S Y BANCORP INC
Form 10-K
March 16, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-K

Annual Report Pursuant to Section 13
or 15(d) of the Securities Exchange Act of 1934

For the Fiscal Year Ended	**Commission File Number**
December 31, 2006	**1-13661**

S.Y. BANCORP, INC.

1040 East Main Street

Louisville, Kentucky 40206

(502) 582-2571

Incorporated in Kentucky	**I.R.S. No. 61-1137529**

Securities registered pursuant to Section 12(b) of the Act:

Title of each class:	*Name of each exchange on which registered:*
Common Stock, no par value	NASDAQ
Preferred Share Purchase Rights	NASDAQ

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

None

Indicate by check mark if the registrant is a well-known seasoned issuer (as defined in Rule 405 of the Securities Act)

Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes o No x

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

Yes x No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. **o**

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act:

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

The aggregate market value of registrant s voting stock (Common Stock, no par value) held by non-affiliates of the registrant as of June 30, 2006 (the last business day of the registrant s most recently completed second fiscal quarter) was $353,481,000.

The number of shares of the registrant s Common Stock, no par value, outstanding as of March 5, 2007, was 14,368,212.

Documents Incorporated By Reference

Portions of Registrant s definitive proxy statement related to Registrant s Annual Meeting of Shareholders to be held on April 25, 2007 (the Proxy Statement), are incorporated by reference into Part III of this Form 10-K.

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Part I

Item 1. Business

S. Y. Bancorp, Inc. (Bancorp) was incorporated in 1988 and is a Kentucky corporation headquartered in Louisville, Kentucky. Bancorp is a bank holding company registered with, and subject to supervision, regulation and examination by the Board of Governors of the Federal Reserve System. Bancorp has two subsidiaries, Stock Yards Bank & Trust Company (the Bank) and S.Y. Bancorp Capital Trust I (the Trust). The Bank is wholly owned and is a state chartered bank. Bancorp conducts no active business operations; the business of Bancorp is substantially the same as that of the Bank. The operations of the Bank are fully reflected in the consolidated financial statements of Bancorp. Accordingly, references to Bancorp in this document may encompass both the holding company and the Bank. The Trust is a Delaware statutory business trust that has no current business operations.

Stock Yards Bank & Trust Company

Stock Yards Bank & Trust Company is the only banking subsidiary of Bancorp and was originally chartered in 1904. The Bank is headquartered in Louisville, Kentucky and provides commercial banking services in the Louisville Metropolitan Statistical Area (MSA) and Indianapolis through 25 full service banking offices (See ITEM 2. PROPERTIES). The Bank is chartered under the laws of the Commonwealth of Kentucky. In addition to traditional commercial and personal banking activities, the Bank has an investment management and trust department offering a wide range of trust and investment services. This department operates under the name of Stock Yards Trust Company. The Bank also originates and sells single-family residential mortgages through its operating, Stock Yards Mortgage Company. Additionally, the Bank offers securities brokerage services and life insurance products through arrangements with a third party provider. See Note 21 to Bancorp s consolidated financial statements for the year ended December 31, 2006 for information relating to the Bank s business segments.

At December 31, 2006, the Bank had 437 full-time equivalent employees. Management of Bancorp strives to be an employer of choice and considers the relationship with employees to be good.

Supervision and Regulation

Bank holding companies and commercial banks are extensively regulated under both federal and state law. Any change in applicable law or regulation may have a material effect on the business and prospects of Bancorp and the Bank.

Bancorp, as a registered bank holding company, is subject to the supervision of and regulation by the Federal Reserve Board under the Bank Holding Company Act of 1956. In addition, Bancorp is subject to the provisions of Kentucky s banking laws regulating bank acquisitions and certain activities of controlling bank shareholders.

The Bank is subject to the supervision of and regular examination by the Federal Deposit Insurance Corporation and the Kentucky Department of Financial Institutions. The Federal Deposit Insurance Corporation insures the deposits of the Bank to the current maximums of $100,000 per depositor for time and demand deposit accounts, and $250,000 per depositor for self-directed retirement accounts.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the 1994 Act) removed state law barriers to interstate bank acquisitions and permits the consolidation of interstate banking operations. Under the 1994 Act, adequately capitalized and managed bank holding companies may acquire banks in any state, subject to Community Reinvestment Act compliance, compliance with federal and state antitrust laws and deposit concentration limits and subject to any state laws restricting the transaction. Kentucky banks are also permitted to acquire a branch in another state if permitted by law of the other state. Kentucky currently allows out-of-state banks to enter Kentucky to provide banking services on the same terms that a Kentucky bank could enter that bank s state.

The Gramm-Leach-Bliley Act (the GLB Act) allows for affiliations among banks, securities firms and insurance companies by means of a financial holding company (FHC). In most cases, the creation of an FHC is a simple election and notice to the Federal Reserve Board. The GLB Act requires that, at the time of establishment of an FHC, all depository institutions within that corporate group must be well managed and well capitalized and must have received a rating of satisfactory or better under its most recent Community Reinvestment Act examination. Further, non-banking financial firms (for example an insurance company or securities firm) may establish an FHC and acquire a depository institution. While the distinction between banks and non-banking financial firms has been blurring over recent years, the GLB Act makes it less cumbersome for banks to offer services financial in nature but beyond traditional commercial banking activities. Likewise, non-banking financial firms may find it easier to offer services that had, heretofore, been provided primarily by depository institutions. Management of Bancorp has chosen not to become an FHC at this time, but may chose to do so in the future.

The USA Patriot Act of 2001 was enacted in response to the 2001 terrorist attacks in the U.S. and is intended to strengthen U.S. law enforcement s and the intelligence community s ability to work cohesively to combat terrorism. The Patriot Act contains sweeping anti-money laundering and financial transparency laws and requires various regulations, including: (a) due diligence requirements for financial institutions that administer, maintain, or manage private bank accounts for non-U.S. persons; (b) standards for verifying customer identification at account opening; (c) rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering; (d) currency transaction reports (CTRs) for transactions exceeding $10,000; and (e) filing of suspicious activities reports (SARs) if the Bank believes a customer may be in violation of U.S. laws and regulations.

Available Information

Bancorp files reports with the SEC. Those reports include the Annual Report on Form 10-K, quarterly reports on Form 10-Q, current event reports on Form 8-K and proxy statements, as well as any amendments to those reports. The public may read and copy any materials the Registrant files with the SEC at the SEC s Public Reference Room at 100 F Street, NE, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC at http://www.sec.gov. Bancorp s Annual Report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to section 13(a) or 15(d) of the Exchange Act are accessible at no cost on Bancorp s web site at http://www.syb.com after they are electronically filed with or furnished to the SEC.

Item 1A. Risk Factors

Investments in Bancorp s common stock involve risk, and Bancorp s profitability and success may be affected by a number of factors including those discussed below.

Fluctuations in interest rates could reduce Bancorp s profitability.

Bancorp s primary source of income is from the difference between interest earned on loans and investments and the interest paid on deposits and borrowings. Management expects to periodically experience gaps in the interest rate sensitivities of Bancorp s assets and liabilities, meaning that either Bancorp s interest-bearing liabilities will be more sensitive to changes in market interest rates than Bancorp s interest-earning assets, or vice versa. In either event, if market interest rates should move contrary to Bancorp s position, this gap will work against Bancorp and Bancorp s earnings may be negatively affected.

Many factors affect the fluctuation of market interest rates, including, but not limited to the following:

- inflation;
- recession;
- a rise in unemployment;
- tightening money supply; and
- international disorder and instability in domestic and foreign financial markets.

Bancorp s asset-liability management strategy, which is designed to mitigate Bancorp s risk from changes in market interest rates, may not be able to prevent changes in interest rates from having a material adverse effect on Bancorp s results of operations and financial condition.

Competition with other financial institutions could adversely affect Bancorp s profitability.

Bancorp faces vigorous competition from banks and other financial institutions. A number of these banks and other financial institutions have substantially greater resources and lending limits, larger branch systems and a wider array of banking services. Additionally, Bancorp encounters competition from both de novo and smaller community banks entering its markets. Bancorp also competes with other providers of financial services, such as brokerage firms, consumer finance companies and insurance companies. This competition may reduce or limit Bancorp s margins on banking services, reduce Bancorp s market share and adversely affect Bancorp s results of operations and financial condition.

The unexpected loss of key members of Bancorp s management team may adversely affect Bancorp s operations.

Bancorp s success to date has been influenced strongly by Bancorp s ability to attract and to retain senior management experienced in banking and financial services. Bancorp s ability to retain executive officers and the current management teams of each of Bancorp s lines of business will continue to be important to successful implementation of Bancorp s strategies. There are no employment or non-compete agreements with any of these key employees, but there are non-solicitation agreements with all Bank officers. The unexpected loss of services of any key management personnel, or the inability to recruit and retain qualified personnel in the future, could have an adverse effect on Bancorp s business and financial results.

Bancorp s profitability depends on local and national economic conditions.

Bancorp s success depends on general economic conditions both locally and nationally. Most of Bancorp s customers are in the Louisville MSA with a growing number of customers in the Indianapolis area. Some of Bancorp s customers are directly impacted by the local economy while others have more national or global business dealings. Local economic conditions have an impact on the demand of Bancorp s customers for loans, the ability of some borrowers to repay these loans, and the value of the collateral securing these loans.

Some of the factors influencing general national economic conditions include inflation, recession, and unemployment. As these factors impact the overall business climate, they can have a significant effect on loan demand. Loan growth is critical to Bancorp s profitability. Significant decline in general economic conditions will negatively affect the financial results of Bancorp s banking operations.

If Bancorp s allowance for loan losses is not sufficient to cover actual loan losses, Bancorp s earnings could decrease.

Bancorp s loan customers may not repay their loans according to the terms of these loans, and the collateral securing the payment of these loans may be insufficient to ensure repayment. Accordingly, Bancorp may experience significant credit losses which could have a material adverse effect on operating results. Management makes various assumptions and judgments about the collectibility of Bancorp s loan portfolio, including the creditworthiness of Bancorp s borrowers and the value of real estate and other assets serving as collateral for repayment of many of Bancorp s loans. In determining the size of the allowance for loan losses, management considers, among other factors, Bancorp s loan loss experience and an evaluation of economic conditions. If Bancorp s assumptions prove to be incorrect, Bancorp s current allowance may not be sufficient to cover future loan losses and adjustments may be necessary to allow for different economic conditions or adverse developments in Bancorp s loan portfolio. Material additions to Bancorp s allowance would materially decrease Bancorp s net income.

In addition, federal and state regulators periodically review Bancorp s allowance for loan losses and may require an increase in Bancorp s provision for loan losses or further loan charge-offs. Any increase in Bancorp s provision for loan losses or loan charge-offs as required by these regulatory agencies could have a negative effect on net income.

Bancorp operates in a highly regulated environment and may be adversely affected by changes in federal and local laws and regulations.

Bancorp is subject to extensive regulation, supervision and examination by federal and state banking authorities. Any change in applicable regulations or federal or state legislation could have a substantial impact on Bancorp s bank and its operations. Additional legislation and regulations may be enacted or adopted in the future that could significantly affect Bancorp s powers, authority and operations, which could have a material adverse effect on Bancorp s financial condition and results of operations. Further, regulators have significant discretion and power to prevent or remedy unsafe or unsound practices or violations of laws by banks and bank holding companies in the performance of their supervisory and enforcement duties. The exercise of regulatory power may have negative impact on Bancorp s results of operations and financial condition.

Item 1B. Unresolved Staff Comments

Bancorp has no unresolved SEC staff comments.

Item 2. Properties

The principal offices of Bancorp and the Bank are located at 1040 East Main Street, Louisville, Kentucky. The Bank s operations center is a part of the main office complex. In addition to the main office complex, the Bank owned eight branch properties at December 31, 2006 (two of which are located on leased land) and Bancorp owned three. The Bank also leased thirteen branch facilities. Of the twenty-five banking locations, twenty-four are located in the Louisville MSA and one is located in Indianapolis, Indiana. See Notes 5 and 17 to Bancorp s consolidated financial statements for the year ended December 31, 2006, for additional information relating to amounts invested in premises, equipment and lease commitments.

Item 3. Legal Proceedings

See Note 17 to Bancorp s consolidated financial statements for the year ended December 31, 2006, for information relating to legal proceedings.

Item 4. Submission of Matters to a Vote of Security Holders

None

Executive Officers of the Registrant

The following table lists the names and ages (as of December 31, 2006) of all current executive officers of Bancorp. Each executive officer is appointed by Bancorp s Board of Directors to serve at the discretion of the Board. There is no arrangement or understanding between any executive officer of Bancorp and any other person(s) pursuant to which he/she was or is to be selected as an officer.

Name and Age of Executive Officer	**Position and Offices with Bancorp**
David P. Heintzman Age 47	Chairman, President and Chief Executive Officer
Kathy C. Thompson Age 45	Senior Executive Vice President and Director
Phillip S. Smith Age 49	Executive Vice President
Gregory A. Hoeck Age 56	Executive Vice President
Nancy B. Davis Age 51	Executive Vice President, Secretary, Treasurer and Chief Financial Officer
Philip S. Poindexter Age 40	Executive Vice President
James A. Hillebrand Age 38	Executive Vice President

Mr. Heintzman was appointed Chairman and Chief Executive Officer effective January 1, 2005. Prior thereto, he served as President of Bancorp and the Bank since 1992. Mr. Heintzman joined the Bank in 1985.

Ms. Thompson was appointed Senior Executive Vice President in January 2005. Prior thereto, she served as Executive Vice President of Bancorp and the Bank. She joined the Bank in 1992 and is Manager of the Investment Management and Trust Department and is also responsible for the sales, service and marketing areas of the Bank.

Mr. Smith was appointed Executive Vice President of the Bank in 1996. He joined the Bank in 1982 and is the Chief Credit Officer of the Bank, responsible for Bank-wide lending policy and operations.

Mr. Hoeck joined the Bank as Executive Vice President in 1998. He is primarily responsible for the retail area of the Bank.

Ms. Davis was appointed Executive Vice President of Bancorp and the Bank in 1999. She joined the Bank in 1991 and was appointed Chief Financial Officer in 1993.

Mr. Poindexter joined the Bank as Executive Vice President in 2004. He is the Director of Commercial Lending for the Bank. Prior to joining the Bank, Mr. Poindexter served as City Executive for BB&T, managing all commercial banking functions for the Louisville region.

Mr. Hillebrand was appointed Executive Vice President in January 2005. Prior thereto, he was Senior Vice President of the Bank. He has been primarily responsible for Private Banking since joining the Bank in 1996 and is also responsible for the Bank s expansion efforts into the Indianapolis market.

Part II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Bancorp s common stock is traded on the NASDAQ Global Select under the ticker symbol SYBT. Prior to July 2005, the stock traded on the American Stock Exchange under the symbol SYI. The table below sets forth the quarterly high and low market closing prices of Bancorp s common stock and dividends declared per share. The payment of dividends by the Bank to Bancorp is subject to the restriction described in Note 16 to the consolidated financial statements. Management believes that Bancorp will continue to generate adequate earnings to continue to pay dividends on a quarterly basis. On December 31, 2006, Bancorp had 1,268 shareholders of record, and approximately 3,200 non-objecting beneficial owners holding shares in nominee or street name .

	2006			**2005**		
Quarter	**High**	**Low**	**Cash Dividends Declared**	**High**	**Low**	**Cash Dividends Declared**
First	$ 25.16	$ 23.13	$ 0.13	$ 24.10	$ 20.78	$ 0.11
Second	28.28	24.15	0.14	22.37	19.97	0.11
Third	30.03	25.55	0.15	23.62	21.01	0.11
Fourth	29.54	27.55	0.15	24.29	21.48	0.12

The following table shows information relating to the repurchase of shares of common stock by Bancorp during the three months ended December 31, 2006.

	Total Number of Shares Purchased	**Average Price Paid Per Share**	**Total Number of Shares Purchased as Part of Publicly Announced Plan**	**Maximum Number of Shares that May Yet Be Purchased Under the Plan**
October 1-October 31	987	$ 29.52		223,013
November 1-November 30	5,700	27.85	5,700	217,313
December 1-December 31	40,100	27.91	40,100	177,213
Total	46,787	$ 27.94	45,800	177,213

The Board of Directors of S.Y. Bancorp, Inc. first approved a share buyback plan in 1999. In February 2007, the Board of Directors extended the term of its existing plan to February 2008.

The following performance graph and data included shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934 or otherwise subject to the liabilities of that section, nor shall it be deemed soliciting material or subject to Regulation 14A of the Exchange Act or incorporated by reference in any filing under the Exchange Act or the Securities Act of 1933, except as shall be expressly set forth by specific reference in such filing.

The graph compares the performance of Bancorp Common Stock to the Russell 2000 index, the SNL NASDAQ Bank index and the SNL Midwest Bank index for Bancorp s last five fiscal years. The graph assumes the value of the investment in Bancorp Common Stock and in each index was $100 at December 31, 2001 and that all dividends were reinvested.

	Period Ending					
Index	**12/31/01**	**12/31/02**	**12/31/03**	**12/31/04**	**12/31/05**	**12/31/06**
S.Y. Bancorp, Inc.	100.00	112.95	127.12	151.59	160.53	192.74
Russell 2000 Index	100.00	79.52	117.09	138.55	144.86	171.47
SNL NASDAQ Bank Index	100.00	102.85	132.76	152.16	147.52	165.62
SNL Midwest Bank Index	100.00	96.47	123.48	139.34	134.26	155.19

Item 6. Selected Financial Data

Selected Consolidated Financial Data

(Dollars in thousands except per share data)	**Years ended December 31** 2006	2005	2004	2003	2002
Net interest income	$ 53,886	$ 49,235	$ 44,221	$ 42,748	$ 40,580
Provision for loan losses	2,100	225	2,090	2,550	4,500
Net income	22,896	21,644	18,912	17,709	15,650
Per share data					
Net income, basic	$ 1.58	$ 1.48	$ 1.31	$ 1.25	$ 1.11
Net income, diluted	1.55	1.46	1.27	1.21	1.07
Cash dividends declared	0.57	0.45	0.37	0.29	0.25
Book value	9.54	8.67	7.96	7.05	6.10
Market value	28.00	23.83	22.95	19.58	17.67
Average balances					
Stockholders equity	$ 131,971	$ 121,614	$ 109,414	$ 93,799	$ 79,417
Assets	1,353,651	1,270,178	1,148,652	1,083,949	998,421
Federal Home Loan Bank advances	34,466	25,809	25,573		
Long-term debt	10,458	20,769	20,799	20,829	20,867
Selected ratios					
Return on average assets	1.69 %	1.70 %	1.65 %	1.63 %	1.57 %
Return on average stockholders equity	17.35	17.80	17.28	18.88	19.71
Average stockholders equity to average assets	9.75	9.57	9.53	8.65	7.95
Net interest rate spread	3.76	3.79	3.82	3.86	3.90
Net interest rate margin, fully tax-equivalent	4.36	4.25	4.20	4.25	4.38
Non-performing loans to total loans	0.59	0.44	0.57	0.55	0.68
Non-performing assets to total assets	0.65	0.59	0.75	0.76	0.58
Net charge offs to average loans	0.18	0.07	0.15	0.29	0.47
Allowance for loan losses to average loans	1.12	1.19	1.37	1.38	1.48

Per share information has been adjusted to reflect 5% stock dividend effective May 2006 and 2-for-1 stock split effective September 2003.

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

The purpose of this discussion is to provide information as to the analysis of the consolidated financial condition and results of operations of S.Y. Bancorp, Inc. (Bancorp) and its wholly owned subsidiary, Stock Yards Bank & Trust Company (the Bank). Bancorp, incorporated in 1988, has no active business operations. Thus, Bancorp s business is substantially the same as that of the Bank. The Bank has operated continuously since it opened in 1904. The Bank conducted business at one location for 85 years and then began branching. At December 31, 2006, the Bank had twenty-four full service banking locations in the Louisville MSA and one full service banking location in Indianapolis, Indiana. The combined effect of added convenience with the Bank s focus on flexible, attentive customer service has been key to the Bank s growth and profitability. The wide range of services added by the investment management and trust department, the brokerage department, and the mortgage department helps support the corporate philosophy of capitalizing on full service customer relationships.

Forward-Looking Statements

This report contains forward-looking statements under the Private Securities Litigation Reform Act that involve risks and uncertainties. These forward-looking statements may be identified by the use of words such as expect , anticipate , plan , foresee or other words with similar meaning. Although Bancorp believes the assumptions underlying the forward-looking statements contained herein are reasonable, any of these assumptions could be inaccurate. Factors that could cause actual results to differ from results discussed in forward-looking statements include, but are not limited to: economic conditions both generally and more specifically in the markets in which Bancorp and its subsidiaries operate; competition for the Bank s customers from other providers of financial services; government legislation and regulation which change from time to time and over which Bancorp has no control; changes in interest rates; material unforeseen changes in liquidity, results of operations or financial condition of the Bank s customers; or other risks detailed in Bancorp s filings with the Securities and Exchange Commission and Item 1A of this Form 10-K all of which are difficult to predict and many of which are beyond the control of Bancorp.

Critical Accounting Policies

Bancorp has prepared all of the consolidated financial information in this report in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). In preparing the consolidated financial statements in accordance with U.S. GAAP, Bancorp makes estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. There can be no assurances that actual results will not differ from those estimates.

Management has identified the accounting policy related to the allowance and provision for loan losses as critical to the understanding of Bancorp s results of operations and discussed this conclusion with the Audit Committee of the Board of Directors. Since the application of this policy requires significant management assumptions and estimates, it could result in materially different amounts to be reported if conditions or underlying circumstances were to change. Assumptions include many factors such as changes in borrowers financial condition which can change quickly or historical loss ratios related to certain loan portfolios which may or may not be indicative of future losses. To the extent that management s assumptions prove incorrect, the results from operations could be materially affected by a higher provision for loan losses. The impact and any associated risks related to this policy on Bancorp s business operations are discussed in the Allowance for Loan Losses section below.

Additionally, management has identified the accounting policy related to accounting for income taxes as critical to the understanding of Bancorp s results of operations and discussed this conclusion with the Audit Committee of the Board of Directors. The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity s financial statements or tax returns. Judgment is required in assessing the future tax consequences of events that have been recognized in Bancorp s financial statements or tax returns. Fluctuations in the actual outcome of these future tax consequences, including the effects of IRS examinations and examinations by other state agencies, could

materially impact Bancorp s financial position and its results from operations. Additional information regarding income taxes is discussed in the Income Taxes section below and note 7 to the consolidated financial statements.

Overview of 2006

The following discussion should be read in conjunction with Bancorp s consolidated financial statements and accompanying notes and other schedules presented elsewhere in this report.

The 2006 business environment was influenced by a continuation of improving local economic trends and increasing competition from other financial institutions including several new institutions to the Louisville, KY and Indianapolis, IN MSAs. With stable interest margins, steady loan growth, and continued growth in non-interest income, Bancorp completed its nineteenth consecutive year of higher earnings.

As is the case with most banks, the primary source of Bancorp s revenue is net interest income and fees from various financial services provided to customers. Net interest income is the difference between interest income earned on loans, investment securities and other interest earning assets less interest expense on deposit accounts and other interest bearing liabilities. Loan volume and the interest rates earned on those loans are critical to overall profitability. Similarly deposit volume is crucial to funding loans, and rates paid on deposits directly impact profitability. Business volumes are influenced by overall economic factors including market interest rates, business spending, consumer confidence and competitive conditions within the marketplace.

Bancorp s loan portfolio increased 9% during 2006 and was the driving force of growth in interest income. This growth reflects an increasingly significant contribution from our expanding Indianapolis presence. Deposits grew in support of loan growth. Net interest margin increased slightly on a year to year basis. With approximately half of the loan portfolio being comprised of variable rate loans and primarily indexed to the prime interest rate, the increases in this rate from 7.25% at the beginning of 2006 to 8.25% at the end of 2006 benefited Bancorp s 2006 net interest income. While deposit rates also trended up, Bancorp was able to hold those rates at a lower level to maintain the net interest margin at 4.36% for the year compared to 4.25% in 2005.

Distinguishing Bancorp from other similarly sized community banks is its diverse revenue stream. Non-interest income as a percentage of total revenues continued to be over 34% in 2006 and proved key to earnings growth. Stock Yards Trust Company maintained new business growth in 2006, and revenues increased accordingly. Also, increases in revenues from service charges on deposit accounts and bankcard transactions offset a decline in revenues from brokerage activity and gains on sales of mortgage loans.

Also impacting 2006 net income, the Bancorp:

- Resumed quarterly provisions for loan losses after having recorded no provision since the first quarter of 2005. The total provision for 2006 amounted to $2,100,000 compared with $225,000 for 2005.

- Redeemed all of its trust preferred securities, recognizing expense of $879,000 for unamortized issuance costs.

- Recognized $531,000 in stock option expense in 2006, while only $34,000 was recorded in the prior year due to the adoption of SFAS 123R Share-Based Payment .

Challenges for 2007 could include net interest margin contraction and loan growth.

- Having benefited from loan rates repricing more quickly than deposit rates, market conditions will likely reverse, and loan rates could decline more quickly than deposit costs to impact net interest margin negatively.

- Competition from other financial institutions both well established and newcomers could result in loan and deposit pricing pressures.

- To achieve our goals for 2007, net loan growth must exceed that of 2006. This will be impacted by competition and prevailing economic conditions. While we believe there is significant opportunity for growth in the Louisville MSA, we know that our ability to deliver attractive growth over the long-term is linked to our succession in

new markets. In 2007, we plan to open a second location in Indianapolis, and we have begun to explore the Cincinnati market for the future.

The following sections provide more details on subjects presented in this overview.

Results of Operations

Net income was $22,896,000 or $1.55 per share on a diluted basis for 2006 compared to $21,644,000 or $1.46 per share for 2005 and $18,912,000 or $1.27 per share for 2004.

- The increase in 2006 net income was attributable to growth in net interest income and non-interest income, which were partially offset by increased provision for loan losses, non-interest expenses and taxes. Earnings include a 9.5% increase in fully taxable equivalent net interest income and a 4.8% increase in non-interest income.

- In 2006, the Company provided $2,100,000 for loan losses compared to $225,000 in 2005. In the first quarter of 2006, the Bank resumed quarterly provisions for loan losses after recoding no provisions since the first quarter of 2005. Management s decision to suspend loan loss provisions in 2005 reflected steadily improving credit quality with the loan portfolio.

- Non-interest income improved mainly due to a 7.6% increase in income from investment management and trust, a 4.3% increase in service charges on deposit, and a 19.0% increase in Bankcard transaction revenue. Non-interest expenses increased 4.3% primarily from salaries and benefits and the write-off of issuance costs of trust preferred securities.

The following paragraphs provide a more detailed analysis of the significant factors affecting operating results.

Net Interest Income

Net interest income, the most significant component of Bancorp s earnings, is total interest income less total interest expense. Net interest spread is the difference between the taxable equivalent rate earned on average interest earning assets and the rate expensed on average interest bearing liabilities. Net interest margin represents net interest income on a taxable equivalent basis as a percentage of average earning assets. Net interest margin is affected by both the interest rate spread and the level of non-interest bearing sources of funds, primarily consisting of demand deposits and stockholders equity. The level of net interest income is determined by the mix and volume of interest earning assets, interest bearing deposits and interest bearing liabilities and by changes in interest rates. The discussion that follows is based on tax-equivalent interest data.

Comparative information regarding net interest income follows:

(Dollars in thousands)	2006	2005	2004	2006/2005 Change	2005/2004 Change
Net interest income, tax equivalent basis	$ 54,912	$ 50,131	$ 45,091	9.5 %	11.2 %
Net interest spread	3.76 %	3.79 %	3.82 %	(3)bp	(3)bp
Net interest margin	4.36 %	4.25 %	4.20 %	11 bp	5 bp
Average earning assets	$ 1,258,591	$ 1,178,922	$ 1,074,845	6.8 %	9.7 %
Five year treasury bond at year end	4.70 %	4.36 %	3.61 %	34 bp	75 bp
Average five year treasury bond	4.75 %	4.04 %	3.42 %	71 bp	62 bp
Prime rate at year end	8.25 %	7.25 %	5.25 %	100 bp	200 bp
Average prime rate	7.96 %	6.19 %	4.34 %	177 bp	185 bp

bp = basis point = 1/100th of a percent

Although the average prime rate increased 177 basis points in 2006 compared to the previous year, net interest margin increased 11 basis points and net interest spread decreased 3 basis points.

Prime rate and the five year treasury are included above to provide a general indication of the interest rate environment in which the Bank operated. A large portion of the Bank s variable rate loans are indexed to the

Bank s prime rate and reprice as the prime rate changes. Most of the Bank s fixed rate loans are indexed to the five year Treasury bond.

Average loans increased 7.7% in 2006, and the competitive environment held average loan yields to an increase of 80 basis points. Average interest costs on interest bearings deposits increased 80 basis points as Bancorp grew average interest bearing deposits $60,833,000, or 7.3%. Also favorably impacting the net interest spread and margin was the mid-year redemption of Bancorp s $20 million in trust preferred securities. These securities bore a rate of 9%.

For 2007 management anticipates a relatively flat prime rate while competitive pressures could decrease the rate the Bank earns on loans. Similarly, contractual repricing coupled with ever increasing competition could increase the rates paid on deposit accounts. These factors would result in compression of net interest spread and margin.

Asset/Liability Management and Interest Rate Risk

Managing interest rate risk is fundamental for the financial services industry. The primary objective of interest rate risk management is to neutralize effects of interest rate changes on net income. By considering both on and off-balance sheet financial instruments, management evaluates interest rate sensitivity while attempting to optimize net interest income within the constraints of prudent capital adequacy, liquidity needs, market opportunities and customer requirements.

Interest Rate Simulation Sensitivity Analysis

Bancorp uses an earnings simulation model to estimate and evaluate the impact of changing interest rates on earnings. The simulation model is designed to reflect the dynamics of interest earning assets, interest bearing liabilities and off-balance sheet financial instruments in a one year forecast. By estimating the effects of interest rate increases and decreases, the model can reveal approximate interest rate risk exposure. The simulation model is used by management to gauge approximate results given a specific change in interest rates at a given point in time. The model is therefore a tool to indicate earnings trends in given interest rate scenarios and does not indicate actual expected results. The December 31, 2006 simulation analysis indicates that an increase in interest rates of 100 to 200 basis points would have a positive effect on net interest income, and a decrease of 100 to 200 basis points in interest rates would have a negative effect on net interest income. These estimates are summarized below.

	Net Interest Income % Change
Increase 200 bp	5.94
Increase 100 bp	2.96
Decrease 100 bp	(2.93)
Decrease 200 bp	(5.85)

To assist in achieving a desired level of interest rate sensitivity, management has in the past entered into derivative financial instruments that are designed to mitigate the effect of changes in interest rates. Derivative financial instruments can be a cost and capital efficient method of modifying interest rate risk sensitivity. Based upon management s assessment of interest rate sensitivity, Bancorp had no derivative financial instruments during fiscal years 2006 or 2005.

The following table presents the increases in net interest income due to changes in rate and volume computed on a tax-equivalent basis and indicates how net interest income in 2006 and 2005 was impacted by volume increases and the higher average interest rate environment. The tax-equivalent adjustments are based on a 35% federal tax rate. The change in interest due to both rate and volume has been allocated to the change due to rate and the change due to volume in proportion to the relationship of the absolute dollar amounts of the change in each.

Taxable Equivalent Rate/Volume Analysis

	2006/2005 Increase (Decrease) Due to			**2005/2004 Increase (Decrease) Due to**		
(In thousands)	**Net Change**	**Rate**	**Volume**	**Net Change**	**Rate**	**Volume**
Interest income						
Loans	$ 13,796	$ 8,434	$ 5,362	$ 10,801	$ 4,359	$ 6,442
Federal funds sold	462	288	174	343	324	19
Mortgage loans held for sale	(83)	57	(140)	121	23	98
Securities						
Taxable	149	55	94	288	570	(282)
Tax-exempt	(210)	(15)	(195)	276	(95)	371
Total interest income	14,114	8,819	5,295	11,829	5,181	6,648
Interest expense						
Deposits						
Interest bearing demand deposits	329	599	(270)	574	812	(238)
Savings deposits	66	69	(3)	96	95	1
Money market deposits	2,392	1,914	478	2,888	2,225	663
Time deposits	5,667	3,350	2,317	2,498	610	1,888
Securities sold under agreements to repurchase and federal funds purchased	838	827	11	540	503	37
Other short-term borrowings	269	49	220	20	21	(1)
Federal Home Loan Bank advances	694	406	288	173	168	5
Long-term debt	(922)	5	(927)		3	(3)
Total interest expense	9,333	7,219	2,114	6,789	4,437	2,352
Net interest income	$ 4,781	$ 1,600	$ 3,181	$ 5,040	$ 744	$ 4,296

Bancorp s net interest income increased $4,781,000 for the year ended December 31, 2006 compared to the same period of 2005 while 2005 compared to 2004 saw a $5,040,000 increase. Net interest income for the year 2006 compared to 2005 was positively impacted by a significant increase in loan and deposit volume and, to a lesser degree, an increase in rates. Although interest rates increased in 2006, which increased interest income, the effect was somewhat offset by the impact of higher deposit rates. If the yield curve remains flat or inverted and if deposit rates continue to increase due to market competition, Bancorp could experience a decrease in net interest spread and margin. Strong loan growth accounted for $5,362,000 of the increase in interest income, which was somewhat offset by volume in money market and time deposit growth which increased interest expense by $2,795,000 for the year of 2006 compared to 2005.

For the year 2005 compared to 2004, loan growth generated an increase of $6,442,000 in interest income, and increases in average deposit balances and rates paid on those deposits increased interest expense.

Provision for Loan Losses

In determining the provision for loan losses charged to expense, management considers many factors. Among these are the quality and underlying collateral of the loan portfolio, previous loss experience, the size and composition of the loan portfolio, changes in lending personnel and an assessment of the impact of current economic conditions on borrowers ability to pay. The provision for loan losses is summarized below:

(Dollars in thousands)	2006	2005	2004
Provision for loan losses	$ 2,100	$ 225	$ 2,090
Allowance to loans at year end	1.06 %	1.14 %	1.27 %
Allowance to average loans for year	1.12 %	1.19 %	1.37 %

The provision for loan losses increased $1,875,000 during 2006 compared to 2005 in response to Bancorp s assessment of inherent risk in the loan portfolio. Bancorp resumed quarterly provisions for loan losses in 2006 after having recorded no provision since the first quarter of 2005. Management s decision to suspend loan loss provisions in 2005 reflected steadily improving credit quality. In many respects, good credit quality remained evident in 2006, even though total non-performing loans and net charge-offs rose to a higher level during the year. Although non-performing loans and net charge-offs increased in 2006, management does not believe there is significant loss exposure to Bancorp other than the length of time involved in liquidating these loans. See Financial Condition-Non-performing Loans and Assets for further discussion of non-performing loans. See Financial Condition-Summary of Loan Loss Experience for further discussion of loans charged off during the year.

The Bank s loan portfolio is diversified with no significant concentrations of credit. Geographically, most loans are extended to borrowers in the Louisville, Kentucky and Indianapolis, Indiana metropolitan areas. The adequacy of the allowance is monitored on an ongoing basis and it is the opinion of management that the balance of the allowance for loan losses at December 31, 2006 is adequate to absorb losses inherent in the loan portfolio as of the financial statement date. See Financial Condition-Allowance for Loan Losses for more information on the allowance for loan losses.

Non-Interest Income and Non-Interest Expenses

The following table provides a comparison of the components of non-interest income for 2006, 2005 and 2004. The table shows the dollar and percentage change from 2005 to 2006 and from 2004 to 2005. Below the table is a discussion of significant changes and trends.

(Dollars in thousands)	2006	2005	2004	2006/2005 Change	%	2005/2004 Change	%
Non-interest income							
Investment management and trust services	$ 11,632	$ 10,813	$ 9,427	$ 819	7.6 %	$ 1,386	14.7 %
Service charges on deposit accounts	8,791	8,426	8,890	365	4.3 %	(464)	(5.2)%
Bankcard transaction revenue	2,028	1,704	1,262	324	19.0 %	442	35.0 %
Gains on sales of mortgage loans held for sale	1,270	1,391	1,064	(121)	(8.7)%	327	30.7 %
Gains on sales of securities available for sale							
Brokerage commissions and fees	1,973	2,055	1,675	(82)	(4.0)%	380	22.7 %
Other	2,988	2,973	2,358	15	0.5 %	615	26.1 %
	$ 28,682	$ 27,362	$ 24,676	$ 1,320	4.8 %	$ 2,686	10.9 %

Total non-interest income increased 4.8% for the year ended December 31, 2006 compared to the same period for 2005. The largest component of non-interest income is investment management and trust services. This area of the Bank continues to grow through attraction of new business and customer retention. At

December 31, 2006 assets under management totaled $1.6 billion compared to $1.4 billion at December 31, 2005 and $1.3 billion as of December 31, 2004. Because assets under management are expressed in terms of fair value, increases in market value of existing accounts during the last two years and the attraction of new business have both served to increase assets under management. Growth in the department s assets consisted primarily of personal trust accounts during both 2006 and 2005.

Service charges on deposit accounts increased $365,000 or 4.3%, for the year ended December 31, 2006 compared to the same period a year ago. Several factors contributed to the increase, including higher transaction volume compared to the prior year. Somewhat offsetting these increases is the impact of higher interest rates on commercial analysis accounts as higher rates serve to increase earnings credits which in turn reduce service charge income.

Bankcard transaction revenue increased $324,000 or 19.0% in 2006 compared to 2005 and primarily represents income that the Bank derives from customers use of debit cards. As the popularity of these cards has grown, there have been increases in the number of transactions by cardholders as customers recognize the convenience that the cards offer.

The Bank operates a mortgage banking company. This division originates residential mortgage loans and sells the loans in the secondary market. The division offers conventional, VA and FHA financing, as well as a program for low-income first time home buyers. Loans are made for both the purchase of and refinancing of homes. Virtually all loans originated by the mortgage banking company are sold in the secondary market with servicing rights released. Interest rates on the loans sold are locked with the buyer and investor, thus Bancorp bears no interest rate risk related to these loans. The mortgage banking company also offers home equity conversion mortgages or reverse mortgages designed by the U.S. Department of Housing and Urban Development (HUD). These HUD loans give older homeowners a vehicle for turning equity in their homes to cash. Interest rates on conventional mortgage loans directly impact the volume of business transacted by the mortgage banking division. Higher rates in 2005 and 2006 have led to an industry-wide slowdown in loan volume during the past few years as the housing market has softened.

Brokerage commissions and fees decreased during 2006 as overall transaction volume was slightly down compared to the prior year. Bancorp continues to offer a full compliment of financial services to its customer base and feels that brokerage services are a key component of that strategy.

Other non-interest income increased slightly during 2006 compared to 2005 partly as a result of increased income related to two bank-owned life insurance (BOLI) policies. The BOLI policies generated income of $914,000 and $882,000 during 2006 and 2005, respectively. Somewhat offsetting any increases were decreases in fees related to mortgage processing and internet banking fee income. In 2006, the Bank began offering internet banking services to customers for no charge.

The following table provides a comparison of the components of non-interest expenses for 2006, 2005 and 2004. The table shows the dollar and percentage change from 2005 to 2006 and from 2004 to 2005. Below the table is a discussion of significant changes and trends.

(Dollars in thousands)	2006	2005	2004	2006/2005 Change	%	2005/2004 Change	%
Non-interest expense							
Salaries and employee benefits	$ 26,406	$ 24,544	$ 21,652	$ 1,862	7.6 %	$ 2,892	13.4 %
Net occupancy expense	3,480	3,444	3,027	36	1.0 %	417	13.8 %
Data processing expense	3,834	3,668	3,419	166	4.5 %	249	7.3 %
Furniture and equipment expense	1,152	1,191	1,178	(39)	(3.3)%	13	1.1 %
Amortization and write-off of issuance costs of trust preferred securities	897	35	35	862	2,462.9 %		
State bank taxes	1,298	1,562	1,076	(264)	(16.9)%	486	45.2 %
Other	9,543	10,228	8,586	(685)	(6.7)%	1,642	19.1 %
	$ 46,610	$ 44,672	$ 38,973	$ 1,938	4.3 %	$ 5,699	14.6 %

Salaries and benefits are the largest component of non-interest expenses. Increases in personnel expense rose in part from increases in regular salaries during 2006 and 2005. Base salaries increased 8.5% in 2006 as a result of annual increases and competitive pressures of attracting and retaining exceptional employees. Also contributing to the 2006 increase was Bancorp s self-funded health insurance plan. Claims experience impacts benefit costs in the year of occurrence, and claims ran higher in 2006 than 2005. The Bank s employee levels remained relatively flat during 2006 compared to 2005. At December 31, 2006, the Bank had 437 full-time equivalent employees compared to 442 at the same date in 2005 and 416 for 2004. There are no significant obligations for post-retirement or post-employment benefits.

Additionally, Bancorp recognized $531,000 in stock option expense in 2006 with the implementation of SFAS No. 123R compared to $34,000 in 2005 when Bancorp accelerated the vesting of all employees stock options. By vesting these stock options early, Bancorp avoided recognizing approximately $1,000,000 in expense over what would have been future vesting periods of one to four years. See Note 15 to Bancorp s consolidated financial statements for further discussion of stock options.

Net occupancy expense has increased as the Bank has added banking centers. The Bank opened one location in 2006, no locations in 2005 and two locations in 2004. In addition, in June 2004, the Bank s Indianapolis, Indiana location was converted from a loan production office into a full service branch and was moved to a new location. At December 31, 2006 the Bank had twenty-five banking center locations including the main office.

Data processing expense rose as the Bank continues to update computer equipment and software to keep pace with technology advances. Costs of capital asset additions flow through the statement of income over the lives of the assets in the form of depreciation expense.

Amortization and write off of issuance costs of trust preferred securities are related to the subordinated debentures redeemed on July 1, 2006. See Note 11 for further details. These instruments bore an interest rate of 9.00% and were redeemed at par value. Unamortized issuance costs related to these instruments of $879,000 were expensed at redemption. Amortization expense on the issuance costs was $9,000 for each quarter of 2005 and the first two quarters of 2006.

State bank taxes in Kentucky are based primarily on average capital and deposit levels. Bancorp used state historic tax credits to help reduce state bank tax during 2006. Additionally, in the third quarter of 2005, Bancorp re-evaluated state tax accruals and adjusted expenses accordingly.

Other non-interest expenses decreased for the year ended December 31, 2006 compared to the same period of 2005 by $685,000. In 2005 Bancorp made an additional $500,000 contribution to the Bank s charitable foundation for continuing support of non-profit and community-oriented organizations in the Bancorp s markets. Legal and professional expenses were higher in 2005 mainly due to expenses related to listing on the NASDAQ and computer network consulting services. Also 2005 included a charge for expensing of obsolete or replaced equipment, facilities, equipment and software.

Income Taxes

A three year comparison of income tax expense and effective tax rate follows:

(Dollars in thousands)	2006	2005	2004
Income tax expense	$ 10,962	$ 10,056	$ 8,922
Effective tax rate	32.4 %	31.7 %	32.1 %

The increase in the effective tax rate for 2006 was primarily due to a decreasing proportion of municipal tax-exempt income and an increase in Indiana state income taxes due to growing operations in Indiana. The decrease in the effective tax rate in 2005 compared to 2004 was primarily due to increased investment in transactions that generate low income housing tax credits.

Financial Condition

Earning Assets and Interest Bearing Liabilities

Summary information with regard to Bancorp s financial condition follows:

(Dollars in thousands)	2006	2005	2004	2006/2005 Change	%	2005/2004 Change	%
Average earning assets	$ 1,258,591	$ 1,178,922	$ 1,074,845	$ 79,669	6.8 %	$ 104,077	9.7 %
Average interest bearing liabilities	1,018,620	954,726	865,086	63,894	6.7 %	89,640	10.4 %
Average total assets	1,353,651	1,270,178	1,148,652	83,473	6.6 %	121,526	10.6 %
Total year end assets	1,426,321	1,330,438	1,212,015	95,883	7.2 %	118,423	9.8 %

The Bank has experienced steady growth in earning assets over the last several years primarily in the area of loans. From 2006 to 2005, average loans increased 7.7%. More specifically, period end commercial and industrial loans increased 27.3%, construction loans decreased 6.3% and consumer loans decreased 4.1%. The Bank has targeted commercial and industrial loans as having attractive growth potentials. Not only do these relationships afford loan growth, but they also bring opportunities to provide full-service financial relationships. During 2005, average loans increased 11.1% with growth being primarily from commercial and industrial loans and construction loans.

The increase in average interest bearing liabilities from 2005 to 2006 occurred primarily in money market deposits and time deposits spurred by deposit promotions to support loan growth. Total interest bearing accounts increased 7.3% and non-interest bearing accounts grew 1.6%. The average cost of the interest bearing deposits rose to 3.1%, an 80 basis point increase from 2.3% for 2005. In addition, Bancorp continued to utilize fixed rate advances from the Federal Home Loan Bank during 2006 as a more favorably priced alternative to time deposits. Bancorp had an average of $34,466,000 in outstanding advances in 2006 compared to $25,809,000 and $25,573,000 in 2005 and 2004, respectively.

Average Balances and Interest Rates   Taxable Equivalent Basis

(Dollars in thousands)	Year 2006 Average Balances	Interest	Average Rate	Year 2005 Average Balances	Interest	Average Rate	Year 2004 Average Balances	Interest	Average Rate
Earning assets									
Federal funds sold	$ 20,651	$ 977	4.73 %	$ 16,057	$ 515	3.21 %	$ 14,604	$ 172	1.18 %
Mortgage loans held for sale	3,707	251	6.77 %	5,902	334	5.66 %	4,137	213	5.15 %
Securities									
Taxable	104,621	4,240	4.05 %	102,509	4,126	4.03 %	110,283	3,873	3.51 %
Tax-exempt	32,283	1,748	5.41 %	35,895	1,958	5.45 %	29,162	1,682	5.77 %
FHLB stock	3,485	200	5.74 %	3,298	165	5.00 %	3,157	130	4.12 %
Loans, net of unearned income	1,093,844	79,937	7.31 %	1,015,261	66,141	6.51 %	913,502	55,340	6.06 %
Total earning assets	1,258,591	87,353	6.94 %	1,178,922	73,239	6.21 %	1,074,845	61,410	5.71 %
Less allowance for loan losses	12,406			12,662			12,592		
	1,246,185			1,166,260			1,062,253		
Non-earning assets									
Cash and due from banks	34,680			34,485			32,257		
Premises and equipment	25,063			25,913			25,503		
Accrued interest receivable and other assets	47,723			43,520			28,639		
Total assets	$ 1,353,651			$ 1,270,178			$ 1,148,652		

(Dollars in thousands)	Year 2006 Average Balances	Interest	Average Rate	Year 2005 Average Balances	Interest	Average Rate	Year 2004 Average Balances	Interest	Average Rate
Interest bearing liabilities									
Deposits									
Interest bearing demand deposits	$ 221,019	$ 3,159	1.43 %	$ 242,769	$ 2,830	1.17 %	$ 269,120	$ 2,256	0.84 %
Savings deposits	46,382	283	0.61 %	47,081	217	0.46 %	46,797	121	0.26 %
Money market deposits	185,152	6,294	3.40 %	166,458	3,902	2.34 %	112,643	1,014	0.90 %
Time deposits	436,288	17,760	4.07 %	371,700	12,093	3.25 %	312,848	9,595	3.07 %
Securities sold under agreements to repurchase and federal funds purchased	79,752	2,295	2.88 %	79,170	1,457	1.84 %	76,173	917	1.20 %
Other short-term borrowings	5,103	298	5.84 %	970	29	2.99 %	1,133	9	0.79 %
FHLB advances	34,466	1,412	4.10 %	25,809	718	2.78 %	25,573	545	2.13 %
Long-term debt	10,458	940	8.99 %	20,769	1,862	8.97 %	20,799	1,862	8.95 %
Total interest bearing liabilities	1,018,620	32,441	3.18 %	954,726	23,108	2.42 %	865,086	16,319	1.89 %
Non-interest bearing liabilities									
Non-interest bearing demand deposits	172,640			169,971			155,005		
Accrued interest payable and other liabilities	30,420			23,867			19,147		
Total liabilities	1,221,680			1,148,564			1,039,238		
Stockholders equity	131,971			121,614			109,414		
Total liabilities and stockholders equity	$ 1,353,651			$ 1,270,178			$ 1,148,652		

Net interest income	$ 54,912	$ 50,131	$ 45,091
Net interest spread	3.76 %	3.79 %	3.82 %
Net interest margin	4.36 %	4.25 %	4.20 %

Notes:

- Yields on municipal securities have been computed on a fully tax-equivalent basis using the federal income tax rate of 35%.

- The approximate tax-equivalent adjustments to interest income were $1,026,000, $896,000 and $870,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

- Average balances for loans include the principal balance of non-accrual loans.

- Loan interest income includes loan fees and is computed on a fully tax-equivalent basis using the federal income tax rate of 35%. Loan fees, net of deferrals, included in interest income amounted to $1,039,000, $1,054,000 and $1,591,000 in 2006, 2005 and 2004, respectively.

Securities

The primary purpose of the securities portfolio is to provide another source of interest income, as well as liquidity management. In managing the composition of the balance sheet, Bancorp seeks a balance between earnings sources and credit and liquidity considerations.

Securities intended to be held until maturity are carried at amortized cost. Securities available for sale include securities that may be sold in response to changes in interest rates, resultant prepayment risk and other factors related to interest rate and prepayment risk changes. Securities available for sale are carried at fair value with unrealized gains or losses, net of tax effect, included in stockholders equity.

The carrying value of securities is summarized as follows:

(In thousands)	December 31 2006	2005	2004
Securities available for sale			
U.S. Treasury and federal agency obligations	$ 101,369	$ 105,188	$ 70,536
Mortgage-backed securities	13,801	19,619	21,571
Obligations of states and political subdivisions	27,072	30,224	32,074
Other	3,453	1,919	1,983
	$ 145,695	$ 156,950	$ 126,164
Securities held to maturity			
Mortgage-backed securities	$ 89	$ 133	$ 294
Obligations of states and political subdivisions	3,059	3,991	4,989
	$ 3,148	$ 4,124	$ 5,283

The maturity distribution and weighted average interest rates of debt securities at December 31, 2006, are as follows:

(Dollars in thousands)	Within one year Amount	Rate	After one but within five years Amount	Rate	After five but within ten years Amount	Rate	After ten years Amount	Rate
Securities available for sale								
U.S. Treasury and federal agencies	$ 46,819	4.34 %	$ 41,768	3.89 %	$ 12,782	5.05 %	$	
Mortgage-backed securities			3,650	4.17 %	8,109	3.99 %	2,042	5.60 %
Obligations of states and political subdivisions	3,187	5.78 %	10,912	4.61 %	11,841	6.63 %	1,132	7.36 %
Other	2,175	7.21 %					1,278	7.92 %
	$ 52,181	4.55 %	$ 56,330	4.05 %	$ 32,732	5.36 %	$ 4,452	6.71 %
Securities held to maturity								
Mortgage-backed securities	$		$		$ 43	6.48 %	$ 46	6.07 %
Obligations of states and political subdivisions	1,985	6.62 %	1,074	6.72 %				
	$ 1,985	6.62 %	$ 1,074	6.72 %	$ 43	6.48 %	$ 46	6.07 %

Loan Portfolio

Bancorp s primary source of income is interest on loans. The composition of loans as of the end of the last five years follows:

(In thousands)	December 31 2006	2005	2004	2003	2002
Commercial and industrial	$ 286,987	$ 225,369	$ 215,755	$ 189,477	$ 175,002
Construction and development	118,909	126,961	82,261	53,506	34,910
Real estate mortgage:					
Commercial	(a)	(a)	336,382	299,654	280,688
Commercial investment	242,742	219,852	(a)	(a)	(a)
Owner occupied commercial	178,439	151,651	(a)	(a)	(a)
1-4 family residential	152,349	153,252	201,109	200,956	203,642
Home equity	136,893	140,287	116,053	99,184	71,363
Consumer	32,635	36,499	33,281	43,376	52,968
	$ 1,148,954	$ 1,053,871	$ 984,841	$ 886,153	$ 818,573

(a) In 2006 the Company changed its methodology for disclosing the types of loans in its portfolio to provide more detailed information. Loan secured by commercial real estate were divided into two categories; however, it was not feasible to obtain comparable amounts for these categories for 2002 through 2004.

The following tables detail the amounts of commercial and industrial loans, and construction and development loans at December 31, 2006, which based on remaining scheduled repayments of principal, are due in the periods indicated. Also shown are the commercial and industrial loans due after one year classified according to sensitivity to changes in interest rates.

(In thousands)	Maturing Within one year	After one but within five years	After five years	Total
Commercial and industrial	$ 101,373	$ 123,364	$ 62,250	$ 286,987
Construction and development	45,249	61,476	12,184	118,909

(In thousands)	Interest Sensitivity Fixed rate	Variable rate
Due after one but within five years	$ 82,223	$ 41,141
Due after five years	30,520	31,730
	$ 112,743	$ 72,871

Non-performing Loans and Assets

Information summarizing non-performing assets, including non-accrual loans follows:

(Dollars in thousands)	December 31 2006	2005	2004	2003	2002
Non-accrual loans	$ 5,900	$ 3,709	$ 4,944	$ 4,417	$ 4,840
Loans past due 90 days or more and still accruing	853	891	696	433	754
Non-performing loans	6,753	4,600	5,640	4,850	5,594
Foreclosed real estate	2,466	3,226	3,284	3,633	310
Other foreclosed property		40	113		88
Non-performing assets	$ 9,219	$ 7,866	$ 9,037	$ 8,483	$ 5,992
Non-performing loans as a percentage of total loans	0.59 %	0.44 %	0.57 %	0.55 %	0.68 %
Non-performing assets as a percentage of total assets	0.65 %	0.59 %	0.75 %	0.76 %	0.58 %
Allowance for loan losses as a percentage of non-performing loans	181 %	262 %	222 %	243 %	209 %

Non-performing loans as a percentage of total loans increased 15 basis points compared to the prior year. This total increased partially as the result of placing loans totaling $1,200,000 related to one borrower on non-accrual status in the second quarter of 2006. The overall level of non-performing loans as a percentage of total loans at December 31, 2006 has returned to a more normalized historic level for the Bank compared to a lower level experienced in 2005.

The threshold at which loans are generally transferred to non-accrual of interest status is 90 days past due unless they are well secured and in the process of collection. Interest income recorded on non-accrual loans for was $164,000, $127,000, and $144,000 for 2006, 2005, and 2004, respectively. Interest income that would have been recorded if non-accrual loans were on a current basis in accordance with their original terms was $554,000, $382,000, and $257,000 for 2006, 2005, and 2004, respectively.

In addition to the non-performing loans discussed above, there were loans for which payments were current or less than 90 days past due where borrowers are experiencing significant financial difficulties. These loans totaled approximately $5,110,000, $6,211,000, and $5,234,000 at December 31, 2006, 2005, and 2004, respectively. These loans are monitored by management and considered in determining the level of the allowance for loan losses. Management believes these loans currently do not present significant exposure to loss.

Non-performing assets as a percentage of total assets increased 6 basis points from 2005 to 2006. The increase in non-performing assets as a percentage of total assets was the result of the increase in non-performing loans. Foreclosed real estate primarily consists of a residential subdivision development that will require several years for full disposition due to the nature of the property. Some costs were capitalized as lots were made ready for sale, and partial dispositions of this real estate occurred during 2006 and 2005 as lots were sold. This asset is periodically evaluated for impairment. No impairment charges have been recorded.

Allowance for Loan Losses

An allowance for loan losses has been established to provide for loans that may not be fully repaid. The allowance for loan losses is increased by provisions charged to expense and decreased by charge-offs, net of recoveries. Loans are charged off by management when deemed uncollectible and typically after underlying

collateral has been liquidated; however, collection efforts continue and future recoveries may occur. Management may partially charge a loan down to net realizable value.

Bancorp s lending policies and procedures center on controlling credit risk and include procedures to identify and measure this risk. These procedures begin with lenders assigning a risk rating to each of their credits, and this rating is confirmed in the loan approval process. Internal loan review, through a year-round process of examining individually significant obligor relationships as well as a sample of each lender s portfolio, tests the reliability of these risk assessments. Additionally, a review of this process is an integral part of regulatory bank examinations.

Adversely rated credits are included on a loan watch list. This list also includes loans requiring closer monitoring due to borrower s circumstances. However, these loans have generally not reached a level of adversity which would cause them to be criticized credits by regulators. Loans are added to the watch list when circumstances are detected which might affect the borrower s ability to comply with terms of the loan. This could include any of the following:

- Delinquency of a scheduled loan payment,
- Deterioration in the borrower s financial condition identified in a review of periodic financial statements,
- Decrease in the value of collateral securing the loan, or
- Change in the economic environment in which the borrower operates.

Loans on the watch list require detailed status reports, including recommended corrective actions, prepared by the responsible loan officer every three months. These reports are reviewed by management. The watch list is also discussed in quarterly meetings with the Board Loan Committee.

Downgrades of loan risk ratings may be initiated by the responsible loan officer, internal loan review, or the senior loan committee at any time. Upgrades of risk ratings may only be made with the concurrence of management and internal loan review generally at the time of quarterly watch list review meetings.

In determining the allowance and related provision for loan losses, these principal elements are considered:

- Specific allocations based upon probable losses identified during the ongoing review of the loan portfolio.
- Allocations for loans not reviewed are based principally on historical charge-off information by loan type.
- Additional allowance allocations based on subjective factors.

The first element reflects management s estimate of probable losses based upon a systematic review of specific loans. Loans are reviewed and, if necessary, assigned a loss allocation. These estimates are based primarily upon discounted collateral exposure, but other objective factors such as payment history and financial condition of the borrower or guarantor may be used as well.

The second element estimates losses for the portion of the portfolio not specifically reviewed. These loans are totaled by loan category, and are assigned a loss allocation factor based upon the Bank s historic net charge offs by loan type.

The third element is based on factors not necessarily associated with a specific credit or loan category and represents management s attempt to ensure that the overall allowance for loan losses appropriately reflects a margin for the imprecision necessarily inherent in the estimates of expected credit losses. Management considers a number of subjective factors, including local and general economic business factors and trends, portfolio concentrations, and changes in the size, mix and general terms of the loan portfolio.

Based on this quantitative and qualitative analysis, provisions are made to the allowance for loan losses. Such provisions are reflected as a charge against current earnings in Bancorp s consolidated statements of income.

The allocation of the allowance for loan losses by loan category is a result of the analysis above. The same procedures used to determine requirements for the allowance for loan losses establish the distribution of the allowance by loan category. The distribution of the allowance will change from period to period due to changes in the identified risk in each loan in the portfolio, changes in the aggregate loan balances by loan category, and changes in management s view of the subjective factors noted above.

The method of calculating the allowance requirements has not changed significantly over time. The reallocations among different categories of loans between periods are the result of the redistribution of the individual loans that comprise the aggregate portfolio as described above. However, the perception of risk with respect to particular loans within the portfolio will change over time as a result of the characteristics and performance of those loans, overall economic and market trends, and the actual and expected trends in non-performing loans.

The adequacy of the allowance for loan losses is monitored by the internal loan review staff and reported quarterly to the Audit Committee of the Board of Directors. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the adequacy of Bancorp s allowance for loan losses. Such agencies may require Bancorp to make additional provisions to the allowance based upon their judgments about information available to them at the time of their examinations. Management believes that the allowance for loan losses is adequate to absorb probable inherent losses on existing loans that may become uncollectible. See Provision for Loan Losses for further discussion of the allowance for loan losses.

Summary of Loan Loss Experience

The following table summarizes average loans outstanding, changes in the allowance for loan losses arising from loans charged off and recoveries on loans previously charged off by loan category and additions to the allowance charged to expense.

	Year ended December 31				
(Dollars in thousands)	**2006**	**2005**	**2004**	**2003**	**2002**
Average loans	$ 1,093,844	$ 1,015,261	$ 913,502	$ 853,299	$ 792,770
Balance of allowance for loan losses at beginning of year	$ 12,035	$ 12,521	$ 11,798	$ 11,705	$ 10,965
Loans charged off					