FLAG FINANCIAL CORP
Form 10-Q
November 09, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2004

OR

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

For the Transition Period from _____ to ______

Commission file number 0-24532

FLAG FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

Georgia (State of incorporation)	58-2094179 (I.R.S. Employer Identification No.)
3475 Piedmont Road N.E. Suite 550 Atlanta, Georgia (Address of principal executive offices)	30305 (Zip Code)

(404) 760-7700
(Telephone Number)

Indicate by check mark whether the registrant has (1) filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES XX NO

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

YES XX NO

Common stock, par value $1 per share: 8,259,663 shares outstanding as of November 4, 2004

Flag Financial Corporation and Subsidiaries

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Part I. Financial Information
Item 1. Financial Statements
Flag Financial Corporation and Subsidiaries

Consolidated Balance Sheets
(in thousands)

		(UNAUDITED) September 30, 2004	(AUDITED) December 31, 2003	(UNAUDITED) September 30, 2003
ASSETS				
Cash and due from banks	$	13,721	17,454	17,434
Interest-bearing deposits in banks		15,852	12,183	19,201
Federal funds sold		18,826	7,100	-
Total cash and cash equivalents		48,399	36,737	36,635
Interest-bearing deposits		1,626	2,675	99
Investment securities available-for-sale		94,607	122,565	123,728
Other investments		13,211	14,944	15,265
Mortgage loans held-for-sale		6,666	4,234	4,829
Loans, net		582,046	477,095	428,292
Premises and equipment, net		14,284	16,497	16,766
Other assets		32,199	29,110	29,038
Total assets	$	793,038	703,857	654,652
LIABILITIES				
Non interest-bearing deposits	$	42,679	51,087	41,475
Interest-bearing demand deposits		320,777	282,261	244,362
Savings		21,863	23,898	25,241
Time		277,998	213,324	200,514
Total deposits		663,317	570,570	511,592
Advances from Federal Home Loan Bank		40,000	58,000	53,000
Federal funds purchased and other borrowings		4,144	5,197	19,715
Subordinated debt		14,433	-	-
Accrued interest payable and other liabilities		6,106	4,830	6,150
Total liabilities		728,000	638,597	590,457
STOCKHOLDERS' EQUITY				
Preferred stock (10,000 shares authorized, none issued and outstanding)		-	-	-
Common stock ($1 par value, 20,000 shares authorized, 9,811, 9,775 and 9,757 shares issued at				

September 30, 2004, December 31, 2003 and				
September 30, 2003, respectively	$	9,811	9,775	9,757
Additional paid-in capital		24,799	24,557	24,433
Retained earnings		43,460	39,294	38,276
Accumulated other comprehensive income		472	1,211	1,306
Less: Treasury stock at cost; 1,551 shares at September 30, 2004, 1,247 shares at				
December 31, 2003 and 1,247 shares at September 30, 2003, respectively		(13,504)	(9,577)	(9,577)
Total stockholders' equity		65,038	65,260	64,195
Total liabilities and stockholders' equity	$	793,038	703,857	654,652

See Accompanying Notes to Unaudited Consolidated Financial Statements.

Consolidated Statements of Earnings

(in thousands, except per share data)		(UNAUDITED)			
		Three Months Ended September 30,		Nine Months Ended September 30,	
		2004	**2003**	**2004**	**2003**
Interest Income					
Interest and fees on loans	$	9,515	7,757	26,313	22,197
Interest on investment securities		1,177	1,383	3,925	4,371
Interest on federal funds sold and interest-bearing deposits		121	127	320	506
Total interest income		10,813	9,267	30,558	27,074
Interest Expense					
Interest on deposits:					
Demand		1,343	821	3,576	2,345
Savings		32	37	99	112
Time		1,436	1,413	3,857	4,848
Interest on other borrowings		354	219	887	634
Total interest expense		3,165	2,490	8,419	7,939
Net interest income before provision for loan losses		7,648	6,777	22,139	19,135
Provision for Loan Losses		375	375	1,470	946
Net interest income after provision for loan losses		7,273	6,402	20,669	18,189
Other Income					
Fees and service charges on deposit accounts		946	850	2,796	2,572
Mortgage banking activities		744	1,144	1,869	3,487
Insurance commissions and brokerage fees		162	49	438	424
Gain on sale of branch		-	-	3,000	-
Gain on sale of investment securities		7	4	700	12
Other income		395	285	734	1,827
Total other income		2,254	2,332	9,537	8,322
Other Expenses					
Salaries and employee benefits		4,480	3,939	13,347	12,018
Occupancy		974	825	2,747	2,522
Professional fees		235	123	817	564
Postage, printing and supplies		244	230	693	759
Amortization of intangibles		23	23	68	60
Communications and data		556	626	1,670	1,832
Other operating		785	737	2,676	2,121
Total other expenses		7,297	6,503	22,018	19,876
Earnings before provision for income taxes		2,230	2,231	8,188	6,635
Provision for income taxes		571	685	2,512	2,060
Net earnings	$	1,659	1,546	5,676	4,575

Basic earnings per share	$	0.20	0.18	0.67	0.54
Diluted earnings per share	$	0.19	0.17	0.63	0.51

See Accompanying Notes to Unaudited Consolidated Financial Statements.

Consolidated Statements of Comprehensive Income

(in thousands)		Three Months Ended September 30,		Nine Months Ended September 30, (UNAUDITED)	
		2004	**2003**	**2004**	**2003**
Net earnings	$	1,659	1,546	5,676	4,575
Other comprehensive loss, net of tax:					
Unrealized gains (losses) on investment securities available-for-sale:					
Unrealized gains (losses) arising during the period, net of tax of $271, $387, $187 and $374, respectively		441	(631)	(306)	(611)
Reclassification adjustment for (gains) losses included in net earnings net of tax of $3, $1, $266 and $5, respectively		(4)	(3)	(433)	(7)
Unrealized gain on cash flow hedges, net of tax of $46		-	-	-	(75)
Other comprehensive income (loss)		437	(634)	(739)	(693)
Comprehensive income	$	2,096	912	4,937	3,882

See Accompanying Notes to Unaudited Consolidated Financial Statements

Consolidated Statements of Cash Flows

(in thousands)		(UNAUDITED) Nine Months Ended September 30, 2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net earnings	$	5,676	4,575
Adjustment to reconcile net earnings to net			
cash provided by operating activities:			
Depreciation, amortization and accretion		2,322	2,606
Provision for loan losses		1,470	946
Gain on sale of branch office		(3,000)	-
Gain on sale of available-for-sale securities		(700)	(12)
Gain on sale of loans		(1,028)	(1,899)
Loss (gain) on sale, write-down of fixed assets		56	(922)
Gain on sale of other real estate		(113)	(113)
Change in:			
Mortgage loans held-for-sale		(1,404)	7,777
Other		(3,084)	2,551
Net cash provided by operating activities		195	15,509
CASH FLOWS FROM INVESTING ACTIVITIES:			
Cash paid in branch sale		(14,141)	-
Net change in interest-bearing deposits		1,049	12,312
Proceeds from sales and maturities of investment			
securities available-for-sale		65,603	69,033
Purchases of investment securities available-for-sale		(39,649)	(55,874)
Purchases of other investments		(750)	(8,920)
Proceeds from sales of other investments		3,160	450
Net change in loans		(123,110)	(54,454)
Proceeds from sale of other real estate		1,650	1,933
Proceeds from sale of premises and equipment		183	4,345
Purchases of premises and equipment		(1,136)	(691)
Purchases of cash surrender value life insurance		(115)	(123)
Net cash used in investing activities		(107,256)	(31,989)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net change in deposits		128,502	1,860
Change in federal funds purchased		(2,453)	17,030
Change in other borrowed funds		1,400	1,350
Proceeds from FHLB advances		15,000	
Payments of FHLB advances		(33,000)	(5,000)
Proceeds from issuance of subordinated debt		14,433	-
Purchase of treasury stock		(3,927)	-
Proceeds from exercise of stock options		278	939
Proceeds from issuance of stock		-	138

Proceeds from issuance of warrants		-	12
Cash dividends paid		(1,510)	(1,524)
Net cash provided by financing activities		118,723	14,805
Net change in cash and cash equivalents		11,662	(1,675)
Cash and cash equivalents at beginning of period		36,737	38,310
Cash and cash equivalents at end of period	$	48,399	36,635

See Accompanying Notes to Unaudited Consolidated Financial Statements

Notes to Consolidated Financial Statements

The accompanying consolidated financial statements have not been audited. The results of operations are not necessarily indicative of the results of operations for the full year or any other interim periods.

Note 1. Basis of Presentation
The consolidated financial statements include the accounts of Flag and its wholly owned subsidiaries, Flag Bank (Atlanta, Georgia) and Flag Financial Corporation Statutory Trust. All significant inter-company accounts and transactions have been eliminated in consolidation.

The consolidated financial information furnished herein represents all adjustments that are, in the opinion of management, necessary to present a fair statement of the results of operations, and financial position for the periods covered herein and are normal and recurring in nature. For further information, refer to the consolidated financial statements and footnotes included in Flag s annual report on Form 10-K for the year ended December 31, 2003.

Note 2. Earnings Per Share
Net earnings per common share are based on the weighted average number of common shares outstanding during each period. The calculation of basic and diluted earnings per share is as follows:

(in thousands, except per share data)		Three Months Ended **September 30,**		**Nine Months Ended September 30,**	
		2004	**2003**	**2004**	**2003**
Basic earnings per share:					
Net earnings	$	1,659	1,546	5,676	4,575
Weighted average common shares outstanding		8,263	8,500	8,416	8,456
Per share amount	$	0.20	0.18	0.67	0.54
Diluted earnings per share:					
Net earnings	$	1,659	1,546	5,676	4,575
Effect of stock options and warrants		593	665	562	586
Diluted earnings per share	$	0.19	0.17	0.63	0.51

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Note 3. Stock-based Compensation
Flag sponsors stock-based compensation plans. Flag accounts for these plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. No stock-based employee compensation cost is reflected in net earnings, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net earnings and earnings per share if Flag had applied the fair value recognition provisions of Statement of Financing Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

	Three months ended	**Nine months ended**

(in thousands, except per share data)

		September 30,		September 30,	
		2004	**2003**	**2004**	**2003**
Net earnings as reported	$	1,659	1,546	5,676	4,575
Compensation expense determined by fair value method	$	(49)	(76)	(104)	(229)
Pro forma net earnings	$	1,610	1,470	5,572	4,346
Basic earnings per share:					
As reported	$	0.20	0.18	0.67	0.54
Pro forma	$	0.19	0.17	0.66	0.51
Diluted earnings per share:					
As reported	$	0.19	0.17	0.63	0.51
Pro forma	$	0.18	0.16	0.62	0.48

Notes to Consolidated Financial Statements

During the first nine months of 2004, Flag issued 91,500 options with a weighted average estimated value of $3.48 each. The fair value of each option was estimated on the date of grant using the Black-Scholes options-pricing model with the following weighted average assumptions: dividend yield of 1.80%; volatility of .2865; risk free interest rate of 4.23%; and an expected life of five years.

Note 4. Loans
Flag engages in a full complement of lending activities, including real estate-related, commercial and financial loans and consumer installment loans. Flag generally concentrates lending efforts on real estate related loans. As of September 30, 2004, Flag s loan portfolio consisted of 86.6% real estate-related loans, 10.9% commercial and financial loans, and 2.5% consumer installment loans. While risk of loss is primarily tied to the credit quality of the various borrowers, risk of loss may also increase due to factors beyond the Flag s control, such as local, regional and/or national economic downturns. General conditions in the real estate market may also impact the relative risk in the real estate portfolio. Of the target areas of lending activities, commercial and financial loans are generally considered to have a greater risk of loss than real estate loans or consumer installment loans.

Loans are stated at unpaid balances, net of unearned income and deferred loan fees. Balances within the major loans receivable categories are represented in the following table:

(in thousands)		**September 30, 2004**	**December 31, 2003**	**September 30, 2003**
Commercial/financial/agricultural	$	64,603	50,435	58,224
Real estate - Construction		159,308	100,108	81,111
Real estate - Mortgage		351,669	315,610	276,042
Installment loans to individuals		14,620	17,287	19,300
Lease financing		174	340	402
Total loans	$	590,374	483,780	435,079
Less: Allowance for loan losses		8,328	6,685	6,787
Total net loans	$	582,046	477,095	428,292

Note 5. Trust Preferred Securities
During the first quarter of 2004, the Company formed a wholly-owned Connecticut statutory business trust, Flag Financial Corporation Statutory Trust, a subsidiary whose sole purpose was to issue $14.4 million of Trust Preferred Securities through a pool sponsored by SunTrust Bank in Atlanta, Georgia. The Trust Preferred Securities have a maturity of 30 years and are redeemable after five years with certain exceptions. During the third quarter of 2004, the floating-rate securities had a 4.34% interest rate, which will reset quarterly at the three-month LIBOR rate plus 2.75%. The Trust Preferred Securities are recorded as subordinated debentures on the balance sheets, but subject to certain limitations, qualify as Tier 1 capital for regulatory capital purposes.

Note 6. Stock Repurchase Program
In March 2004, Flag s board of directors authorized a stock repurchase program covering an amount equal to 10% of the outstanding shares of Flag s common stock. Through September 30, 2004 the Company had purchased approximately 304,000 shares of the approximately 853,000 shares authorized to be purchased, at an average price of

$12.91.

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

Overview
Growth in the balance sheet, primarily driven from efforts in Metro Atlanta, highlighted the Company s performance in the third quarter. Total assets grew to approximately $793.0 million, an increase of 12.7% from December 31, 2003. Loans outstanding (excluding loans held for sale) increased 22.0% to $590.4 million at September 30, 2004 when compared to December 31, 2003. Total deposits grew to $663.3 million, an increase of $92.7 million or 16.3% from balances at December 31, 2003.

The growth in the balance sheet and earning assets contributed to solid growth in net interest income. Net interest income for the third quarter of 2004 increased 12.9% to $7.6 million from $6.8 million in the third quarter of 2003. For the nine-month period, net interest income increased 15.7% to $22.1 million from the $19.1 million recorded during the same time period in 2003. Total interest income for the nine-month period increased 12.9% to $30.6 million. This increase in interest income is the result of several factors, the most significant of which are the growth in loan balances and the growth in loan fees. Fees on loans for the nine-month period ended September 30, 2004 were $4.1 million, an increase of 36.6% when compared to the same period in 2003.

Return on average equity for the three months ended September 30, 2004 was 10.21% on average shareholders equity of $65.0 million. This compares to 9.70% on average equity of $63.8 million for the same period in 2003. Return on average assets for the three months ended September 30, 2004 was 0.87%. This compares to 0.98% for the same period in 2003. For the nine-month periods ended September 30, 2004 and 2003, Flag s return on average shareholders equity was 11.50% and 9.72%, respectively. Flag s return on average assets for the same periods was 1.04% and 0.97%, respectively.

Forward-Looking Statements
The following discussion and comments contain "forward-looking statements" relating to, without limitation, future economic performance, plans and objectives of management for future operations, and projections of revenues and other financial items that are based on the beliefs of our management, as well as assumptions made by and information currently available to our management. The words expect , estimate , anticipate , and believe , as wel similar expressions, are intended to identify forward-looking statements. Our actual results may differ materially from the results discussed in the forward-looking statements, and our operating performance each quarter is subject to various risks and uncertainties. Factors that could cause actual results to differ from those discussed in the forward-looking statements include, but are not limited to, (i) the strength of the U.S. economy as well as the strength of the local economies in which operations are conducted; (ii) the effects of changing interest rates which could lower margins; (iii) inflation, interest rate, market and monetary fluctuations; (iv) unanticipated regulatory proceedings or legal actions, or changes in accounting policies and practices as adopted by the Financial Accounting Standards Board; (v) issues involved in the integration of any acquisitions; and (vi) the timely development of products and services that position Flag to succeed in an increasingly competitive industry. If we are unsuccessful in managing the risks relating to these factors, together with other risks incident to the operation of our business, our financial condition, results of operations and cash flows could be adversely affected. Forward-looking statements speak only as of the date on which they are made. We undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made to reflect the occurrence of unanticipated events.

Critical Accounting Policies
The accounting principles we follow and our methods of applying these principles conform with accounting principles generally accepted in the United States and with general practices within the banking industry. In connection with the

application of those principles, we have made judgments, estimates and assumptions which, in the case of the determining our allowance for loan losses (ALL), have been critical to the determination of our financial position and results of operations. Management assesses the adequacy of the ALL regularly during the year, and formally prior to the end of each calendar quarter. This assessment includes procedures to estimate the allowance and test the adequacy and appropriateness of the resulting balance.

This estimation process can affect our estimated loan loss expense for a given period. Generally, the allowance for loan losses increases as the outstanding balance of loans or the level of classified or impaired loans increases. Loans or portions of loans that are deemed uncollectible are charged against and reduce the allowance. The allowance is replenished by means of a provision for loan losses that is charged as an expense against income. As a result, our estimate of the allowance for loan losses affects our earnings directly.

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

The ALL consists of two portions: (1) allocated amounts representing the potential exposures on specifically identified credits and other exposures readily predictable by historical or comparative experience; and (2) an unallocated amount
representative of inherent loss, which is not readily identifiable. Even though the ALL is composed of two components, the entire ALL is available to absorb any credit losses. Allocated amounts are used on loans where management has determined that there is an increased probability or severity of loss than on the loan portfolio as a whole. We base the allocation for these unique loans primarily on risk rating grades assigned to each of these loans as a result of our loan management and review processes. We then assign each risk-rating grade a loss ratio, which is determined based on the experience of management, discussions with banking regulators and our independent loan review process. We estimate losses on impaired loans based on estimated cash flows discounted at the loan's original effective interest rate or based on the underlying collateral value. To the extent that management does not believe that a certain loan's risk is appropriately represented by the risk rating grades, a specific review of the credit is performed which would result in a less subjective allocation for that particular loan.

Unallocated amounts are particularly subjective and do not lend themselves to exact mathematical calculation. The unallocated amount represents estimated inherent credit losses which may exist, but have not yet been identified, as of the balance sheet date. In estimating the unallocated amount, such matters as changes in the local or national economy, the depth or experience in the lending staff, any concentrations of credit in any particular industry group, and new banking laws or regulations. After we assess applicable factors, we evaluate the aggregate unallocated amount based on our management's experience. We then est the resulting ALL balance by comparing the balance in the ALL to historical trends and peer information. Our management then evaluates the result of the procedures performed, including the result of our testing, and concludes on the appropriateness of the balance of the ALL in its entirety.

The audit committee of our board of directors reviews the assessment prior to the filing of quarterly and annual financial information. In assessing the adequacy of the ALL, we also rely on an ongoing independent loan review process. We undertake this process both to ascertain whether there are loans in the portfolio whose credit quality has weakened over time and to assist in our overall evaluation of the risk characteristics of the entire loan portfolio. Our loan review process includes the judgment of management, the input from our independent loan reviewer, and reviews that may have been conducted by bank regulatory agencies as part of their usual examination process.

Summary Financial Data

The following table presents summary financial data for the previous five quarters

(in thousands, except per share data)		2004			2003
	Third	Second	First	Fourth	Third
(unaudited)	Quarter	Quarter	Quarter	Quarter	Quarter
INCOME SUMMARY					
Interest income	$ 10,813	10,071	9,674	9,461	9,267
Interest expense	3,165	2,712	2,541	2,608	2,490
Net interest income	7,648	7,359	7,133	6,853	6,777
Provision for loan losses	375	375	720	375	375
Other income	2,254	2,591	4,692	2,042	2,332
Other expenses	7,297	6,734	7,988	6,327	6,503
Earnings before taxes	2,230	2,841	3,117	2,193	2,231
Income taxes	571	920	1,021	664	685
Earnings	$ 1,659	1,921	2,096	1,530	1,546
PERFORMANCE RATIOS					
Earnings per common share:					
Basic	$ 0.20	0.23	0.25	0.18	0.18
Diluted	0.19	0.21	0.23	0.17	0.17
Return on average equity					