

FENTURA FINANCIAL INC  
Form 10-Q  
May 15, 2006

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the quarterly period ended March 31, 2006

**OR**

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 000-23550

**Fentura Financial, Inc.**

(Exact name of registrant as specified in its charter)

**Michigan**

(State or other jurisdiction of  
incorporation or organization)

**38-2806518**

(IRS Employee Identification No.)

**175 N Leroy, P.O. Box 725, Fenton, Michigan 48430**

(Address of Principal Executive Offices)

**(810) 629-2263**

(Registrant's telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

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  Accelerated filer  Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: May 1, 2006

| Class | Common Stock | Shares Outstanding |
|-------|--------------|--------------------|
|       |              | 1,946,236          |

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**Fentura Financial Inc.**  
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## PART I-- FINANCIAL INFORMATION

## ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

Fentura Financial, Inc.  
Consolidated Balance Sheets

| (000's omitted except share data)  | March 31,<br>2006<br>(unaudited) | Dec 31,<br>2005 |
|--|----------------------------------|-----------------|
| <b>ASSETS</b>  |                                  |                 |
| Cash and due from banks  | \$ 19,156                        | \$ 21,327       |
| Federal funds sold   | 8,650                            | 9,750           |
| Total cash & cash equivalents  | 27,806                           | 31,077          |
| Securities-available for sale  | 93,217                           | 99,542          |
| Securities-held to maturity, (fair value of \$15,359<br>at March 31, 2006 and \$14,672 at December 31, 2005) | 15,395                           | 14,851          |
| Total securities   | 108,612                          | 114,393         |
| Loans held for sale  | 1,695                            | 1,042           |
| Loans:   |                                  |                 |
| Commercial   | 260,054                          | 254,498         |
| Real estate loans - construction   | 86,449                           | 76,386          |
| Real estate loans - mortgage   | 36,347                           | 37,627          |
| Consumer loans   | 69,534                           | 70,845          |
| Total loans  | 452,384                          | 439,356         |
| Less: Allowance for loan losses  | (6,518)                          | (6,301)         |
| Net loans  | 445,866                          | 433,055         |
| Bank Owned Life Insurance  | 6,642                            | 6,579           |
| Bank premises and equipment  | 15,350                           | 14,617          |
| Federal Home Loan Bank stock   | 2,300                            | 2,300           |
| Accrued interest receivable  | 2,830                            | 2,676           |
| Goodwill   | 7,955                            | 7,955           |
| Acquisition intangibles  | 988                              | 1,075           |
| Other assets   | 4,276                            | 4,320           |
| Total assets   | \$ 624,320                       | \$ 619,089      |
| <b>LIABILITIES</b>   |                                  |                 |
| Deposits:  |                                  |                 |
| Non-interest bearing deposits  | \$ 77,652                        | \$ 76,792       |
| Interest bearing deposits  | 456,313                          | 451,262         |
| Total deposits   | 533,965                          | 528,054         |
| Short term borrowings  | 20                               | 1,537           |
| Federal Home Loan Bank Advances  | 14,189                           | 14,228          |
| Repurchase Agreements  | 10,000                           | 10,000          |
| Subordinated debentures  | 14,000                           | 14,000          |
| Accrued taxes, interest and other liabilities  | 4,421                            | 4,375           |
| Total liabilities  | 576,595                          | 572,194         |
| <b>SHAREHOLDERS' EQUITY</b>  |                                  |                 |
| Common stock - no par value  |                                  |                 |

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|  | <b>March 31,<br/>2006<br/>(unaudited)</b> | <b>Dec 31,<br/>2005</b> |
|--|---|-------------------------|
| <b>(000's omitted except share data)</b>             |   |                         |
| 1,942,968 shares issued (1,931,297 at Dec. 31, 2005) | 34,798                                    | 34,491                  |
| Retained earnings                                    | 14,429                                    | 13,729                  |
| Accumulated other comprehensive income (loss)        | (1,502)                                   | (1,325)                 |
|  | <hr/>                                     | <hr/>                   |
| Total shareholders' equity                           | 47,725                                    | 46,895                  |
|  | <hr/>                                     | <hr/>                   |
| Total Liabilities and Shareholders' Equity           | \$ 624,320                                | \$ 619,089              |
|  | <hr/>                                     | <hr/>                   |

See notes to consolidated financial statements.

**Fentura Financial, Inc.**  
**Consolidated Statements of Income (Unaudited)**

| (000's omitted except per share data)                          | Three Months Ended<br>March 31 |                 |
|--|--------------------------------|-----------------|
|  | 2006                           | 2005            |
| <b>INTEREST INCOME</b>   |                                |                 |
| Interest and fees on loans                                     | \$ 8,430                       | \$ 6,541        |
| Interest and dividends on securities:                          |                                |                 |
| Taxable  | 883                            | 852             |
| Tax-exempt   | 207                            | 244             |
| Interest on federal funds sold                                 | 94                             | 10              |
| <b>Total interest income</b>                                   | <b>9,614</b>                   | <b>7,647</b>    |
| <b>INTEREST EXPENSE</b>  |                                |                 |
| Deposits   | 3,241                          | 1,800           |
| Borrowings   | 507                            | 458             |
| <b>Total interest expense</b>                                  | <b>3,748</b>                   | <b>2,258</b>    |
| <b>NET INTEREST INCOME</b>                                     |                                |                 |
| Provision for loan losses                                      | 400                            | 269             |
| <b>Net interest income after<br/>Provision for loan losses</b> | <b>5,466</b>                   | <b>5,120</b>    |
| <b>NONINTEREST INCOME</b>                                      |                                |                 |
| Service charges on deposit accounts                            | 831                            | 785             |
| Gain on sale of mortgage loans                                 | 163                            | 182             |
| Trust and investment services income                           | 383                            | 335             |
| Loss on sale of securities                                     | 0                              | (111)           |
| Other income and fees  | 420                            | 395             |
| <b>Total noninterest income</b>                                | <b>1,797</b>                   | <b>1,586</b>    |
| <b>NONINTEREST EXPENSE</b>                                     |                                |                 |
| Salaries and employee benefits                                 | 3,334                          | 2,964           |
| Occupancy  | 432                            | 436             |
| Furniture and equipment  | 508                            | 544             |
| Loan and collection  | 71                             | 97              |
| Advertising and promotional                                    | 153                            | 127             |
| Other operating expenses                                       | 1,071                          | 925             |
| <b>Total noninterest expense</b>                               | <b>5,569</b>                   | <b>5,093</b>    |
| <b>INCOME BEFORE TAXES</b>                                     |                                |                 |
| Federal income taxes   | 487                            | 461             |
| <b>NET INCOME</b>  | <b>\$ 1,207</b>                | <b>\$ 1,152</b> |
| Per share:   |                                |                 |
| Net income - basic   | \$ 0.62                        | \$ 0.61         |

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**Three Months Ended  
March 31**

|                         |    |      |    |      |
|-------------------------|----|------|----|------|
| Net income - diluted    | \$ | 0.62 | \$ | 0.61 |
| Cash Dividends declared | \$ | 0.25 | \$ | 0.24 |

See notes to consolidated financial statements.

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**Fentura Financial, Inc.**  
**Consolidated Statements of Changes in Shareholders' Equity (Unaudited)**

| (000's omitted)   | Three Months Ended<br>March 31, |                  |
|---|---------------------------------|------------------|
|   | 2006                            | 2005             |
| <b>COMMON STOCK</b>   |                                 |                  |
| Balance, beginning of period                                  | \$ 34,491                       | \$ 33,110        |
| Issuance of shares under                                      |                                 |                  |
| Director stock purchase plan &                                |                                 |                  |
| Dividend reinvestment program (7,625 and 5,956 shares)        | 252                             | 215              |
| Stock repurchase (977 shares - 2006)                          | (32)                            | 0                |
| Stock options exercised (5,023 shares - 2006)                 | 87                              | 0                |
|   | 34,798                          | 33,325           |
| <b>RETAINED EARNINGS</b>                                      |                                 |                  |
| Balance, beginning of period                                  | 13,729                          | 10,514           |
| Net income  | 1,207                           | 1,152            |
| Cash dividends declared                                       | (507)                           | (455)            |
|   | 14,429                          | 11,211           |
| <b>ACCUMULATED OTHER COMPREHENSIVE<br/>INCOME (LOSS)</b>      |                                 |                  |
| Balance, beginning of period                                  | (1,325)                         | (655)            |
| Change in unrealized gain (loss)<br>on securities, net of tax | (177)                           | (694)            |
|   | (1,502)                         | (1,349)          |
| <b>TOTAL SHAREHOLDERS' EQUITY</b>                             | <b>\$ 47,725</b>                | <b>\$ 43,187</b> |

See notes to consolidated financial statements.

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**Fentura Financial, Inc.**  
**Consolidated Statements of Cash Flows (Unaudited)**

| (000's omitted)   | Three Months Ended<br>March 31 |            |
|---|--------------------------------|------------|
|   | 2006                           | 2005       |
| <b>OPERATING ACTIVITIES:</b>                                    |                                |            |
| Net income  | \$ 1,207                       | \$ 1,152   |
| Adjustments to reconcile net income to cash                     |                                |            |
| <b>Provided by Operating Activities:</b>                        |                                |            |
| Depreciation and amortization                                   | 119                            | 347        |
| Provision for loan losses                                       | 400                            | 269        |
| Loans originated for sale                                       | (9,933)                        | (11,141)   |
| Proceeds from the sale of loans                                 | 9,443                          | 9,632      |
| Loss on sale of securities                                      | 0                              | 111        |
| Gain on sales of loans  | (163)                          | (182)      |
| Net increase in bank owned life insurance                       | (63)                           | (41)       |
| Net (increase) decrease in interest receivable & other assets   | 172                            | (236)      |
| Net increase (decrease) in interest payable & other liabilities | 177                            | (542)      |
|   | 152                            | (1,783)    |
| <b>Total Adjustments</b>  |                                |            |
| <b>Net Cash Provided By (Used In) Operating Activities</b>      | 1,359                          | (631)      |
| <b>Cash Flows From Investing Activities:</b>                    |                                |            |
| Proceeds from maturities of securities - HTM                    | 151                            | 50         |
| Proceeds from maturities of securities - AFS                    | 5,427                          | 0          |
| Proceeds from calls of securities - HTM                         | 0                              | 2          |
| Proceeds from calls of securities - AFS                         | 985                            | 5,195      |
| Proceeds from sales of securities - AFS                         | 0                              | 14,039     |
| Purchases of securities - HTM                                   | (700)                          | (521)      |
| Purchases of securities - AFS                                   | (394)                          | (13,806)   |
| Net increase in loans   | (13,211)                       | (17,645)   |
| Net cash from acquisition of WMFC                               | 0                              | 0          |
| Acquisition of premises and equipment, net                      | (1,082)                        | (1,135)    |
|   | (8,824)                        | (13,821)   |
| <b>Net Cash Provided By (Used in) Investing Activities</b>      |                                |            |
| <b>Cash Flows From Financing Activities:</b>                    |                                |            |
| Net increase (decrease) in deposits                             | 5,911                          | (16,831)   |
| Net increase (decrease) in borrowings                           | (1,517)                        | 12,156     |
| Purchase of advances from FHLB                                  | 4,000                          | 19,400     |
| Repayments of advances from FHLB                                | (4,000)                        | (9,900)    |
| Net proceeds from stock issuance and purchase                   | 307                            | 215        |
| Cash dividends  | (507)                          | (455)      |
|   | 4,194                          | 4,585      |
| <b>Net Cash Provided By (Used In) Financing Activities</b>      |                                |            |
| <b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>                  | \$ (3,271)                     | \$ (9,867) |
| <b>CASH AND CASH EQUIVALENTS - BEGINNING</b>                    | \$ 31,077                      | \$ 27,255  |
|   | \$ 27,806                      | \$ 17,388  |
| <b>CASH AND CASH EQUIVALENTS - ENDING</b>                       |                                |            |
| <b>CASH PAID FOR:</b>   |                                |            |



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|              | <b>Three Months Ended</b> |       |    |       |
|--------------|---------------------------|-------|----|-------|
|              | <b>March 31</b>           |       |    |       |
| INTEREST     | \$                        | 3,674 | \$ | 2,193 |
| INCOME TAXES | \$                        | 51    | \$ | 450   |

See notes to consolidated financial statements

**Fentura Financial, Inc.**  
**Consolidated Statements of Comprehensive Income (Unaudited)**

| (000's omitted)   | Three Months Ended<br>March 31, |          |
|---|---------------------------------|----------|
|   | 2006                            | 2005     |
| Net Income  | \$ 1,207                        | \$ 1,152 |
| Other comprehensive income (loss), net of tax:                            |                                 |          |
| Unrealized holding gains (losses) arising during period                   | (177)                           | (767)    |
| Less: reclassification adjustment for gains/losses included in net income | (0)                             | (73)     |
| Other comprehensive income (loss)   | (177)                           | (694)    |
| Comprehensive income  | \$ 1,030                        | \$ 458   |

**Fentura Financial, Inc.**  
**Notes to Consolidated Financial Statements (Unaudited)**
**Note 1. Basis of Presentation**

The consolidated financial statements at December 31, 2005 and March 31, 2006 include Fentura Financial, Inc. (the Corporation) and its wholly owned subsidiaries, The State Bank in Fenton, Michigan; Davison State Bank in Davison, Michigan; and West Michigan Community Bank in Hudsonville, Michigan ( the Banks ), as well as Fentura Mortgage Company, West Michigan Mortgage Company, LLC, and the other subsidiaries of the Banks. Intercompany transactions and balances are eliminated in consolidation.

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information, refer to the consolidated financial statements and footnotes thereto included in the Corporation's annual report on Form 10-K for the year ended December 31, 2005.

Reclassifications: Some items in the prior year financial statements were reclassified to conform to the current presentation.

Allowance for Loan Losses: The allowance for loan losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan losses and decreased by charge-offs less recoveries. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed.

A loan is impaired when full payment under the loan terms is not expected. Impairment is evaluated in total for smaller-balance loans of similar nature such as residential mortgage, consumer, and credit card loans, and on an individual loan basis for other loans. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral.

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### Stock Option Plans

The Nonemployee Director Stock Option Plan grants options to nonemployee directors to purchase the Corporation's common stock on April 1 each year. The purchase price of the shares is the fair market value at the date of the grant, and there is a three-year vesting period before options may be exercised. Options to acquire no more than 7,392 shares of stock may be granted under the Plan in any calendar year and options to acquire not more than 66,635 shares in the aggregate may be outstanding at any one time.

The Employee Stock Option Plan grants options to eligible employees to purchase the Corporation's common stock at or above, the fair market value of the stock at the date of the grant. Awards granted under this plan are limited to an aggregate of 79,033 shares. The administrator of the plan is a committee of directors. The administrator has the power to determine the number of options to be granted, the exercise price of the options and other terms of the options, subject to consistency with the terms of the plan.

The following table summarizes stock option activity:

|  | <b>Number of<br/>Options</b> | <b>Weighted<br/>Average Price</b> |
|--|------------------------------|-----------------------------------|
| Options outstanding at December 31, 2004 | 42,212                       | \$ 30.80                          |
| Options granted 2005                     | 735                          | 35.00                             |
| Options forfeited 2005                   | (645)                        | 32.97                             |
|  | 42,302                       | \$ 30.84                          |
| Options outstanding at December 31, 2005 | 42,302                       | \$ 30.84                          |
| Options exercised 2006                   | (5,023)                      | 17.32                             |
|  | 37,279                       | \$ 32.66                          |
| Options outstanding at March 31, 2006    | 37,279                       | \$ 32.66                          |

The aggregate intrinsic value of all options outstanding at March 31, 2006 was \$59,000. The aggregate intrinsic value of all options that were exercisable at March 31, 2006 was \$5,000.

|                                       | <b>Three months ended<br/>March 31, 2006<br/>Total unvested options<br/>Shares</b> |
|---------------------------------------|--|
| Unvested options, beginning of period | 13,686   |
| Vested                                | (46)   |
| Granted                               | 0  |
|                                       | 13,640   |
| Unvested options, end of period       | 13,640   |

Proceeds, related tax benefits realized from options exercised and intrinsic value of options exercised were as follows:

|                                      | <b>Three months ended<br/>March 31, 2005</b> |
|--------------------------------------|--|
| Proceeds of options exercised        | \$ 87  |
| Related tax benefit recognized       | 0  |
| Intrinsic value of options exercised | 85   |

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Options outstanding at March 31, 2006 were as follows:

|                           | Outstanding |   | Exercisable |                                 |
|---------------------------|-------------|---|-------------|---------------------------------|
|                           | Shares      | Weighted Average Remaining Contractual Life | Shares      | Weighted Average Exercise Price |
| \$20.01-\$30.00           | 7,032       | 5.2   | 7,032       | \$ 23.28                        |
| \$30.01-\$40.00           | 29,982      | 7.4   | 16,342      | \$ 34.79                        |
| \$40.01-\$50.00           | 264         | 3.3   | 264         | \$ 40.91                        |
| Outstanding at period end | 37,279      | 7.0   | 23,639      | \$ 33.54                        |

No stock options were granted during the three months ended March 31, 2006.

The expected average risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for periods corresponding with the life of the option. The expected average life represents the weighted average period of time that options granted are expected to be outstanding giving consideration to vesting schedules, historical exercise and forfeiture patterns. Expected volatility is based on historical volatilities of the Company's common stock. The expected dividend yield is based on historical information.

Employment compensation expense under stock options is reported using the intrinsic value method. Beginning with the first quarter of 2006 stock-based compensation cost is reflected in net income, as required by *Statement of Financial Accounting Standards No. 123R - Share based Payments*. Prior to the first quarter of 2006, stock-based compensation cost was reflected as a footnote adjustment to net income, as allowed by *FASB Statement No. 123, Accounting for Stock-Based Compensation*. All options granted have an exercise price equal to or greater than the market price of the underlying common stock at date of grant.

Compensation costs for all share-based plans were as follows:

**Three months ended March 31, 2006**

|  | Stock Options |
|--|---------------|
| Compensation cost recognized in income | \$ 4          |
| Related tax benefit recognized         | 0             |

The compensation cost yet to be recognized for stock-based awards that have been awarded but not vested is as follows:

**Three months ended March 31, 2006**

|                   | Stock Options |
|-------------------|---------------|
| Remainder of 2006 | \$ 15         |
| 2007              | 16            |
| 2008              | 8             |
| Total             | \$ 39         |

Weighted average life in years is 1.25.

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The following table illustrates the effect on net income and earnings per share if expense was measured using the fair value recognition provisions of FASB Statement No. 123, Accounting for Stock-Based Compensation (unaudited):

| <i>(Dollars in thousands except per share data)</i>                    | <b>Three months ended<br/>March 31,</b> |                    |
|--|---|--------------------|
|  | <b><u>2006</u></b>                      | <b><u>2005</u></b> |
| Net Income as Reported   | \$ 1,207                                | \$ 1,152           |
| Less: Value Determined Under Fair Value<br>Based Method (net of taxes) | 4                                       | 2                  |
| Amount Expensed in the Period (net of taxes)                           | (4)                                     | 0                  |
|  | \$ 1,207                                | \$ 1,150           |
| Pro Forma Net Income   |   |                    |
| Basic Earnings per Share as Reported                                   | \$ 0.62                                 | \$ 0.61            |
| Pro Forma Basic Earnings per Share                                     | \$ 0.62                                 | \$ 0.61            |
| Diluted Earnings per Share as Reported                                 | \$ 0.62                                 | \$ 0.61            |
| Pro Forma Diluted Earnings per Share                                   | \$ 0.62                                 | \$ 0.61            |

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**Note 2. Earnings Per Common Share**

A reconciliation of the numerators and denominators used in the computation of basic earnings per common share and diluted earnings per common share is presented below. Earnings per common share are presented below for the three months ended March 31, 2006 and 2005:

|   | <b>Three Months Ended<br/>March 31,</b> |              |
|---|---|--------------|
|   | <b>2006</b>                             | <b>2005</b>  |
| Basic Earnings Per Common Share:  |   |              |
| Numerator   |   |              |
| Net Income  | \$ 1,207,000                            | \$ 1,152,000 |
| Denominator   |   |              |
| Weighted average common shares<br>Outstanding   | 1,936,876                               | 1,892,367    |
| Basic earnings per common share   | \$ 0.62                                 | \$ 0.61      |
| Diluted Earnings Per Common Share:  |   |              |
| Numerator   |   |              |
| Net Income  | \$ 1,207,000                            | \$ 1,152,000 |
| Denominator   |   |              |
| Weighted average common shares<br>outstanding for basic earnings per<br>common share  | 1,936,876                               | 1,892,367    |
| Add: Dilutive effects of assumed<br>exercises of stock options                        | 1,792                                   | 6,714        |
| Weighted average common shares<br>and dilutive potential common<br>shares outstanding | 1,938,668                               | 1,899,080    |
| Diluted earnings per common share   | \$ 0.62                                 | \$ 0.61      |

Stock options for 2,867 shares of common stock for the three-month period ended March 31, 2006 and stock options for 14,200 shares of common stock for the three-month period ended March 31, 2005 were not considered in computing diluted earnings per common share because they were not dilutive.

**Note 3. Commitments and Contingencies**

There are various contingent liabilities that are not reflected in the financial statements including claims and legal actions arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, the ultimate disposition of these matters is not expected to have a material effect on the Corporation's consolidated financial condition or results of operations.

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

Results of Operations

Certain of the Corporation's accounting policies are important to the portrayal of the Corporation's financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Facts and circumstances, which could affect these judgments, include, but without limitation, changes in interest rates, in the performance of the economy or in the financial condition of borrowers. Management believes that its critical accounting policies include determining the allowance for loan losses and determining the fair value of securities and other financial instruments.

As indicated in the income statement, earnings for the three months ended March 31, 2006 were \$1,207,000 compared to \$1,152,000 for the same period in 2005. Higher net interest income and increases in noninterest income, which were offset by increases in noninterest expense, contributed to the increase in net income. Net interest income was higher due to favorable increases in the prime rate and significantly higher loan balances during the first quarter of 2006 compared with the same period in 2005. The Corporation continues to focus on core banking activities and new opportunities in current and surrounding markets.

The banking industry uses standard performance indicators to help evaluate a banking institution's performance. Return on average assets is one of these indicators. For the three months ended March 31, 2006 the Corporation's return on average assets (annualized) was 0.79% compared to 0.80% for the same period in 2005. Net income per share basic and diluted was \$0.62 in the first three months of 2006 compared to \$0.61 net income per share basic and diluted for the same period in 2005.

Net Interest Income

Net interest income and average balances and yields on major categories of interest-earning assets and interest-bearing liabilities for the three months ended March 31, 2006 and 2005 are summarized in Table 2. The effects of changes in average interest rates and average balances are detailed in Table 1 below.

**Table 1**

| (000'S OMITTED)                    | THREE MONTHS ENDED<br>MARCH 31,<br>2006 COMPARED TO 2005<br>INCREASE (DECREASE)<br>DUE TO |                |        |
|------------------------------------|---|----------------|--------|
|                                    | VOL   | YIELD/<br>RATE | TOTAL  |
| Taxable Securities                 | \$ (61)   | \$ 92          | \$ 31  |
| Tax-Exempt Securities              | (64)  | 8              | (56)   |
| Federal Funds Sold                 | 41  | 43             | 84     |
| Total Loans                        | 740   | 1,144          | 1,884  |
| Loans Held for Sale                | (1)   | 4              | 3      |
| Total Earning Assets               | 655   | 1,291          | 1,946  |
| Interest Bearing Demand Deposits   | (17)  | 285            | 268    |
| Savings Deposits                   | (42)  | (4)            | (46)   |
| Time CD's \$100,000 and Over       | 556   | 356            | 912    |
| Other Time Deposits                | 15  | 292            | 307    |
| Other Borrowings                   | (102)   | 151            | 49     |
| Total Interest Bearing Liabilities | 410   | 1,080          | 1,490  |
| Net Interest Income                | \$ 245  | \$ 211         | \$ 456 |

As indicated in Table 1, during the three months ended March 31, 2006, net interest income increased compared to the same period in 2005, principally because of the increase in loan interest income. Loan income increased due to increases in the prime rate and higher balances during the first three months of 2006 compared to the same period in 2005. Interest expenses increased compared to the first quarter of 2005 due to the increase in deposit pricing and deposit balances for the Corporation.

Net interest income (displayed with consideration of full tax equivalency), average balance sheet amounts, and the corresponding yields for the three months ended March 31, 2006 and 2005 are shown in Table 2. Net interest income for the three months ended March 31, 2006 was \$5,998,000, an increase of \$456,000, or 8.2%, over the same period in 2005. Net interest margin increased due to favorable increases in the prime rate and loan volumes during the quarter. Management's actions to reprice loans and deposits to improve the margin and short-term rate stability contributed substantially to the improvement during the first three months of 2006 compared to the first three months of 2005.

Management reviews economic forecasts and strategy on a monthly basis. Accordingly, the Corporation will continue to strategically manage the balance sheet structure in an effort to create stability in net interest income. The Corporation expects to continue to seek out new loan opportunities while continuing to maintain sound credit quality.



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As indicated in Table 2, for the three months ended March 31, 2006, the Corporation's net interest margin (with consideration of full tax equivalency) was 4.26% compared with 4.24% for the same period in 2005. This increase is attributable to the impact of higher loan volumes and repricing of variable rate instruments, which helped increase net interest income and increased the net interest margin. The Corporation's net interest margin was also positively impacted by the Federal Reserve increasing interest rates during the first quarter in 2006.

Average earning assets increased 7.6% or approximately \$40,331,000 comparing the first three months of 2006 to the same time period in 2005. Loans, the highest yielding component of earning assets, represented 78.3% of earning assets in 2006 compared to 75.7% in 2005. Average interest bearing liabilities increased 8.3% or \$37,802,000 comparing the first three months of 2006 to the same time period in 2005. Non-interest bearing deposits amounted to 13.6% of average earning assets in the first three months of 2006 compared with 15.3% in the same time period of 2005.

Management continually monitors the Corporation's balance sheet in an effort to insulate net interest income from significant swings caused by interest rate volatility. If market rates change in 2006, corresponding changes in funding costs will be considered to avoid potential negative impacts on net interest income. The Corporation's policies in this regard are further discussed in the section titled "Interest Rate Sensitivity Management."

**Table 2 Average Balance and Rates**

| (000's omitted)(Annualized)<br>ASSETS  | THREE MONTHS ENDED MARCH 31, |                   |                |                    |                    |                |
|--|------------------------------|-------------------|----------------|--------------------|--------------------|----------------|
|  | 2006                         |                   |                | 2005               |                    |                |
|  | AVERAGE<br>BALANCE           | INCOME<br>EXPENSE | YIELD/<br>RATE | AVERAGE<br>BALANCE | INCOME/<br>EXPENSE | YIELD/<br>RATE |
| Securities:                            |                              |                   |                |                    |                    |                |
| U.S. Treasury and Government Agencies  | \$ 88,026                    | \$ 852            | 3.93%          | \$ 96,108          | \$ 824             | 3.48%          |
| State and Political (1)                | 21,817                       | 314               | 5.84%          | 26,430             | 370                | 5.67%          |
| Other                                  | 4,308                        | 31                | 2.92%          | 3,305              | 28                 | 3.44%          |
| <b>Total Securities</b>                | <b>114,151</b>               | <b>1,197</b>      | <b>4.25%</b>   | <b>125,843</b>     | <b>1,222</b>       | <b>3.94%</b>   |
| Fed Funds Sold                         | 8,357                        | 94                | 4.56%          | 1,648              | 10                 | 2.46%          |
| Loans:                                 |                              |                   |                |                    |                    |                |
| Commercial                             | 335,935                      | 6,363             | 7.68%          | 292,461            | 4,730              | 6.56%          |
| Tax Free (1)                           | 4,538                        | 73                | 6.52%          | 4,989              | 80                 | 6.53%          |
| Real Estate-Mortgage                   | 35,751                       | 654               | 7.42%          | 32,213             | 556                | 7.00%          |
| Consumer                               | 70,665                       | 1,342             | 7.70%          | 71,849             | 1,182              | 6.67%          |
| <b>Total loans</b>                     | <b>446,889</b>               | <b>8,432</b>      | <b>7.65%</b>   | <b>401,512</b>     | <b>6,548</b>       | <b>6.61%</b>   |
| Allowance for Loan Losses              | (6,426)                      |                   |                | (5,651)            |                    |                |
| <b>Net Loans</b>                       | <b>440,463</b>               | <b>8,432</b>      | <b>7.76%</b>   | <b>395,861</b>     | <b>6,548</b>       | <b>6.71%</b>   |
| Loans Held for Sale                    | 1,354                        | 23                | 6.89%          | 1,417              | 20                 | 5.72%          |
| <b>TOTAL EARNING ASSETS</b>            | <b>\$ 570,751</b>            | <b>\$ 9,746</b>   | <b>6.93%</b>   | <b>\$ 530,420</b>  | <b>\$ 7,800</b>    | <b>5.96%</b>   |
| Cash Due from Banks                    | 17,688                       |                   |                | 19,826             |                    |                |
| All Other Assets                       | 37,385                       |                   |                | 35,589             |                    |                |
| <b>TOTAL ASSETS</b>                    | <b>\$ 619,398</b>            |                   |                | <b>\$ 580,454</b>  |                    |                |
| LIABILITIES & SHAREHOLDERS'<br>EQUITY: |                              |                   |                |                    |                    |                |
| Deposits:                              |                              |                   |                |                    |                    |                |
| Interest bearing - DDA                 | \$ 108,790                   | \$ 591            | 2.20%          | \$ 114,965         | \$ 323             | 1.14%          |
| Savings Deposits                       | 105,353                      | 317               | 1.22%          | 140,465            | 363                | 1.05%          |
| Time CD's \$100,000 and Over           | 125,158                      | 1,316             | 4.26%          | 50,871             | 404                | 3.22%          |
| Other Time CD's                        | 110,606                      | 1,017             | 3.73%          | 94,063             | 710                | 3.06%          |
| <b>Total Deposits</b>                  | <b>449,907</b>               | <b>3,241</b>      | <b>2.92%</b>   | <b>400,364</b>     | <b>1,800</b>       | <b>1.82%</b>   |
| Other Borrowings                       | 41,034                       | 507               | 5.01%          | 52,775             | 458                | 3.52%          |
| <b>INTEREST BEARING LIABILITIES</b>    | <b>\$ 490,941</b>            | <b>\$ 3,748</b>   | <b>3.10%</b>   | <b>\$ 453,139</b>  | <b>\$ 2,258</b>    | <b>2.02%</b>   |

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|   | THREE MONTHS ENDED MARCH 31, |              |                   |              |
|---|------------------------------|--------------|-------------------|--------------|
| Non-Interest bearing - DDA                  | 77,418                       |              | 81,049            |              |
| All Other Liabilities                       | 3,102                        |              | 2,037             |              |
| Shareholders' Equity                        | 47,937                       |              | 44,229            |              |
|   | <u>          </u>            |              | <u>          </u> |              |
| TOTAL LIABILITIES &<br>SHAREHOLDERS' EQUITY | \$ 619,398                   |              | \$ 580,454        |              |
|   | <u>          </u>            |              | <u>          </u> |              |
| Net Interest Rate Spread                    |                              | <u>3.83%</u> |                   | <u>3.94%</u> |
| Net Interest Income /Margin                 | \$ 5,998                     | <u>4.26%</u> | \$ 5,542          | <u>4.24%</u> |

(1) Presented on a fully taxable equivalent basis using a federal income tax rate of 34%.

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### Allowance and Provision For Loan Losses

The Corporation maintains formal policies and procedures to control and monitor credit risk. Management believes the allowance for loan losses is adequate to provide for probable incurred losses in the loan portfolio. The Corporation's loan portfolio has no significant concentrations in any one industry or any exposure in foreign loans. The Corporation has not extended credit to finance highly leveraged transactions nor does it intend to do so in the future. Employment levels and other economic conditions in the Corporation's local markets may have a significant impact on the level of loan losses. Management continues to identify and devote attention to credits that are not performing as agreed. Of course, deterioration of economic conditions could have an impact on the Corporation's credit quality, which could impact the need for greater provision for loan losses and the level of the allowance for loan losses as a percentage of gross loans. Non-performing loans are discussed further in the section titled "Non-Performing Assets."

The allowance for loan losses (*ALL*) reflects management's judgment as to the level considered appropriate to absorb probable losses in the loan portfolio. The Corporation's subsidiary banks' methodology in determining the adequacy of the *ALL* relies on several key elements, which include specific allowances for identified problem loans and a formula-based risk-allocated allowance for the remainder of the portfolio. This includes a review of individual loans, historical loss experience, current economic conditions, portfolio trends, and other pertinent factors. The amount of the provision for loan losses is based on our review of the historical credit loss experience and such factors that, in our judgment, deserve consideration under existing economic conditions in estimating probable credit losses. While we consider the allowance for loan losses to be adequate based on information currently available, future adjustments to the allowance may be necessary due to changes in economic conditions, delinquencies, or loss rates. Although portions of the allowance have been allocated to various portfolio segments, the *ALL* is general in nature and is available for the portfolio in its entirety. At March 31, 2006, the *ALL* was \$6,518,000, or 1.44% of total loans compared to \$6,301,000, or 1.43%, at December 31, 2005, increasing the *ALL* \$217,000 during the first quarter of 2006 but providing substantially the same coverage. Non performing loan levels, discussed later, decreased during the period and net charge-offs were nominal. Management believes that the allowance is appropriate given identified risk in the loan portfolio based on asset quality.

Table 3 below summarizes loan losses and recoveries for the first three months of 2006 and 2005. During the first three months of 2006, the Corporation experienced net charge-offs of \$183,000 or .04% compared with net recoveries of \$10,000 in the first three months of 2005. The provision for loan losses was \$400,000 in the first three months of 2006 and \$269,000 for the same time period in 2005 resulting principally from the growth in the loan portfolio during 2006 and charge-offs incurred.

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**Table 3 Analysis Of The Allowance For Loan Losses**

| (000's omitted)                         | Three Months Ended March 31, |          |
|---|------------------------------|----------|
|   | 2006                         | 2005     |
| Balance at Beginning of Period          | \$ 6,301                     | \$ 5,501 |
| Charge-Offs:                            |                              |          |
| Commercial, Financial and Agriculture   | (138)                        | (15)     |
| Real Estate-Mortgage                    | 0                            | 0        |
| Installment Loans to Individuals        | (72)                         | (43)     |
| Total Charge-Offs                       | (210)                        | (58)     |
| Recoveries:                             |                              |          |
| Commercial, Financial and Agriculture   | 8                            | 39       |
| Real Estate-Mortgage                    | 0                            | 0        |
| Installment Loans to Individuals        | 19                           | 29       |
| Total Recoveries                        | 27                           | 68       |
| Net Charge-Offs                         | (183)                        | 10       |
| Provision                               | 400                          | 269      |
| Balance at End of Period                | \$ 6,518                     | \$ 5,780 |
| Ratio of Net Charge-Offs to Gross Loans | 0.04%                        | 0.00%    |

Non-Interest Income

Non-interest income increased during the three months ended March 31, 2006 as compared to the same period in 2005, primarily due to the increase in service charges on deposits and an increase in trust and investment income. Overall non-interest income was \$1,797,000 for the three months ended March 31, 2006 compared to \$1,586,000 for the same period in 2005. These figures represent an increase of 13.3%. The income statement provides a detailed breakdown of the components of non-interest income.

The most significant category of non-interest income is service charges on deposit accounts. These fees were \$831,000 in the first three months of 2006 compared to \$785,000 for the same period of 2005. This represents an increase of 5.9%. The increases are attributable to increases in overdraft privilege service charges and regular deposit account service charges in the Banks. The increase was due to lower balances in deposit accounts and more customers using the overdraft privilege product during the first quarter of 2006.

Gains on the sale of mortgage loans originated by the Banks and sold in the secondary market were \$163,000 in the three months ended March 31, 2006 and \$182,000 in the same period in 2005. In the first quarter of 2006 gain on the sale of mortgages decreased 10.4% over the same period in 2005, due to higher mortgage rates and slower real estate markets.

Trust and investment services income increased \$48,000 (14.3%) in the first three months of 2006 compared to the same period in the prior year. The increase in fees is attributable to the increase in the average market value of assets under management, the increase in investment services at The State Bank, and an increase in West Michigan Community Bank trust and investment services fees.

The Banks did not sell any securities in the first quarter of 2006. Loss on sale of securities was \$111,000 in the first three months of 2005, due to the Banks selling securities in the first quarter of 2005. The Banks took the loss to reposition their securities portfolios into higher yielding securities.

Other operating income increased \$25,000 (6.3%) to \$420,000 in the first three months of 2005 compared to \$395,000 in the same time period in 2005. Other operating income increased due to the increase in debit card fees and an increase in the official check commissions in the first quarter of 2006.

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### Non-Interest Expense

Total non-interest expense increased 9.3% to \$5,569,000 in the three months ended March 31, 2006, compared with \$5,093,000 in the same period of 2005. This increase was largely attributable to an increase in salaries and benefits expense and other operating expenses for new bank branch offices.

Salary and benefit costs, the Corporation's largest non-interest expense category, were \$3,334,000 in the first three months of 2006, compared with \$2,964,000, or an increase of 12.5%, for the same time period in 2005. Increased costs were primarily a result of a modest salary increase for employees and an increase in employee benefit costs and modest staffing increases.

Occupancy expenses at \$432,000 decreased in the three months ended March 31, 2006 compared to the same period in 2005 by \$4,000 or .9%. The decreases were attributable to a decrease in facility repairs and maintenance contracts expense.

During the three months ended March 31, 2006 furniture and equipment expenses were \$508,000 compared to \$544,000 for the same period in 2005, a decrease of 6.6%. The decreases in expenses were attributable to a decrease in equipment maintenance contracts and equipment depreciation.

Loan and collection expenses, at \$71,000, were down \$26,000 during the three months ended March 31, 2006 compared to the same time period in 2005. In the first quarter of 2006, loan and collection expense decreased 26.8% compared to the first quarter of 2005. The decrease was primarily attributable to a decrease in other loan expense relating to other real estate and decreases in other loan costs.

Advertising expenses were \$153,000 in the three months ended March 31, 2006, up 20.5% compared with \$127,000 for the same period in 2005. The increases were primarily due to the increase in media, shareholder and promotional expenses and free checking campaign in all of the subsidiary banks.

Other operating expenses were \$1,071,000 in the three months ended March 31, 2006 compared to \$925,000 in the same time period in 2005, an increase of \$146,000 or 15.8%. The increases were attributable to an increase in the amount of correspondent bank service charges due to our Banks maintaining lower balances with such correspondent banks and an increase in other outside services and consulting expenses.

### Financial Condition

Proper management of the volume and composition of the Corporation's earning assets and funding sources is essential for ensuring strong and consistent earnings performance, maintaining adequate liquidity and limiting exposure to risks caused by changing market conditions. The Corporation's securities portfolio is structured to provide a source of liquidity through maturities and to generate an income stream with relatively low levels of principal risk. The Corporation does not engage in securities trading. Loans comprise the largest component of earning assets and are the Corporation's highest yielding assets. Customer deposits are the primary source of funding for earning assets while short-term debt and other sources of funds could be further utilized if market conditions and liquidity needs change.

The Corporation's total assets were \$624 million at March 31, 2006 compared to total assets of \$619 million at December 31, 2005. Loans comprised 72.5% of total assets at March 31, 2006 compared to 71.0% at December 31, 2005. Loans grew \$13.0 million for the Corporation during the first quarter of 2006. The ratio of non-interest bearing deposits to total deposits remained steady at 14.5% for March 31, 2006 and December 31, 2005. Interest bearing deposit liabilities totaled \$456 million at March 31, 2006 compared to \$451 million at December 31, 2005. Total deposits increased \$5.9 million with non-interest bearing demand deposits increasing \$860,000 and interest bearing deposits increasing \$5.1 million. Short-term borrowings decreased \$1.5 million due to the increase in deposit volume. FHLB advance balances remained steady comparing the two periods. Repurchase agreement balances remained steady comparing the two periods. Repurchase agreements are instruments with deposit type characteristics, which are secured by government securities. The repurchase agreements were leveraged against securities to increase net interest income.

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Bank premises and equipment increased \$733,000 to \$15.4 million at March 31, 2006 compared to \$14.6 million at December 31, 2005. The increase was due to the branch construction project in process at one of the Bank subsidiaries.

### Non-Performing Assets

Non-performing assets are assets that have more than a normal risk of loss and include loans on which interest accruals have ceased, loans that have been renegotiated, and real estate acquired through foreclosure. Past due loans are loans which are delinquent 90 days or more, but have not been placed on non-accrual status. Table 4 reflects the levels of these assets at March 31, 2006 and December 31, 2005.

Non-performing assets decreased at March 31, 2006 compared to December 31, 2005. This decrease was primarily due to a decrease in Other Real Estate, which decreased due to the sale of a residential property (acquired in foreclosure) in the first three months of 2005. The property was sold by our Bank on a land contract. One residential property comprises of the entire \$102,000 REO-in-Redemption balance. Marketability of this property is dependent on the real estate market. Renegotiated loans decreased significantly due to the resolution of the restructure of two SBA guaranteed loans from 2005. Non-performing loans increased as compared to December 31, 2005 due to a \$96,000 increase in non-accrual loans.

The level and composition of non-performing assets are affected by economic conditions in the Corporation's local markets. Non-performing assets, charge-offs, and provisions for loan losses tend to decline in a strong economy and increase in a weak economy, potentially impacting the Corporation's operating results. In addition to non-performing loans, management carefully monitors other credits that are current in terms of principal and interest payments but, in management's opinion, may deteriorate in quality if economic conditions change.

**Table 4 Non-Performing Assets and Past Due Loans**

|  | March 31,<br>2006 | December 31,<br>2005 |
|--|-------------------|----------------------|
| Non-Performing Loans:                  |                   |                      |
| Loans Past Due 90 Days or More & Still |                   |                      |
| Accruing                               | \$ 71             | \$ 80                |
| Non-Accrual Loans                      | 1,572             | 1,476                |
| Renegotiated Loans                     | 440               | 1,401                |
|  | <hr/>             | <hr/>                |
| Total Non-Performing Loans             | 2,083             | 2,957                |
|  | <hr/>             | <hr/>                |
| Other Non-Performing Assets:           |                   |                      |
| Other Real Estate                      | 0                 | 500                  |
| REO in Redemption                      | 102               | 0                    |
| Other Non-Performing Assets            | 25                | 6                    |
|  | <hr/>             | <hr/>                |
| Total Other Non-Performing Assets      | 127               | 506                  |
|  | <hr/>             | <hr/>                |
| Total Non-Performing Assets            | \$ 2,210          | \$ 3,463             |
|  | <hr/>             | <hr/>                |
| Non-Performing Loans as a % of         |                   |                      |
| Total Loans                            | 0.46%             | 0.67%                |
| Allowance for Loan Losses as a % of    |                   |                      |
| Non-Performing Loans                   | 312.91%           | 213.09%              |
| Accruing Loans Past Due 90 Days or     |                   |                      |
| More to Total Loans                    | 0.02%             | 0.02%                |
| Non-performing Assets as a % of        |                   |                      |
| Total Assets                           | 0.35%             | 0.56%                |

**Liquidity and Interest Rate Risk Management**

Asset/Liability management is designed to assure liquidity and reduce interest rate risks. The goal in managing interest rate risk is to maintain a strong and relatively stable net interest margin. It is the responsibility of the Asset/Liability Management Committee (ALCO) to set policy guidelines and to establish short-term and long-term strategies with respect to interest rate exposure and liquidity. The ALCO, which is comprised of key members of management, meets regularly to review financial performance and soundness, including interest rate risk and liquidity exposure in relation to present and prospective markets, business conditions, and product lines. Accordingly, the committee adopts funding and balance sheet management strategies that are intended to maintain earnings, liquidity, and growth rates consistent with policy and prudent business standards.

Liquidity maintenance together with a solid capital base and strong earnings performance are key objectives of the Corporation. The Corporation's liquidity is derived from a strong deposit base comprised of individual and business deposits. Deposit accounts of customers in the mature market represent a substantial portion of deposits of individuals. The Bank's deposit base plus other funding sources (federal funds purchased, short-term borrowings, FHLB advances, repurchase agreements, other liabilities and shareholders' equity) provided primarily all funding needs in the first quarter of 2006. While these sources of funds are expected to continue to be available to provide funds in the future, the mix and availability of funds will depend upon future economic conditions. The Corporation does not foresee any difficulty in meeting its funding requirements.

Primary liquidity is provided through short-term investments or borrowings (including federal funds sold and purchased) while the securities portfolio provides secondary liquidity. The securities portfolio has decreased \$5.8 million since December 31, 2005 due to the calls of securities and the increase in loan demand. The Corporation has decided to invest the excess funds, from the call of these securities, in the securities and loan portfolios to increase yield and income versus keeping the excess funds in federal funds sold at a lower yield. The Corporation regularly monitors liquidity to ensure adequate cash flows to cover unanticipated reductions in the availability of funding sources.

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Interest rate risk is managed by controlling and limiting the level of earnings volatility arising from rate movements. The Corporation regularly performs reviews and analysis of those factors impacting interest rate risk. Factors include maturity and re-pricing frequency of balance sheet components, impact of rate changes on interest margin and prepayment speeds, market value impacts of rate changes, and other issues. Both actual and projected performance are reviewed, analyzed, and compared to policy and objectives to assure present and future financial viability.

The Corporation had cash flows from financing activities resulting primarily from the decrease of borrowings and increase of demand and savings deposits. In the first three months of 2006, these borrowings decreased \$1,517,000 while these deposits increased \$5,911,000. Cash used by investing activities was \$8,824,000 in first three months of 2006 compared to cash used of \$13,821,000 in first three months of 2005. The change in investing activities was due to the increase in the origination of loans in the first three months of 2006 compared to the first three months of 2005.

### Capital Management

Total shareholders' equity increased 1.8% to \$47,725,000 at March 31, 2006 compared with \$46,895,000 at December 31, 2005. The Corporation's equity to asset ratio remained steady at 7.6% at March 31, 2006 and December 31, 2005. The increase in the amount of capital resulted primarily from net income, partially offset by dividends declared.

As indicated on the balance sheet at December 31, 2005, the Corporation had an accumulated other comprehensive loss of \$1,325,000 compared to accumulated other comprehensive loss at March 31, 2006 of \$1,502,000. The increase in the loss position is attributable to the fluctuation of the market price of securities held in the available for sale portfolio.

### Regulatory Capital Requirements

Bank holding companies and their bank subsidiaries are required by banking industry regulators to maintain certain levels of capital. These are expressed in the form of certain ratios. These ratios are based on the degree of credit risk in the Corporation's assets. All assets and off-balance sheet items such as outstanding loan commitments are assigned risk factors to create an overall risk-weighted asset total. Capital is separated into two levels, Tier I capital (essentially total common shareholders' equity plus qualifying cumulative preferred securities (limited to 33% of common equity), less goodwill) and Tier II capital (essentially the allowance for loan losses limited to 1.25% of gross risk-weighted assets). Capital levels are then measured as a percentage of total risk weighted assets. The regulatory minimum for Tier I capital to risk weighted assets is 4% and the minimum for Total capital (Tier I plus Tier II) to risk weighted assets is 8%. The Tier I leverage ratio measures Tier I capital to average assets and must be a minimum of 3%. As reflected in Table 5, at March 31, 2006 and at December 31, 2005, the Corporation was well in excess of the minimum capital and leverage requirements necessary to be considered a well capitalized banking company.

The FDIC has adopted a risk-based insurance premium system based in part on a bank's capital adequacy. Under this system a depository institution is classified as well capitalized, adequately capitalized, or undercapitalized according to its regulatory capital levels. Subsequently, a financial institution's premium levels are based on these classifications and its regulatory supervisory rating (the higher the classification the lower the premium). It is the Corporation's goal to maintain capital levels sufficient to retain a designation of well capitalized.



Table 5

|                                     | Capital Ratios                               |                   |   |                   |
|-------------------------------------|--|-------------------|---|-------------------|
|                                     | Regulatory Minimum<br>For "Well Capitalized" | March 31,<br>2006 | Fentura Financial, Inc.<br>December 31,<br>2005 | March 31,<br>2005 |
| Total Capital to risk               |  |                   |   |                   |
| Weighted assets                     | 10%  | 11.84%            | 11.40%  | 11.22%            |
| Tier 1 Capital to risk              |  |                   |   |                   |
| Weighted assets                     | 6%   | 10.61%            | 10.20%  | 10.01%            |
| Tier 1 Capital to average<br>Assets | 5%   | 8.89%             | 8.70%   | 8.35%             |

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

The information concerning quantitative and qualitative disclosures about market risk contained on page 53 in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2005, is incorporated herein by reference.

Fentura Financial, Inc. faces market risk to the extent that both earnings and the fair value of its financial instruments are affected by changes in interest rates. The Corporation manages this risk with static GAP analysis and has begun simulation modeling. For the first three months of 2006, the results of these measurement techniques were within the Corporation's policy guidelines. The Corporation does not believe that there has been a material change in the nature of the Corporation's primary market risk exposures, including the categories of market risk to which the Corporation is exposed and the particular markets that present the primary risk of loss to the Corporation, or in how those exposures have been managed in 2006 compared to 2005.

The Corporation's market risk exposure is mainly comprised of its vulnerability to interest rate risk. Prevailing interest rates and interest rate relationships in the future will be primarily determined by market factors, which are outside of the Corporation's control. All information provided in this section consists of forward-looking statements. Reference is made to the section captioned "Forward Looking Statements" in this quarterly report for a discussion of the limitations on the Corporation's responsibility for such statements.

Interest Rate Sensitivity Management

Interest rate sensitivity management seeks to maximize net interest income as a result of changing interest rates, within prudent ranges of risk. The Corporation attempts to accomplish this objective by structuring the balance sheet so that re-pricing opportunities exist for both assets and liabilities in roughly equivalent amounts at approximately the same time intervals. Imbalances in these re-pricing opportunities at any point in time constitute a bank's interest rate sensitivity. The Corporation currently does not utilize derivatives in managing interest rate risk.

An indicator of the interest rate sensitivity structure of a financial institution's balance sheet is the difference between rate sensitive assets and rate sensitive liabilities, and is referred to as "GAP".

Table 6 sets forth the distribution of re-pricing of the Corporation's earning assets and interest bearing liabilities as of March 31, 2006, the interest rate sensitivity GAP, as defined above, the cumulative interest rate sensitivity GAP, the interest rate sensitivity GAP ratio (i.e. interest rate sensitive assets divided by interest rate sensitive liabilities) and the cumulative sensitivity GAP ratio. The table also sets forth the time periods in which earning assets and liabilities will mature or may re-price in accordance with their contractual terms.

Table 6 GAP Analysis March 31, 2006

| (000's omitted)                           | Within<br>Three<br>Months | Three<br>Months to<br>One Year | One to<br>Five<br>Years | After<br>Five<br>Years | Total             |
|---|---------------------------|--------------------------------|-------------------------|------------------------|-------------------|
| <b>Earning Assets:</b>                    |                           |                                |                         |                        |                   |
| Federal Funds Sold                        | \$ 8,650                  | \$ 0                           | \$ 0                    | \$ 0                   | \$ 8,650          |
| Securities                                | 19,860                    | 19,753                         | 51,518                  | 17,481                 | 108,612           |
| Loans                                     | 68,820                    | 97,855                         | 224,598                 | 61,111                 | 452,384           |
| Loans Held for Sale                       | 1,695                     | 0                              | 0                       | 0                      | 1,695             |
| FHLB Stock                                | 2,300                     | 0                              | 0                       | 0                      | 2,300             |
| <b>Total Earning Assets</b>               | <b>\$ 101,325</b>         | <b>\$ 117,608</b>              | <b>\$ 276,116</b>       | <b>\$ 78,592</b>       | <b>\$ 573,641</b> |
| <b>Interest Bearing Liabilities:</b>      |                           |                                |                         |                        |                   |
| Interest Bearing Demand Deposits          | \$ 105,391                | \$ 0                           | \$ 0                    | \$ 0                   | \$ 105,391        |
| Savings Deposits                          | \$ 118,882                | 0                              | 0                       | 0                      | 118,882           |
| Time Deposits Less than \$100,000         | 17,525                    | 47,989                         | 33,258                  | 186                    | 98,958            |
| Time Deposits Greater than \$100,000      | 42,571                    | 44,089                         | 46,422                  | 0                      | 133,082           |
| Short term borrowings                     | 20                        | 0                              | 0                       | 0                      | 20                |
| Other Borrowings                          | 15                        | 2,000                          | 11,060                  | 1,114                  | 14,189            |
| Repurchase agreements                     | 0                         | 0                              | 10,000                  | 0                      | 10,000            |
| Subordinated debentures                   | 0                         | 0                              | 14,000                  | 0                      | 14,000            |
| <b>Total Interest Bearing Liabilities</b> | <b>\$ 284,404</b>         | <b>\$ 94,078</b>               | <b>\$ 114,740</b>       | <b>\$ 1,300</b>        | <b>\$ 494,522</b> |
| Interest Rate Sensitivity GAP             | (\$183,079)               | \$ 23,530                      | \$ 161,376              | \$ 77,292              | \$ 79,119         |
| Cumulative Interest Rate                  |                           |                                |                         |                        |                   |
| Sensitivity GAP                           | (\$183,079)               | (\$159,549)                    | \$ 1,827                | \$ 79,119              |                   |
| Interest Rate Sensitivity GAP             | (0.36)                    | 1.25                           | 2.41                    | 60.46                  |                   |
| Cumulative Interest Rate                  |                           |                                |                         |                        |                   |
| Sensitivity GAP Ratio                     | (0.36)                    | (0.58)                         | (1.00)                  | 1.16                   |                   |

As indicated in Table 6, the short-term (one year and less) cumulative interest rate sensitivity gap is negative. Accordingly, if market interest rates continue to increase, this negative gap position could have a short-term negative impact on interest margin. Conversely, if market rates decline this should theoretically have a short-term positive impact. However, gap analysis is limited and may not provide an accurate indication of the impact of general interest rate movements on the net interest margin since the re-pricing of various categories of assets and liabilities is subject to the Corporation's needs, competitive pressures, and the needs of the Corporation's customers. In addition, various assets and liabilities indicated as re-pricing within the same period may in fact re-price at different times within such period and at different rate volumes. These limitations are evident when considering the Corporation's Gap position at March 31, 2006 and the change in net interest margin for the three months ended March 31, 2006 compared to the same time period in 2005. At March 31, 2006 the Corporation was negatively gapped through one year and since that time interest rates have increased further, yet net interest margin increased when the first three months of 2006 is compared to the same period in 2005. This occurred because certain deposit categories, specifically interest bearing demand and savings deposits, repriced at the same time but not at the same level as the asset portfolios resulting in an increase in net interest margin. In addition to GAP analysis, the Corporation, as a part of managing interest rate risk, also performs simulation modeling, which measures the impact of upward and downward movements of interest rates on interest margin and the market value of equity. Assuming continued success at achieving repricing of loans to higher rates at a faster pace than repricing of deposits, simulation modeling indicates that an upward movement of interest rates could have a positive impact on net interest income. Because management believes that it should be able to continue these repricing relationships, it anticipates improved performance in net interest margin as a result of a rising interest rate environment.

## Forward Looking Statements

This report includes forward-looking statements as that term is used in the securities laws. All statements regarding our expected financial position, business and strategies are forward-looking statements. In addition, the words anticipates, believes, estimates, seeks, expects, plans, intends, and similar expressions, as they relate to us or our management, are intended to identify forward-looking statements. The presentation and discussion of the provision and allowance for loan losses and statements concerning future profitability or future growth or increases, are examples of inherently forward looking statements in that they involve judgments and statements of belief as to the outcome of future events. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse affect on our operations and our future prospects include, but are not limited to, changes in: interest rates, general economic conditions, legislative/regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality or composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in our market area and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Further information concerning us and our business, including additional factors that could materially affect our financial results, is included in our other filings with the Securities and Exchange Commission.

## ITEM 4: CONTROLS AND PROCEDURES

- (a) Evaluation of Disclosure Controls and Procedures. The Corporation's Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of the Corporation's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this Form 10-Q Quarterly Report, have concluded that the Corporation's disclosure controls and procedures were adequate and effective to ensure that material information relating to the Corporation would be made known to them by others within the Corporation, particularly during the period in which this Form 10-Quarterly Report was being prepared.
- (b) Changes in Internal Controls. During the period covered by this report, there have been no changes in the Corporation's internal control over financial reporting that have materially affected or are reasonably likely to materially affect the Corporation's internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings.** - None

**Item 1A. Risk Factors** - There have been no material changes in the risk factors applicable to the Company from those disclosed in its Annual Report on Form 10-K for the year ended December 31, 2005.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.** - None

**Item 3. Defaults Upon Senior Securities.** - None

**Item 4. Submission of Matters to a Vote of Securities Holders.** - None

**Item 5. Other Information.** - None

**Item 6. Exhibits.**

(a) Exhibits

31.1 Certificate of the President and Chief Executive Officer of Fentura Financial, Inc. pursuant to 15 U.S.C. Section 7241, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certificate of the Chief Financial Officer of Fentura Financial, Inc. pursuant to 15 U.S.C. Section 7241, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certificate of the Chief Executive Officer of Fentura Financial, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certificate of the Chief Financial Officer of Fentura Financial, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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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.

Fentura Financial Inc.

/S/ Donald L. Grill

Dated: May 12, 2006

Donald L. Grill  
President & CEO

/S/ Douglas J. Kelley

Dated: May 12, 2006

Douglas J. Kelley  
Chief Financial Officer

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### EXHIBIT INDEX

| Exhibit | Description   |
|---------|---|
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