Form 10-Q for EVANS BANCORP INC

3-Nov-2010

Quarterly Report

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

This Quarterly Report on Form 10-Q may contain certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), that involve substantial risks and uncertainties. When used in this report, or in the documents incorporated by reference herein, the words "anticipate," "believe," "estimate," "expect," "intend," "may," "plan," "seek," and similar expressions identify such forward-looking statements. These forward-looking statements include statements regarding the Company's business plans, prospects, growth and operating strategies, statements regarding the asset quality of the Company's loan and investment portfolios, and estimates of the Company's risks and future costs and benefits.

These forward-looking statements are based largely on the expectations of the Company's management and are subject to a number of risks and uncertainties, including but not limited to general economic conditions, either nationally or in the Company's market areas, that are worse than expected; increased competition among depository or other financial institutions; inflation and changes in the interest rate environment that reduce the Company's margins or reduce the fair value of financial instruments; changes in laws or government regulations affecting financial institutions (such as the Dodd-Frank Wall Street Reform and Consumer Protection Act, discussed in greater detail below), including changes in regulatory fees and capital requirements; the Company's ability to enter new markets successfully and capitalize on growth opportunities; the Company's ability to successfully integrate acquired entities; changes in consumer spending, borrowing and saving habits; changes in the Company's organization, compensation and benefit plans; and other factors discussed elsewhere in this Quarterly Report on Form 10-Q, as well as in the Company's periodic reports filed with the SEC, in particular the "Risk Factors" discussed in Item 1A of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2009. Many of these factors are beyond the Company's control and are difficult to predict.

Because of these and other uncertainties, the Company's actual results, performance or achievements could differ materially from those contemplated, expressed or implied by the forward-looking statements contained herein. Forward-looking statements speak only as of the date they are made. The Company undertakes no obligation to publicly update or revise forward-looking information, whether as a result of new, updated information, future events or otherwise.

APPLICATION OF CRITICAL ACCOUNTING ESTIMATES The Company's Unaudited Consolidated Financial Statements included in this Quarterly Report on Form 10-Q are prepared in accordance with U.S. GAAP and follow general practices within the industries in which it operates. Application of these principles requires management to make estimates, assumptions and judgments that affect the amounts reported in the Company's Unaudited Consolidated Financial Statements and Notes. These estimates, assumptions and judgments are based on information available as of the date of the Unaudited Consolidated Financial Statements. Accordingly, as this information changes, the Unaudited Consolidated Financial Statements could reflect different estimates, assumptions and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions and judgments, and as such, have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available. When third-party information is not available, valuation adjustments are estimated in good faith by management primarily through the use of internal cash flow modeling techniques. Refer to Note 3 - "Fair Value Measurements" to the Company's Unaudited Consolidated Financial Statements included in Item 1 of this Quarterly Report on Form 10-Q for further detail on fair value measurement. Significant accounting policies followed by the Company are presented in Note 1 - "Organization and Summary of

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Significant Accounting Policies" to the Audited Consolidated Financial Statements included in Item 8 in its Annual Report on Form 10-K for the year ended December 31, 2009. These policies, along with the disclosures presented in the other Notes to the Company's Audited Consolidated Financial Statements contained in its Annual Report on Form 10-K and in this financial review, provide information on how significant assets and liabilities are presented in the Company's Unaudited Consolidated Financial Statements and how those values are determined.

Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions and estimates underlying those amounts, management has identified the determination of the allowance for loan and lease losses and valuation of goodwill to be the accounting areas that require the most subjective or complex judgments, and as such, could be most subject to revision as new information becomes available. Allowance for Loan and Lease Losses

The allowance for loan and lease losses represents management's estimate of probable losses in the Company's loan and lease portfolio. Determining the amount of the allowance for loan and lease losses is considered a critical accounting estimate because it requires significant judgment on the part of management and the use of estimates related to the amount and timing of expected future cash flows on impaired loans and leases, estimated losses on pools of homogeneous loans and leases based on historical loss experience and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan and lease portfolio also represents the largest asset type on the Company's Unaudited Consolidated Balance Sheets. Note 1 to the Audited Consolidated Financial Statements included in Item 8 in the Company's Annual Report on Form 10-K for the year ended December 31, 2009, describes the methodology used to determine the allowance for loan and lease losses.

Goodwill

The amount of goodwill reflected in the Company's Unaudited Consolidated Financial Statements is required to be tested by management for impairment on at least an annual basis. The test for impairment of goodwill on the identified reporting unit is considered a critical accounting estimate because it requires judgment on the part of management and the use of estimates related to the growth assumptions and market multiples used in the valuation model. The goodwill impairment testing is typically performed annually on December 31st. Since the stock price of the Company was below the book value per share at September 30, 2010, another goodwill impairment test was performed. No impairment charges were incurred as a result of the test and the fair value of the tested reporting unit substantially exceeded its fair value.

RECENT LEGISLATION

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") was signed into law on July 21, 2010. The Act contains numerous and wide-ranging reforms to the structure and operation of the U.S. financial system. Among the Act's significant regulatory changes are (i) the imposition of more stringent capital requirements on bank holding companies by, among other things, imposing leverage ratios and prohibiting new trust preferred issuances from counting as Tier 1 capital; (ii) making permanent the temporary increase in FDIC deposit insurance coverage from $100,000 to $250,000 and providing for unlimited deposit insurance on noninterest-bearing transaction accounts, together with an increase in the minimum Deposit Insurance Fund reserve requirement and a change in the assessment base from deposits to net assets; (iii) the creation of the Bureau of Consumer Financial Protection, a new financial consumer protection agency, which is empowered to promulgate new consumer protection regulations and revise existing regulations in many areas of consumer compliance; (iv) provisions permitting states to adopt stricter consumer protection laws and permitting state attorneys general to enforce rules issued by the Bureau of Consumer Financial Protection; (v) increased regulation of derivatives and hedging transactions and restrictions on the Company's ability to engage in certain proprietary trading and investing activities; (vi) limitations on debit card interchange fees; (vii) the imposition of new disclosure and other requirements related to corporate governance and executive compensation; and (viii) the creation of the Financial Stability Oversight Council, with responsibility for identifying and monitoring systemic risks posed by financial firms, activities and practices.

The Company is currently evaluating the potential impact of the Act on its business, financial condition and results of operations. Management expects that some provisions of the Act may have adverse effects on the Company, such

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as the cost of complying with the numerous new regulations and disclosure and reporting requirements mandated by the Act. Portions of the Act become effective at different times, and many of the Act's provisions consist of general statements directing various regulators to issue more detailed rules. Consequently, the full scope of the Act's impact on the financial system in general and the Company in particular cannot be predicted at this time.

ANALYSIS OF FINANCIAL CONDITION

Loan and Lease Activity

Total loans and leases grew to $504.6 million at September 30, 2010, reflecting a $1.6 million or 0.3% increase from June 30, 2010 and a 3.1% increase from December 31, 2009. Loans secured by real estate were $410.6 million at September 30, 2010, an increase of $0.5 million or 0.1% from June 30, 2010 and of $21.1 million or 5.4% increase from December 31, 2009. The two portfolios that grew the most in the second quarter were construction loans and commercial and industrial (C&I) loans.

In 2008 and 2009, some of the Bank's larger banking competitors and the conduit markets curtailed their lending activities somewhat and consequently created opportunities in the local commercial real estate market for smaller banks, such as the Bank. The increased opportunities resulted in the Bank's strong commercial real estate growth rates. Given the Bank's experienced and local lending team, its history of low commercial real estate losses, and knowledge of its customers, management feels comfortable that its growth in commercial real estate over the past couple years has put quality assets on the balance sheet. However, the Company's strategy has shifted to a more diverse loan portfolio not as heavily reliant on commercial real estate for growth. This is evidenced in the lack of growth in commercial and multi-family real estate loans in the third quarter while C&I loans increased $4.4 million, or 7.1% from June 30, 2010. C&I loans traditionally provide Evans with a better opportunity to gain commercial deposits and establish deeper relationships.

The national direct financing lease portfolio declined $3.9 million during the third quarter and has declined $12.7 million year-to-date to $18.7 million at September 30, 2010 as the Company ceased lease originations in the second quarter of 2009 and is winding down the portfolio and exiting this business line. In the third quarter of 2009, the Company announced that it had ceased its marketing efforts to sell the portfolio and intends to service the portfolio until maturity. The national direct financing lease portfolio currently comprises 3.7% of the Company's total loan and lease portfolio, down from 4.5% at June 30, 2010 and 6.4% at December 31, 2009.

Residential 1-4 family real estate loans decreased $1.3 million from June 30, 2010 and $2.2 million from December 31, 2009. Recent efforts by the federal government to stimulate housing demand in the face of the economic recession have lowered residential home mortgage rates and resulted in stronger consumer real estate demand. 2009 was the high point of the Bank's residential mortgage demand, with demand slowing somewhat in 2010 as the low rate environment has been in place for so long that many of the consumers who would be candidates to re-finance have already done so. Although demand has abated in 2010 somewhat, it is still higher than the typical volume experienced in the Company's history. Given the low fixed rates and long terms of the loans being originated, the Company has sold many of its originated residential mortgage loans. This, along with prepayments from existing customers re-financing their homes, has resulted in decreased consumer real estate balances at September 30, 2010 when compared with June 30, 2010 and December 31, 2009.

The Bank sells these fixed rate residential mortgages to FNMA, while maintaining the servicing rights for those mortgages. During the three month period ended September 30, 2010, the Bank sold mortgages to FNMA totaling $2.8 million, as compared with $4.0 million sold during the three month period ended September 30, 2009. During the nine month period ended September 30, 2010, the Bank sold mortgages to FNMA totaling $7.6 million, as compared with $12.6 million during the nine month period ended September 30, 2009. Sales to FNMA decreased due to a decline in originations. At September 30, 2010, the Bank had a loan servicing portfolio principal balance of $41.3 million upon which it earns servicing fees, as compared with $40.3 million at June 30, 2010 and $37.4 million at December 31, 2009. The value of the mortgage servicing rights for that portfolio was $0.3 million at September 30, 2010, compared with $0.4 million at June 30, 2010 and $0.3 million at December 31, 2009. The value of the mortgage servicing rights has not increased in perfect correlation to the increase in the size of the servicing portfolio because the historic low interest rate environment portends more prepayments and refinancing of loans in the servicing portfolio with higher coupon rates, reducing the amount of time the Company has to earn servicing fees from FNMA. Residential mortgage loans held-for-sale were $0.7 million at September 30, 2010, compared with

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$0.3 million at June 30, 2010 and $0.3 million at December 31, 2009. The Company has never been contacted by FNMA to repurchase any loans due to improper documentation or fraud.

Loan and Lease Portfolio Composition

The following table presents selected information on the composition of the Company's loan and lease portfolio in dollar amounts and in percentages as of the dates indicated.

	September 30, 2010	December 31, 2009
	(in thousands)	
Mortgage loans on real estate:		
Residential 1-4 family	$ 78,591	$ 80,775
Commercial and multi-family	255,621	244,242
Construction	30,764	21,010
Second mortgages	6,439	7,813
Home equity lines of credit	39,179	35,633
Total real estate loans	410,594	389,473
Direct financing leases	18,745	31,486
Commercial and industrial loans	66,576	60,345
Consumer loans	2,905	2,957
Other	5,453	4,782
Net deferred loan origination costs	315	525
	504,588	489,568
Allowance for loan losses	(9,099)	(6,971)
Loans, net	$ 495,489	$ 482,597

Other loans include $0.9 million and $0.2 million at September 30, 2010 and December 31, 2009, respectively, of overdrawn deposit accounts classified as loans.

Leasing Portfolio

Net loan and lease charge-offs were $0.2 million and $0.4 million for the three and nine month periods ended September 30, 2010 as compared with $0.1 million and $9.6 million in the three and nine month periods ended September 30, 2009. Nearly all of the net charge-offs for 2009 was in the Company's leasing portfolio. What follows is an explanation of the sequence of events for ENL over the past 18 months, followed by a table illustrating the history of the leasing portfolio's accounting over the past 15 months.

The rapid deterioration of the portfolio, the lack of strategic fit in the Company's community banking business model, and the sensitivity of direct financing leases to the economic environment led management to make the strategic decision in April 2009 to exit the national direct financing lease business and market the portfolio for sale. This decision resulted in the classification of the leasing portfolio as held-for-sale and the portfolio being marked to its market value at June 30, 2009. The mark-to-market adjustment was $7.2 million. At September 30, 2009, management determined to keep the lease portfolio, terminated its plans to actively market the portfolio for sale, and the portfolio was placed back into held-for-investment at the revised carrying amount as of June 30, 2009. The difference between the principal value and the carrying value, initially created by the mark-to-market adjustment at June 30, 2009, reduces over time as individual leases deteriorate, become uncollectible, and are written off. The allowance for lease losses was zero at June 30, 2009 when the portfolio was classified as held-for-sale and reported at its fair market value. With the portfolio classified as held-for-investment at September 30, 2010, the portfolio has been evaluated in accordance with the Company's normal credit review policies in determining the appropriate allowance for lease losses. During the third quarter of 2010, $0.3 million in leases were deemed uncollectible and the difference between the principal value and carrying value of the leases declined from $2.4 million to $2.1 million. This is a decline in the quarterly write-offs from $0.6 million in the second quarter of 2010 and $1.1 million in the first quarter of 2010. Non-performing leases of $2.4 million at September 30, 2010 have declined from $2.9 million at December 31, 2009, but remained flat compared with $2.4 million at June 30, 2010. Leases still accruing but delinquent 31 days or more were $0.4 million at September 30, 2010, an increase from $0.2 million at June 30, 2010 and $0.3 million at December 31, 2009. With charge-offs continuing to reduce the remaining mark

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on the leasing portfolio and non-accruing and delinquent leases not correspondingly declining, management determined that an additional $0.3 million in reserve for lease losses was appropriate at September 30, 2010.

	2010			2009	
($ in thousands)	September 30,	June 30,	March 31,	December 31,	September 30,
Leasing Principal Balance	$ 20,869	$ 25,142	$ 29,788	$ 35,645	$ 41,950
Mark	(2,124)	(2,469)	(3,084)	(4,159)	(5,732)
Leasing Carrying Value	$ 18,745	$ 22,673	$ 26,704	$ 31,486	$ 36,218
Mark-to-Market Adjustment	$ 2,469	$ 3,084	$ 4,159	$ 5,732	$ 7,164
Net Write-Offs	(345)	(615)	(1,075)	(1,573)	(1,432)
Remaining Mark	$ 2,124	$ 2,469	$ 3,084	$ 4,159	$ 5,732

	For the three months ended 2010			For the three months ended 2009	
	September 30,	June 30,	March 31,	December 31,	September 30,
Allowance for lease losses	$ 772	$ 772	$ 0	$ 0	$ 0
Provision for leases	305	-	772	-	-
Leasing net charge-offs	-	-	-	-	-
Allowance for lease losses	$ 1,077	$ 772	$ 772	$ 0	$ 0
Total mark plus allowance	$ 3,201	$ 3,241	$ 3,856	$ 4,159	$ 5,732
Mark + allowance/leasing principal balance	15.34 %	12.89 %	12.94 %	11.67 %	13.66 %

Non-Performing Loans and Leases

Total non-performing loans and leases, defined as accruing loans and leases greater than 90 days past due and non-accrual loans and leases, totaled $9.9 million, or 1.96% of total loans and leases outstanding, at September 30, 2010, compared with $11.1 million, or 2.20% of total loans and leases outstanding at June 30, 2010 and $12.9 million, or 2.64% at December 31, 2009. In the third quarter, two loans totaling $1.4 million were removed from the 90 days past due and still accruing category. One of the loans, for $0.8 million, was extended under normal terms after administrative delays caused the loan to go past its original maturity date, and is no longer categorized as a non-performing loan. The other loan, for $0.6 million, was a construction loan and was put on nonaccrual status and is still considered a non-performing loan. Most of the rest of the decline in nonperforming loans in the quarter ($0.2 million) is attributable to charge-offs of previously non-performing loans.

Non-accruing mortgage loans on real estate were $5.1 million as of September 30, 2010, up from $4.5 million at June 30, 2010 and $4.3 million at December 31, 2009. The increase is primarily attributable to the aforementioned downgrade of a $0.6 million construction loan from the former Waterford portfolio. Non-accruing direct financing leases were $2.4 million at September 30, 2010, flat compared with the $2.4 million balance at June 30, 2010, but lower than the $2.9 million balance at December 31, 2009. Most of the Company's direct financing lease write-offs were from loans in non-accruing status. Thus far in 2010, leasing write-offs have outpaced the rate of formerly performing leases being placed into non-accrual status, resulting in the decrease in non-accruing leases.

Non-accruing commercial and industrial loans were $1.7 million at September 30, 2010, compared with $1.9 million at June 30, 2010 and $1.4 million at December 31, 2009. The decrease in the quarter was related to the charge-off of a commercial and industrial loan for $0.2 million. The increase since December was primarily caused by the downgrading of two commercial loan relationships in the second quarter.

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Loans 90 days past due and still accruing were $0.5 million at September 30, 2010, a decrease from $2.0 million at June 30, 2010 and $4.1 million at December 31, 2009. The two loans remaining in this category are more than 90 days past the initial maturity. The Bank intends to either extend the loans under normal underwriting criteria and market terms or receive payment in full. The delay in refinancing or repayment is generally due to administrative, legal, or other processing matters, and not due to the ability to pay or creditworthiness of the borrower. Of the matured loans that made up this balance at December 31, 2009, March 31, 2010, and June 30, 2010, all except the construction loan for $0.6 million at June 30, 2010 that went into nonaccrual were renewed under normal underwriting criteria and market terms or paid in full.

The following table sets forth information regarding non-performing loans and leases as of the dates specified.

	September 30, 2010	December 31, 2009
	(in thousands)	
Non-accruing loans and leases:		
Mortgage loans on real estate		
Residential 1-4 family	$ 816	$ 1,076
Commercial and multi-family	2,102	2,713
Construction	1,966	417
Second mortgages	74	-
Home equity lines of credit	189	128
Total mortgage loans on real estate	5,147	4,334
Direct financing leases	2,372	2,905
Commercial and industrial loans	1,661	1,400
Consumer loans	200	197
Total non-accruing loans and leases	$ 9,380	$ 8,836
Accruing loans and leases 90+ days past due	523	4,112
Total non-performing loans and leases	$ 9,903	$ 12,948
Total non-performing loans and leases as a percentage of total assets	1.50 %	2.09 %
Total non-performing loans and leases as a percentage of total loans and leases	1.96 %	2.64 %