for the nine month

period of 2003, the efficiency ratio was 58.9% compared to 61.2% in the like 2002 period. The growth in non interest income and net interest income grew at a faster rate than did non interest expense in comparing the 2003 periods with 2002 thus creating the improvements in this ratio.

Provision for Income Taxes. The year-to-date provision for income taxes was \$13.4 million, which is up from the same period in 2002 when it was \$11.9 million. For the third quarter of 2003 the provision for income

taxes rose \$795 thousand, up from \$4.0 million in the 2002 period to \$4.8 million. The effective tax rate for the nine months year-to-date in 2003 was 35.0% compared to 35.9% in 2002. While the normal combined federal and state statutory tax rate is 42% for Mid-State Bancshares, the tax exempt income generated by its municipal bond portfolio is the primary reason that the effective rate is lower.

Balance Sheet. Total assets of the Company were up 8.2% to \$2.086 billion from \$1.928 billion at September 30, 2002. This growth was fueled by an increase in deposits of 9.5% to \$1.795 billion, up from \$1.639 billion one year earlier. The growth in deposits was centered in core deposits. While Time Deposits decreased to \$392.4 million from one year earlier of \$405.2 million, all other categories of Demand, NOW, Money Market and Savings increased to \$1.402 billion from \$1.234 billion one year earlier. In an ongoing effort to improve earnings, the Company continues to focus its attention on attracting lower cost core deposits while trying to remain competitive in retaining Time Deposits. Loan activity over the last year has been slow with the loan portfolio decreasing to \$1.091 billion at September 30, 2003 from \$1.106 billion one year earlier. Consequently, the growth in deposits has funded a \$130.6 million increase in Investments and Fed Funds Sold along with a \$38.3 million increase in the total of Mortgage Loans Available for Sale. Management expects to promote more heavily its consumer lending products over the next several quarters. It is difficult to predict what impact this will have in increasing the size of the loan portfolio going forward.

Mid-State Bank & Trust's loan to deposit ratio of 60.8% at September 30, 2003 is down from the 67.5% ratio one year