

---

---

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

**Form 10-Q**

**QUARTERLY REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2009

**TRANSITION REPORT UNDER SECTION 13 OR 15(D) OF THE EXCHANGE ACT**

For transition period to

Commission File Number: 000-51901

**Santa Lucia Bancorp**

(Exact name of registrant as specified in its charter)

**California**

(State or other jurisdiction of incorporation)

**35-2267934**

(IRS Employer Identification No.)

**7480 El Camino Real, Atascadero, CA 93422**

(Address of principal executive offices)

**805-466-7087**

(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 Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting Company

(Do not check if smaller reporting company)

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Title of Class: Common Stock, no par value; shares outstanding as of May 1, 2009: 1,923,053.

---

---

[Table of Contents](#)

| <u>Index</u>   | <u>Page</u> |
|--|-------------|
| <u>Part I — Financial Information</u>  |             |
| Item 1. <u>Consolidated Financial Statements (unaudited except year end)</u>   |             |
| <u>Consolidated Balance Sheet</u><br><u>March 31, 2009 and December 31, 2008</u>   | 3           |
| <u>Consolidated Statements of Income</u><br><u>for three months ended</u><br><u>March 31, 2009 and March 31, 2008</u>                                | 4           |
| <u>Consolidated Statements of Cash Flows</u><br><u>for three months ended</u><br><u>March 31, 2009 and March 31, 2008</u>                            | 5           |
| <u>Consolidated Statement of Stockholders' Equity</u><br><u>for three months ended</u><br><u>March 31, 2009 and the year ended December 31, 2008</u> | 6           |
| <u>Notes to Consolidated Financial Statements</u>  | 7 - 10      |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>   | 11 - 22     |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>  | 23          |
| Item 4T. <u>Controls and Procedures</u>  | 23          |
| <u>Part II—Other Information</u>   |             |
| Item 1. <u>Legal Proceedings</u>   | 24          |
| Item 1A. <u>Risk Factors</u>   | 24          |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>   | 24          |
| Item 3. <u>Defaults Upon Senior Securities</u>   | 24          |
| Item 4. <u>Submission of Matters to a Vote of Security Holders</u>   | 24          |
| Item 5. <u>Other Information</u>   | 25          |
| Item 6. <u>Exhibits</u>  | 25          |
| <u>Signatures</u>  | 25          |
| <u>Exhibit Index</u>   | 26          |
| <u>Certifications</u>  |             |

**PART I - FINANCIAL INFORMATION**

**ITEM I - Financial Statements**

**Santa Lucia Bancorp  
Consolidated Balance Sheets**  
(in thousands)

|   | <u>31-Mar-09</u><br>(unaudited) | <u>31-Dec-08</u>  |
|---|---------------------------------|-------------------|
| <b>Assets</b>   |                                 |                   |
| Cash and due from banks   | \$ 8,498                        | \$ 8,220          |
| Federal funds sold  | —                               | —                 |
| Total cash and cash equivalents   | <u>8,498</u>                    | <u>8,220</u>      |
| Securities available for sale   | 37,363                          | 38,471            |
| Loans, net  | 195,191                         | 186,632           |
| Premises and equipment, net   | 8,995                           | 8,624             |
| Cash surrender value of life insurance  | 5,243                           | 5,195             |
| Federal Reserve Bank and Federal Home Loan Bank stock, at cost  | 1,517                           | 1,517             |
| Accrued interest and other assets   | 3,232                           | 3,221             |
| Total Assets  | <u>\$ 260,039</u>               | <u>\$ 251,880</u> |
| <b>Liabilities and Shareholders' Equity</b>   |                                 |                   |
| Deposits:   |                                 |                   |
| Noninterest-bearing demand  | \$ 71,092                       | \$ 75,155         |
| Interest-bearing demand and NOW accounts  | 14,147                          | 12,889            |
| Money market  | 29,405                          | 26,214            |
| Savings   | 26,968                          | 26,754            |
| Time certificates of deposit of \$100,000 or more   | 43,838                          | 37,894            |
| Other time certificates   | 35,101                          | 33,411            |
| Total Deposits  | <u>220,551</u>                  | <u>212,317</u>    |
| Short-term borrowings   | 5,000                           | 5,000             |
| Long-term debt  | 6,655                           | 6,822             |
| Accrued interest and other liabilities  | 2,539                           | 2,190             |
| Total Liabilities   | <u>234,745</u>                  | <u>226,329</u>    |
| Commitments and contingencies   | —                               | —                 |
| Shareholders' equity  |                                 |                   |
| Preferred Stock - Series A  | 3,809                           | 3,799             |
| Common stock - no par value; authorized 20,000,000 shares; Issued and outstanding, 1,923,053 shares at March 31, 2009 and 1,923,053 shares at December 31, 2008 | 9,895                           | 9,894             |
| Additional Paid-in Capital  | 711                             | 677               |
| Retained earnings   | 10,392                          | 10,683            |
| Accumulated other comprehensive income-net unrealized gains on available-for-sale securities, net of taxes  | 487                             | 498               |
| Total shareholders' equity  | <u>25,294</u>                   | <u>25,551</u>     |
| Total liabilities and shareholders' equity  | <u>\$ 260,039</u>               | <u>\$ 251,880</u> |

(see accompanying notes)

[Table of Contents](#)

**Santa Lucia Bancorp  
Consolidated Statements of Income**  
(in thousands except per share data)

|                 | <b>For the three month period ending</b> |                                 |
|-----------------|--|---------------------------------|
|                 | <u>31-Mar-09</u><br>(unaudited)          | <u>31-Mar-08</u><br>(unaudited) |
| Interest Income |  |                                 |

|   |    |              |    |              |
|---|----|--------------|----|--------------|
| Interest and fees on loans                          | \$ | 3,050        | \$ | 3,378        |
| Federal funds sold                                  |    | —            |    | 3            |
| Investment securities                               |    | 413          |    | 669          |
|   |    | <u>3,463</u> |    | <u>4,050</u> |
| Interest expense                                    |    |              |    |              |
| Time certificates of deposit of \$100,000 or more   |    | 279          |    | 426          |
| Other deposits                                      |    | 391          |    | 549          |
| Short-term borrowings                               |    | 38           |    | 59           |
| Long-term debt                                      |    | 57           |    | 120          |
|   |    | <u>765</u>   |    | <u>1,154</u> |
| Net interest income                                 |    | 2,698        |    | 2,896        |
| Provision for credit losses                         |    | 240          |    | —            |
| Net interest income after provision for loan losses |    | <u>2,458</u> |    | <u>2,896</u> |
| Noninterest income                                  |    |              |    |              |
| Service charges and fees                            |    | 121          |    | 149          |
| Gain on sale of investment securities               |    | 92           |    | 108          |
| Other income  |    | 110          |    | 98           |
|   |    | <u>323</u>   |    | <u>355</u>   |
| Noninterest expense                                 |    |              |    |              |
| Salaries and employee benefits                      |    | 1,380        |    | 1,416        |
| Occupancy   |    | 167          |    | 160          |
| Equipment   |    | 165          |    | 158          |
| Professional services                               |    | 153          |    | 149          |
| Data processing                                     |    | 132          |    | 122          |
| Office related expenses                             |    | 102          |    | 97           |
| Marketing   |    | 101          |    | 105          |
| Regulatory assessments                              |    | 45           |    | 34           |
| Directors' fees and expenses                        |    | 88           |    | 81           |
| Other   |    | 98           |    | 86           |
|   |    | <u>2,431</u> |    | <u>2,408</u> |
| Earnings before income taxes                        |    | 350          |    | 843          |
| Income taxes  |    | 119          |    | 323          |
| Net Earnings  | \$ | <u>231</u>   | \$ | <u>520</u>   |
| Per Share Data                                      |    |              |    |              |
| Net Earnings - basic                                | \$ | <u>0.10</u>  | \$ | <u>0.27</u>  |
| Net Earnings - diluted                              | \$ | <u>0.10</u>  | \$ | <u>0.26</u>  |

(see accompanying notes)

[Table of Contents](#)

**Santa Lucia Bancorp**  
**Consolidated Statements of Cash Flow**  
(in thousands)

|   | (For the three month period ended) |           |
|---|------------------------------------|-----------|
|   | 31-Mar-09                          | 31-Mar-08 |
| <b>Cash flows from operating activities:</b>  |                                    |           |
| Net earnings  | \$                                 | 231       |
| Adjustments to reconcile net earnings to net cash provided by operating activities: |                                    |           |
| Depreciation and amortization   |                                    | 157       |
| Provision for loan losses   |                                    | 240       |
|   |                                    | <u>—</u>  |

|  |                 |                  |
|--|-----------------|------------------|
| Stock-based compensation expense                         | 34              | 36               |
| Gain on sale of investment securities                    | (92)            | (108)            |
| Other items, net   | 753             | 1,087            |
| <b>Net cash provided by operating activities</b>         | <b>1,323</b>    | <b>1,697</b>     |
| <b>Cash flows from investing activities:</b>             |                 |                  |
| Proceeds from maturities of investment securities        | 2,634           | 3,574            |
| Proceeds from sale of investment securities              | 2,555           | 5,513            |
| Purchases of investment securities                       | (4,000)         | —                |
| Net change in loans                                      | (9,263)         | (543)            |
| Purchases of bank premises and equipment                 | (527)           | (79)             |
| <b>Net cash provided (used) by investing activities</b>  | <b>(8,601)</b>  | <b>8,465</b>     |
| <b>Cash flows from financing activities:</b>             |                 |                  |
| Net change in deposits                                   | 8,234           | (277)            |
| Proceeds and tax benefit from exercise of stock options  | —               | 15               |
| Net change in borrowings                                 | (166)           | (900)            |
| Dividends paid on Preferred Stock                        | (31)            | —                |
| Cash dividends paid Common Stock                         | (481)           | (482)            |
| Stock repurchases  | —               | (79)             |
| <b>Net cash provided (used) by financing activities</b>  | <b>7,556</b>    | <b>(1,723)</b>   |
| <b>Net increase in cash and cash equivalents</b>         | <b>278</b>      | <b>8,439</b>     |
| Cash and cash equivalents at beginning of year           | 8,220           | 7,399            |
| Cash and cash equivalents at end of year                 | <u>\$ 8,498</u> | <u>\$ 15,838</u> |
| <b>Supplemental disclosure of cash flow information:</b> |                 |                  |
| Interest paid  | \$ 796          | \$ 1,144         |
| Income taxes paid  | \$ —            | \$ —             |
| Transfer of loans to Other Real Estate Owned             | \$ 464          | \$ —             |

[Table of Contents](#)

**Santa Lucia Bancorp**  
**Consolidated Statement of Shareholders' Equity**  
(in thousands except shares outstanding)

**For year ending December 31, 2008 and the period ending March 31, 2009**

|   | Comprehensive<br>Income | Preferred Stock | Common Stock          |           | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income |
|---|-------------------------|-----------------|-----------------------|-----------|----------------------------------|----------------------|---|
|   |                         |                 | Shares<br>Outstanding | Amount    |                                  |                      |   |
| <b>Balance at January 1, 2008</b>   |                         |                 | 1,924,873             | 9,851,392 | 358,203                          | 10,782,741           | 196,510   |
| Cash dividends - \$0.50 per share   |                         |                 |                       |           |                                  | (962,534)            |   |
| Exercise of stock options, including the realization of tax benefits of \$19,000                    |                         |                 | 4,360                 | 43,115    | 19,000                           | (27,725)             |   |
| Repurchase and retirement of stock  |                         |                 | (6,180)               |           |                                  | (146,649)            |   |
| Cumulative - effect adjustment of change in accounting for split-dollar life insurance arrangements |                         |                 |                       |           |                                  | (101,815)            |   |
| Preferred Stock - Series A  |                         | 3,799,003       |                       |           | 150,997                          |                      |   |
| Stock Option Compensation Expense   |                         |                 |                       |           | 148,534                          |                      |   |
| <b>Comprehensive Income:</b>  |                         |                 |                       |           |                                  |                      |   |
| Net earnings for the year   | \$ 1,138,904            |                 |                       |           |                                  | 1,138,904            |   |
| Change in unrealized gain on available-for-sale securities, net of taxes of \$255,702               | 364,837                 |                 |                       |           |                                  |                      | 364,837   |
| Less reclassification adjustment for gains included in net income, deferred of tax of \$44,347      | (63,816)                |                 |                       |           |                                  |                      | (63,816)  |
| <b>Total Comprehensive Income</b>   | <u>\$ 1,439,925</u>     |                 |                       |           |                                  |                      |   |

| <b>Balance at December 31, 2008</b>   |                             |                        |                           |               |                                   |                          |   |
|---|-----------------------------|------------------------|---------------------------|---------------|-----------------------------------|--------------------------|---|
|   |                             | \$ 3,799,003           | 1,923,053                 | \$ 9,894,507  | \$ 676,734                        | \$ 10,682,922            | \$ 497,531                                    |
|   | <b>Comprehensive Income</b> | <b>Preferred Stock</b> | <b>Common Stock</b>       |               | <b>Additional Paid-in Capital</b> | <b>Retained Earnings</b> | <b>Accumulated Other Comprehensive Income</b> |
|   |                             |                        | <b>Shares Outstanding</b> | <b>Amount</b> |                                   |                          |   |
| <b>Balance at December 31, 2008</b>   |                             | 3,799,003              | 1,923,053                 | 9,894,507     | 676,734                           | 10,682,922               | 497,531                                       |
| Dividend Preferred Stock  |                             |                        |                           |               |                                   | (31,111)                 |   |
| Common Cash dividends - \$0.25 per share  |                             |                        |                           |               |                                   | (480,763)                |   |
| Accretion on Preferred Stock  |                             | 10,049                 |                           |               |                                   | (10,049)                 |   |
| Stock Option Compensation Expense   |                             |                        |                           |               | 34,068                            |                          |   |
| <b>Comprehensive Income:</b>  |                             |                        |                           |               |                                   |                          |   |
| Net earnings for the year   | \$ 231,201                  |                        |                           |               |                                   | 231,201                  |   |
| Change in unrealized gain on available-for-sale securities, net of taxes of \$30,606      | 43,590                      |                        |                           |               |                                   |                          | 43,590  |
| Less reclassification adjustment for gains included in net income, net of tax of \$37,906 | (53,988)                    |                        |                           |               |                                   |                          | (53,988)                                      |
| <b>Total Comprehensive Income</b>   | \$ 220,803                  |                        |                           |               |                                   |                          |   |
| <b>Balance at March 31, 2009</b>  |                             | \$ 3,809,052           | 1,923,053                 | \$ 9,894,507  | \$ 710,802                        | \$ 10,392,200            | \$ 487,133                                    |

6

[Table of Contents](#)

SANTA LUCIA BANCORP

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

March 31, 2009

**Note 1 Bases of Presentation:**

The accompanying unaudited condensed consolidated financial statements of Santa Lucia Bancorp (the "Company") and its subsidiary Santa Lucia Bank (the "Bank") have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). The unaudited condensed financial statements further assume that the holding company reorganization involving the Bank and Company was effective March 31, 2006 rather than the actual effectiveness of April 3, 2006. Certain information and footnote disclosures, normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such SEC rules and regulations. Nevertheless, the Company believes that the disclosures are adequate to make the information presented not misleading. These interim condensed consolidated financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Bank's 2008 Annual Report as filed on Form 10K.

In the opinion of management, all adjustments, including normal recurring adjustments necessary to present fairly the financial position of the Company with respect to the interim consolidated financial statements and the results of its operations for the interim period ended March 31, 2009, have been included. The results of operations for interim periods are not necessarily indicative of the results for a full year.

**Note 2 Loans and Related Allowance for Loan Losses:**

A summary of loans as of March 31, 2009 and December 31, 2008 is as follows:

|                            | <b>(in thousands)</b> |                   |
|----------------------------|-----------------------|-------------------|
|                            | <b>31-Mar-09</b>      | <b>31-Dec-08</b>  |
| Real estate - construction | \$ 58,471             | \$ 52,389         |
| Real estate - other        | 98,341                | 94,372            |
| Commercial                 | 39,443                | 41,478            |
| Consumer                   | 1,741                 | 1,415             |
| <b>Gross Loans</b>         | <b>197,996</b>        | <b>189,654</b>    |
| Deferred loan fees         | (673)                 | (712)             |
| Allowance for loan losses  | (2,132)               | (2,310)           |
| <b>Net Loans</b>           | <b>\$ 195,191</b>     | <b>\$ 186,632</b> |

The Bank's loan portfolios consist primarily of loans to borrowers within the San Luis Obispo and northern Santa Barbara Counties, California.

Although the Bank seeks to avoid concentrations of loans to a single industry or based upon a single class of collateral, real estate and real estate associated businesses are among the principal industries in the Bank's market areas. As a result, the Bank's loan and collateral portfolios are, to some degree, concentrated in those industries. When real estate is taken as collateral, advances are generally limited to a certain percentage of the appraised value of the collateral at the time the loan is made, depending on the type of loan, the underlying property and other factors.

The Bank's Allowance for loan losses as a percentage of total loans was 1.08% as of March 31, 2009 a decrease of 0.14% compared to 1.22% as of December 31, 2008. The decrease in the allowance for loan loss is primarily due to charged of loans during the first quarter 2009. Management believes that the Allowance for loan losses at March 31, 2009 is adequate based upon its analysis of the loan portfolio and the methodologies used for this purpose.

[Table of Contents](#)

*Concentration of Credit Risk.* As of March 31, 2009, real estate served as the principal source of collateral with respect to approximately 77.8% of our loan portfolio, of which, 56.2% is considered commercial real estate (CRE). Within the makeup of our CRE, approximately 43.3% of our commercial term loans are granted for owner use, which is repaid from the cash flow of the owner's business. We believe that this factor coupled with the diversification of business types, location, conservative underwriting and loss history further mitigates the risk in our CRE portfolio. The Bank targets commercial term loans for owners use as it supports the local business economy. The Bank believes that owner occupied properties do not carry the same risk as commercial strip centers and other income properties with higher vacancy factors that rely on third parties for repayment.

The Bank also targets experienced local builders that are active in residential construction for owner's use, spec construction and small-scale residential construction projects. The Bank originates loans on a limited number of large projects and 18.9% of our construction loans are in owner occupied residential construction and commercial properties for owner use.

A continued decline in current economic conditions and the declining interest rates have had an effect on the demand for new loans, the ability of borrowers to repay outstanding loans, the value of real estate and other collateral securing loans and the value of real estate owned by us, as well as our financial condition and results of operations in general.

**Note 3 Commitments and Contingencies**

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those commitments. Commitments to extend credit (such as the unfunded portion on lines of credit and commitments to fund new loans) as of March 31, 2009 and 2008 amounts to approximately \$54,433,000 and \$60,095,000 respectively, of which approximately \$2,758,000 and \$4,045,000 are related to standby letters of credit, respectively. The Bank uses the same credit policies in these commitments as for all of its lending activities. As such, the credit risk involved in these transactions is essentially the same as that involved in extending loan facilities to customers.

Because of the nature of its activities, the Company and Bank are from time to time subject to pending and threatened legal actions, which arise out of the normal course of their business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the Company's financial position, results of operations or liquidity.

**Note 4 Earnings Per Share**

Basic earnings per share are based on the weighted average number of shares outstanding before any dilution from common stock equivalents. Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shares in the earnings of the entity.

The following is a reconciliation of the net income and shares outstanding to the income and number of shares used to compute EPS:

|  | Three Months Ending<br>31-Mar-09 |                         | Three Months Ending<br>31-Mar-08 |                         |
|--|----------------------------------|-------------------------|----------------------------------|-------------------------|
|  | Income<br>(Numerator)            | Shares<br>(Denominator) | Income<br>(Numerator)            | Shares<br>(Denominator) |
| Net income                                   | \$ 231                           |                         | \$ 520                           |                         |
| Less dividends Preferred Stock               | \$ (41)                          |                         |                                  |                         |
| Average shares outstanding                   |                                  | 1,923,053               |                                  | 1,925,842               |
| <b>Used in Basic EPS</b>                     |                                  | 190                     | 520                              | 1,925,842               |
| Dilutive effect of outstanding stock options |                                  | 10,605                  |                                  | 53,706                  |
| <b>Used in Diluted EPS</b>                   | <u>\$ 190</u>                    | <u>1,933,658</u>        | <u>\$ 520</u>                    | <u>1,979,548</u>        |

---

[Table of Contents](#)
**Note 5 Stock Based Compensation**

The Company has two stock option plans, which are fully described in Note K in the Bank's Annual Report on Form 10-K. On January 1, 2006, the Company implemented Statement of Financial Accounting Standards 123R, "Share-Based Payments" ("SFAS 123R") which replaced SFAS 123 and supersedes APB Opinion No. 25 and the related implementation guidance. SFAS 123R addresses accounting for equity-based compensation arrangements, including employee stock options. The Company adopted the "modified prospective method" where stock-based compensation expense is recorded beginning on the adoption date and prior periods are not restated. Under this method, compensation expense is recognized using the fair-value based method for all new awards granted after January 1, 2006. Additionally, compensation expense for unvested options that were outstanding at December 31, 2005 is recognized over the requisite service period based on the fair value of those options as previously calculated under the pro forma disclosures of SFAS 123.

**Note 6- Fair Value Measurement**

SFAS No. 159, "*The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115*", became effective January 1, 2008. The Company has not elected to fair value any existing financial instruments under SFAS No. 159.

Effective January 1, 2008, upon adoption of SFAS 157, "*Fair Value Measurements*", we group our financial assets and financial liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

- Level 1 – Valuations for assets and liabilities traded in active exchange markets, such as the New York exchange. Level 1 also includes U.S. Treasury, other U.S. government and agency mortgage-backed securities that are traded by dealers or brokers in active markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.
- Level 2 – Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from third party pricing services for identical or comparable assets or liabilities.
- Level 3 – Valuations for assets and liabilities that are derived from other valuation methodologies, including option pricing models, discounted cash flow models and similar techniques, and not based on market exchange, dealer, or broker traded transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities.

The only assets and liabilities measured at fair value on a recurring basis is our securities available for sale which totaled \$37.4 million which are valued using level 2 valuation.

**Note 7— Recently Issued Accounting Pronouncements**

In April 2009, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position ("FSP") FAS 157-4, "*Determining Whether a Market Is Not Active and a Transaction Is Not Distressed*," FSP FAS 157-4 provides guidelines for making fair value measurements more consistent with the principles presented in SFAS 157. FSP FAS 157-4 provides additional authoritative guidance in determining whether a market is active or inactive, and whether a transaction is distressed, is applicable to all assets and liabilities (i.e. financial and nonfinancial) and will require enhanced disclosures.

In April 2009, the FASB issued FSP FAS 115-2, FAS 124-2, and EITF 99-20-2, "*Recognition and Presentation of Other-Than-Temporary Impairments*," The FSP amends FASB Statements No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, and EITF Issue No. 99-20, "*Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets*," to make the other-than-temporary impairment guidance more operational and to improve the presentation of other-than-temporary impairments in the financial statements. This statement applies to other-than-temporary impairments of debt and equity securities and requires a company to assert that (a) it does not have the intent to sell the security in question and (b) it is more likely than not that it will not have to sell the security in question before recovery of its cost basis to avoid an impairment being considered other-than-temporary. This FSP also changes the amount of impairment losses recognized in earnings. Under



this FSP impairments are separated into two components: (i) the amount of impairments related to credit losses and (ii) and the amount related to other factors. The amount of impairment related to credit losses is reflected as a charge to earnings, while the amount deemed to be related to other factors is reflected as an adjustment to shareholders' equity through other comprehensive income.

In April 2009 the FASB issued FSP FAS 107-1 and APB 28-1, "Interim Disclosures about Fair Value of Financial Instrument." FSP FAS 107-1 and APB 28-1, amends FASB Statement No. 107, "Disclosures about Fair Value of Financial Instruments," to require disclosures about fair value of financial instruments in interim as well as in annual financial statements. This FSP also amends APB Opinion No. 28, "Interim Financial Reporting," to require those disclosures in all interim financial statements.

The standards summarized in the preceding paragraphs are effective for periods ending after June 15, 2009. The Company is currently determining the impact these standards will have on their financial statements.

---

[Table of Contents](#)

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

The following is management's discussion and analysis of the major factors that influenced our financial performance for the three months ended March 31, 2009. This analysis should be read in conjunction with the Company's 2008 Annual Report as filed on Form 10-K and with the unaudited financial statements and notes as set forth in this report. *Unless the context requires otherwise, the terms "Company," "us," "we," and "our" refers to Santa Lucia Bancorp on a consolidated basis.*

### **FORWARD LOOKING INFORMATION**

**Certain statements contained in this Quarterly Report on Form 10-Q ("Report"), including, without limitation, statements containing the words "estimate," "believes," "anticipates," "intends," "may," "expects," "could," and words of similar import, constitute "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements relate to, among other things, our current expectations regarding future operating results, net interest margin, strength of the local economy, and allowance for credit losses. Such forward looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others, the following: the current economic downturn and turmoil in financial markets and the response of federal and state regulators thereto, the effect of changing regional and national economic conditions; significant changes in interest rates and prepayment speeds; credit risks of lending and investment activities; changes in federal and state banking laws or regulations; competitive pressure in the banking industry; changes in governmental fiscal or monetary policies; uncertainty regarding the economic outlook resulting from the continuing war on terrorism, as well as actions taken or to be taken by the U.S. or other governments as a result of further acts or threats of terrorism; and other factors discussed in Item 1A. Risk Factors of the company's 2008 Annual Report as filed on Form 10-K. Readers are cautioned not to place undue reliance on these forward-looking statements which speak only as of the date hereof. The Company undertakes no obligation to update any forward-looking statements to reflect events or circumstances arising after the date on which they are made.**

This discussion should be read in conjunction with our financial statements, including the notes thereto, appearing elsewhere in this report.

### **EXECUTIVE OVERVIEW**

#### **General**

Santa Lucia Bancorp (the "Company") (OTC Bulletin Board SLBA.OB) is a California corporation organized in 2006 to act as the holding company for Santa Lucia Bank (the "Bank"), a four office bank serving San Luis Obispo and northern Santa Barbara Counties.

The Company reported financial results driven by the economic realities in its market areas, California and the United States in general. Net income for the three months ended March 31, 2009 decreased 55.6% to \$231 thousand compared to \$520 thousand for the comparable period in 2008. Diluted earnings per share decreased \$0.16 to \$0.10 from \$0.26 for the same period in 2008. The primary reasons for the decrease in net earnings, return on average assets and return on average equity was the 56 basis point decrease in the Company's net interest margin from 5.21% for the three months ending March 31, 2008 to 4.65% for the same period in 2009, coupled with the \$240,000 addition to the loan loss provision. Net Interest Income for the three months ended March 31, 2009 decreased \$198,000 or 6.8% to \$2,698,000 compared to \$2,896,000 for the same period in 2008. Interest income decreased \$587,000 or 14.5% for the first three months of 2009, from \$4,050,000 in 2008, to \$3,463,000 in 2008. This decrease was primarily due to the decrease in the net interest margin caused by a 200 basis point drop in the prime lending rate during the past twelve months as the average rate paid on interest earning assets declined from 7.28% at March 31, 2008 to 5.97% at March 31, 2009.

[Table of Contents](#)

Interest expense decreased \$389,000 or 33.7% from \$1,154,000 as of March 31, 2008, to \$765,000 as of March 31, 2009. This was due to a 114 basis point decrease in the average rate paid on interest bearing liabilities from 3.11% as of March 31, 2008 to 1.97% as of March 31, 2009.

The Company's return on average assets declined from 0.84% as of March 31, 2008 to 0.36% for the same period in 2009, which represents a 57.1% decline. At the same time we have seen the return on average equity decrease from 9.52% as of March 31, 2008 to 3.61% for the same period in 2009. Total Stockholders Equity increased \$3,694,000 or 17.1% from \$21,600,000 as of March 31, 2008 to \$25,294,000 for the same period in 2009. The increase in the Shareholders Equity was primarily due to the Company's previously announced participation in the United States Treasury's Capital Purchase Program.

Noninterest income for the three months ended March 31, 2009 decreased 9.0% to \$323 thousand compared to \$355 thousand for the comparable period in 2008. The decrease is primarily due to the reduction in non-sufficient funds charges collected on customer accounts. Management believes customers are better managing their accounts by utilizing internet banking services the company provides.

Noninterest expense for the three months ended March 31, 2009 increased by 1.0% or \$23 thousand to \$2.4 million compared to \$2.4 million for the same period in 2008. The increase in noninterest expense was primarily attributed to legal fees related to the collection of non-accrual loans.

Net loans increased \$8.6 million or 4.6% during the three months ending March 31, 2009 compared to an increase of \$543 thousand or 0.3% for the same period ending March 31, 2008. Total real estate loans increased \$10.0 million and commercial loans decreased \$2.0 million during the first three months of 2009. Construction loans increased \$6.0 million or 11.6% while real estate loans increased \$4.0 million or 4.2% to \$98.3 million and commercial loans decreased \$2.0 million or 5.0% to \$39.4 million for the first three months of 2009 compared to December 31, 2008.

Gross loans increased \$28.6 million or 16.9% as of March 31, 2009 compared to March 31, 2008. Construction loans increased \$11.1 million or 23.5%, real estate loans increased \$15.9 million or 19.2% and commercial loans increased \$1.1 million or 2.8% for the same period.

Deposits increased \$8.2 million or 3.9% during the first three months of 2008 compared to a decrease of \$277 thousand or 0.1% during the same period in 2008. Non-interest bearing demand deposits decreased \$4.0 million or 5.4% during the three month period ending March 31, 2009, while interest bearing deposits increased \$12.2 million or 9.0%.

As of March 31, 2009 compared to March 31, 2008 deposits increased \$8.1 million or 3.8% overall. Non interest bearing deposit decreased \$4.6 million or 6.1%, interest bearing demand deposits increased \$1.0 million or 7.3%, money market accounts increased \$4.2 million or 16.8%, savings increased \$1.0 million or 3.7% and time certificates increased \$6.6 million or 8.9%.

[Table of Contents](#)
**SELECTED FINANCIAL INFORMATION**

|   | (in thousands, except share data and ratios) |          |         |
|---|--|----------|---------|
|   | Unaudited                                    |          |         |
|   | Three Months Ended<br>March 31,              |          | %       |
| 2009  | 2008   | Change   |         |
| <b>Summary of Operations:</b>                       |  |          |         |
| Interest Income                                     | \$ 3,463                                     | \$ 4,050 | -14.49% |
| Interest Expense                                    | 765  | 1,154    | -33.71% |
| Net Interest Income                                 | 2,698  | 2,896    | -6.84%  |
| Provision for Loan Loss                             | 240  | —        | —       |
| Net Interest Income After Provision for Loan Losses | 2,458  | 2,896    | -15.12% |
| Noninterest Income                                  | 323  | 355      | -9.01%  |
| Noninterest Expense                                 | 2,431  | 2,408    | 0.96%   |
| Income Before Income Taxes                          | 350  | 843      | -58.48% |
| Income Taxes  | 119  | 323      | -63.16% |

|                                     |    |     |    |     |         |
|-------------------------------------|----|-----|----|-----|---------|
| Net Income                          | \$ | 231 | \$ | 520 | -55.58% |
| Cash Dividends Paid                 | \$ | 481 | \$ | 482 | -0.21%  |
| Cash Dividends Paid Preferred Stock | \$ | 31  | \$ | —   |         |

#### Per Common Share Data:

|                      |    |       |    |       |         |
|----------------------|----|-------|----|-------|---------|
| Net Income - Basic   | \$ | 0.10  | \$ | 0.27  | -62.96% |
| Net Income - Diluted | \$ | 0.10  | \$ | 0.26  | -61.54% |
| Dividends            | \$ | 0.250 | \$ | 0.250 | 0.00%   |
| Book Value           | \$ | 11.07 | \$ | 11.21 | -1.25%  |

|                                   |  |           |  |           |        |
|-----------------------------------|--|-----------|--|-----------|--------|
| <b>Common Outstanding Shares:</b> |  | 1,923,053 |  | 1,925,983 | -0.15% |
|-----------------------------------|--|-----------|--|-----------|--------|

#### Statement of Financial Condition Summary:

|                            |    |         |    |         |        |
|----------------------------|----|---------|----|---------|--------|
| Total Assets               | \$ | 260,039 | \$ | 248,559 | 4.62%  |
| Total Deposits             |    | 220,551 |    | 212,441 | 3.82%  |
| Total Net Loans            |    | 195,191 |    | 167,162 | 16.77% |
| Allowance for Loan Losses  |    | 2,132   |    | 1,616   | 31.93% |
| Total Shareholders' Equity |    | 25,294  |    | 21,600  | 17.10% |

#### Selected Ratios:

|  |  |        |  |        |         |
|--|--|--------|--|--------|---------|
| Return on Average Assets                             |  | 0.36%  |  | 0.84%  | -57.14% |
| Return on Average Equity                             |  | 3.61%  |  | 9.52%  | -62.07% |
| Net interest margin                                  |  | 4.65%  |  | 5.21%  | -10.75% |
| Average Loans as a Percentage of Average Deposits    |  | 91.17% |  | 79.68% | 14.42%  |
| Allowance for Loan Losses to Total Loans             |  | 1.08%  |  | 0.95%  | 13.68%  |
| Tier I Capital to Average Assets - "Bank Only"       |  | 11.11% |  | 9.88%  | 12.45%  |
| Tier I Capital to Risk-Weighted Assets - "Bank Only" |  | 13.07% |  | 12.37% | 5.66%   |
| Total Capital to Risk-Weighted Assets - "Bank Only"  |  | 14.45% |  | 13.83% | 4.48%   |
| Tier I Capital to Average Assets - "Bancorp"         |  | 11.76% |  | 10.56% | 11.36%  |
| Tier I Capital to Risk-Weighted Assets - "Bancorp"   |  | 13.85% |  | 13.24% | 4.61%   |
| Total Capital to Risk-Weighted Assets - "Bancorp"    |  | 15.23% |  | 14.70% | 3.61%   |

## [Table of Contents](#)

### KEY FACTORS IN EVALUATING FINANCIAL CONDITION AND OPERATING PERFORMANCE

As a publicly traded community bank holding company, we focus on several key factors including:

- Return to our shareholders
- Return on average assets
- Asset quality
- Asset growth
- Operating efficiency

*Return to our shareholders.* Our return to our shareholders is measured in the form of return on average equity, or ROAE. Our net income decreased 55.6% to \$231 thousand for the quarter ended March 31, 2009 from \$520 thousand for the same period in 2008. The Company is asset sensitive, which means when interest rates decrease, the Company's variable rate loans reprice more rapidly than its fixed rate deposits. In a declining interest rate environment, this has a negative effect on net interest margin. The primary reason for the decrease in EPS was the Federal Reserve Bank actions that reduced the Bank's Prime Lending Rate by 2.0% in the last three quarters of 2008, following a 2.0% decrease in the in the first quarter of 2008. This caused the Company's net interest margin to decrease from 5.2% to 4.7% when comparing March 31, 2008 to March 31, 2009. Net interest income was \$2.7 million at March 31, 2009 compared to \$2.9 million at March 31, 2008, or \$200 thousand less due primarily to declining yields on our variable rate loans. Basic and diluted earnings per share for the quarter ended March 31, 2009 were \$0.10, and \$0.10, respectively, which compares to \$0.27 and \$0.26 for the quarter ended March 31, 2008. ROAE for the quarter ending March 31, 2009, decreased to 3.6% compared to 9.5% for the same period in 2008.

*Return on Average Assets.* Our return on average assets, or ROAA, is a measure we use to compare our performance with other bank's and bank holding companies. ROAA for the quarter ended March 31, 2009 was 0.36% compared to 0.84% for the same period in 2008 primarily due to the reductions in net interest income and in net interest margin.

*Asset Quality.* For all bank's and bank holding companies, asset quality has a significant impact on overall financial condition and results of operations. Asset quality is measured in terms of nonperforming loans and assets as a percentage of total assets and net charge-offs as a percentage of average loans. These measures are key elements in estimating the future earnings of a company. There were three nonperforming loans totaling \$1,058,000 as of March 31, 2009 compared to three loans totaling \$1,614,000 at December 31, 2008 and \$2,119,000 at March 31, 2008. Nonperforming loans as a percentage of total loans decreased to 0.53% as of March 31, 2009, compared to 0.85% at December 31, 2008 and 1.25% as of March 31, 2008, due primarily to \$418 thousand in charged off loans and \$464 thousand in Other Real Estate Loans. Charge-offs to gross loans were 0.21% for the three months ended March 31, 2009, compared to 0.19% as of December 31, 2008 and 0.03% as of March 31, 2008. Allowance for loan losses increased 31.9% to \$2.1 million when comparing March 31, 2009 to March 31, 2008.

*Asset Growth.* Total assets of \$260.0 million increased \$8.2 million or 3.2% for the period ending March 31, 2009 compared to December 31, 2008. Total assets for the period ending March 31, 2009 of \$260.0 million increased \$11.5 million or 4.6% compared to \$248.6 million as of March 31, 2008. Net loans increased \$28.0 million or 16.8% from \$167.1 million as of March 31, 2008 to \$195.1 million for the same period in 2009. Total deposits increased to \$220.5 million as of March 31, 2009 compared to \$212.3 million as of December 31, 2008 and \$212.4 million as of March 31, 2008. This increase of \$8.1 million or 3.8% is primarily due to the increase in time deposits over \$100 thousand when comparing March 31, 2009 to March 31, 2008. Gross loans increased to \$198.0 million as of March 31, 2009 compared to \$189.6 million as of December 31, 2008 and \$169.4 million as of March 31, 2008.

*Operating Efficiency.* Operating efficiency is the measure of how efficiently earnings before taxes are generated as a percentage of revenue. Our efficiency ratio increased to 80.5% for the first three months of 2009 compared to 74.1% for the same period in 2008, this is due to a decrease in the bank's net interest margin, and a slight increase in noninterest expense. Net interest income before provision decreased 6.8% to \$2.7 million for the three months ended March 31, 2009, while operating expenses increased 1.0% to \$2.43 million from \$2.40 million.

## **Economic Conditions**

The Company believes that the local economies, in which it operates, Atascadero, Paso Robles, Arroyo Grande, and Santa Maria continue to decline as the loss of jobs increase and businesses cash flows continue to decline. Competition for deposits continues to be very strong both from traditional sources as well as alternative investments such as mutual

## **[Table of Contents](#)**

funds, money market accounts and the stock market. The Bank's growth in the loan portfolio reflects increased demand for commercial loans and various term real estate products. During the past twelve months the prime lending rate decreased 200 basis points placing additional pressure on the Company's margins.

The following sections set forth a discussion of the significant operating changes, business trends, financial condition, earnings, capital position and liquidity that occurred, in the three months ended March 31, 2009 compared with the three months ended March 31, 2008.

## **RESULTS OF OPERATIONS**

### **Net Income**

Net income of \$231 thousand for the three months ended March 31, 2009, reflects a \$289 thousand or 55.6% decrease over the like period in 2008. Net interest income decreased primarily due to a decrease in net interest margin from 5.21% for the first quarter 2008 to 4.65% for the same period in 2009, largely attributable to the Federal Reserve Bank decreasing the prime lending rate by 2.0% during the last three quarters of 2008 which followed a 2.0% decrease in the first quarter of 2008. The Company's loan portfolio was repricing at a faster rate than the deposits causing the net interest margin to decrease.

### **Net Interest Income**

Net interest income is the Company's largest source of operating income and is derived from interest and fees received on interest earning assets, less interest expense incurred on interest bearing liabilities. The most significant impact on the Company's net interest income between periods is derived from the interaction of changes in the volume of and rates earned or paid on interest earning assets and interest bearing liabilities. The volume of loans, investment securities and other interest earning assets, compared to the volume of interest bearing deposits and indebtedness, combined with the spread, produces changes in the net interest income between periods.

Net loans increased \$8.6 million or 4.6% for the three months ended March 31, 2009 when comparing December 31, 2008 of \$186.6 million to March 31, 2009 \$195.1million. The Company continues to experience good loan growth.

The following table presents for the periods indicated, condensed average balance sheet information for the Company, together with interest income and yields earned on average interest earnings assets, as well as interest expense and rates paid on average interest bearing liabilities.

[Table of Contents](#)

**AVERAGE BALANCE SHEET INFORMATION**

|  | For the three months ending March 31, |                 |            |                   |                 |            |
|--|---------------------------------------|-----------------|------------|-------------------|-----------------|------------|
|  | 2009                                  |                 |            | 2008              |                 |            |
|  | Average Balance                       | Interest        | Yield/Rate | Average Balance   | Interest        | Yield/Rate |
|  | (in thousands)                        |                 |            |                   |                 |            |
| <b>Assets:</b>                                     |                                       |                 |            |                   |                 |            |
| Loans  | \$ 193,981                            | \$ 3,050        | 6.29%      | \$ 166,382        | \$ 3,378        | 8.12%      |
| Investment securities                              | 37,046                                | 413             | 4.46%      | 55,433            | 669             | 4.83%      |
| Federal funds sold                                 | 966                                   | —               | 0.00%      | 651               | 3               | 1.84%      |
| Interest-earning deposits with other institutions  | —                                     | —               | —          | —                 | —               | —          |
| Total average interest-earning assets              | 231,993                               | 3,463           | 5.97%      | 222,466           | 4,050           | 7.28%      |
| Other assets                                       | 25,014                                |                 |            | 26,019            |                 |            |
| Less allowance for loan losses                     | (2,281)                               |                 |            | (1,665)           |                 |            |
| Total average assets                               | <u>\$ 254,726</u>                     |                 |            | <u>\$ 246,820</u> |                 |            |
| <b>Liabilities and Shareholders' Equity:</b>       |                                       |                 |            |                   |                 |            |
| Interest Bearing liabilities:                      |                                       |                 |            |                   |                 |            |
| Deposits   |                                       |                 |            |                   |                 |            |
| Interest-bearing demand – NOW                      | \$ 13,137                             | \$ 10           | 0.30%      | \$ 12,173         | \$ 9            | 0.30%      |
| Money Market                                       | 28,149                                | 132             | 1.88%      | 24,679            | 150             | 2.43%      |
| Savings  | 26,304                                | 16              | 0.24%      | 25,962            | 38              | 0.59%      |
| Time certificates of deposit                       | 73,476                                | 512             | 2.79%      | 71,691            | 778             | 4.34%      |
| Total average interest-bearing deposits            | 141,066                               | 670             | 1.90%      | 134,505           | 975             | 2.90%      |
| Short-term borrowings                              | 7,291                                 | 38              | 2.08%      | 6,980             | 59              | 3.38%      |
| Long-term borrowings                               | 6,807                                 | 57              | 3.35%      | 7,155             | 120             | 6.71%      |
| Total interest-bearing liabilities                 | 155,164                               | 765             | 1.97%      | 148,640           | 1,154           | 3.11%      |
| Demand deposits                                    | 71,706                                |                 |            | 74,306            |                 |            |
| Other liabilities                                  | 2,269                                 |                 |            | 2,027             |                 |            |
| Shareholders' equity                               | 25,587                                |                 |            | 21,847            |                 |            |
| Total average liabilities and shareholders' equity | <u>\$ 254,726</u>                     |                 |            | <u>\$ 246,820</u> |                 |            |
| Net interest income                                |                                       | <u>\$ 2,698</u> |            |                   | <u>\$ 2,896</u> |            |
| Net interest margin                                |                                       |                 | 4.65%      |                   |                 | 5.21%      |

Net interest income decreased 6.8% for the quarter ended March 31, 2009 as compared to the same period in 2008, as decreasing yields on earning assets, and the slower effect of repricing higher cost of funds combined to decrease our net interest margin. The yield on interest-earning assets decreased to 5.97% for the current quarter, as compared to 6.77% in the immediately preceding quarter and 7.28% a year ago. The cost of total interest-bearing liabilities decreased to 1.97% for the current quarter, as compared to 2.58% in the immediately preceding quarter and 3.11% a year ago. Net interest margin for the three months ended March 31, 2009 was 4.65% compared to 5.21% for the three months ended March 31, 2008. This represents a decrease of 56 basis points or 10.7%. The table below indicates an increase in the fed fund portfolio from 0.29% of average earning assets as of March 31, 2008 to 0.42% as of March 31, 2009. The table also indicates an increase in the loan portfolio from 74.79% of average earning assets to 83.62% and a decrease in investment portfolio from 24.92% to 15.97% when comparing March 31, 2008 to March 31, 2009:

|                              | (dollars in thousands) |                                 |                   |                                 |
|------------------------------|------------------------|---------------------------------|-------------------|---------------------------------|
|                              | March<br>2009          | Percent of<br>Earning<br>Assets | March<br>2008     | Percent of<br>Earning<br>Assets |
| Federal Funds Sold           | 966                    | 0.42%                           | \$ 651            | 0.29%                           |
| Loans                        | \$ 193,981             | 83.62%                          | 166,382           | 74.79%                          |
| Investments                  | 37,046                 | 15.96%                          | 55,433            | 24.92%                          |
| Total Average Earning Assets | <u>\$ 231,993</u>      | <u>100.00%</u>                  | <u>\$ 222,466</u> | <u>100.00%</u>                  |

For the three months ended March 31, 2009, the average prime rate was 3.25%, the average Fed Fund rate was .10%, and the yield on the investment portfolio averaged 4.46%. During the three months ended March 31, 2008 the average prime rate was 6.22%, the average Fed Fund rate was 1.84%, and the Bank's investment portfolio posted an average yield of 4.83%. These decreases were primarily due to the 200 basis point decrease in the prime lending rate from January 1, 2008 to March 31, 2008 and an additional 200 basis point reduction in the last three quarters of 2008.

Deposit interest expense for the three months ended March 31, 2009 totaled \$670,000, which reflects a decrease of \$305,000 or 31.3% over the like period in 2008. The decrease in deposit interest expense was due to the declining interest rates and the increase in interest bearing deposits. The schedule shown below indicates that average interest bearing savings and time deposits increased \$2.1 million or 2.18% from March of 2008 to March of 2009. During the same period, average non interest bearing deposits decreased \$2.6 million or 3.50%.

|   | (dollars in thousands) |                   |                    |                     |
|---|------------------------|-------------------|--------------------|---------------------|
|   | March<br>2009          | March<br>2008     | Dollar<br>Variance | Percent<br>Variance |
| Average noninterest bearing deposits      | 71,706                 | \$ 74,306         | \$ (2,600)         | -3.50%              |
| Average interest bearing demand deposits  | 41,286                 | 36,852            | 4,434              | 12.03%              |
| Average interest bearing savings and time | 99,780                 | 97,653            | 2,127              | 2.18%               |
| Total Deposits                            | <u>\$ 212,772</u>      | <u>\$ 208,811</u> | <u>\$ 3,961</u>    | 1.90%               |

The average deposit cost of funds for the three months ended March 31, 2009 decreased 100 basis points from 2.9% in March of 2008 to 1.9% in March of 2009. The Company anticipates a continued decrease in its deposit cost of funds during the balance of this year as higher cost fixed rate deposits mature.

### **Noninterest Income**

Noninterest income for the three months ended March 31, 2009 was \$323,000 compared to \$355,000 for the same period in 2008. That represents a decrease of \$32,000 or 9.0%, which is primarily due to the reduction of service charges and NSF fees collected.

Service charges on deposit accounts for the three months ended March 31, 2009 totaled \$121,000, which represents a decrease of \$28,000 or 18.8% compared to \$149,000 in the same period of 2008. The decrease in services charges was primarily due to the reduction of NSF fees collected as customers better manage their accounts by utilizing internet banking services.

Gain on sale of investment securities totaled \$92,000 for the three months ended March 31, 2008 compared to \$108,000 for the same period of 2008.

Other noninterest income for the three months ended March 31, 2009 was \$110,000 compared to \$98,000 for an increase of \$12,000 or 12.2% compared to the same period of 2008.

### **Operating Expenses**

Salary and employee benefits for the three months ended March 31, 2009 totaled \$1,380,000, which reflects a decrease of \$36,000 or 2.5% over the like period in 2008. This was primarily due to the retirement of the President and Chief Executive Officer on January 3, 2009.

Occupancy expense for the three months ended March 31, 2009 totaled \$167,000, which reflects an increase of \$7,000 or 4.4% over the same period in 2008. This was primarily due to the cost of utilities increasing and routine maintenance on buildings.



Equipment expense for the three months ended March 31, 2009 totaled \$165,000, which reflects an increase of \$7,000 or 4.4% over the same period in 2008. This was primarily due to equipment upgrades.

Professional services for the three months ended March 31, 2009 totaled \$153,000, which reflects an increase of \$4,000 or 2.7% over the same period in 2008. This is primarily due to the collection of non-accrual loans which caused an increase in legal fees.

Data processing expense for the three months ended March 31, 2009 totaled \$132,000, which reflects an increase of \$10,000 or 8.2% from the same period in 2008. This is primarily due to the increase in transaction accounts item processing.

Office related expense for the three months ended March 31, 2009 totaled \$102,000, which reflects an increase of \$5,000 or 5.2% over the same period in 2008. This was primarily due to an increase in stationery and supplies.

Marketing related expense for the three months ended March 31, 2009 totaled \$101,000 which reflects a decrease of \$4,000 or 3.8% over the same period in 2008. The decrease is primarily due to the reduction in the purchase of promotional items.

Regulatory assessment fees for the period ending March 31, 2009 was \$45,000, which reflects an increase of \$11,000 or 32.4% over the same period in 2008. This was primarily due to the increase in the Federal Deposit Insurance Assessment fees.

Director expense for the three months ended March 31, 2009 totaled \$88,000, which reflects an increase of \$7,000 or 8.6% over the like period in 2008. This is primarily due to the retirement of the President and CEO in January 2009, who now receives director fees.

Other expense for the three months ended March 31, 2009 totaled \$98,000, which reflects an increase of \$12,000 or 14.0% over the same period in 2008. This is primarily due to loan related expenses.

### **Loan Related Data**

The Company has taken several positive steps over the past years to improve upon the overall credit administration of the Bank. The Company has implemented additional controls to ensure the quality of the overall credit portfolio. The Bank has been able to increase the loan portfolio without lowering credit quality, which has been validated by the Bank's outside credit review firm. The Bank's credit portfolio continues to be reviewed by our outside loan review firm on a monthly basis.

### **Table of Contents**

On a comparative basis, problem loan and loan related data are detailed in the following tables:

|                                      | <b>March<br/>2009</b> | <b>December<br/>2008</b> | <b>March<br/>2008</b> |
|--------------------------------------|-----------------------|--------------------------|-----------------------|
| Charge offs                          | \$ 418                | \$ 352                   | \$ 58                 |
| Recoveries                           | —                     | 14                       | 1                     |
| OREO                                 | 464                   | —                        | —                     |
| Nonaccrual Loans                     | 1,058                 | 1,614                    | 2,119                 |
| Accruing loans over 90 days past due | —                     | —                        | —                     |
| Allowance for Loan Loss              | 2,132                 | 2,310                    | 1,616                 |
| Period-end Gross Loans               | 197,996               | 189,654                  | 169,404               |

|  | <b>March<br/>2009</b> | <b>December<br/>2008</b> | <b>March<br/>2008</b> |
|--|-----------------------|--------------------------|-----------------------|
| <b>Ratio comparison to Period-end Gross Loans to</b> |                       |                          |                       |
| Charge offs  | 0.21%                 | 0.19%                    | 0.03%                 |
| Recoveries   | 0.00%                 | 0.01%                    | 0.00%                 |
| OREO   | 0.23%                 | 0.00%                    | 0.00%                 |
| Nonaccrual Loans                                     | 0.53%                 | 0.85%                    | 1.25%                 |
| Accruing loans over 90 days past due                 | 0.00%                 | 0.00%                    | 0.00%                 |
| Allowance for Loan Loss                              | 1.08%                 | 1.22%                    | 0.95%                 |

### **Allowance for Loan Losses**

The Bank made a \$240,000 addition to its allowance for loan losses during the three month period ending March 31, 2009 compared to no additions in the first quarter 2008. The Bank evaluates the allowance for possible loan losses based upon an individual analysis of specific categories of loans,

specific categories of classified loans and individual classified assets. The adequacy of the allowance is determinable only on an approximate basis, since estimates as to the magnitude and timing of loan losses are not predictable because of the impact of external events. Based on the analysis performed by the Bank and its outside loan review firm, both believe that the allowance for loan loss at March 31, 2009 is adequate. The allowance on that date was 1.08% of total loans, compared to 1.22% at December 31, 2008 and 0.95% at March 31, 2008.

### **Nonaccrual Loans**

The Bank had three non-accrual loans totaling \$1,058,000 as of March 31, 2009, compared to three nonaccrual loans totaling \$2,119,000 at March 31, 2008. The first two loans total \$926,000 and are secured by unimproved real estate. The third loan totals \$133,000 and is secured by equipment.

### **OREO**

During the first quarter 2009 the Bank had one real estate property totaling \$463,500 in OREO on its books. As of May 8, 2009 the company has an accepted offer on the subject property and expects to close escrow within the second quarter.

### **Other Borrowings**

On July 9, 2008 the Company entered into a one year commitment with Federal Home Loan Bank for \$5,000,000 at a fixed rate of 2.91%.

### **Trust Preferred Securities**

On April 28, 2006, the Company issued \$5,155,000 in Trust Preferred securities. The issue was priced at 1.48% over the quarterly adjustable 3-month LIBOR. The issue was written for a term of 30-years, with an option to redeem in whole or part at par anytime after the fifth year. The Company contributed \$3,000,000 to the Bank. The Company paid \$37,000 in interest expense during the three month period ending March 31, 2009.

---

### [Table of Contents](#)

### **Subordinated Debt**

During the Third Quarter of 2003, the Bank completed a private placement of subordinated debentures (“notes”) to augment its Tier II capital. The total principal amount of the notes issued was \$2,000,000. The notes were sold pursuant to an applicable exemption from registration under the Securities Act of 1933 to certain accredited investors, including some of the Bank’s directors and senior officers.

The \$2.0 million in notes have a floating rate of interest, which is reset quarterly, equal to the prime rate published in the western edition of the Wall Street Journal plus 1.5%. The initial rate for the notes was 5.5%. The current balance and rate as of March 31, 2009, is \$1,500,000 at 4.75%. Quarterly principal payments of \$166,678 began in the third quarter of 2008 and will continue over the next three years. The notes mature in June 2011.

### **Capital**

Total shareholders’ equity at March 31, 2009 totaled \$25,294,000 compared to \$25,551,000 at December 31, 2008, for a decrease of \$257,000 or 1.0%. The decrease is due primarily to the payment of preferred stock dividend of \$31,000 and \$481,000 cash dividends on common stock that were paid to shareholders of record as of March 31, 2009 coupled with net earnings of \$231,201.

As part of the United States Treasury’s Capital Purchase Program, the Company entered into a Letter Agreement on December 19, 2008 with the United States Department of Treasury, where the Company agreed to issue and sell 4,000 shares of the Company’s Preferred Stock and a warrant to purchase 37,360 shares of the Company’s Common Stock for an aggregate purchase price of \$4,000,000 in cash. The Preferred Stock will qualify as Tier 1 capital and will pay cumulative dividends at a rate of 5% per annum for the first five years and 9% per annum thereafter. It is the Company’s intention to repay the capital within the five year time frame. The warrant has a 10-year term and is immediately exercisable upon its issuance, with an exercise price equal to \$16.06 per share of the Common Stock.

The Company maintains capital ratios above the Federal regulatory guidelines for a “well-capitalized” bank. The ratios are as follows:

| <b>Regulatory<br/>Minimum Ratio<br/>For<br/>“Well-Capitalized”</b> | <b>Regulatory<br/>Minimum Ratio</b> | <b>March<br/>2009</b> | <b>Dec.<br/>2008</b> |
|--|-------------------------------------|-----------------------|----------------------|
| _____  | _____                               | _____                 | _____                |



|  |        |       |       |       |
|--|--------|-------|-------|-------|
| Tier I Capital (to Average Assets)       | 5.00%  | 4.00% | 11.8% | 11.9% |
| Tier I Capital (to Risk Weighted Assets) | 6.00%  | 4.00% | 13.9% | 14.4% |
| Total Capital (to Risk Weighted Assets)  | 10.00% | 8.00% | 15.2% | 15.9% |

## **Liquidity**

Liquidity management involves our ability to meet cash flow requirements arising from fluctuations in deposit levels and demands of daily operations, which include funding of securities purchases, providing for customers' credit needs and ongoing repayment of borrowings. Our liquidity is actively managed on a daily basis and reviewed periodically by our ALCO Committee and Board of Directors. This process is intended to ensure the maintenance of sufficient funds to meet our needs, including adequate cash flow for off-balance sheet instruments.

Our primary sources of liquidity are derived from financing activities that include the acceptance of customer deposits, federal fund purchase lines and a Federal Home Loan Bank advance line. The Bank currently has two federal fund lines totaling \$6.0 million and two credit lines with FHLB totaling \$43.6 million. On July 9, 2008 the Company entered into a one year advance with FHLB for \$5,000,000 at a fixed rate of 2.91%. The Bank's current Liquidity policy is to maintain a liquidity ratio of not less than 20.0% based on regulatory formula. As of March 31, 2009 the Bank had a liquidity ratio of 19.0% or 1.0% below the policy limit. The Board of Directors is aware of the decrease in liquidity ratio and will monitor on a monthly basis. The Company's decrease in the liquidity ratio is primarily due to continued strong loan demand.

20

## **Table of Contents**

### **Interest Rate Sensitivity**

The Bank closely follows the maturities and repricing opportunities of both assets and liabilities to reduce gaps in interest spreads. An analysis is performed quarterly to determine the various interest sensitivity gaps, the economic value of equity and earnings at risk. The reports indicate that the Bank is asset sensitive, meaning that when interest rates change, assets (loans) will reprice faster than short-term liabilities (deposits). Therefore, with the decrease in the prime lending rate loans are repricing faster than the deposits.

The asset liability reports as of March 31, 2009 indicate that the Bank has an actual dollar risk exposure of \$87,000 to interest income if interest rates fall 100 basis points. This represents a 0.8% risk to projected interest income. The Equity to Asset ratio is currently 14.10% and will fall to a projected 12.63% if interest rates fall 100 basis points.

### **Interest Income and Expense Under Rate Shock**

|                                   | <u>200bp</u> | <u>-100bp</u> | <u>0bp</u> | <u>+100bp</u> | <u>+200bp</u> |
|-----------------------------------|--------------|---------------|------------|---------------|---------------|
| <b><u>Net Interest Income</u></b> |              |               |            |               |               |
| Earnings at Risk                  | \$ 18        | \$ 87         | \$ 0       | \$ 111        | \$ 346        |
| Percent of Risk                   | 0.2%         | 0.8%          | 0.0%       | 1.0%          | 3.2%          |

Assumptions are inherently uncertain and, consequently, the model cannot precisely measure net interest income or precisely predict the impact of changes in interest rates on net interest income. Actual results will differ from simulated results due to timing, magnitude and frequency of interest rate changes, as well as changes in market conditions and management strategy.

### **Off-Balance Sheet Arrangements**

Off-balance sheet arrangements are any contractual arrangement to which an unconsolidated entity is a party, under which the Company has: (1) any obligation under a guarantee contract; (2) a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to that entity for such assets; (3) any obligation under certain derivative instruments; or (4) any obligation under a material variable interest held by the Company in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the Company, or engages in leasing, hedging or research and development services with the Company.

In the ordinary course of business, the Bank has entered into off-balance sheet financial instruments consisting of commitments to extend credit, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded in the financial statement when they are funded or related fees are incurred or received. For a fuller discussion of these financial instruments, refer to Note M of the Bank's financial statements contained in Item 7 of Part II of the Bank's Form 10-K for the year ended December 31, 2008.

21

## **Critical Accounting Policies**

*This discussion should be read in conjunction with the unaudited consolidated financial statements of the Company, including the notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations and audited financial statements, including the note's thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations appearing in the Bank's Form 10-K for the year ended December 31, 2008.*

*Our accounting policies are integral to understanding the results reported. Our most complex accounting policies require management's judgment to ascertain the valuation of assets, liabilities, commitments and contingencies. We have established detailed policies and control procedures that are intended to ensure valuation methods are well controlled and applied consistently from period to period. In addition, the policies and procedures are intended to ensure that the process for changing methodologies occurs in an appropriate manner. The following is a brief description of our current accounting policies involving significant management valuation judgments.*

## **Use of Estimates in the Preparation of Financial Statements**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of certain assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of certain revenues and expenses during the reporting period. Actual results could differ from those estimates.

## **Allowance for Loan Losses**

The allowance for loan losses represents management's best estimate of losses inherent in the existing loan portfolio. The allowance for loan losses is increased by the provision for loan losses charged to expense and reduced by loans charged off, net of recoveries. The provision for loan losses is determined based on management's assessment of several factors: reviews and evaluation of specific loans, changes in the nature and volume of the loan portfolio, current economic conditions and the related impact on specific borrowers and industry groups, historical loan loss experiences, the level of classified and nonperforming loans and the results of regulatory examinations.

Loans are considered impaired if, based on current information and events, it is probable that we will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. The measurement of impaired loans is generally based on the present value of expected future cash flows discounted at the historical effective interest rate stipulated in the loan agreement, except that all collateral-dependent loans are measured for impairment based on the fair value of the collateral. In measuring the fair value of the collateral, management uses assumptions and methodologies consistent with those that would be utilized by unrelated third parties.

Changes in the financial condition of individual borrowers, in economic conditions, in historical loss experience and in the condition of the various markets in which collateral may be sold may all affect the required level of the allowance for loan losses and the associated provision for loan losses.

## **Available-for-Sale Securities**

The fair value of most securities classified as available-for-sale are based on quoted market prices. If quoted market prices are not available, fair values are extrapolated from the quoted prices of similar instruments.

## **Deferred Tax Assets**

We use an estimate of future earnings to support our position that the benefit of our deferred tax assets will be realized. If future income should prove non-existent or less than the amount of the deferred tax assets within the tax years to which they may be applied, the asset may not be realized and our net income will be reduced.

## **Deferred Compensation Liabilities**

Management estimates the life expectancy of the participants and the accrual methods used to accrue compensation expense. If individuals or their beneficiaries outlive their assumed expectancies the amounts accrued for the payment of their benefits will be inadequate and additional charges to income will be required.

### **ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risk is the risk of loss in a financial instrument arising from adverse changes in market prices, interest rates, foreign currency exchange rates, commodity prices and equity prices. The Company's market risk arises primarily from interest rate risk inherent in its lending and deposit taking activities. Management uses various asset/liability strategies to manage the re-pricing characteristics of the Company's earning assets and funding liabilities to ensure that exposure to interest rate fluctuations is within its guidelines of acceptable risk-taking. Hedging strategies, including the terms and pricing of loans and deposits, and managing the deployment of the Company's securities are used to reduce mismatches in interest rate re-pricing opportunities of portfolio assets and their funding sources.

Interest rate risk is addressed by our Asset Liability Management Committee ("ALCO") which is comprised of senior management officers of the bank. The ALCO monitors interest rate risk by analyzing the potential impact on the net equity value and net interest income from potential changes in interest rates, and considers the impact of alternative strategies or changes in balance sheet structure. The ALCO manages the Company's balance sheet in part to maintain, within acceptable ranges, the potential impact on net equity value and net interest income despite fluctuations in market interest rates.

Exposure to interest rate risk is reviewed on at least a quarterly basis by the ALCO and the Board of Directors. Interest rate risk exposure is measured using interest rate sensitivity analysis to determine the change in net portfolio value in the event of hypothetical changes in interest rates. If potential changes to net equity value and net interest income resulting from hypothetical interest rate changes are not within the limits established by the Board of Directors, management may adjust the asset and liability mix to bring interest rate risk within approved limits.

### **ITEM 4T — CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, management, including the Company's Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures with respect to the information generated for use in this Quarterly Report. Based upon, and as of the date of that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the disclosures controls and procedures were effective to provide reasonable assurances that information required to be disclosed in the reports the Company files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

There was no change in the Company's internal controls over financial reporting during the quarter ended March 31, 2009 that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

In designing and evaluating disclosure controls and procedures, the Company's management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable, not absolute, assurances of achieving the desired control objectives and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

[Table of Contents](#)

## ***PART II — OTHER INFORMATION***

### **ITEM 1. Legal Proceedings.**

The Company is involved in various legal proceedings occurring in the ordinary course of business which, in aggregate, are believed by management to be immaterial to the financial condition and results of operations of the Company.

### **ITEM 1A. Risk Factors.**

There have been no material changes from the risk factors disclosed in the Company's annual report on Form 10-K for the year ended December 31, 2008.

### **ITEM 2. Unregistered Sale of Equity Securities and Use of Proceeds.**

None.

### **ITEM 3. Defaults Upon Senior Securities.**

Not applicable.

**ITEM 4. Submission of Matters to a Vote of Security Holders.**

The Company held its Annual Meeting of Shareholders on April 15, 2009. The following are the matters that were represented and voted on at the meeting:

1. *Election of Directors.* The following, all of which were the incumbent directors of the Company, were elected to serve until the next annual meeting of shareholders. The directors elected were:

|                       | Votes<br>For | Votes<br>Withheld |
|-----------------------|--------------|-------------------|
| Khatchik H. Achadjian | 1,571,889    | 19,391            |
| Stanley R Cherry      | 1,570,870    | 20,410            |
| Jerry W. DeCou III    | 1,573,090    | 18,190            |
| Douglas C. Filipponi  | 1,571,290    | 19,990            |
| John C. Hansen        | 1,569,490    | 21,790            |
| Jean Hawkins          | 1,573,090    | 18,190            |
| Paul G. Moerman       | 1,573,090    | 18,190            |
| Larry H. Putnam       | 1,569,490    | 21,790            |
| D. Jack Stinchfield   | 1,571,400    | 19,880            |

2. *Non-Binding Vote on Approval of Executive Compensation.* To adopt a non-binding resolution approving the executive compensation disclosed in the proxy statement for the 2009 Annual Meeting of Shareholders, dated March 20, 2009:

| Votes<br>For | Votes<br>Against | Votes<br>Abstain | Broker<br>Non-Votes |
|--------------|------------------|------------------|---------------------|
| 1,419,560    | 97,739           | 73,281           | —                   |

24

[Table of Contents](#)

**ITEM 5. Other Information**

Not applicable.

**ITEM 6. Exhibits**

31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

**SIGNATURES**

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**SANTA LUCIA BANCORP**

Date: May 14, 2009

/s/ John C. Hansen

John C. Hansen

President and Chief Executive Officer

Date: May 14, 2009

/s/ James M. Cowan

James M. Cowan

Executive Vice President and Chief Financial Officer

**EXHIBIT INDEX**

**Exhibit**

**Sequential**

| <b><u>Number</u></b> | <b><u>Description</u></b>  |
|----------------------|--|
| 31.1                 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2                 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1                 | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2                 | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |