SOUTHERN FIRST BANCSHARES INC
Form 10-Q
November 07, 2012

**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

**S QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the Quarterly Period Ended September 30, 2012**
**OR**
**o 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 000-27719**

**Southern First Bancshares, Inc.**

(Exact name of registrant as specified in its charter)

**864-679-9000**
(Registrant's telephone number, including area code)

**Not Applicable**
(Former name, former address, and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the 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 S No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes S  No o

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 definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 3,854,312 shares of common stock, par value $0.01 per share, were issued and outstanding as of November 1, 2012.

***SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY***
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***SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY***
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**(Unaudited)**

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***NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS***

**NOTE 1 – Nature of Business and Basis of Presentation**

*Business Activity*

***Southern First Bancshares, Inc.*** (the "Company") is a South Carolina corporation that owns all of the capital stock of Southern First Bank, N.A. (the "Bank") and all of the stock of Greenville First Statutory Trust I and II (collectively, the "Trusts"). On July 2, 2007, the Company and Bank changed their names to Southern First Bancshares, Inc. and Southern First Bank, N.A., respectively. The Bank is a national bank organized under the laws of the United States and located in Greenville County, South Carolina and operates as Greenville First Bank in Greenville County. The Bank is primarily engaged in the business of accepting demand deposits and savings deposits insured by the Federal Deposit Insurance Corporation (the "FDIC"), and providing commercial, consumer and mortgage loans to the general public. The Trusts are special purpose non-consolidated entities organized for the sole purpose of issuing trust preferred securities.

*Basis of Presentation*

The accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all the information and footnotes 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 three and nine month periods ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011 (Registration Number 000-27719) as filed with the Securities and Exchange Commission on March 9, 2012. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, the Bank. In accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 810, "Consolidation," the financial statements related to the special purpose subsidiaries, the Trusts, have not been consolidated.

*Use of Estimates*

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amount of income and expenses during the reporting periods. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, other real estate owned, fair value of financial instruments, evaluating other-than-temporary-impairment of investment securities and valuation of deferred tax assets.

*Reclassifications*

Certain amounts, previously reported, have been reclassified to state all periods on a comparable basis that had no effect on shareholders' equity or net income.

*Formal Agreement with the Office of the Comptroller of the Currency*

On June 8, 2010, the Bank entered into a formal agreement (the "Formal Agreement") with its primary regulator, the Office of the Comptroller of the Currency (the "OCC"). The Formal Agreement seeks to enhance the Bank's existing practices and procedures in the areas of credit risk management, credit underwriting, liquidity, and funds management. The Board of Directors and management of the Bank have aggressively worked to address the findings of the exam and believe the Company is currently in compliance with substantially all of the requirements of the Formal Agreement. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" for more discussion of the Formal Agreement.

*Subsequent Events*

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Non-recognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management performed an evaluation to determine whether there have been any subsequent events since the balance sheet date and determined that no subsequent events occurred requiring accrual or disclosure.

*Recently Adopted Accounting Pronouncements*

The following is a summary of recently adopted authoritative pronouncements that have impacted the accounting, reporting, and/or disclosure of financial information by the Company.

The Comprehensive Income topic of the ASC was amended in June 2011. The amendment eliminates the option to present other comprehensive income as a part of the statement of changes in stockholders' equity and requires consecutive presentation of the statement of net income and other comprehensive income. The amendments were applicable to the Company on January 1, 2012 and have been applied retrospectively. In December 2011, the topic was further amended to defer the effective date of presenting reclassification adjustments from other comprehensive income to net income on the face of the financial statements. Companies should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect prior to the amendments while FASB deliberates future requirements.

Accounting Standards Update ("ASU") 2011-04 was issued in May 2011 to amend the Fair Value Measurement topic of the ASC by clarifying the application of existing fair value measurement and disclosure requirements and by changing particular principles or requirements for measuring fair value or for disclosing information about fair value measurements. The amendments were effective for the Company beginning January 1, 2012 and had no effect on the financial statements.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

**NOTE 2 – Preferred Stock Issuance and Partial Redemption**

On February 27, 2009, as part of the Capital Purchase Program ("CPP"), the Company entered into a Securities Purchase Agreement with the U.S. Department of the Treasury ("the Treausry"), pursuant to which the Company sold 17,299 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series T (the "Series T Preferred Stock") and a warrant to purchase 399,970.34 shares of the Company's common stock (the "Warrant") for an aggregate purchase price of $17.3 million in cash. The Series T Preferred Stock qualified as Tier 1 capital and was entitled to cumulative dividends at a rate of 5% per annum for the first five years and 9% per annum thereafter. The Warrant had a 10-year term and was immediately exercisable upon its issuance, with an exercise price, subject to anti-dilution adjustments equal to $6.487 per share of the common stock.

On June 28, 2012, the Treasury sold its Series T Preferred Stock through a public offering structured as a modified Dutch auction. The Company bid on a portion of the Series T Preferred Stock in the auction after receiving approval from its regulators to do so. The clearing price per share for the preferred shares was $904 (compared to a par value of $1,000 per share), and the Company was successful in repurchasing 1,000 shares of the 17,299 shares of Series T Preferred Stock outstanding through the auction process. The remaining 16,299 shares of Series T Preferred Stock held by the Treasury were sold to unrelated third-parties through the auction process. Included in the September 30, 2012 operating results are approximately $130,000 of costs incurred by the Company related to the offering. These costs are not tax-deductible. The net balance sheet impact was a reduction to shareholders' equity of $904,000 which is comprised of a decrease in Series T Preferred Stock of $1.0 million and a $96,000 increase to retained earnings related to the discount on the shares repurchased. The redemption of the $1.0 million in preferred shares will save the Company $50,000 annually in dividend expenses.

In addition, on July 25, 2012, the Company completed its repurchase of the Warrant from the Treasury for a mutually agreed upon price of $1.1 million. The difference between the fair value of the Warrant, as originally recorded, and the $1.1 million was $343,000 which resulted in a decrease to additional paid in capital. The Company also recorded the remaining accretion of $180,000 on the Series T Preferred Stock which brought the Preferred Stock to its par value. In conjunction with the repurchase of the Warrant, the Company obtained an interest only line of credit for $1.5 million with another financial institution. Interest is payable quarterly at a rate of 5%, and the line of credit matures on February 3, 2014.

Following the settlement of the Warrant on July 25, 2012, the Treasury has completely eliminated its equity stake in the Company through the Capital Purchase Program. As a result, the executive compensation and corporate governance standards that were applicable to the Company while the Treasury held shares of the Series T Preferred Stock are no longer applicable to our Company, and we have the option to increase the compensation for our executive officers and other senior employees on a going forward basis.

**NOTE 3 – Investment Securities**

The amortized costs and fair value of investment securities are as follows:

During the first nine months of 2012, we developed a need for additional liquidity as we experienced increased loan demand and, as a result, sold $45.1 million of our mortgage-backed securities and state and municipal obligations, reinvested $18.1 million of the securities in similar investments at current rates, and recorded a net gain on sale of investment securities of $363,000.

Other investments are comprised of the following and are recorded at cost which approximates fair value.

Contractual maturities and yields on our investment securities at September 30, 2012 and December 31, 2011 are shown in the following table. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. We had no securities with maturities less than five years at September 30, 2012.

The tables below summarize gross unrealized losses on investment securities and the fair market value of the related securities at September 30, 2012 and December 31, 2011, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position.

**NOTE 4 – Loans and Allowance for Loan Losses**

The following table summarizes the composition of our loan portfolio.

*Maturities and Sensitivity of Loans to Changes in Interest Rates*

The information in the following tables summarizes the loan maturity distribution by type and related interest rate characteristics based on the contractual maturities of individual loans, including loans which may be subject to renewal at their contractual maturity. Renewal of such loans is subject to review and credit approval, as well as modification of terms upon maturity. Actual repayments of loans may differ from the maturities reflected below, because borrowers have the right to prepay obligations with or without prepayment penalties.

| | December 31, 2011 | | | |
|---|---|---|---|---|
| | **One year or less** | **After one but within five years** | **After five years** | **Total** |
| **Commercial** | | | | |
| Owner occupied RE | $28,068 | 85,016 | 36,170 | 149,254 |
| Non-owner occupied RE | 49,082 | 105,177 | 10,364 | 164,623 |
| Construction | 6,281 | 3,998 | 7,562 | 17,841 |
| Business | 60,195 | 47,548 | 4,088 | 111,831 |
| Total commercial loans | 143,626 | 241,739 | 58,184 | 443,549 |
| **Consumer** | | | | |
| Real estate | 16,170 | 19,984 | 21,644 | 57,798 |
| Home equity | 15,221 | 21,369 | 46,074 | 82,664 |
| Construction | 5,446 | - | 100 | 5,546 |
| Other | 4,908 | 3,480 | 689 | 9,077 |
| Total consumer | 41,745 | 44,833 | 68,507 | 155,085 |
| Total gross loan, net of deferred fees | $185,371 | 286,572 | 126,691 | 598,634 |
| Loans maturing after one year with: | | | | |
| Fixed interest rates | | | | $240,767 |
| Floating interest rates | | | | 172,496 |

**Portfolio Segment Methodology**

*Commercial*

Commercial loans are assessed for estimated losses by grading each loan using various risk factors identified through periodic reviews. We apply historic grade-specific loss factors to each funded loan. In the development of our statistically derived loan grade loss factors, we observe historical losses over the most recent eight quarters for each loan grade. These loss estimates are adjusted as appropriate based on additional analysis of external loss data or other risks identified from current economic conditions and credit quality trends. The allowance also includes an amount for the estimated impairment on nonaccrual commercial loans and commercial loans modified in a troubled debt restructuring ("TDR"), whether on accrual or nonaccrual status.

*Consumer*

For consumer loans, we determine the allowance on a collective basis utilizing forecasted losses to represent our best estimate of inherent loss. We pool loans, generally by product types with similar risk characteristics. In addition, we establish an allowance for consumer loans that have been modified in a TDR, whether on accrual or nonaccrual status.

**Credit Quality Indicators**

*Commercial*

We manage a consistent process for assessing commercial loan credit quality by monitoring our loan grading trends and past due statistics. All loans are subject to individual risk assessment. Our categories include Pass, Special Mention, Substandard, Doubtful, and Loss, each of which is defined by banking regulatory agencies. Delinquency statistics are also an important indicator of credit quality in the establishment of our allowance for loan losses.

The tables below provide a breakdown of outstanding commercial loans by risk category.

The following tables provide past due information for outstanding commercial loans and include loans on nonaccrual status as well as accruing TDRs.

As of September 30, 2012 and December 31, 2011, loans 30 days or more past due represented 1.33% and 2.38% of our total loan portfolio, respectively. Commercial loans 30 days or more past due were 1.14% and 2.12% as of September 30, 2012 and December 31, 2011, respectively.

*Consumer*

We manage a consistent process for assessing consumer loan credit quality by monitoring our loan grading trends and past due statistics. All loans are subject to individual risk assessment. Our categories include Pass, Special Mention, Substandard, Doubtful, and Loss, each of which is defined by banking regulatory agencies. Delinquency statistics are also an important indicator of credit quality in the establishment of our allowance for loan losses.

The tables below provide a breakdown of outstanding consumer loans by risk category.

The following tables provide past due information for outstanding consumer loans and include loans on nonaccrual status as well as accruing TDRs.

As of September 30, 2012 and December 31, 2011, consumer loans 30 days or more past due were 0.17% and 0.25% as of September 30, 2012 and December 31, 2011, respectively.

**Nonperforming assets**

Nonperforming assets include real estate acquired through foreclosure or deed taken in lieu of foreclosure and loans on nonaccrual status. The following table shows our nonperforming assets and the related percentage of nonperforming assets to total assets and gross loans. Generally, a loan is placed on nonaccrual status when it becomes 90 days past due as to principal or interest, or when we believe, after considering economic and business conditions and collection efforts, that the borrower's financial condition is such that collection of the contractual principal or interest on the loan is doubtful. A payment of interest on a loan that is classified as nonaccrual is recognized as a reduction in principal when received. Our policy with respect to nonperforming loans requires the borrower to make a minimum of six consecutive payments in accordance with the loan terms before that loan can be placed back on accrual status. Further, the borrower must show capacity to continue performing into the future prior to restoration of accrual status. As of September 30, 2012 and December 31, 2011, we had no loans 90 days past due and still accruing.

**Impaired Loans**

The table below summarizes key information for impaired loans. Our impaired loans include loans on nonaccrual status and loans modified in a TDR, whether on accrual or nonaccrual status. These impaired loans may have estimated impairment which is included in the allowance for loan losses. Our commercial impaired loans are evaluated individually to determine the related allowance for loan losses while our consumer impaired loans are evaluated on a collective basis.

The following table provides the average recorded investment in impaired loans and the amount of interest income recognized on impaired loans after impairment by portfolio segment and class.

**Allowance for Loan Losses**

The allowance for loan loss is management's estimate of credit losses inherent in the loan portfolio. The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience (most recent eight quarters), the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

We have an established process to determine the adequacy of the allowance for loan losses that assesses the losses inherent in our portfolio. While we attribute portions of the allowance to specific portfolio segments, the entire allowance is available to absorb credit losses inherent in the total loan portfolio. Our process involves procedures to appropriately consider the unique risk characteristics of our commercial and consumer loan portfolio segments. For each portfolio segment, impairment is measured collectively for groups of smaller loans with similar characteristics and individually for larger impaired loans. Our allowance levels are influenced by loan volumes, loan grade migration or delinquency status, historic loss experience and other economic conditions.

The allowance consists of general and specific components.

Commercial loans are assessed for estimated losses by grading each loan using various risk factors identified through periodic reviews. We apply historic grade-specific loss factors to each funded loan. In the development of our statistically derived loan grade loss factors, we observe historical losses over a relevant period for each loan grade. These loss estimates are adjusted as appropriate based on additional analysis of external loss data or other risks identified from current economic conditions and credit quality trends. For consumer loans, we determine the allowance on a collective basis utilizing historical losses to represent our best estimate of inherent loss. We pool loans, generally by product types with similar risk characteristics.

Included in the general component of the allowance for loan losses for both portfolio segments is a margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating general losses in the portfolio. Uncertainties and subjective issues such as changes in the lending policies and procedures, changes in the local/national economy, changes in volume or type of credits, changes in volume/severity or problem loans, quality of loan review and board of director oversight, concentrations of credit, and peer group comparisons are factors considered.

The specific component relates to loans that are classified as impaired. For loans that are classified as impaired, an allowance is established when the value of the impaired loan is lower than the carrying value of that loan. A loan is considered impaired when, based on current information and events, it is probable that the company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Impairment is measured on a loan by loan basis for commercial loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. The specific component also includes an amount for the estimated impairment on commercial and consumer loans modified in a TDR, whether on accrual or nonaccrual status.

In conjunction with the changes in the current economic environment and as required by our Formal Agreement with the OCC, we have revised and updated our allowance for loan losses policy. Specifically, since December 31, 2010, we have modified our allowance methodology related to the commercial and consumer loan portfolios to use historical loss rates in determining the appropriate level of allowance needed. In addition, we have allocated the unallocated component of the allowance that existed at December 31, 2010 into the commercial and consumer portfolio segments.

While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in local or national economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review our allowance for loan losses. Such agencies may require us to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

The following table summarizes the activity related to our allowance for loan losses:

The following tables summarize the activity in the allowance for loan losses by our commercial and consumer portfolio segments.

The following table disaggregates our allowance for loan losses and recorded investment in loans by impairment methodology.

**NOTE 5 – Troubled Debt Restructurings**

At September 30, 2012, we had 39 loans totaling $14.0 million and at December 31, 2011 we had 42 loans totaling $12.2 million, which we considered as TDRs. The Company considers a loan to be a TDR when the debtor experiences financial difficulties and the Company provides concessions such that we will not collect all principal and interest in accordance with the original terms of the loan agreement. Concessions can relate to the contractual interest rate, maturity date, or payment structure of the note. As part of our workout plan for individual loan relationships, we may restructure loan terms to assist borrowers facing challenges in the current economic environment.

Our policy with respect to accrual of interest on loans restructured in a TDR follows relevant supervisory guidance. That is, if a borrower has demonstrated performance under the previous loan terms and shows capacity to perform under the restructured loan terms; continued accrual of interest at the restructured interest rate is likely. If a borrower was materially delinquent on payments prior to the restructuring, but shows capacity to meet the restructured loan terms, the loan will likely continue as nonaccrual going forward. Lastly, if the borrower does not perform under the restructured terms, the loan is placed on nonaccrual status. We will continue to closely monitor these loans and will cease accruing interest on them if management believes that the borrowers may not continue performing based on the restructured note terms. If, after previously being classified as a TDR, a loan is restructured a second time, then the loan is automatically placed on nonaccrual status.

In the determination of the allowance for loan losses, management considers TDRs on commercial loans and subsequent defaults in these restructurings by measuring impairment, on a loan by loan basis, based on either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral, less costs to sell, if the loan is collateral dependent. Consumer loans, which we typically consider to be homogeneous, are collectively evaluated for impairment.

The following table summarizes the concession at the time of modification and the recorded investment in our TDRs before and after their modification during the nine months ended September 30, 2012.

The following table summarizes the TDRs that are more than 60 days past due, and have subsequently defaulted during the nine months ended September 30, 2012.

**NOTE 6 – Fair Value Accounting**

FASB ASC 820, "Fair Value Measurement and Disclosures," defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. FASB ASC 820 also 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:

Following is a description of valuation methodologies used for assets recorded at fair value.

*Investment Securities*

Securities available for sale are valued on a recurring basis at quoted market prices where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable securities. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange or U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities and debentures issued by government sponsored entities, municipal bonds and corporate debt securities. In certain cases where there is limited activity or less transparency around inputs to valuations, securities are classified as Level 3 within the valuation hierarchy. Securities held to maturity are valued at quoted market prices or dealer quotes similar to securities available for sale. The carrying value of Other Investments, such as Federal Reserve Bank and Federal Home Loan Bank ("FHLB") stock, approximates fair value based on their redemption provisions.

*Loans*

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan may be considered impaired and an allowance for loan losses may be established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures the impairment in accordance with FASB ASC 310, "Receivables." The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At September 30, 2012, substantially all of the impaired loans were evaluated based on the fair value of the collateral. In accordance with FASB ASC 820, "Fair Value Measurement and Disclosures," impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company considers the impaired loan as nonrecurring Level 2. The Company's current loan and appraisal policies require the Bank to obtain updated appraisals on an "as is" basis at renewal, or in the case of an impaired loan, on an annual basis, either through a new external appraisal or an appraisal evaluation. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company considers the impaired loan as nonrecurring Level 3. The fair value of impaired loans may also be estimated using the present value of expected future cash flows to be realized on the loan, which is also considered a Level 3 valuation. These fair value estimates are subject to fluctuations in assumptions about the amount and timing of expected cash flows as well as the choice of discount rate used in the present value calculation.

*Other Real Estate Owned ("OREO")*

OREO, consisting of properties obtained through foreclosure or in satisfaction of loans, is reported at the lower of cost or fair value, determined on the basis of current appraisals, comparable sales, and other estimates of value obtained principally from independent sources, adjusted for estimated selling costs (Level 2). At the time of foreclosure, any excess of the loan balance over the fair value of the real estate held as collateral is treated as a charge against the allowance for loan losses. Gains or losses on sale and generally any subsequent adjustments to the value are recorded as a component of real estate owned activity. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company considers the OREO as nonrecurring Level 3.

*Assets and Liabilities Recorded at Fair Value on a Recurring Basis*

The tables below present the recorded amount of assets and liabilities measured at fair value on a recurring basis.

| | | | December 31, 2011 | |
|---|---|---|---|---|
| | **Level 1** | **Level 2** | **Level 3** | **Total** |
| Assets | | | | |
| Securities available for sale | | | | |
| State and political subdivisions | $- | 18,248 | - | 18,248 |
| Mortgage-backed securities | - | 82,412 | - | 82,412 |
| Other investments | - | - | 7,924 | 7,924 |
| Total assets measured at fair value on a recurring basis | $- | 100,660 | 7,924 | 108,584 |

The Company has no liabilities carried at fair value or measured at fair value on a recurring or nonrecurring basis.

*Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis*

The Company is predominantly an asset based lender with real estate serving as collateral on more than 80% of loans as of September 30, 2012. Loans which are deemed to be impaired are valued net of the allowance for loan losses, and other real estate owned is valued at the lower of cost or net realizable value of the underlying real estate collateral. Such market values are generally obtained using independent appraisals, which the Company considers to be level 2 inputs. The tables below present the recorded amount of assets and liabilities measured at fair value on a nonrecurring basis.

For Level 3 assets and liabilities measured at fair value on a recurring or non-recurring basis as of September 30, 2012, the significant unobservable inputs used in the fair value measurements were as follows:
*Fair Value of Financial Instruments*

Financial instruments require disclosure of fair value information, whether or not recognized in the consolidated balance sheets, when it is practical to estimate the fair value. A financial instrument is defined as cash, evidence of an ownership interest in an entity or a contractual obligation which requires the exchange of cash. Certain items are specifically excluded from the disclosure requirements, including the Company's common stock, premises and equipment and other assets and liabilities.

The following is a description of valuation methodologies used to estimate fair value for certain other financial instruments.

Fair value approximates carrying value for the following financial instruments due to the short-term nature of the instrument: cash and due from banks, federal funds sold, federal funds purchased, and securities sold under agreement to repurchase.

*Bank Owned Life Insurance* - The cash surrender value of bank owned life insurance policies held by the Bank approximates fair values of the policies.

*Deposits* - Fair value for demand deposit accounts and interest-bearing accounts with no fixed maturity date is equal to the carrying value. The fair value of certificate of deposit accounts are estimated by discounting cash flows from expected maturities using current interest rates on similar instruments.

*FHLB Advances and Other Borrowings* - Fair value for FHLB advances and other borrowings are estimated by discounting cash flows from expected maturities using current interest rates on similar instruments.

*Junior subordinated debentures* - Fair value for junior subordinated debentures are estimated by discounting cash flows from expected maturities using current interest rates on similar instruments.

The Company has used management's best estimate of fair value based on the above assumptions. Thus, the fair values presented may not be the amounts that could be realized in an immediate sale or settlement of the instrument. In addition, any income taxes or other expenses, which would be incurred in an actual sale or settlement, are not taken into consideration in the fair value presented.

The estimated fair values of the Company's financial instruments at September 30, 2012 and December 31, 2011 are as follows:

**NOTE 7 – Earnings Per Common Share and Stock Dividend**

On January 17, 2012, the Company's Board of Directors approved a 10% stock dividend to the Company's shareholders. The record date for shareholders entitled to receive the stock dividend was February 3, 2012 and the distribution date was February 17, 2012. Certain amounts in our Consolidated Balance Sheets, including common shares outstanding, have been adjusted for the prior period to reflect the stock dividend. In addition, earnings per share and average shares outstanding in our Consolidated Statements of Income have been adjusted for the prior period to reflect the stock dividend.

The following schedule reconciles the numerators and denominators of the basic and diluted earnings per share computations for the three and nine month periods ended September 30, 2012 and 2011. Dilutive common shares arise from the potentially dilutive effect of the Company's stock options that were outstanding at September 30, 2012. The assumed conversion of stock options can create a difference between basic and dilutive net income per common share. At September 30, 2012 and 2011, 73,002 and 79,970 options, respectively, were anti-dilutive in the calculation of earnings per share as their exercise price exceeded the fair market value.

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

*The following discussion reviews our results of operations for the three and nine month periods ended September 30, 2012 as compared to the three and nine month periods ended September 30, 2011 and assesses our financial condition as of September 30, 2012 as compared to December 31, 2011. You should read the following discussion and analysis in conjunction with the accompanying consolidated financial statements and the related notes and the consolidated financial statements and the related notes for the year ended December 31, 2011 included in our Annual Report on Form 10-K for that period. Results for the three and nine month periods ended September 30, 2012 are not necessarily indicative of the results for the year ending December 31, 2012 or any future period.*

**Discussion of forward-looking statements**

This report, including information included or incorporated by reference in this report, contains statements which constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may relate to our financial condition, results of operation, plans, objectives, or future performance. These statements are based on many assumptions and estimates and are not guarantees of future performance. Our actual results may differ materially from those anticipated in any forward-looking statements, as they will depend on many factors about which we are unsure, including many factors which are beyond our control. The words "may," "would," "could," "should," "will," "expect," "anticipate," "predict," "project," "potential," "believe," "continue," "assume," "intend," "plan," and "estimate," as well as similar expressions, are meant to identify such forward-looking statements. Potential risks and uncertainties that could cause our actual results to differ from those anticipated in any forward-looking statements include, but are not limited to, those described under Item 1A- Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2011, as well as the following:

changes in political conditions and the legislative or regulatory environment, including the effect of the recent financial reform legislation on the banking and financial services industries;

general economic conditions in the U.S., including the possibility of a prolonged period of limited economic growth; disruptions to the credit and financial markets; and contractions or limited growth in consumer spending or consumer credit;

reduced earnings due to higher credit losses, including losses in the sectors of our loan portfolio secured by real estate, may be greater than expected due to economic factors, including, but not limited to, declining real estate values, increasing interest rates, increasing unemployment, changes in payment behavior or other factors;

reduced earnings due to higher credit losses because our loans are concentrated by loan type, industry segment, borrower type, or location of the borrower or collateral;

the high concentration of our real estate-based loans collateralized by real estate in a weak commercial real estate market;

our ability to comply with our Formal Agreement and potential regulatory actions if we fail to comply;

results of examinations by our regulatory authorities, including the possibility that the regulatory authorities may, among other things, require us to increase our allowance for loan losses or write-down assets;

restrictions or conditions imposed by our regulators on our operations may make it more difficult for us to achieve our goals, including the potential that the regulatory agencies may require higher levels of capital above the current standard regulatory-mandated minimums, including the impact of the proposed capital rules under Basel III;

significant increases in competitive pressure in the banking and financial services industries;

increased funding costs due to market illiquidity, increased competition for funding and/or increased regulatory requirements with regard to funding;

changes in the interest rate environment which could reduce anticipated margins;

general economic conditions, either nationally or regionally and especially in our primary service area, being less favorable than expected, resulting in, among other things, a deterioration in credit quality;

changes occurring in business conditions and inflation;

changes in deposit flows;

changes in technology;

changes in monetary and tax policies;

adequacy of the level of our allowance for loan losses;

the rate of delinquencies and amount of loans charged-off;

the rate of loan growth;

adverse changes in asset quality and resulting credit risk-related losses and expenses;

loss of consumer confidence and economic disruptions resulting from terrorist activities;

changes in the securities markets; and

other risks and uncertainties detailed from time to time in our filings with the Securities and Exchange Commission (the "SEC").

All forward-looking statements in this report are based on information available to us as of the date of this report. Although we believe that the expectations reflected in our forward-looking statements are reasonable, we cannot guarantee you that these expectations will be achieved. We undertake no obligation to publicly update or otherwise revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

These risks are exacerbated by the developments over the last three plus years in local, national and international financial markets, and we are unable to predict what effect these uncertain market conditions will continue to have on our Company. Beginning in 2008 and continuing into 2012, the capital and credit markets have experienced severe levels of volatility and disruption. During the first nine months of 2012, economic conditions, while slow by historical standards and still fluctuating on a day-to-day basis, have shown general signs of stabilization. However, as a result of U.S. government fiscal challenges, continued volatility in European sovereign and bank debt, slow improvement in domestic employment conditions and the economic and monetary policy statements by the Federal Reserve, it is difficult to predict if this stabilization is indicative of a lasting trend. There can be no assurance that these challenging developments will not materially and adversely affect our business, financial condition and results of operations.

**OVERVIEW**

We are a bank holding company headquartered in Greenville, South Carolina, and were incorporated in March 1999 under the laws of South Carolina. We provide a wide range of banking services and products to our clients through our wholly-owned bank subsidiary, Southern First Bank, N.A., formerly known as Greenville First Bank, N.A. In July of 2007, we changed the name of our Company and Bank to Southern First Bancshares, Inc. and Southern First Bank, N.A., respectively. We do not engage in any significant operations other than the ownership of our banking subsidiary.

We currently have six offices located in Greenville and Lexington Counties of South Carolina. On July 16, 2012, we announced our pending expansion into Charleston, South Carolina with the hiring of Mr. Lenwood Howell as Executive Vice President and Charleston Regional Executive. We expect to open a Charleston office during the fourth quarter of 2012 at 480 East Bay Street, Charleston, South Carolina. In addition, we are currently in the process of constructing a third full-service office in Columbia, South Carolina, which is also expected to open in the fourth quarter of 2012.

Our business model continues to be client-focused, utilizing relationship teams to provide our clients with a specific banker contact and support team responsible for all of their banking needs. The purpose of this structure is to provide a consistent and superior level of professional service, and we believe it provides us with a distinct competitive advantage. We consider exceptional client service to be a critical part of our culture, which we refer to as "ClientFIRST."

Like most community banks, we derive the majority of our income from interest received on our loans and investments. Our primary source of funds for making these loans and investments is our deposits, on which we pay interest. Consequently, one of the key measures of our success is our amount of net interest income, or the difference between the income on our interest-earning assets, such as loans and investments, and the expense on our interest-bearing liabilities, such as deposits and borrowings. Another key measure is the spread between the yield we earn on these interest-earning assets and the rate we pay on our interest-bearing liabilities, which is called our net interest spread.

There are risks inherent in all loans, so we maintain an allowance for loan losses to absorb probable losses on existing loans that may become uncollectible. We maintain this allowance by charging a provision for loan losses against our operating earnings for each period. We have included a detailed discussion of this process, as well as several tables describing our allowance for loan losses.

In addition to earning interest on our loans and investments, we earn income through fees and other charges to our clients. We have also included a discussion of the various components of this noninterest income, as well as of our noninterest expense.

Economic conditions, competition, and the monetary and fiscal policies of the Federal government significantly affect most financial institutions, including the Bank. Lending and deposit activities and fee income generation are influenced by levels of business spending and investment, consumer income, consumer spending and savings, capital market activities, and competition among financial institutions, as well as customer preferences, interest rate conditions and prevailing market rates on competing products in our market areas.

The following discussion and analysis also identifies significant factors that have affected our financial position and operating results during the periods included in the accompanying financial statements. We encourage you to read this discussion and analysis in conjunction with our financial statements and the other statistical information included in our filings with the SEC.

**Effect of Economic Trends**

The twelve months ended December 31, 2011 and the first nine months of 2012 continue to reflect the tumultuous economic conditions which have negatively impacted our clients' liquidity and credit quality. Concerns regarding increased credit losses from the weakening economy have negatively affected capital and earnings of most financial institutions. Financial institutions have experienced significant declines in the value of collateral for real estate loans, heightened credit losses, which have resulted in record levels of non-performing assets, charge-offs and foreclosures.

Liquidity in the debt markets remains low in spite of efforts by the Treasury and the Federal Reserve to inject capital into financial institutions. The federal funds rate set by the Federal Reserve has remained at 0.25% since December 2008, following a decline from 4.25% to 0.25% during 2008 through a series of seven rate reductions.

In response to the challenges facing the financial services sector, beginning in 2008 a multitude of new regulatory and governmental actions have been announced, including the Emergency Economic Stabilization Act of 2008 (the "EESA"), the Troubled Asset Relief Program (the "TARP"), the American Recovery and Reinvestment Act of 2009 (the "Recovery Act"), the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and related economic recovery programs. Some of the more recent actions include those described in Part I. Item 1. Business - Supervision and Regulation of our Annual Report on Form 10-K for the year ended December 31, 2011 as filed with the SEC.

On April 5, 2012, the U.S. President signed the Jumpstart Our Business Startup Act (the "JOBS Act"), which is intended to stimulate economic growth by helping smaller and emerging growth companies access the U.S. capital markets. The JOBS Act amends various provisions of, and adds new sections to, the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as provisions of the Sarbanes-Oxley Act of 2002. In addition, under the JOBS Act, a bank or bank holding company is permitted to have 2,000 shareholders before being subject to public company requirements and to deregister from the SEC when its shareholder count falls below 1,200. While we do not anticipate that the JOBS Act will have a significant effect on the Company, it is unclear what long term effects this new legislation will have on community banks in general.

In addition, in June 2012, the Federal Reserve approved three notices of proposed rulemaking ("NPRs") to, among other things, implement the Basel III minimum capital requirements and capital conservation buffer. The three NPRs are expected to be published jointly by the Federal Reserve, the FDIC and the OCC after each agency has completed its approval process. The comment period on the NPRs expired on October 22, 2012. If approved in their current form, the NPRs would be effective over a phased-in period from 2013 to 2019. We are in the process of evaluating the impact of the proposed rules on the Company and the Bank.

Future regulations, or enforcement of the terms of programs already in place, may require financial institutions to raise additional. There can be no assurance as to the actual impact of the Dodd-Frank Act, the JOBS Act, Basel III or any other governmental program or regulation on the financial markets.

The weak economic conditions are expected to continue through the remainder of 2012 and into 2013. Certain financial institutions in the Southeast will likely continue to experience heightened credit losses and higher levels of non-performing assets, charge-offs and foreclosures. In light of these conditions, financial institutions also face heightened levels of scrutiny from federal and state regulators. These factors negatively influenced, and likely will continue to negatively influence, earning asset yields at a time when the market for deposits is intensely competitive. As a result, financial institutions experienced, and are expected to continue to experience, pressure on credit costs, loan yields, deposit and other borrowing costs, liquidity, and capital.

**EARNINGS REVIEW**

Our net income was $1.2 million and $483,000 for the three months ended September 30, 2012 and 2011, respectively, an increase of $743,000. After our dividend payment to our preferred shareholders, net income to common shareholders was $842,000, or diluted earnings per share ("EPS") of $0.21, for the third quarter of 2012 as compared to net income to common shareholders of $197,000, or diluted EPS of $0.05 for the same period in 2011. The increase in net income resulted primarily from increases in net interest income and noninterest income as well as a decrease in the provision for loan losses.

Our net income for the first nine months of 2012 was $2.7 million compared to $1.7 million for the first nine months of 2011. Net income to common shareholders was $1.8 million, or diluted EPS of $0.46, for the nine months ended September 30, 2012, and $793,000, or diluted EPS of $0.20, for the nine months ended September 30, 2011. The increase in net income resulted primarily from increases in net interest income and noninterest income, partially offset by increases in noninterest expense and income tax expense.

**Net Interest Income and Margin**

Our level of net interest income is determined by the level of earning assets and the management of our net interest margin. For the three month period ended September 30, 2012, our net interest income was $6.7 million, a 12.3% increase over net interest income of $6.0 million for the same period in 2011. In comparison, our average earning assets increased 1.9%, or $13.5 million, during the third quarter of 2012 compared to the third quarter of 2011, while our interest bearing liabilities decreased by $16.8 million during the same period. The increase in average earning assets is primarily related to an increase in average loans, partially offset by a decrease in federal funds sold, while the decrease in average interest-bearing liabilities is a result of a decrease in time deposits, specifically, out-of-market certificates of deposit which decreased $35.0 million, offset in part by an increase in interest-bearing transaction accounts.

We have included a number of tables to assist in our description of various measures of our financial performance. For example, the "Average Balances, Income and Expenses, Yields and Rates" table reflects the average balance of each category of our assets and liabilities as well as the yield we earned or the rate we paid with respect to each category during the three and nine month periods ended September 30, 2012 and 2011. A review of this table shows that our loans typically provide higher interest yields than do other types of interest-earning assets, which is why we direct a substantial percentage of our earning assets into our loan portfolio. Similarly, the "Rate/Volume Analysis" table demonstrates the effect of changing interest rates and changing volume of assets and liabilities on our financial condition during the periods shown. We also track the sensitivity of our various categories of assets and liabilities to changes in interest rates, and we have included tables to illustrate our interest rate sensitivity with respect to interest-earning accounts and interest-bearing accounts. Finally, we have included various tables that provide detail about our investment securities, our loans, our deposits, and other borrowings.

The following tables set forth information related to our average balance sheets, average yields on assets, and average costs of liabilities. We derived these yields by dividing income or expense by the average balance of the corresponding assets or liabilities. We derived average balances from the daily balances throughout the periods indicated. During the same periods, we had no securities purchased with agreements to resell. All investments owned have an original maturity of over one year. Nonaccrual loans are included in the following tables. Loan yields have been reduced to reflect the negative impact on our earnings of loans on nonaccrual status. The net of capitalized loan costs and fees are amortized into interest income on loans.

**Average Balances, Income and Expenses, Yields and Rates**

(1) Annualized for the three month period.

(2) The tax-equivalent adjustment to net interest income adjusts the yield for assets earning tax-exempt income to a comparable yield on a taxable basis.

Our net interest margin, on a tax-equivalent basis, was 3.72% for the three months ended September 30, 2012 compared to 3.36% for the third quarter of 2011. The 36 basis point increase in net interest margin as compared to the same period in 2011, was driven primarily by a 46 basis point reduction in the cost of our interest bearing liabilities.

While our interest-earning assets increased by $13.5 million as compared to the same quarter in 2011, our tax-equivalent interest income decreased by $45,000 or 10 basis points. The decline in yield on our interest earning assets was driven primarily by reduced yields on our investment securities and loan portfolios. Our average loan balances increased by $46.9 million as of the third quarter of 2012, compared to the same period in 2011, while our loan yield decreased by 33 basis points. The decrease in loan yield was driven primarily by loans being originated or renewed at market rates which are lower than those in the past.

Our interest expense also decreased during the third quarter of 2012 as compared to the third quarter of 2011 due to lower rates on our interest-bearing liabilities. While our average interest-bearing liabilities decreased by $16.8 million as of the third quarter of 2012, compared to the same period in 2011, the rate on these liabilities decreased by 46 basis points. In effect, our interest-bearing liabilities continue to reprice downward at a faster rate than our interest-earning assets. In addition, as of September 30, 2012, over half of our FHLB advances were at fixed interest rates, while all of our other borrowings, including notes payable and junior subordinated debt, had variable interest rates.

Our net interest spread was 3.50% for the three months ended September 30, 2012 compared to 3.14% for the same period in 2011. The net interest spread is the difference between the yield we earn on our interest-earning assets and the rate we pay on our interest-bearing liabilities. The 46 basis point reduction in rate on our interest-bearing liabilities, partially offset by an 10 basis point decline in yield on our earning assets, resulted in a 36 basis point increase in our net interest spread for the 2012 period.

(1) Annualized for the nine month period.

(2) The tax-equivalent adjustment to net interest income adjusts the yield for assets earning tax-exempt income to a comparable yield on a taxable basis.

Our net interest margin, on a tax-equivalent basis, was 3.60% for the nine months ended September 30, 2012 compared to 3.27% for the nine months ended September 30, 2011. The 33 basis point increase in net interest margin for the nine months ended September 30, 2012 was driven primarily by a 50 basis point reduction in the cost of our interest bearing liabilities compared to the same period in 2011.

Despite the $14.0 million increase in interest-earning assets during the first nine months of 2012, as compared to the same period in 2011, our tax-equivalent interest income decreased by $403,000 or 17 basis points. The decline in yield on our interest earning assets was driven primarily by reduced yields on our investment securities and loan portfolios. Although we transitioned a portion of our low-yielding federal funds sold into investment securities which yield a higher rate, the yield earned on these investments has declined in the past twelve months due to our decision to sell some of these investments which were yielding higher rates and recognize a gain on the sale. In addition, our average loan balances increased by $34.6 million as compared to the same period in 2011 while our loan yield decreased by 40 basis points. The decrease in loan yield was driven primarily by loans being originated or renewed at market rates which are lower than those in the past.

Our interest expense also decreased during the first nine months of 2012 as compared to the same period in 2011 due to lower rates on our interest-bearing liabilities. While our average interest-bearing liabilities decreased by $17.6 million during the first nine months of 2012, compared to the same period in 2011, the rate on these liabilities decreased by 50 basis points. In effect, our interest-bearing liabilities continue to reprice downward at a faster rate than our interest-earning assets.

Our net interest spread was 3.38% for the nine months ended September 30, 2012 compared to 3.05% for the same period in 2011. The net interest spread is the difference between the yield we earn on our interest-earning assets and the rate we pay on our interest-bearing liabilities. The 50 basis point reduction in rate on our interest-bearing liabilities, partially offset by a 17 basis point decline in yield on our earning assets, resulted in a 33 basis point increase in our net interest spread for the 2012 period.

*Rate/Volume Analysis*

Net interest income can be analyzed in terms of the impact of changing interest rates and changing volume. The following table sets forth the effect which the varying levels of interest-earning assets and interest-bearing liabilities and the applicable rates have had on changes in net interest income for the periods presented.

Net interest income, the largest component of our income, was $6.7 million for the three month period ended September 30, 2012 and $6.0 million for the three months ended September 30, 2011. Although our average interest-earning assets increased by $13.5 million, our average loan balances increased by $46.9 million during the third quarter of 2012 compared to the same period in 2011 while average interest-bearing liabilities decreased $16.8 million during the 2012 period. The $734,000 increase in net interest income during the three months ended September 30, 2012 was driven primarily by the decreased rates on our interest bearing liabilities as well as increased loan volume as evidenced in the above table.

Net interest income for the nine months ended September 30, 2012 was $19.2 million compared to $17.2 million for the nine months ended September 30, 2011. While our average interest-earning assets increased by $14.0 million overall during the first nine months of 2012 compared to the same period in 2011, our average loan balances increased by $34.6 million. In comparison, our average interest-bearing liabilities decreased by $17.6 million during the first nine months of 2012. The $2.0 million increase in net interest income during the nine months ended September 30, 2012 was primarily driven by the increased loan volume as well as decreased rates on our interest bearing liabilities.

*Provision for Loan Losses*

We have established an allowance for loan losses through a provision for loan losses charged as an expense on our consolidated statements of income. We review our loan portfolio periodically to evaluate our outstanding loans and to measure both the performance of the portfolio and the adequacy of the allowance for loan losses. Please see the discussion below under "Balance Sheet Review - Allowance for Loan Losses" for a description of the factors we consider in determining the amount of the provision we expense each period to maintain this allowance.

For the three months ended September 30, 2012 and 2011, we incurred a noncash expense related to the provision for loan losses of $1.1 million and $1.7 million, respectively, resulting in an allowance for loan losses of $9.3 million and $8.8 million for the 2012 and 2011 periods, respectively. For the nine months ended September 30, 2012, our provision for loan losses was $3.6 million as compared to $3.1 million for the nine months ended September 30, 2011. The lower provision for loan losses during the 2012 periods relates primarily to the overall improvement in the credit quality of our loan portfolio during the first nine months of 2012. The $9.3 million allowance represented 1.45% of gross loans at September 30, 2012 while the $8.8 million allowance was 1.48% of gross loans at September 30, 2011.

During the past twelve months, our loan balances increased by $46.6 million, while the amount of our nonperforming and past due loans declined. Factors such as these are also considered in determining the amount of loan loss provision necessary to maintain our allowance for loan losses at an adequate level.

*Noninterest Income*

The following table sets forth information related to our noninterest income.

Noninterest income increased $563,000, or 77.9%, in the third quarter of 2012 as compared to the same period in 2011. The increase in total noninterest income during this 2012 period resulted primarily from the following:

- Loan fee income increased 56.9%, or $132,000, resulting primarily from increased mortgage origination fee income of $130,000.
- Service fees on deposit accounts increased $62,000, or 36.9%, primarily related to increased NSF fee income, and additional income from service charges on our checking, money market, and savings accounts.
- Income from bank owned life insurance increased $31,000 due to income earned on $3.0 million of additional life insurance policies purchased during the third quarter of 2011.
- A gain on sale of investment securities of $295,000 was recognized during the 2012 period, compared to a gain on sale of $15,000 during the third quarter of 2011.
- Other income increased by 31.9%, or $58,000, due primarily to rental income received from tenants at our Columbia, South Carolina headquarters building and income received from ATM and debit card transactions which is volume driven.

Noninterest income increased by 51.0%, or $968,000, during the nine months ended September 30, 2012 as compared to the same period in 2011. The increase relates to increases of $198,000 in loan fee income, $119,000 in service fees on deposit accounts, $79,000 in income from bank owned life insurance, $348,000 in gains on sale of investment securities, and $199,000 in other income which includes rental income.

The Dodd-Frank Act calls for new limits on interchange transaction fees that banks receive from merchants via card networks like Visa, Inc. and MasterCard, Inc. when a customer uses a debit card. In June 2011, the Federal Reserve approved the final rule which caps an issuer's base fee at 21 cents per transaction and allows an additional 5 basis point charge per transaction to help cover fraud losses. Although the rule technically does not apply to institutions with less than $10 billion in assets, such as the Bank, there is concern that the price controls may harm community banks, which could be pressured by the marketplace to lower their own interchange rates. Our ATM/Debit card fee income is included in other noninterest income and was $121,000 and $105,000 for the three months ended September 30, 2012 and 2011, respectively, and $343,000 and $298,000 for the nine months endes September 30, 2012 and 2011, respectively. We will continue to monitor the regulations as they are implemented and will review our policies, products and procedures to insure full compliance but also attempt to minimize any negative impact on our operations.

*Noninterest expenses*

The following table sets forth information related to our noninterest expenses.

Noninterest expense increased $673,000, or 15.5%, during the third quarter of 2012 as compared to the same period in 2011. Our efficiency ratio, excluding gains on sale of investment securities and real estate owned activity, was 61.8% for the third quarter of 2012 compared to 64.9% for the same period in 2011. The improvement in the efficiency ratio relates primarily to the increase in net interest income and noninterest income, excluding the gain on sale of securities.

The increase in total noninterest expenses resulted primarily from the following:

Compensation and benefits expense increased 8.7%, or $211,000, relating primarily to increases in base compensation and benefits expenses. Base compensation increased by $153,000 driven by the cost of ten additional employees, three of which were hired to support our new Charleston office, as well as annual salary increases, while benefit expenses increased $40,000 during the same period, compared to the third quarter of the prior year.

Occupancy expenses increased $41,000, or 7.1%, driven by increased depreciation, utilities and repairs and maintenance expenses.

Real estate owned activity increased by $251,000, due primarily to a loss on sale and write-down incurred on two properties recorded during the third quarter of 2012.

Data processing and related costs increased 6.4%, or $31,000, primarily related to the increased number of clients and accounts we service.

Insurance expense increased by $73,000, or 27.2%, due to the change in the assessment base calculation for FDIC insurance which took place in the third quarter of 2011.

Professional fees increased $79,000, or 46.7%, driven by increased legal and accounting expenses and loan appraisal fees during the third quarter of 2012. Of the $248,000 in professional fees during the 2012 period, approximately $37,000 is related to expenses associated with the sale of our Series T Preferred Stock by the Treasury in the TARP auction and repurchase of the CPP Warrant.

Noninterest expense for the nine months ended September 30, 2012 increased 5.7%, or $785,000, as compared to the nine months ended September 30, 2011. The increase relates primarily to the $693,000 increase in compensation and benefits expense, $148,000 in occupancy expense, $158,000 in data processing and related costs, and $203,000 in professional fees,

$130,000 of which is related to expenses associated with the sale of our Series T Preferred Stock by the Treasury in the TARP auction and repurchase of the Warrant. Partially offsetting the increases in noninterest expense were decreases of $337,000 in real estate owned activity and $68,000 in insurance expenses.

We incurred income tax expense of $618,000 for the three months ended September 30, 2012 as compared to $192,000 during the same period in 2011. Income tax expense for the nine months ended September 30, 2012 was $1.3 million as compared to $706,000 for the same period of 2011. The increase in income tax expense during the 2012 periods is primarily a result of the increase in our net income during the respective periods.

**Balance Sheet Review**

At September 30, 2012, we had total assets of $780.4 million, consisting principally of $628.4 million in net loans, $71.9 million in investment securities, $35.9 million in cash and cash equivalents, and $18.6 million in bank owned life insurance. Our liabilities at September 30, 2012 totaled $717.1 million, which consisted principally of $574.4 million in deposits, $124.1 million in FHLB advances and other borrowings, and $13.4 million in junior subordinated debentures. At September 30, 2012, our shareholders' equity was $63.3 million.

At December 31, 2011, we had total assets of $767.8 million, consisting principally of $589.7 million in net loans, $108.6 million in investment securities, $23.0 million in cash and cash equivalents, and $18.1 million in bank owned life insurance. Our liabilities at December 31, 2011 totaled $705.2 million, consisting principally of $562.9 million in deposits, $122.7 million in FHLB advances and repurchase agreements, and $13.4 million in junior subordinated debentures. At December 31, 2011, our shareholders' equity was $62.5 million.

*Federal Funds Sold*

At September 30, 2012, our federal funds sold were $11.1 million, or 1.4% of total assets. At December 31, 2011, we had no short-term investments in federal funds sold on an overnight basis.

*Investment Securities*

At September 30, 2012, the $71.9 million in our investment securities portfolio represented approximately 9.2% of our total assets. We held government agencies, municipal securities, and mortgage-backed securities with a fair value of $64.1 million and an amortized cost of $62.0 million resulting in an unrealized gain of $2.1 million. During the first nine months of 2012, we developed a need for additional liquidity as we experienced increased loan demand and, as a result, sold $45.1 million of our mortgage-backed securities and state and municipal obligations, reinvested $18.1 million of the securities in similar investments at current rates, and recorded a net gain on sale of investment securities of $363,000.

At December 31, 2011, the $108.6 million in our investment securities portfolio represented approximately 14.1% of our total assets. We held municipal securities, and mortgage-backed securities with a fair value of $100.7 million and an amortized cost of $99.1 million for an unrealized gain of $1.6 million.

*Loans*

Since loans typically provide higher interest yields than other types of interest earning assets, a substantial percentage of our earning assets are invested in our loan portfolio. Average loans for the nine months ended September 30, 2012 and 2011 were $614.6 million and $580.0 million, respectively. Before the allowance for loan losses, total loans outstanding at September 30, 2012 and December 31, 2011 were $637.7 and $598.6 million, respectively.

The principal component of our loan portfolio is loans secured by real estate mortgages. As of September 30, 2012, our loan portfolio included $519.3 million, or 81.4%, of real estate loans. As of December 31, 2011, real estate loans made up 79.8% of our loan portfolio and totaled $477.7 million. Most of our real estate loans are secured by residential or commercial property. We obtain a security interest in real estate, in addition to any other available collateral. This collateral is taken to increase the likelihood of the ultimate repayment of the loan. Generally, we limit the loan-to-value ratio on loans to coincide with the appropriate regulatory guidelines. We attempt to maintain a relatively diversified loan portfolio to help reduce the risk inherent in concentration in certain types of collateral. We do not generally originate traditional long term residential mortgages, but we do issue traditional second mortgage residential real estate loans and home equity lines of credit. Home equity lines of credit totaled $77.3 million as of September 30, 2012, of which approximately 36% were in a first lien position, while the remaining balance was second liens. The average loan had a balance of approximately $84,000 and a loan to value of 75%. Further, 1.08% of our total home equity lines of credit were over 30 days past due.

Following is a summary of our loan composition at September 30, 2012 and December 31, 2011. The $28.0 million increase in consumer real estate loans is related to our focus to continue to originate high quality 1-4 family consumer real estate loans. In addition, our East Bay Street office in Charleston has contributed to the growth in owner occupied real estate and business loans. Our average consumer real estate loan currently has a principal balance of $313,000, a term of eight years, and an average rate of 4.92%.

*Nonperforming assets*

Following is a summary of our nonperforming assets, including nonaccruing TDRs.

At September 30, 2012 nonperforming assets were $11.2 million, or 1.43% of total assets and 1.75% of gross loans. Comparatively, nonperforming assets were $14.0 million, or 1.82% of total assets and 2.33% of gross loans at December 31, 2011. Nonaccrual loans decreased $1.1 million to $9.2 million at September 30, 2012 from $10.3 million at December 31, 2011. Nonaccrual loans at September 30, 2012 include eight loan relationships which were put on nonaccrual status during the first nine months of 2012. In addition, during the first nine months of 2012, six nonaccrual loans were transferred to OREO, four nonaccrual loans were paid off, and five nonaccrual loans were charged-off. The amount of foregone interest income on the nonaccrual loans in the first nine months of 2012 was approximately $401,000.

Nonperforming assets include other real estate owned which decreased by $1.7 million from December 31, 2011. During the first nine months of 2012 we sold ten properties for $2.4 million and added seven new properties for $1.4 million. In addition, we incurred write-downs totaling $248,000 on five of our properties. The balance at September 30, 2012 includes five commercial properties totaling $1.6 million and four residential properties totaling $348,000. All of these properties are located in the Upstate of South Carolina. We believe that these properties are appropriately valued at the lower of cost or market as of September 30, 2012.

*Allowance for Loan Losses*

We have established an allowance for loan losses through a provision for loan losses charged as an expense. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance, either in whole or in part, is confirmed. Subsequent recoveries, if any, are credited to the allowance.

Management regularly evaluates the allowance for loan losses and periodically reviews the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. Periodically, we adjust the amount of the allowance based on changing circumstances.

Following is a summary of the activity in the allowance for loan losses.

The allowance for loan losses was $9.3 million and $8.8 million at September 30, 2012 and 2011, respectively, or 1.45% and 1.48% of outstanding loans, respectively. At December 31, 2011, our allowance for loan losses was $8.9 million, or 1.49% of outstanding loans, and we had net loans charged-off of $4.7 million for the year ended December 31, 2011.

During the nine months ended September 30, 2012, we charged-off $3.3 million of loans and recorded $20,000 of recoveries on loans previously charged-off, for net charge-offs of $3.3 million, or 0.71% of average loans. Comparatively, we charged-off $2.8 million of loans and recorded $83,000 of recoveries on loans previously charged-off, resulting in net charge-offs of $2.7 million, or 0.46% of average loans for the first nine months of 2011. The increased level of charge-offs during the 2012 period resulted primarily from two commercial relationships which comprised $1.5 million of the charge-offs during 2012.

The allowance for loan losses as a percentage of gross loans decreased during the first nine months of 2012 based on a decrease in the specific reserves on our commercial portfolio. As of September 30, 2012, $17.8 million of loans were evaluated for specific reserves compared to $17.7 million at December 31, 2011. Based on these evaluations, the allowance for loan losses includes specific reserves of $3.8 million at September 30, 2012 and $3.9 million at December 31, 2011.

In addition, at September 30, 2012 and 2011, the allowance for loan losses represented 100.5% and 94.9% of the total amount of nonperforming loans, respectively. A significant portion, or 84%, of nonperforming loans at September 30, 2012 is secured by real estate. Our nonperforming loans have been written down to approximately 71% of their original nonperforming balance. We have evaluated the underlying collateral on these loans and believe that the collateral on these loans is sufficient to minimize future losses. Based on the level of coverage on nonperforming loans and analysis of our loan portfolio, we believe the allowance for loan losses of $9.3 million as of September 30, 2012 to be adequate.

Our impaired loans include loans on nonaccrual status and TDRs, whether on accrual or nonaccrual status. For loans that are also classified as impaired, an allowance is established when the fair value (discounted cash flows, collateral value, or observable market price) of the impaired loan less costs to sell, are lower than the carrying value of that loan. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due, among other factors. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including, without limitation, the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Large groups

of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

A significant portion of the loans in our loan portfolio have been originated in the past five years. In general, loans do not begin to show signs of credit deterioration or default until they have been outstanding for some period of time, a process known as seasoning. The benefit of having time for loans to "season," is that it allows a company to evaluate how loans perform during different economic cycles. We believe that the recent prolonged recession has allowed us to evaluate the performance of our loan portfolio during "stressful" times. If delinquencies and defaults increase, we may be required to increase our provision for loan losses, which would adversely affect our results of operations and financial condition.

As a general practice, most of our loans are originated with relatively short maturities of less than 10 years. As a result, when a loan reaches its maturity we frequently renew the loan and thus extend its maturity using the same credit standards as those used when the loan was first originated. Due to these loan practices, we may, at times, renew loans which are classified as nonperforming after evaluating the loan's collateral value and financial strength of its guarantors. Nonperforming loans are renewed at terms generally consistent with the ultimate source of repayment and rarely at reduced rates. In these cases the Company will seek additional credit enhancements, such as additional collateral or additional guarantees to further protect the loan. When a loan is no longer performing in accordance with its stated terms, the Company will typically seek performance under the guarantee.

In addition, at September 30, 2012, 81.4% of our loans are collateralized by real estate and 91.9% of our impaired loans are secured by real estate. The Company utilizes third party appraisers to determine the fair value of collateral dependent loans. Our current loan and appraisal policies require the Company to obtain updated appraisals on an "as is" basis at renewal, or in the case of an impaired loan, on an annual basis, either through a new external appraisal or an appraisal evaluation. In situations where a current appraisal is not available, we use the best available information (including recent appraisals for similar properties, communications with qualified real estate professionals, and other observable market data) to estimate the current fair value. Impaired loans are individually reviewed on a quarterly basis to determine the level of impairment based on external market data. As of September 30, 2012, we do not have any impaired real estate loans carried at a value in excess of the appraised value. We typically charge-off a portion or create a specific reserve for impaired loans when we do not expect repayment to occur as agreed upon under the original terms of the loan agreement.

For commercial loans, we generally fully charge off or charge collateralized loans down to net realizable value when management determines the loan to be uncollectible; repayment is deemed to be protracted beyond reasonable time frames; the loan has been classified as a loss by either our internal loan review process or our banking regulatory agencies; the customer has filed bankruptcy and the loss becomes evident owing to a lack of assets; or the loan is 120 days past due unless both well-secured and in the process of collection. For consumer loans, we generally charge down to net realizable value when the loan is 180 days past due.

*Deposits and Other Interest-Bearing Liabilities*

Our primary source of funds for loans and investments is our deposits, advances from the FHLB, and structured repurchase agreements. In the past, we have chosen to obtain a portion of our certificates of deposits from areas outside of our market (which we refer to as "out-of-market" or "brokered" deposits) in order to obtain longer term deposits than are readily available in our local market. In accordance with our Formal Agreement, we have adopted guidelines regarding our use of brokered deposits that limit such deposits to 25% of total deposits and dictate that our current interest rate risk profile determines the terms. In addition, we do not obtain time deposits of $100,000 or more through the Internet. These guidelines allow us to take advantage of the attractive terms that wholesale funding can offer while mitigating the related inherent risk.

Our retail deposits represented $561.4 million, or 97.7%, of total deposits at September 30, 2012, while our out-of-market, or brokered, deposits represented $13.0 million, or 2.3%, of total deposits. At December 31, 2011, retail deposits represented $517.1 million, or 91.9%, of our total deposits and brokered CDs were $45.8 million, representing 8.1% of our total deposits. As our wholesale deposits have matured during the past 12 months, we have successfully replaced them with local deposits. While wholesale deposits decreased $32.8 million during the first nine months of 2012, our retail deposits have increased $44.3 million. We anticipate being able to continue to replace these out-of-market deposits when they mature. Our loan-to-deposit ratio was 111% and 106% at September 30, 2012 and December 31, 2011, respectively.

The following table shows the average balance amounts and the average rates paid on deposits.

The $48.7 million increase in average transaction accounts and the $37.0 million decrease in time deposits of $100,000 or more for the nine months ended September 30, 2012 compared to the 2011 period is a result of our intense focus to replace our out-of-market deposits with local deposits and the nationwide trend of increasing deposits due to economic uncertainty. The increase in retail funding continued to enable the company to reduce its wholesale funding by approximately $33 million during the last twelve month period. As a result, brokered deposits now represent only 1.7% of total funding for the Company compared to 6.0% at September 30, 2011. The Company has reduced its brokered deposits by over $200 million since June 2009.

Core deposits, which exclude out-of-market deposits and time deposits of $100,000 or more, provide a relatively stable funding source for our loan portfolio and other earning assets. Our core deposits were $429.2 million and $413.1 million at September 30, 2012 and December 31, 2011, respectively. Included in time deposits greater than $100,000 at September 30, 2012 is $9.0 million of wholesales CDs scheduled to mature within the next 12 months at a weighted average rate of 2.45%.

All of our time deposits are certificates of deposits. The maturity distribution of our time deposits of $100,000 or more at September 30, 2012 was as follows:

The Dodd-Frank Act also permanently raised the current standard maximum deposit insurance amount to $250,000. The standard maximum insurance amount of $100,000 had been temporarily raised to $250,000 until December 31, 2013. The FDIC insurance coverage limit applies per depositor, per insured depository institution for each account ownership category. In addition, the FDIC provides unlimited deposit insurance coverage for noninterest-bearing transaction accounts (typically business checking accounts) and certain funds swept into noninterest-bearing savings accounts. The unlimited deposit insurance coverage for noninterest-bearing savings accounts is currently set to expire on December 31, 2012. We are currently evaluating the potential impact of the expiration for unlimited deposit insurance coverage for noninterest-bearing savings accounts on our deposit strategy.

**Capital Resources**

Total shareholders' equity at September 30, 2012 was $63.3 million. At December 31, 2011, total shareholders' equity was $62.5 million. The $748,000 increase from December 31, 2011 is primarily related to net income of $2.7 million during the nine month period ended September 30, 2012, offset partially by the $904,000 repurchase of 1,000 shares of our Series T Preferred Stock and $1.1 million repurchase of the Warrant.

The following table shows the return on average assets (net income divided by average total assets), return on average equity (net income divided by average equity), and equity to assets ratio (average equity divided by average assets) annualized for the nine months ended September 30, 2012 and the year ended December 31, 2011. Since our inception, we have not paid cash dividends.

The Treasury sold all of the Series T Preferred Stock in a public auction on June 28, 2012 at which time the Company repurchased 1,000 of the 17,299 outstanding shares of Series T Preferred Stock. The transaction settled on July 3, 2012. In addition, on July 25, 2012, the Company completed its repurchase of the Warrant to purchase 399,970.34 shares of common stock of the Company that was issued to Treasury on February 27, 2009, as part of the CPP. The Warrant was repurchased at a mutually agreed upon priced of $1.1 million. Following the settlement of the Warrant on July 25, 2012, the Treasury has completely eliminated its equity stake in the Company through the Capital Purchase Program.

Under the capital adequacy guidelines, regulatory capital is classified into two tiers. These guidelines require an institution to maintain a certain level of Tier 1 and Tier 2 capital to risk-weighted assets. Tier 1 capital consists of common shareholders' equity, excluding the unrealized gain or loss on securities available for sale, minus certain intangible assets. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight factor of 0% to 100% based on the risks believed to be inherent in the type of asset. Tier 2 capital consists of Tier 1 capital plus the general reserve for loan losses, subject to certain limitations. We are also required to maintain capital at a minimum level based on total average assets, which is known as the Tier 1 leverage ratio.

At both the holding company and bank level, we are subject to various regulatory capital requirements administered by the federal banking agencies. To be considered "well-capitalized," we must maintain total risk-based capital of at least 10%, Tier 1 capital of at least 6%, and a leverage ratio of at least 5%. To be considered "adequately capitalized" under these capital guidelines, we must maintain a minimum total risk-based capital of 8%, with at least 4% being Tier 1 capital. In addition, we must maintain a minimum Tier 1 leverage ratio of at least 4%.

In addition, we have agreed with the OCC that the Bank will maintain total risk-based capital of at least 12%, Tier 1 capital of at least 10%, and a leverage ratio of at least 9%.  As of September 30, 2012, our capital ratios exceed these ratios and we remain "well capitalized." However, if we fail to maintain these required capital levels, then the OCC may deem noncompliance to be an unsafe and unsound banking practice which may make the Bank subject to an additional capital directive, consent order, or such other administrative action or sanction as the OCC considers necessary.  It is uncertain what actions, if any, the OCC would take with respect to noncompliance with these ratios, what action steps the OCC might require the Bank to take to remedy this situation, and whether such actions would be successful.

In December 2010, the Basel Committee released its final framework for strengthening international capital and liquidity regulation, now officially identified by the Basel Committee as "Basel III". Basel III, if implemented by the U.S. banking agencies and fully phased-in, would require certain bank holding companies and their bank subsidiaries to maintain substantially more capital, with a greater emphasis on common equity. On June 8, 2012, the Federal Reserve approved three NPRs to, among other things, implement the Basel III minimum capital requirements (raising the minimum Tier 1 common equity ratio to 4.5% and minimum Tier 1 equity ratio to 6.0% with full implementation by January 2015) and capital conservation buffer of common equity of an additional 2.5% with implementation by January 2019. The three NPRs are expected to be published jointly by the Federal Reserve, the FDIC, and the OCC after each agency has completed its approval process. The comment period on the NPRs ended on October 22, 2012. If approved in their current form, the NPRs would be effective over a phased-in period from 2013 to 2019. We are currently evaluating the impact of the propsed rules on the Company and the Bank.

The following table summarizes the capital amounts and ratios of the Bank and the regulatory minimum requirements.

The following table summarizes the capital amounts and ratios of the Company and the minimum regulatory requirements.

The ability of the Company to pay cash dividends is dependent upon receiving cash in the form of dividends from the Bank. The dividends that may be paid by the Bank to the Company are subject to legal limitations and regulatory capital requirements. The approval of the OCC is required if the total of all dividends declared by a national bank in any calendar year exceeds the total of its net profits for that year combined with its retained net profits for the preceding two years, less any required transfers to surplus. Further, the Company cannot pay cash dividends on its common stock during any calendar quarter unless full dividends on the Series T preferred stock for the dividend period ending during the calendar quarter have been declared and the Company has not failed to pay a dividend in the full amount of the Series T preferred stock with respect to the period in which such dividend payment in respect of its common stock would occur.

**Effect of Inflation and Changing Prices**

The effect of relative purchasing power over time due to inflation has not been taken into account in our consolidated financial statements. Rather, our financial statements have been prepared on an historical cost basis in accordance with generally accepted accounting principles.

Unlike most industrial companies, our assets and liabilities are primarily monetary in nature. Therefore, the effect of changes in interest rates will have a more significant impact on our performance than will the effect of changing prices and inflation in general. In addition, interest rates may generally increase as the rate of inflation increases, although not necessarily in the same magnitude. As discussed previously, we seek to manage the relationships between interest sensitive assets and liabilities in order to protect against wide rate fluctuations, including those resulting from inflation.

**Off-Balance Sheet Risk**

Commitments to extend credit are agreements to lend money to a client as long as the client has not violated any material condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of a fee. At September 30, 2012, unfunded commitments to extend credit were $109.9 million, of which $19.9 million was at fixed rates and $90.0 million was at variable rates. At December 31, 2011, unfunded commitments to extend credit were $98.9 million, of which approximately $17.6 million was at fixed rates and $81.3 million was at variable rates. A significant portion of the unfunded commitments related to consumer equity lines of credit. Based on historical experience, we anticipate that a significant portion of these lines of credit will not be funded. We evaluate each client's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by us upon extension of credit, is based on our credit evaluation of the borrower. The type of collateral varies but may include accounts receivable, inventory, property, plant and equipment, and commercial and residential real estate.

At September 30, 2012 and December 31, 2011, there was a $2.5 million commitment under letters of credit. The credit risk and collateral involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Since most of the letters of credit are expected to expire without being drawn upon, they do not necessarily represent future cash requirements.

Except as disclosed in this report, we are not involved in off-balance sheet contractual relationships, unconsolidated related entities that have off-balance sheet arrangements or transactions that could result in liquidity needs or other commitments that significantly impact earnings.

**Market Risk and Interest Rate Sensitivity**

Market risk is the risk of loss from adverse changes in market prices and rates, which principally arises from interest rate risk inherent in our lending, investing, deposit gathering, and borrowing activities. Other types of market risks, such as foreign currency exchange rate risk and commodity price risk, do not generally arise in the normal course of our business.

We actively monitor and manage our interest rate risk exposure in order to control the mix and maturities of our assets and liabilities utilizing a process we call asset/liability management. The essential purposes of asset/liability management are to ensure adequate liquidity and to maintain an appropriate balance between interest sensitive assets and liabilities in order to minimize potentially adverse impacts on earnings from changes in market interest rates. Our asset/liability management committee ("ALCO") monitors and considers methods of managing exposure to interest rate risk. We have both an internal ALCO consisting of senior management that meets at various times during each month and a board ALCO that meets monthly. The ALCOs are responsible for maintaining the level of interest rate sensitivity of our interest sensitive assets and liabilities within board-approved limits.

As of September 30, 2012, the following table summarizes the forecasted impact on net interest income using a base case scenario given upward and downward movements in interest rates of 100, 200, and 300 basis points based on forecasted assumptions of prepayment speeds, nominal interest rates and loan and deposit repricing rates. Estimates are based on current economic conditions, historical interest rate cycles and other factors deemed to be relevant. However, underlying assumptions may be impacted in future periods which were not known to management at the time of the issuance of the Consolidated Financial Statements. Therefore, management's assumptions may or may not prove valid. No assurance can be given that changing economic conditions and other relevant factors impacting our net interest income will not cause actual occurrences to differ from underlying assumptions. In addition, this analysis does not consider any strategic changes to our balance sheet which management may consider as a result of changes in market conditions.

Liquidity represents the ability of a company to convert assets into cash or cash equivalents without significant loss, and the ability to raise additional funds by increasing liabilities. Liquidity management involves monitoring our sources and uses of funds in order to meet our day-to-day cash flow requirements while maximizing profits. Liquidity management is made more complicated because different balance sheet components are subject to varying degrees of management control. For example, the timing of maturities of our investment portfolio is fairly predictable and subject to a high degree of control at the time investment decisions are made. However, net deposit inflows and outflows are far less predictable and are not subject to the same degree of control.

At September 30, 2012 and December 31, 2011, our liquid assets, consisting of cash and due from banks and federal funds sold, amounted to $35.9 million and $23.0 million, or 4.6% and 3.0% of total assets, respectively. Our investment securities at September 30, 2012 and December 31, 2011 amounted to $71.9 million and $108.6 million, or 9.2% and 14.1% of total assets, respectively. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. However, approximately 50% of these securities are pledged against outstanding debt. Therefore, the related debt would need to be repaid prior to the securities being sold in order for these securities to be converted to cash.

Our ability to maintain and expand our deposit base and borrowing capabilities serves as our primary source of liquidity. We plan to meet our future cash needs through the liquidation of temporary investments, the generation of deposits, loan payoffs, and from additional borrowings. In addition, we will receive cash upon the maturity and sale of loans and the maturity of investment securities. We maintain three federal funds purchased lines of credit with correspondent banks totaling $30.5 million for which there were no borrowings against the lines of credit at September 30, 2012.

We are also a member of the FHLB, from which applications for borrowings can be made. The FHLB requires that securities, qualifying mortgage loans, and stock of the FHLB owned by the Bank be pledged to secure any advances from the FHLB. The unused borrowing capacity currently available from the FHLB at September 30, 2012 was $16.6 million, based on the Bank's $5.8 million investment in FHLB stock, as well as qualifying mortgages available to secure any future borrowings. However, we are able to pledge additional securities to the FHLB in order to increase our available borrowing capacity.

We believe that our existing stable base of core deposits, borrowings from the FHLB, and short-term repurchase agreements will enable us to successfully meet our long-term liquidity needs. However, as short-term liquidity needs arise, we have the ability to sell a portion of our investment securities portfolio to meet those needs. During the first nine months of 2012, we developed a need for additional liquidity as we experienced increased loan demand and, as a result, sold $45.1 million of our mortgage-backed securities and state and municipal obligations, reinvested $18.1 million of the securities in similar investments at current rates, and recorded a net gain on sale of investment securities of $363,000.

**Critical Accounting Policies**

We have adopted various accounting policies that govern the application of accounting principles generally accepted in the United States and with general practices within the banking industry in the preparation of our financial statements. Our significant accounting policies are described in the footnotes to our audited consolidated financial statements as of December 31, 2011, as filed in our Annual Report on Form 10-K.

Certain accounting policies involve significant judgments and assumptions by us that have a material impact on the carrying value of certain assets and liabilities. We consider these accounting policies to be critical accounting policies. The judgment and assumptions we use are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Our Critical Accounting Policies are the allowance for loan losses, fair value of financial instruments, other-than-temporary impairment analysis, other real estate owned, and income taxes. Because of the nature of the judgment and assumptions we make, actual results could differ from these judgments and estimates that could have a material impact on the carrying values of our assets and liabilities and our results of operations.

**Accounting, Reporting, and Regulatory Matters**

*Recently Issued Accounting Standards*

The following is a summary of recent authoritative pronouncements that could affect accounting, reporting, and disclosure of financial information by us:

In April 2011, the criteria used to determine effective control of transferred assets in the Transfers and Servicing topic of the ASC was amended by ASU 2011-03. The requirement for the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms and the collateral maintenance implementation guidance related to that criterion were removed from the assessment of effective control. The other criteria to assess effective control were not changed. The amendments were effective for the Company on January 1, 2012 and had no effect on the financial statements.

The Balance Sheet topic of the ASC was amended in December 2011 for companies with financial instruments and derivative instruments that offset or are subject to a master netting agreement. The amendments require disclosure of both gross information and net information about instruments and transactions eligible for offset or subject to an agreement similar to a master netting agreement. The amendments are effective for reporting periods beginning on or after January 1, 2013 and must be provided retrospectively for all comparative periods presented. The Company does not expect these amendments to have a material effect on its financial statements.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on the consolidated financial statements upon adoption.

*Recent Regulatory Developments*

On June 8, 2010, the Bank entered into the Formal Agreement with its primary regulator, the OCC. The Formal Agreement is based on the findings of the OCC during their on-site examination of the Bank as of March 31, 2009. The Formal Agreement seeks to enhance the Bank's existing practices and procedures in the areas of credit risk management, credit underwriting, liquidity, and funds management. Specifically, under the terms of the Formal Agreement, the Bank is required to (i) protect its interest in assets criticized by the OCC; (ii) develop, implement, and adhere to a written program to reduce the high level of credit risk; (iii) obtain credit information on all loans lacking such information and ensure proper collateral documentation is in place; (iv) engage the services of an independent appraiser to provide updated appraisals for certain loans where the most recent appraisal is more than 12 months old; (v) update and implement written policies/programs addressing loan policy, allowance for loan and lease losses, and other real estate owned; (vi) continue to improve its liquidity position and maintain adequate sources of funding; (vii) obtain prior written determination of no supervisory objection from the OCC before accepting, renewing, or rolling over brokered deposits in excess of 25% of total deposits; (viii) update and adhere to its profit plan designed to improve the condition of the Bank; and (ix) submit periodic reports to the OCC regarding various aspects of the foregoing actions.

The Formal Agreement requires the establishment of certain plans and programs within various time periods. After having completed the following through September 30, 2012, management believes that the Bank is in compliance with substantially all of the conditions established in the Formal Agreement. However, no assurance can be given that the OCC will concur with management's assessment. In addition, the Formal Agreement requires that various reports be submitted to the OCC on a quarterly basis until the Formal Agreement is terminated.

- The Bank has established a compliance committee of its Board of Directors to oversee management's response to all sections of the Formal Agreement. The committee consists of all 11 members of the Bank's Board of Directors and meets at least monthly to receive written progress reports from management on the results and status of actions needed to achieve full compliance with each article of the Formal Agreement.
- Policies and procedures were revised or established and approved relating to the following issues:
- Current and satisfactory credit information was obtained on all loans lacking such information to ensure proper collateral documentation is in place.
- We received and evaluated current independent appraisals or updated appraisals on loans secured by certain properties.
- The Bank's liquidity position was enhanced. We reduced our level of brokered deposits to comply with the OCC agreed upon levels.
- A profit plan was updated to improve the financial condition of the Bank.

If the Bank does not satisfy and maintain adherence with each of the requirements listed above, the Bank will not be in compliance with the Formal Agreement. Failure to comply with the Formal Agreement could result in regulators taking additional enforcement actions against the Bank. The Bank's ability to meet the goals set forth in the Formal Agreement is contingent in part upon the stabilization of the local real estate markets and on its financial performance.

In addition, we have agreed with the OCC that the Bank will maintain total risk-based capital ratio of at least 12%, Tier 1 capital of at least 10%, and a leverage ratio of at least 9%. As of September 30, 2012, our capital ratios exceed these ratios and we remain "well capitalized." See "Management's Discussion and Analysis - Results of Operations - Capital Resources" for more discussion of the Minimum Capital Ratio levels established by the OCC and our capital ratios as of September 30, 2012.

*Recent Legislative and Regulatory Initiatives to Address Financial and Economic Crises*

Markets in the United States and elsewhere have experienced extreme volatility and disruption over the past three plus years. These circumstances have exerted significant downward pressure on prices of equity securities and virtually all other asset classes, and have resulted in substantially increased market volatility, severely constrained credit and capital markets, particularly for financial institutions, and an overall loss of investor confidence. Loan portfolio performances have deteriorated at many institutions resulting from, among other factors, a weak economy and a decline in the value of the collateral supporting their loans. Dramatic slowdowns in the housing industry, due in part to falling home prices and increasing foreclosures and unemployment, have created strains on financial institutions. Many borrowers are now unable to repay their loans, and the collateral securing these loans has, in some cases, declined below the loan balance.

In response to the challenges facing the financial services sector, beginning in 2008 a multitude of new regulatory and governmental actions have been announced, including the EESA, the TARP, the Recovery Act, the Dodd-Frank Act, the JOBS Act and related economic recovery programs. Some of the more recent actions include those described in Part I. Item 1. Business - Supervision and Regulation of our Annual Report on Form 10-K for the year ended December 31, 2011 as filed with the SEC. Although it is likely that further regulatory actions will arise as the Federal government attempts to address the economic situation, we cannot predict the effect that fiscal or monetary policies, economic control, or new federal or state legislation may have on our business and earnings in the future.

**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

See Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations - Market Risk and Interest Rate Sensitivity and - Liquidity Risk.

**Item 4. CONTROLS AND PROCEDURES.**

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer (Principal Executive Officer) and Chief Financial Officer (Principal Financial Officer), of the effectiveness of our disclosure controls and procedures as defined in Exchange Act Rule 13a-15(e). Based upon that evaluation, our Chief Executive Officer (Principal Executive Officer) and Chief Financial Officer (Principal Financial Officer) have concluded that our current disclosure controls and procedures are effective as of September 30, 2012. There have been no significant changes in our internal controls over financial reporting during the fiscal quarter ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

The design of any system of controls and procedures is based in part upon certain assumptions about the likelihood of future events. There can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

**PART II. OTHER INFORMATION**

**Item 1. LEGAL PROCEEDINGS.**

There are no material pending legal proceedings to which the company is a party or of which any of its property is the subject.

**Item 1A RISK FACTORS.**

Not applicable

**Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.**

Not applicable

**Item 3. DEFAULTS UPON SENIOR SECURITIES.**

Not applicable

**Item 4. MINE SAFETY DISCLOSURES.**

Not applicable

**Item 5. OTHER INFORMATION.**

Not applicable

**Item 6. EXHIBITS.**

31.1 Rule 13a-14(a) Certification of the Principal Executive Officer.

31.2 Rule 13a-14(a) Certification of the Principal Financial Officer.

32 Section 1350 Certifications.

101 The following materials from the Quarterly Report on Form 10-Q of Southern First Bancshares, Inc. for the quarter ended September 30, 2012, formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Operations, (iii) Consolidated Statements of Comprehensive Income, (iv) Consolidated Statement of Changes in Shareholders' Equity, (v) Consolidated Statements of Cash Flows and (vi) Notes to Unaudited Consolidated Financial Statements.(1)

(1) As provided in Rule 406T of Regulation S-T, this information shall not be deemed "filed" or part of a registration statement or prospectus for purposes of Section 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934 or otherwise subject to liability under those sections.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

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**INDEX TO EXHIBITS**