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BLACKHAWK BANCORP INC
Form 10QSB
August 09, 2002

FORM 10-QSB
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2002

OR

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

FOR THE TRANSITION PERIOD FROM ---- TO ----

COMMISSION FILE NUMBER 0-18599

BLACKHAWK BANCORP, INC.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

WISCONSIN 39-1659424
(STATE OR OTHER JURISDICTION OF (I. R. S. EMPLOYER
INCORPORATION OR ORGANIZATION) IDENTIFICATION NO.)
400 BROAD STREET
BELOIT, WISCONSIN 53511
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

(608) 364-8911
(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 Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days.

YES X NO

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class of Common Stock | Outstanding at July 23, 2002 |
|--------------------------|---------------------------------|
| ----- \$.01 par value | ----- 2,501,321 shares |

INDEX

PART I - FINANCIAL INFORMATION

Page

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ITEM 1. FINANCIAL STATEMENTS

| | |
|--|------|
| Consolidated Condensed Balance Sheets as of June 30, 2002 and December 31, 2001 | 3 |
| Consolidated Condensed Statements of Income for the Three Months Ended June 30, 2002 and 2001 | 4 |
| Consolidated Condensed Statements of Income for the Six Months Ended June 30, 2002 and 2001 | 5 |
| Consolidated Condensed Statements of Shareholders' Equity for the Six Months Ended June 30, 2002 and 2001 | 6 |
| Consolidated Condensed Statements of Cash Flows for the Six Months Ended June 30, 2002 and 2001 | 7-8 |
| Notes to Consolidated Condensed Financial Statements | 9-11 |

| | |
|---|-------|
| ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION | 12-21 |
|---|-------|

PART II - OTHER INFORMATION

| | |
|---|----|
| ITEM 4. SUBMISSION OF MATTERS TO VOTE OF SECURITY HOLDERS | 22 |
| ITEM 6. A) EXHIBITS | 23 |
| B) REPORTS ON FORM 8-K | 23 |
| SIGNATURES | 24 |
| INDEX TO EXHIBITS | 25 |

BLACKHAWK BANCORP, INC. AND SUBSIDIARY CONSOLIDATED CONDENSED BALANCE SHEETS (UNAUDITED)

| | JUNE 30, 2002 | DECEMBER 31, 2001 |
|---|------------------------|----------------------|
| ASSETS | (Dollars in thousands) | |
| Cash and cash equivalents | \$12,514 | \$11,746 |
| Interest-bearing deposit accounts | 326 | 7,857 |
| Federal funds sold and other short-term investments | 5,431 | 16,417 |
| Securities available for sale | 69,007 | 42,623 |
| Securities held to maturity, fair value of \$25,789 and \$24,172 | 24,203 | 23,735 |
| Federal Home Loan Bank of Chicago stock, at cost | 2,449 | 2,385 |
| Loans held for sale | 624 | 2,752 |
| Loans, net of allowance for loan losses of \$2,519 and \$2,404 | 192,773 | 206,383 |
| Bank premises and equipment, net | 6,443 | 6,716 |
| Accrued interest receivable | 2,136 | 2,067 |
| Intangible assets | 4,845 | 5,040 |
| Other assets | 2,211 | 2,554 |
| Total Assets | \$322,962 | \$330,275 |

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LIABILITIES AND SHAREHOLDERS' EQUITY

LIABILITIES:

Deposits:

| | | |
|----------------------|-----------|-----------|
| Non-interest bearing | \$ 31,399 | \$ 36,618 |
| Interest bearing | 208,361 | 212,987 |
| | ----- | ----- |
| Total deposits | 239,760 | 249,605 |
| | ----- | ----- |

Borrowed Funds:

| | | |
|-----------------------|--------|--------|
| Short-term borrowings | 14,408 | 6,087 |
| Other borrowings | 41,167 | 48,388 |
| | ----- | ----- |
| Total borrowed funds | 55,575 | 54,475 |
| | ----- | ----- |

| | | |
|--------------------------|---------|---------|
| Accrued interest payable | 860 | 1,044 |
| Other liabilities | 1,363 | 1,410 |
| | ----- | ----- |
| Total Liabilities | 297,558 | 306,534 |
| | ----- | ----- |

SHAREHOLDERS' EQUITY:

Preferred stock

| | | |
|---|----|----|
| 1,000,000 shares, \$.01 par value per share authorized, none issued or outstanding | -- | -- |
|---|----|----|

Common stock

| | | |
|---|----|----|
| 10,000,000 shares, \$.01 par value per share authorized, 2,502,199 and 2,371,398 shares issued | 25 | 24 |
|---|----|----|

| | | |
|----------------------------|-------|-------|
| Additional paid-in capital | 8,668 | 7,555 |
|----------------------------|-------|-------|

| | | |
|-------------------|--------|--------|
| Retained earnings | 15,750 | 15,447 |
|-------------------|--------|--------|

| | | |
|---|------|------|
| Treasury stock, 2,260 and 4,980 shares, at cost | (26) | (58) |
|---|------|------|

| | | |
|--|-------|-------|
| Accumulated other comprehensive income | 987 | 773 |
| | ----- | ----- |

| | | |
|----------------------------|--------|--------|
| Total Shareholders' Equity | 25,404 | 23,741 |
| | ----- | ----- |

| | | |
|--|-----------|-----------|
| Total Liabilities and Shareholders' Equity | \$322,962 | \$330,275 |
| | ----- | ----- |

See Notes to Unaudited Consolidated Condensed Financial Statements

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED CONDENSED STATEMENTS OF INCOME
(UNAUDITED)

THREE MONTHS ENDED JUNE 30,
2002 2001

INTEREST INCOME: (Dollars in thousands)

| | | |
|----------------------------|---------|---------|
| Interest and fees on loans | \$3,673 | \$4,806 |
|----------------------------|---------|---------|

Interest on securities:

| | | |
|---------|-----|-----|
| Taxable | 926 | 741 |
|---------|-----|-----|

| | | |
|----------------------------------|-----|-----|
| Exempt from federal income taxes | 209 | 192 |
|----------------------------------|-----|-----|

| | | |
|--|----|----|
| Interest on fed funds sold and other short-term investments | 19 | 20 |
|--|----|----|

| | | |
|---------------------------------------|-------|-------|
| Interest on interest-bearing deposits | 5 | 13 |
| | ----- | ----- |

| | | |
|-----------------------|-------|-------|
| Total Interest Income | 4,832 | 5,772 |
| | ----- | ----- |

INTEREST EXPENSE:

| | | |
|----------------------|-------|-------|
| Interest on deposits | 1,547 | 2,374 |
|----------------------|-------|-------|

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| | | |
|---|---------|---------|
| Interest on short-term borrowings | 49 | 294 |
| Interest on other borrowings | 555 | 531 |
| | ----- | ----- |
| Total Interest Expense | 2,151 | 3,199 |
| | ----- | ----- |
| Net Interest Income | 2,681 | 2,573 |
| Provision for loan losses (Note 3) | 122 | 171 |
| | ----- | ----- |
| Net Interest Income After Provision For Loan Losses | 2,559 | 2,402 |
| | ----- | ----- |
| OTHER OPERATING INCOME: | | |
| Service charges on deposit accounts | 396 | 381 |
| Gain on sale of mortgage loans | 54 | 142 |
| Gain on sale of securities | 225 | 94 |
| Brokerage and annuity commissions | 53 | 65 |
| Net loss on sale of other assets | (17) | --- |
| Other income | 159 | 143 |
| | ----- | ----- |
| Total Other Operating Income | 870 | 825 |
| | ----- | ----- |
| OTHER OPERATING EXPENSES: | | |
| Salaries and employee benefits | 1,338 | 1,330 |
| Occupancy expense, net | 261 | 182 |
| Furniture and equipment | 208 | 200 |
| Data processing | 188 | 172 |
| Amortization of intangible assets | 78 | 124 |
| Legal and professional fees | 117 | 117 |
| Office supplies | 69 | 68 |
| Telephone and telecommunications | 79 | 71 |
| Other operating expenses | 501 | 442 |
| | ----- | ----- |
| Total Other Operating Expenses | 2,839 | 2,706 |
| | ----- | ----- |
| Income Before Income Taxes | 590 | 521 |
| Provision for Income Taxes | 160 | 169 |
| | ----- | ----- |
| Net Income | \$ 430 | \$ 352 |
| | ----- | ----- |
| Basic Earnings Per Share | \$ 0.17 | \$ 0.15 |
| | ----- | ----- |
| Diluted Earnings Per Share | \$ 0.17 | \$ 0.15 |
| | ----- | ----- |
| Dividends Per Share | \$ 0.09 | \$ 0.12 |
| | ----- | ----- |
| | ----- | ----- |

See Notes to Unaudited Consolidated Condensed Financial Statements

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED CONDENSED STATEMENTS OF INCOME
(UNAUDITED)

| | SIX MONTHS ENDED JUNE 30, | |
|----------------------------|---------------------------|---------|
| | 2002 | 2001 |
| | ---- | ---- |
| INTEREST INCOME: | (Dollars in thousands) | |
| Interest and fees on loans | \$7,581 | \$9,534 |
| Interest on securities: | | |
| Taxable | 1,612 | 1,629 |

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| | | |
|--|---------|---------|
| Exempt from federal income taxes | 417 | 363 |
| Interest on fed funds sold and other short-term investments | 55 | 38 |
| Interest on interest-bearing deposits | 29 | 26 |
| | ----- | ----- |
| Total Interest Income | 9,694 | 11,590 |
| | ----- | ----- |
| INTEREST EXPENSE: | | |
| Interest on deposits | 3,108 | 4,886 |
| Interest on short-term borrowings | 95 | 681 |
| Interest on other borrowings | 1,119 | 1,024 |
| | ----- | ----- |
| Total Interest Expense | 4,322 | 6,591 |
| | ----- | ----- |
| Net Interest Income | 5,372 | 4,999 |
| Provision for loan losses (Note 3) | 261 | 275 |
| | ----- | ----- |
| Net Interest Income After Provision For Loan Losses | 5,111 | 4,724 |
| | ----- | ----- |
| OTHER OPERATING INCOME: | | |
| Service charges on deposit accounts | 745 | 718 |
| Gain on sale of mortgage loans | 127 | 230 |
| Gain on sale of securities | 229 | 94 |
| Brokerage and annuity commissions | 82 | 83 |
| Net loss on sale of other assets | (1) | 5 |
| Other income | 330 | 297 |
| | ----- | ----- |
| Total Other Operating Income | 1,512 | 1,427 |
| | ----- | ----- |
| OTHER OPERATING EXPENSES: | | |
| Salaries and employee benefits | 2,731 | 2,597 |
| Occupancy expense, net | 449 | 388 |
| Furniture and equipment | 428 | 399 |
| Data processing | 387 | 320 |
| Amortization of intangible assets | 154 | 248 |
| Legal and professional fees | 296 | 211 |
| Office supplies | 125 | 150 |
| Telephone and telecommunications | 151 | 147 |
| Other operating expenses | 899 | 795 |
| | ----- | ----- |
| Total Other Operating Expenses | 5,620 | 5,255 |
| | ----- | ----- |
| Income Before Income Taxes | 1,003 | 896 |
| Provision for Income Taxes | 256 | 278 |
| | ----- | ----- |
| Net Income | \$ 747 | \$ 618 |
| | ----- | ----- |
| Basic Earnings Per Share | \$ 0.31 | \$ 0.26 |
| | ----- | ----- |
| Diluted Earnings Per Share | \$ 0.31 | \$ 0.26 |
| | ----- | ----- |
| Dividends Per Share | \$ 0.18 | \$ 0.24 |
| | ----- | ----- |

See Notes to Unaudited Consolidated Condensed Financial Statements

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED CONDENSED STATEMENTS OF SHAREHOLDERS' EQUITY

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(UNAUDITED)

| | SIX MONTHS ENDED JUNE 30, | |
|--|------------------------------|----------|
| | 2002 | 2001 |
| | ---- | ---- |
| | (Dollars in thousands) | |
| Common Stock: | | |
| Balance at beginning of period | \$ 24 | \$ 23 |
| Stock options exercised | 1 | 1 |
| | ----- | ----- |
| Balance at end of period | 25 | 24 |
| | ----- | ----- |
| Additional Paid-in Capital: | | |
| Balance at beginning of period | 7,555 | 7,417 |
| Stock options exercised | 1,117 | 118 |
| Sale of treasury stock | (4) | -- |
| | ----- | ----- |
| Balance at end of period | 8,668 | 7,535 |
| | ----- | ----- |
| Retained Earnings: | | |
| Balance at beginning of period | 15,447 | 15,573 |
| Net income | 747 | 618 |
| Dividends declared on common stock | (444) | (565) |
| | ----- | ----- |
| Balance at end of period | 15,750 | 15,626 |
| | ----- | ----- |
| Treasury Stock, at cost: | | |
| Balance at beginning of period | (58) | (120) |
| Sale of treasury stock | 32 | 18 |
| | ----- | ----- |
| Balance at end of period | (26) | (102) |
| | ----- | ----- |
| Accumulated other comprehensive income: | | |
| Balance at beginning of period | 773 | 102 |
| Other comprehensive income, net of taxes | 214 | 421 |
| | ----- | ----- |
| Balance at end of period | 987 | 523 |
| | ----- | ----- |
| Total Shareholders' Equity | \$25,404 | \$23,606 |
| | ----- | ----- |
| | ----- | ----- |

See Notes to Unaudited Consolidated Condensed Financial Statements

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(UNAUDITED)

| | SIX MONTHS ENDED JUNE 30, | |
|---|------------------------------|--------|
| | 2002 | 2001 |
| | ---- | ---- |
| | (Dollars in thousands) | |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net Income | \$ 747 | \$ 618 |
| Adjustments to reconcile net income to net cash | | |

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| | | |
|---|---------|----------|
| provided by (used in) operating activities: | | |
| Provision for loan losses | 261 | 275 |
| Provision for depreciation and amortization | 617 | 698 |
| Amortization of premiums and (accretion of discounts) on Investment securities, net | 41 | 29 |
| Gain on sale of loans held for sale | (127) | (230) |
| FHLB stock dividends | (60) | (75) |
| (Gain) loss on sale of property, equipment and OREO | 76 | (5) |
| Gain on sale of securities | (229) | (94) |
| Loans originated for sale | (9,971) | (16,316) |
| Proceeds from sale of loans held for sale | 12,226 | 13,633 |
| Change in assets and liabilities: | | |
| Decrease in other assets | 122 | 458 |
| (Increase) decrease in accrued interest receivable | (74) | 223 |
| Decrease in accrued interest payable | (184) | (497) |
| Increase (decrease) in other liabilities | 8 | (183) |
| | ----- | ----- |
| Net cash provided by (used in) operating activities | 3,453 | (1,466) |
| | ----- | ----- |

CASH FLOWS FROM INVESTING ACTIVITIES:

| | | |
|---|----------|----------|
| Decrease in federal funds sold, interest-bearing deposits and other short-term investments, net | 18,517 | 2,451 |
| Proceeds from maturities and calls of securities available-for-sale | 6,263 | 23,608 |
| Purchase of securities available-for-sale | (40,600) | (13,952) |
| Proceeds from maturities and calls of securities held-to-maturity | 2,363 | 1,629 |
| Purchase of securities held-to-maturity | (2,868) | (4,528) |
| Proceeds from sale of securities available-for-sale | 8,523 | 96 |
| (Loans originated), net of principal collected | 13,064 | (1,265) |
| Proceeds from the sale of property, equipment and OREO | 376 | 641 |
| Purchase of bank premises and equipment | (225) | (661) |
| | ----- | ----- |
| Net cash provided by investing activities | 5,413 | 8,019 |
| | ----- | ----- |

See Notes to Unaudited Consolidated Condensed Financial Statements.

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(CONTINUED)
(UNAUDITED)

| | | |
|---------------------------------------|------------------------|----------|
| | SIX MONTHS ENDED | |
| | JUNE 30, | |
| | 2002 | 2001 |
| | ---- | ---- |
| | (Dollars in thousands) | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Stock options exercised | \$ 1,050 | \$ 119 |
| Sale of treasury stock | 28 | 18 |
| Net decrease in deposits | (9,845) | (24,665) |
| Net increase in borrowings | 1,100 | 18,965 |
| Dividends paid | (431) | (565) |
| | ----- | ----- |
| Net cash used in financing activities | (8,098) | (6,128) |

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| | | |
|---|----------|----------|
| Increase in cash and cash equivalents | 768 | 425 |
| CASH AND CASH EQUIVALENTS: | | |
| Beginning | 11,746 | 13,336 |
| Ending | \$12,514 | \$13,761 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | |
| Cash payments for: | | |
| Interest | \$ 4,506 | \$ 7,088 |
| Income taxes | \$ (118) | \$ 108 |
| SUPPLEMENTAL SCHEDULE OF NON-CASH FINANCING ACTIVITIES: | | |
| Other assets acquired in settlement of loans | \$ 285 | \$ 741 |

See Notes to Unaudited Consolidated Condensed Financial Statements.

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
 NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
 June 30, 2002

Note 1. General:

The accompanying consolidated condensed financial statements conform to generally accepted accounting principles and to general practices within the banking industry. The more significant policies used by the Company in preparing and presenting its financial statements are stated in the Corporation's Form 10-KSB.

The effect of timing differences in the recognition of revenue and expense for tax liability is not determined until the end of each fiscal year.

In the opinion of Management, the accompanying unaudited consolidated condensed financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly the financial position of the Corporation as of June 30, 2002, and the results of operations for the three and six months ended June 30, 2002 and 2001.

The results of operations for the three and six months ended June 30, 2002 and 2001 are not necessarily indicative of the results to be expected for the full year.

Certain reclassifications have been made to the 2001 historical financial statements to conform to the 2002 presentation.

Note 2. Non-Performing Loans

Non-performing loans includes loans which have been categorized by management as non-accruing because collection of interest is not assured, and loans which are past-due ninety days or more as to interest and/or principal payments. The following summarizes information concerning non-performing loans:

| | JUNE 30, | DECEMBER 31, |
|------------------------|----------|--------------|
| | ----- | ----- |
| (Dollars in thousands) | 2002 | 2001 |

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| | | |
|---|---------|---------|
| Non-accruing loans | \$3,065 | \$2,808 |
| Past due 90 days or more and still accruing | 56 | 356 |
| Total non-performing loans | \$3,121 | \$3,164 |
| Performing loans classified as impaired | \$ 638 | \$1,147 |

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
June 30, 2002
(CONTINUED)

Note 3. Allowance For Loan Losses

A summary of transactions in the allowance for loan losses is as follows:

| | THREE MONTHS ENDED JUNE 30, | |
|--------------------------------|--------------------------------|---------|
| | 2002 | 2001 |
| (Dollars in thousands) | | |
| Balance at beginning of period | \$2,517 | \$3,912 |
| Provision charged to expense | 122 | 171 |
| Loans charged off | 131 | 2,076 |
| Recoveries | 11 | 50 |
| Balance at end of period | \$2,519 | \$2,057 |

| | SIX MONTHS ENDED JUNE 30, | |
|--------------------------------|------------------------------|---------|
| | 2002 | 2001 |
| (Dollars in thousands) | | |
| Balance at beginning of period | \$2,404 | \$3,894 |
| Provision charged to expense | 261 | 275 |
| Loans charged off | 182 | 2,168 |
| Recoveries | 36 | 56 |
| Balance at end of period | \$2,519 | \$2,057 |

Note 4. Earnings Per Share

Presented below are the calculations for basic and diluted earnings per share:

| | THREE MONTHS ENDED JUNE 30, | | SIX MONTHS ENDED JUN |
|--------|--------------------------------|------|-------------------------|
| | 2002 | 2001 | 2002 |
| Basic: | | | |

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| | | | |
|--|------------|------------|------------|
| Net income available to common stockholders | \$ 430,000 | \$ 352,000 | \$ 747,000 |
| | ----- | ----- | ----- |
| Weighted average shares outstanding | 2,478,283 | 2,348,125 | 2,431,572 |
| | ----- | ----- | ----- |
| Basic earnings per share | \$ 0.17 | \$ 0.15 | \$ 0.31 |
| | ----- | ----- | ----- |
| Diluted: | | | |
| Net income available to common stockholders | \$ 430,000 | \$ 352,000 | \$ 747,000 |
| | ----- | ----- | ----- |
| Weighted average shares outstanding | 2,478,283 | 2,348,125 | 2,431,572 |
| Effect of dilutive stock options outstanding | 9,782 | 42,685 | 9,782 |
| | ----- | ----- | ----- |
| Diluted weighted average shares outstanding | 2,488,065 | 2,390,810 | 2,441,354 |
| | ----- | ----- | ----- |
| Diluted earnings per share | \$ 0.17 | \$ 0.15 | \$ 0.31 |
| | ----- | ----- | ----- |

BLACKHAWK BANCORP, INC. AND SUBSIDIARY
 NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
 June 30, 2002
 (CONTINUED)

Note 5. Recent Accounting Developments

Business Combinations

In September 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141, "Business Combinations", and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 supersedes Accounting Principles Board (APB) Opinion No. 16, "Business Combinations", and SFAS No. 38, "Accounting for Preacquisition Contingencies of Purchased Enterprises." SFAS No. 141 requires the use of the purchase method of accounting for business combinations initiated after September 30, 2001. SFAS No. 142 supersedes APB Opinion No. 17, "Intangible Assets." SFAS No. 142 addresses how intangible assets acquired outside of a business combination should be accounted for upon acquisition and how goodwill and other intangible assets should be accounted for after they have been initially recognized. SFAS No. 142 eliminates the amortization for goodwill and other intangible assets with indefinite lives. Other intangible assets with a finite life will be amortized over their useful life. Goodwill and other intangible assets with indefinite useful lives shall be tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset may be impaired. SFAS No. 142 is effective for fiscal years beginning after December 15, 2001.

The Company's strategy over the past several years has included business combinations accounted for under the purchase accounting method which created goodwill upon the transactions' closings. The Company has goodwill of \$3.1 million on its balance sheet as of June 30, 2002. It was previously being amortized over 20 years. The pronouncement eliminates amortization of this asset and subjects it to periodic impairment analysis.

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The Company adopted SFAS No. 142 on January 1, 2002. The Company passed step one of the goodwill impairment test at January 1, 2002.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

The purpose of Management's discussion and analysis is to provide relevant information regarding the Registrant's financial condition and its results of operations. The information included herein should be read in conjunction with the company's consolidated financial statements and footnotes thereto for the year ended December 31, 2001.

This quarterly Report contains certain "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements are subject to certain risks and uncertainties, including, among other things, changes in economic conditions in the Company's market area, changes in policies by regulatory agencies, fluctuations in interest rates, demand for loans in the Company's market areas and competition, that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. The Company wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. The company wishes to advise readers that the factors listed above could affect the Company's financial performance and could cause the Company's actual results for future periods to differ materially from any opinions or statements expressed with respect to future periods in any current statements.

The Company does not undertake, and specifically declines any obligation, to publicly release the results of any revisions which may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

RESULTS OF OPERATIONS

SIX MONTHS ENDED JUNE 30

The company reported net income of \$747,000 for the six months ended June 30, 2002, an increase of \$129,000 or 20.9% from the \$618,000 reported for the same six month period in 2001. Net income for the six months ended June 30, 2002 includes the effect of adopting Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets." Accordingly, amortization of intangible assets with indeterminable useful lives resulting from prior acquisitions accounted for under the purchase method of accounting was discontinued. The adoption of SFAS No. 142 had the impact of increasing net income by \$94,000 for the six months ended June 30, 2002 compared to the same period in 2001. In the second quarter of 2002 the company recorded an after tax charge of \$45,000 to reflect the consolidation of it's Wal-Mart branch into a nearby full service branch. The charge reflects the current write-off of the net book value of the branch's fixed assets and the estimated cost to return the leased space to its condition prior to the company's use as a branch. The Company also recorded a \$117,000 charge for officer severance agreements. Diluted earnings per share for the six months ended June 30, 2002 were \$0.31, a \$0.05 or 19.2% increase compared to the \$0.26 per diluted share for the same period in 2001.

NET INTEREST INCOME

Net interest income, which is the sum of interest and certain fees generated by earning assets minus interest paid on deposits and other funding sources,

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is the primary source of the company's earnings. Net interest income increased by \$373,000, or 7.5%, to \$5,372,000 for the six months ended June 30, 2002, compared to \$4,999,000 for the comparable period in 2001. The net interest margin, which is the tax equivalent net interest income divided by average interest earning assets increased 35 basis points to 3.87% for the six months ended June 30, 2002 compared to 3.52% for the six months ended June 30, 2001.

The following table sets forth the company's consolidated average balances of assets, liabilities and shareholders' equity as well as interest income and expense on related items, and the company's average rate for the six month periods ended June 30, 2002 and 2001:

AVERAGE BALANCE SHEET WITH RESULTANT INTEREST AND RATES

| (yields on a tax-equivalent basis) | Six months ended June 30, 2002 | | | Six months ended June 30, 2001 |
|--|--------------------------------|----------------|-----------------|--------------------------------|
| | Average Balance | Interest | Average Rate | Average Balance |
| INTEREST EARNING ASSETS: | | | | |
| Interest-bearing deposit | | | | |
| Accounts | \$ 3,267 | \$ 29 | 1.79% | \$ 1,004 |
| Federal funds sold & short-term investments | 6,734 | 55 | 1.65% | 1,574 |
| Investment securities: | | | | |
| Taxable investment securities | 61,421 | 1,612 | 5.29% | 52,517 |
| Tax-exempt investment securities | 19,453 | 417 | 6.55% | 17,115 |
| Total investment securities | 80,874 | 2,029 | 5.60% | 69,632 |
| Loans | 199,928 | 7,581 | 7.65% | 224,643 |
| TOTAL EARNING ASSETS | \$290,803 | \$9,694 | 6.87% | \$296,853 |
| Allowance for loan losses | (2,519) | | | (3,874) |
| Cash and cash equivalents | 9,820 | | | 10,038 |
| Other assets | 17,203 | | | 18,477 |
| TOTAL ASSETS | \$315,307 | | | \$321,494 |
| INTEREST BEARING LIABILITIES: | | | | |
| Interest bearing demand deposits | \$ 32,148 | \$ 172 | 1.08% | \$ 26,755 |
| Savings deposits | 53,778 | 321 | 1.20% | 49,856 |
| Time deposits | 121,435 | 2,615 | 4.34% | 133,325 |
| Total interest bearing deposits | 207,361 | 3,108 | 3.02% | 209,936 |
| Short-term borrowings | 10,338 | 95 | 1.85% | 24,416 |
| Other borrowings | 41,833 | 1,119 | 5.39% | 35,665 |
| TOTAL INTEREST-BEARING LIABILITIES | \$259,532 | \$4,322 | 3.36% | \$270,017 |
| NET INTEREST SPREAD | | | 3.51% | |

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| | | |
|---|-----------|-----------|
| Demand deposits | 29,257 | 25,090 |
| Other liabilities | 2,113 | 2,574 |
| | ----- | ----- |
| Total liabilities | 290,902 | 297,681 |
| Shareholders' equity | 24,405 | 23,813 |
| | ----- | ----- |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$315,307 | \$321,494 |
| | ----- | ----- |
| | ----- | ----- |
| NET INTEREST MARGIN | \$5,372 | 3.87% |
| | ----- | ----- |
| | ----- | ----- |

For the six months ended June 30, 2002, total interest income decreased by \$1,896,000, or 16.4%, to \$9,694,000 compared to \$11,590,000 for the same period in 2001. The decrease in interest income is due to a 2.0% decrease in average earning assets, and a 113 basis point decrease in the yield on average earning assets to 6.87% for the first six months of 2002, compared to 8.00% for the same period in 2001. The decrease in the yield on average earning assets reflects a shift in the asset mix from loans to investment securities and short-term investments for the first six months of 2002 compared to 2001. The decrease in the yield on average earning assets also reflects the lower interest rate environment during the first six months of 2002 compared to the same period in 2001. Interest and fees on loans decreased 20.5% to \$7,581,000 for the six months ended June 30, 2002 compared to \$9,534,000 in same period of 2001. This decrease was the result of a \$24.7 million or 11.0% decrease in average loans outstanding and a 91 basis point decrease in yield on the portfolio. The lower overall portfolio yield reflects the Federal Reserve Bank's lowering of managed rates by 3.75% during 2001.

Interest income on taxable securities decreased by \$17,000 or 1.0% in the first six months of 2002 to \$1,612,000 from \$1,629,000 for the same period in 2001. Average balances of taxable investment securities increased 17.0% to \$61.4 million for the six months ended June 30, 2002 compared to \$52.5 million for the same period in the prior year. The increase in average balances outstanding was offset by a decrease of 97 basis points in average yield to 5.29% for the first six months of 2002 compared to 6.26% for the first six months of 2001. Average tax exempt securities increased to \$19.5 million for the six months ended June 30, 2002 compared to \$17.1 for the same period in 2001 while their average tax equivalent yield increased from 6.48% for the six months ended June 30, 2001 to 6.55% for the similar period in 2002.

Interest from fed funds sold and short-term investments increased to \$55,000 for the six months ended June 30, 2002 from \$38,000 during the same period in 2001 and reflect higher average invested balances kept in the first quarter of 2002. Interest on interest-bearing deposit accounts increased to \$29,000 for the first six months of 2002 compared to \$26,000 for the same period in 2001 and also reflects higher average balances from the first quarter of 2002. Excess liquidity from loan and investment scheduled payments and prepayments were invested short-term for much of the first three months of 2002 before being re-deployed into investment securities during the second quarter of 2002.

Total interest expense decreased by \$2,269,000, or 34.4%, to \$4,322,000 for the six months ended June 30, 2002 compared to \$6,591,000 for the same period in 2001. This decrease is the result of the aforementioned lower interest rate environment coupled with favorable shifts in the company's funding mix. While interest paid on deposits decreased \$1,778,000, or 36.4%, to \$3,108,000 during the six months ended June 30, 2002 compared to \$4,886,000 for the same period in

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2001, average interest bearing deposits decreased only \$2.6 million or 1.2% year over year. The average balance of time deposits decreased \$11.9 million, or 8.9%, to \$121.4 million for the six months ended June 30, 2002 compared to \$133.3 million for the same period in 2001. The decrease in the average balance of time deposits was offset with increases in the average balances of demand deposits, interest-bearing demand deposits and savings accounts of \$4.2 million, \$5.4 million and \$3.9 million, respectively.

Interest on short-term borrowings decreased \$586,000 to \$95,000 for the six months ended June 30, 2002 compared to \$681,000 for the same period in 2001. This decrease is the result of the decrease in managed interest rates as mentioned earlier and a \$14.1 million, or 57.7% decrease in average short-term borrowings to \$10.3 million for the six months ended June 30, 2002 compared to the same period in 2001.

Interest expense on other borrowings increased \$95,000, or 9.3%, to \$1,119,000 for the first six months of 2002 compared to \$1,024,000 for the first six months of 2001. The increase is the result of a \$6.2 million, or 17.3% increase in the average balance of other borrowings to \$41.8 million for the six months ended June 30, 2002 compared to \$35.7 million for the first six months of 2001. The increase in other borrowings is the result of refinancing FHLB daily advances to term notes during 2001.

PROVISION FOR LOAN LOSSES

The provision for loan losses is an amount added to the allowance for loan losses to provide for the known and estimated amount of loans that will not be collected. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Management determines the appropriate provision based upon a number of criteria, including a detailed evaluation of certain credits, historical performance, economic conditions and overall quality of the loan portfolio. Activity in the allowance for loan losses account for the first six months of 2002 and 2001 is detailed in note 3 to the consolidated condensed financial statements.

The provision for loan losses recorded in the first six months of 2002 was \$261,000 compared to \$275,000 in 2001. At June 30, 2002 the allowance for loan losses was equal to 1.29% of portfolio loans compared to 1.15% at December 31, 2001. It is management's opinion that this amount represents an adequate allowance for loan losses.

OTHER OPERATING INCOME

Total other operating income increased \$85,000, or 6.0%, to \$1,512,000 for the six months ended June 30, 2002 compared to \$1,427,000 for the same period in 2001. The Company recognized securities gains of \$229,000 in the first six months of 2002 compared to \$94,000 in the same period of 2001. Gain on sale of mortgage loans decreased \$103,000 or 44.8% to \$127,000 for the six months ended June 30, 2002 compared to \$230,000 for the same period in 2001. The decrease is due to lower volume and less favorable market pricing. The average gain in 2002 was 1.04% on the \$12.2 million in loans sold to the secondary market compared to an average gain of 1.72% on the \$13.6 million of loans sold in the same period in 2001. Service charges on deposit accounts increased \$27,000, or 3.8%, to \$745,000 for the first six months of 2002 compared to \$718,000 the prior year.

OPERATING EXPENSES

Total operating expenses increased \$365,000, or 6.9%, to \$5,620,000 for the six months ended June 30, 2002 compared to \$5,255,000 for the same period in 2001. This includes a \$134,000, or 5.2% increase in compensation and benefits. The increase reflects the addition of a number of key management personnel as part

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of the company's restructuring efforts. Occupancy expenses increased 15.7%, or \$61,000, to \$449,000 for the six months ended June 30, 2002 compared to \$388,000 for the six months ended June 30, 2001 and include \$75,000 in pre-tax charges related to the Wal-Mart branch consolidation previously discussed. Data processing costs increased \$67,000, or 20.9%, to \$387,000 for the six months ended June 30, 2002. This increase reflects the cost of the company's internet banking and platform systems, which were implemented at the end of 2001, and a conversion credit that was received in the first six months of 2001. Amortization of intangible assets decreased \$94,000 to \$154,000 for the six months ended June 30, 2002, which reflects the adoption of SFAS No. 142, as discussed in Note 5 to the consolidated condensed financial statements. Legal and professional fees increased \$85,000 to \$296,000 as a result of increased legal fees related to the Company's claim against a former data processing service provider and charges in the first quarter of 2002 for a bank regulatory exam. Office supplies decreased by \$25,000 to \$125,000 for the six months ended June 30, 2002 reflecting company efforts to control supply costs. Other operating expenses increased \$104,000 to \$899,000 for the six months ended June 30, 2002 reflecting higher costs for marketing, postage and loan collection expense. Other operating expense also includes \$117,000 of charges to accrue severance payments for executive officers that left the company in 2002. In addition, the company realized an \$87,000 credit against other operating expenses due to an adjustment related to stale reconciling items.

Income taxes decreased \$22,000, or 7.9%, to \$256,000 for the six months ended June 30, 2002 from \$278,000 for the same period in 2001. The decline in effective tax rate to 25.5% for the 2002 period from 31.0% in the same period of 2001 is reflective of greater tax efficiency brought about by an increase in non-taxable income and a reduction in nondeductible purchase accounting amortization.

BALANCE SHEET ANALYSIS

OVERVIEW

Total assets decreased to \$323.0 million at June 30, 2002 compared to \$330.3 million at December 31, 2001, a decrease of 2.2%. The December 31, 2001 balance sheet included short-term year-end deposits of \$14.4 million, which were invested in federal funds sold at December 31, 2001. Excluding these deposits, total assets increased 2.2% from December 31, 2001 to June 30, 2002. While total assets, excluding the short-term year-end deposits, increased by \$7.1 million, there was a considerable shift in balances from loans and short-term investments to investment securities. Securities available for sale increased by \$26.4 million, while loans, net of allowance for loan losses, decreased by \$13.6 million and short-term investments, excluding the year-end deposits of \$14.4 million, decreased by \$4.1 million.

LOANS

Net portfolio loans decreased \$13.6 million, or 6.6%, to \$192.8 million on June 30, 2002 compared to \$206.4 million on December 31, 2001. The bank experienced decreases in consumer, commercial and real estate loans outstanding at June 30, 2002 compared to December 31, 2001. The economic conditions in the markets served by the bank adversely effected loan demand leading to decreases in all categories of loans outstanding.

The allowance for loan losses was \$2.5 million or 1.29% of portfolio loans at June 30, 2002 compared to \$2.4 million or 1.15% of portfolio loans at December 31, 2001. The increase in the reserve percentage reflects the company's commitment to provide an adequate reserve given the weak economy in our markets. As of June 30, 2002, non-performing loans totaled \$3.8 million compared to \$4.3 million at December 31, 2001. Management believes that the allowance is adequate

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at this time.

SHORT-TERM INVESTMENTS

Fed funds sold and other short-term investments decreased \$11.0 million to \$5.4 million at June 30, 2002 compared to \$16.4 million at December 31, 2001. The decrease primarily reflects the liquidation of short-term year-end investments on January 2, 2002 associated with the December 31, 2001 year-end deposits of \$14.4 million.

INVESTMENT SECURITIES

Securities available for sale increased \$26.4 million, or 61.9%, to \$69.0 million at June 30, 2002 compared to \$42.6 million at December 31, 2001. The increase in investments in securities available for sale resulted from the redeployment of cash flows from the decrease in loans and increase in deposits. Securities held to maturity increased \$.5 million or 2.0% to \$24.2 million at June 30, 2002 from \$23.7 million at December 31, 2001.

DEPOSITS

Total deposits decreased \$9.8 million to \$239.8 million at June 30, 2002 compared to \$249.6 million at December 31, 2001. As noted above, the Company's December 31, 2001 financial statements reflect short-term year-end deposits of \$14.4 million. Excluding the short-term year-end deposits, total deposits increased 1.9% from December 31, 2001. Excluding the short-term year-end deposits of \$5.9 million and \$8.5 million included in non-interest bearing and interest bearing deposits, respectively, non-interest bearing deposits increased by \$0.7 million and interest bearing deposits increased by \$3.9 million at June 30, 2002 compared to December 31, 2001.

BORROWINGS

Short-term borrowings increased \$8.3 million to \$14.4 million at June 30, 2002 from \$6.1 million at year-end. The increase is due to higher outstanding balances of repurchase agreements with commercial customers. Other borrowings, consisting of long-term borrowings incurred in part to complete the First Financial acquisition and term advances from the Federal Home Loan Bank ("FHLB"), were \$41.2 million at June 30, 2002 compared to \$48.4 million at December 31, 2001. The decrease primarily reflects the repayment of \$6.8 million in FHLB advances during January 2002.

SHAREHOLDERS' EQUITY

Total shareholders' equity increased \$1.7 million to \$25.4 million at June 30, 2002 compared to \$23.7 million at December 31, 2001. During the first six months of 2002 additional paid in capital increased by \$1.1 million from stock options exercised. Accumulated other comprehensive income, which is the adjustment of securities available for sale to market value, net of tax, increased \$.2 million to \$1.0 million at June 30, 2002 from \$.8 million at December 31, 2001. In addition the company declared two dividends of \$0.09 per share on common stock, which totaled \$444,000.

The Company is subject to certain regulatory capital requirements and continues to remain in a well-capitalized position. The following table shows the company's capital ratios and regulatory requirements to maintain a well-capitalized rating.

| JUNE 30, 2002 ---- | DECEMBER 31, 2001 ---- | REGULATORY REQUIREMENTS ----- |
|--------------------------|------------------------------|-------------------------------------|
|--------------------------|------------------------------|-------------------------------------|

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| | | | |
|--|-------|------|------|
| Total Capital (To Risk-Weighted Assets) | 11.0% | 9.6% | 8.0% |
| Tier I Capital (To Risk-Weighted Assets) | 9.8% | 8.5% | 4.0% |
| Tier I Capital (To Average Assets) | 6.3% | 5.9% | 4.0% |

LIQUIDITY

Liquidity, as it relates to the subsidiary bank, is a measure of its ability to fund loans and withdrawals of deposits in a cost-effective manner. The Bank's principal sources of funds are deposits, scheduled amortization and prepayment of loan principal, maturities of investment securities, short-term borrowings and income from operations. Additional sources include purchasing fed funds, sale of securities, sale of loans, borrowing from both the Federal Reserve Bank and Federal Home Loan Bank, and dividends paid by Nevahawk, a wholly owned subsidiary of the Bank.

The liquidity needs of the Company generally consists of payment of dividends to its shareholders, payments of principal and interest on borrowed funds, and a limited amount of expenses. The sources of funds to provide this liquidity are issuance of capital stock and dividends from its subsidiary bank. Certain restrictions are imposed upon the Bank, which could limit its ability to pay dividends if it did not have net earnings or adequate capital in the future. The Company maintains adequate liquidity to pay its expenses.

OFF BALANCE SHEET ITEMS AND CONTINGENCIES

Off-balance sheet items consist of credit card lines of credit, mortgage commitments, letters of credit and other commitments totaling approximately \$20.5 million as of June 30, 2002. This compares to \$25.8 million at December 31, 2001. The Bank has historically funded off-balance sheet commitments with its primary sources of funds and management anticipates that this will continue.

At June 30, 2002 the Company continues to carry a \$271,000 receivable related to a \$541,000 claim against its former data processor. The claim relates to an improper charge made by a former data processing service provider ("Provider") to the Company's check clearing account maintained with the Federal Home Loan Bank of Chicago. Trial in this matter has been rescheduled for October 2002. The receivable will be adjusted based on the results of the upcoming trial or other developments as they occur. Legal fees relating to this matter are being expensed as incurred. Management intends to aggressively pursue recovery of the entire \$541,000, that was improperly charged, and related legal fees.

RESULTS OF OPERATIONS

THREE MONTHS ENDED JUNE 30

The company reported net income of \$430,000 for the three months ended June 30, 2002, an increase of \$78,000 or 22.2% from the \$352,000 reported for the same three month period in 2001. Net income for the quarter ended June 30, 2002 includes the second quarter effect of adopting Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets." Accordingly, amortization of intangible assets with indeterminable useful lives resulting from prior acquisitions accounted for under the purchase method of accounting was discontinued. The adoption of SFAS No. 142 had the impact of increasing net income by \$46,000 for the second quarter of 2002 compared to the same period in 2001. Diluted earnings per share for the second quarter of 2002 were \$0.17, a \$0.02 or 13.3% increase compared to the \$0.15 per diluted share for the second quarter of 2001.

NET INTEREST INCOME

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Net interest income, which is the sum of interest and certain fees generated by earning assets minus interest paid on deposits and other funding sources, is the primary source of the company's earnings. Net interest income increased by \$108,000, or 4.2%, to \$2,681,000 for the quarter ended June 30, 2002, compared to \$2,573,000 for the comparable period in 2001. The net interest margin, which is the tax equivalent net interest income divided by average interest earning assets increased 19 basis points to 3.81% for the second quarter of 2002 compared to 3.62% the similar period in 2001.

The following table sets forth the company's consolidated average balances of assets, liabilities and shareholders' equity as well as interest income and expense on related items, and the company's average rate for the three month periods ended June 30, 2002 and 2001:

AVERAGE BALANCE SHEET WITH RESULTANT INTEREST AND RATES

| (yields on a tax-equivalent basis) | Three months ended June 30, 2002 | | | Three mon |
|---|----------------------------------|----------------|-----------------|--------------------|
| | Average Balance | Interest | Average Rate | Average Balance |
| INTEREST EARNING ASSETS: | | | | |
| Interest-bearing deposit accounts | \$ 844 | \$ 5 | 2.38% | \$ 1,078 |
| Federal funds sold & short-term investments | 4,469 | 19 | 1.71% | 1,702 |
| Investment securities: | | | | |
| Taxable investment securities | 72,345 | 926 | 5.13% | 48,405 |
| Tax-exempt investment securities | 19,598 | 209 | 6.49% | 18,188 |
| Total investment securities | 91,943 | 1,135 | 5.42% | 66,593 |
| Loans | 196,087 | 3,673 | 7.51% | 226,898 |
| TOTAL EARNING ASSETS | \$293,343 | \$4,832 | 6.75% | \$296,271 |
| Allowance for loan losses | (2,518) | | | (3,812) |
| Cash and cash equivalents | 10,173 | | | 10,196 |
| Other assets | 16,980 | | | 18,072 |
| TOTAL ASSETS | \$317,978 | | | \$320,727 |
| INTEREST BEARING LIABILITIES: | | | | |
| Interest bearing demand deposits | \$ 33,172 | \$ 89 | 1.08% | \$ 28,380 |
| Savings deposits | 53,730 | 157 | 1.17% | 49,776 |
| Time deposits | 121,827 | 1,301 | 4.28% | 131,013 |
| Total interest bearing deposits | 208,729 | 1,547 | 2.97% | 209,169 |
| Short-term borrowings | 10,879 | 49 | 1.81% | 21,997 |
| Other borrowings | 41,306 | 555 | 5.39% | 37,160 |
| TOTAL INTEREST-BEARING LIABILITIES | \$260,914 | \$2,151 | 3.31% | \$268,326 |
| NET INTEREST SPREAD | | | 3.45% | |

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| | | | |
|---|-----------|---------|-----------|
| | | ----- | ----- |
| Demand deposits | 30,274 | | 26,113 |
| Other liabilities | 2,011 | | 2,785 |
| | ----- | | ----- |
| Total liabilities | 293,199 | | 297,224 |
| Shareholders' equity | 24,779 | | 23,503 |
| | ----- | | ----- |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$317,978 | | \$320,727 |
| | ----- | | ----- |
| NET INTEREST MARGIN | | \$2,681 | 3.81% |
| | | ----- | ----- |
| | | ----- | ----- |

For the three months ended June 30, 2002, total interest income decreased by \$940,000, or 16.3%, to \$4,832,000 compared to \$5,772,000 for the same period in 2001. The decrease in interest income is due to a 1.0% decrease in average earning assets, and a 120 basis point decrease in the yield on average earning assets to 6.75% for the second three months of 2002, compared to 7.95% for the same period in 2001. The decrease in the yield on average earning assets reflects a shift in the asset mix from loans to investments for the second quarter of 2002 compared to 2001. The decrease in the yield on average earning assets also reflects the lower interest rate environment during the second three months of 2002 compared to the same period in 2001. Interest and fees on loans decreased 23.6% to \$3,673,000 for the three months ended June 30, 2002 compared to \$4,806,000 in same period of 2001. This decrease was the result of a \$30.8 million or 13.6% decrease in average loans outstanding and a 99 basis point decrease in yield on the portfolio. The lower overall portfolio yield reflects the Federal Reserve Bank's lowering of managed rates by 3.75% during 2001.

Interest income on taxable securities increased by \$185,000 or 25.0% in the second three months of 2002 to \$926,000 from \$741,000 for the same period in 2001. Average balances of taxable investment securities increased 49.4% to \$72.3 million for the quarter ended June 30, 2002 compared to \$48.4 million for the same period in the prior year. However, the yield on average taxable investment securities decreased 101 basis points to 5.13% for the second quarter of 2002 compared to 6.14% for the second quarter of 2001, reflecting the decrease in managed rates which occurred throughout 2001. Tax exempt investment securities increased \$1.4 million, or 7.8% to an average balance of \$19.6 million for the three months ended June 30, 2002 compared to \$18.2 for the same period in 2001.

Interest from fed funds sold and short-term investments decreased to \$19,000 for the three months ended June 30, 2002 from \$20,000 during the same period in 2001. Interest on interest-bearing deposit accounts decreased to \$5,000 for the second quarter of 2002 compared to \$13,000 for the same period in 2001. This is the result of a \$2.5 million increase in the average balance of interest-bearing deposit accounts, fed funds sold and short-term investments to \$5.3 million for the three months ended June 30, 2002 compared to \$2.8 for the same period in 2001 and reflects the lower yields earned in 2002.

Total interest expense decreased by \$1,048,000, or 32.8%, to \$2,151,000 for the three months ended June 30, 2002 compared to \$3,199,000 for the same period in 2001. This decrease is the result of the aforementioned lower interest rate environment coupled with favorable shifts in the company's funding mix. While

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interest paid on deposits decreased \$827,000, or 34.8% to \$1,547,000 during the three months ended June 30, 2002 compared to \$2,374,000 for the same period in 2001, average total deposits increased \$3.7 million quarter over quarter. The average balance of time deposits decreased \$9.2 million, or 7.0%, to \$121.8 million for the three months ended June 30, 2002 compared to \$131.0 million for the same period in 2001. The decrease in the average balance of time deposits was offset with increases in the average balances of demand deposits, interest-bearing demand deposits and savings accounts of \$4.2 million, \$4.8 million and \$4.0 million, respectively.

Interest on short-term borrowings decreased \$245,000 to \$49,000 for the three months ended June 30, 2002 compared to \$294,000 for the same period in 2001. This decrease is the result of the decrease in managed interest rates as mentioned earlier and an \$11.1 million, or 50.5% decrease in average short-term borrowings to \$10.9 million for the three months ended June 30, 2002 compared to \$22.0 million in the same period in 2001. The decrease in short-term borrowings is also the result of refinancing FHLB daily advances to term notes during 2001.

Interest expense on other borrowings increased \$24,000, or 4.5%, to \$555,000 for the second quarter of 2002 compared to \$531,000 for the second quarter of 2001. The decrease is the result of a \$4.1 million or 11.2% increase in the average balance of other borrowings to \$41.3 million for the three months ended June 30, 2002 compared to \$37.2 million for the second quarter of 2001. The increase in other borrowings is the result of refinancing FHLB daily advances to term notes during 2001.

PROVISION FOR LOAN LOSSES

The provision for loan losses is an amount added to the allowance for loan losses to provide for the known and estimated amount of loans that will not be collected. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Management determines the appropriate provision based upon a number of criteria, including a detailed evaluation of certain credits, historical performance, economic conditions and overall quality of the loan portfolio. Activity in the allowance for loan loss account is detailed in note 3 to the consolidated condensed financial statements.

The provision for loan losses recorded in the second quarter of 2002 was \$122,000 compared to \$171,000 in 2001. At June 30, 2002 the allowance for loan losses was equal to 1.29% of portfolio loans compared to 1.15% at December 31, 2001. It is management's opinion that this amount represents an adequate allowance for loan losses.

OTHER OPERATING INCOME

Total other operating income increased \$45,000, or 5.5%, to \$870,000 for the three months ended June 30, 2002 compared to \$825,000 for the same period in 2001. Service charges on deposit accounts increased \$15,000, or 3.9%, to \$396,000 for the second quarter of 2002 compared to \$381,000 in the second quarter of the prior year. The Company recognized security gains of \$225,000 during the second quarter of 2002 compared to the \$94,000 that was recognized in the second quarter of 2001. Gain on the sale of mortgage loans decreased \$88,000 or 62.0% to \$54,000 for the second quarter of 2002 compared to \$142,000 of gains recognized during the second quarter of 2001. In the second quarter of 2002 \$3.9 million of loans were sold to the secondary market compared to \$9.0 million for the same period in 2001.

OPERATING EXPENSES

Total operating expenses increased \$133,000, or 4.9%, to \$2,839,000 for the

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three months ended June 30, 2002 compared to \$2,706,000 for the same period in 2001. Occupancy expenses increased 43.4%, or \$79,000, to \$261,000 for the quarter ended June 30, 2002 and include \$75,000 in pre-tax charges related to the Wal-Mart branch consolidation previously discussed. Data processing costs increased \$16,000, or 9.3%, to \$188,000 for the quarter ended June 30, 2002. This increase reflects the cost of the company's internet banking and platform systems, which were implemented in 2001. Amortization of intangible assets decreased \$46,000 to \$78,000 for the three months ended June 30, 2002, which reflects the adoption of SFAS No. 142, as discussed in Note 5 to the consolidated condensed financial statements. Other operating expenses increased \$59,000 to \$501,000 for the three months ended June 30, 2002 reflecting higher costs for marketing, postage, travel reimbursements and loan collection expenses. Other operating expense also includes a \$50,000 charge to accrue severance agreements.

Income taxes decreased \$9,000, or 5.3%, to \$160,000 for the three months ended June 30, 2002 from \$169,000 for the same period in 2001. The decline in effective tax rate to 27.1% for the 2002 period from 32.4% in the same period of 2001 is reflective of greater tax efficiency brought about by an increase in non-taxable income and a reduction in nondeductible purchase accounting amortization.

PART II

OTHER INFORMATION

ITEM 4. SUBMISSION OF MATTERS TO VOTE OF SECURITY HOLDERS

On May 15, 2002, at the annual meeting of shareholders of the Company, the shareholders re-elected R. Richard Bastian, III, John B. Clark and Charles Hart and elected Roger G. Bryden to three-year terms expiring in 2004. The vote, with respect to the election of each director was as follows:

R. Richard Bastian, III

2,430,838 total votes eligible to be cast
2,072,698 votes were represented at the Annual Meeting
2,026,674 votes were cast "For" re-election
No votes were cast "Against" re-election
46,024 votes abstained

John B. Clark

2,430,838 total votes eligible to be cast
2,072,698 votes were represented at the Annual Meeting
2,029,274 votes were cast "For" re-election
No votes were cast "Against" re-election
43,424 votes abstained

Charles Hart

2,430,838 total votes eligible to be cast
2,072,698 votes were represented at the Annual Meeting
2,007,609 votes were cast "For" re-election
No votes were cast "Against" re-election
65,089 votes abstained

Roger G. Bryden

2,430,838 total votes eligible to be cast
2,072,698 votes were represented at the Annual Meeting
2,030,574 votes were cast "For" re-election
No votes were cast "Against" re-election
42,124 votes abstained

ITEM 6. A) EXHIBITS

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See Exhibit Index following the signature page in this report, which is incorporated herein by this reference.

B) REPORTS ON FORM 8-K

There were three reports on Form 8-K filed during the second quarter of 2002.

A report dated April 5, 2002 announced the appointment of Todd J. James as Senior Vice President and Chief Financial Officer of the Company.

A report dated April 24, 2002 announced the resignation of David A. Stearns, Executive Vice President effective May 1, 2002.

A report dated May 15, 2002 announced the results of the election of directors at the Company's annual shareholders meeting and the decision of Mr. Roger K. Taylor to step down as a director of Blackhawk Bancorp, Inc.

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.

Blackhawk Bancorp, Inc.

(Registrant)

Date: July 23, 2002

/s/R. Richard Bastian, III

R. Richard Bastian, III
President and Chief Executive Officer

/s/Todd J. James

Todd J. James
Senior Vice President
and Chief Financial Officer

/s/Thomas L. Lepinski, CPA

Thomas L. Lepinski, CPA
Principal Accounting Officer

BLACKHAWK BANCORP, INC.

INDEX TO EXHIBITS

| Exhibit Number | Description | Incorporated Herein By Reference To: | Filed Here- with | Page No. |
|-------------------|--|---|------------------------|-------------|
| ----- | ----- | ----- | ---- | --- |
| 4.1 | Amended and restated Articles of Incorporation of the Registrant | Exhibit 3.1 to Amendment No. 1 to Registrant's Registration Statement on Form | | |

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| | | | | |
|-----|--|---|---|-------|
| | | S-1 (Reg. No. 33-32351) | | |
| 4.2 | By-laws of Registrant as amended | Exhibit 3.2 to Amendment No. 1 to Registrant's Registration Statement on Form S-1 (Reg. No. 33-32351) | | |
| 4.3 | Plan of Conversion Beloit Savings Bank as amended | Exhibit 1.2 to Amendment No. 1 to Registrant's Registration Statement on Form S-1 (Reg. No. 33-32351) | | |
| 4.4 | Severance Agreement with Dennis M. Conerton | Exhibit A | X | 26 |
| 4.5 | Severance Agreement with David A. Stearns | Exhibit B | X | 27-30 |
| 4.6 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | Exhibit C | X | 31 |
| 4.7 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | Exhibit D | X | 32 |