

SHORE BANCSHARES INC  
Form 10-Q  
May 09, 2008

**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, 2008

**OR**

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

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

Commission file number 0-22345

**SHORE BANCSHARES, INC.**

(Exact name of registrant as specified in its charter)

Maryland  
(State or Other Jurisdiction of  
Incorporation or Organization)

52-1974638  
(I.R.S. Employer  
Identification No.)

18 East Dover Street, Easton, Maryland  
(Address of Principal Executive Offices)

21601  
(Zip Code)

(410) 822-1400  
Registrant's Telephone Number, Including Area Code

N/A

Former name, former address and former fiscal year, if changed since last report.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods 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, 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. (Check one):

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting  
company)

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

**APPLICABLE ONLY TO CORPORATE ISSUERS**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 8,395,450 shares of common stock outstanding as of April 25, 2008.

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**PART I – FINANCIAL INFORMATION****Item 1. Financial Statements.**

SHORE BANCSHARES, INC.  
CONSOLIDATED BALANCE SHEETS  
(Dollars in thousands, except per share amounts)

|                                                                                         | March 31,<br>2008<br>(Unaudited) | December 31,<br>2007 |
|-----------------------------------------------------------------------------------------|----------------------------------|----------------------|
| <b>ASSETS</b>                                                                           |                                  |                      |
| Cash and due from banks                                                                 | \$ 17,236                        | \$ 17,198            |
| Interest bearing deposits with other banks                                              | 6,928                            | 3,036                |
| Federal funds sold                                                                      | 28,313                           | 6,646                |
| Investment securities:                                                                  |                                  |                      |
| Available for sale, at fair value                                                       | 86,056                           | 97,137               |
| Held-to-maturity, at amortized cost (fair value of \$13,156 and \$12,924, respectively) | 13,006                           | 12,896               |
| Loans                                                                                   | 808,583                          | 776,350              |
| Less: allowance for credit losses                                                       | (7,926)                          | (7,551)              |
| Loans, net                                                                              | 800,657                          | 768,799              |
| Insurance premiums receivable                                                           | 1,854                            | 1,083                |
| Premises and equipment, net                                                             | 15,408                           | 15,617               |
| Accrued interest receivable                                                             | 5,048                            | 5,008                |
| Investment in unconsolidated subsidiary                                                 | 937                              | 937                  |
| Goodwill                                                                                | 15,954                           | 15,954               |
| Other intangible assets, net                                                            | 6,307                            | 6,436                |
| Deferred income taxes                                                                   | 1,688                            | 1,847                |
| Other real estate owned                                                                 | -                                | 176                  |
| Other assets                                                                            | 4,444                            | 4,141                |
| <b>TOTAL ASSETS</b>                                                                     | <b>\$ 1,003,836</b>              | <b>\$ 956,911</b>    |
| <b>LIABILITIES</b>                                                                      |                                  |                      |
| Deposits:                                                                               |                                  |                      |
| Noninterest bearing demand                                                              | \$ 103,328                       | \$ 104,081           |
| Interest bearing demand                                                                 | 114,314                          | 115,623              |
| Money market and savings                                                                | 184,488                          | 169,896              |
| Certificates of deposit \$100,000 or more                                               | 188,605                          | 161,568              |
| Other time                                                                              | 218,182                          | 214,727              |
| Total deposits                                                                          | 808,917                          | 765,895              |
| Accrued interest payable                                                                | 2,579                            | 2,793                |
| Short-term borrowings                                                                   | 42,712                           | 47,694               |
| Long-term debt                                                                          | 15,485                           | 12,485               |
| Other liabilities                                                                       | 11,444                           | 7,809                |
| <b>TOTAL LIABILITIES</b>                                                                | <b>881,137</b>                   | <b>836,676</b>       |

**STOCKHOLDERS' EQUITY**

|                                                                                                                                      |                     |                   |
|--------------------------------------------------------------------------------------------------------------------------------------|---------------------|-------------------|
| Common stock, par value \$.01; shares authorized - 35,000,000; shares issued and outstanding - 8,395,450 and 8,380,530, respectively | <b>84</b>           | 84                |
| Additional paid in capital                                                                                                           | <b>29,578</b>       | 29,539            |
| Retained earnings                                                                                                                    | <b>92,076</b>       | 90,365            |
| Accumulated other comprehensive income                                                                                               | <b>961</b>          | 247               |
| <b>TOTAL STOCKHOLDERS' EQUITY</b>                                                                                                    | <b>122,699</b>      | 120,235           |
| <b>TOTAL LIABILITIES &amp; STOCKHOLDERS' EQUITY</b>                                                                                  | <b>\$ 1,003,836</b> | <b>\$ 956,911</b> |

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.  
CONSOLIDATED STATEMENTS OF INCOME (Unaudited)  
(Dollars in thousands, except per share amounts)

|                                                              | For The Three Months Ended March 31, |              |
|--------------------------------------------------------------|--------------------------------------|--------------|
|                                                              | 2008                                 | 2007         |
| <b>INTEREST INCOME</b>                                       |                                      |              |
| Interest and fees on loans                                   | \$ 14,560                            | \$ 13,624    |
| Interest and dividends on investment securities:             |                                      |              |
| Taxable                                                      | 1,080                                | 1,284        |
| Tax-exempt                                                   | 123                                  | 124          |
| Federal funds sold                                           | 122                                  | 520          |
| Other interest income                                        | 38                                   | 338          |
| Total interest income                                        | 15,923                               | 15,890       |
| <b>INTEREST EXPENSE</b>                                      |                                      |              |
| Interest bearing demand                                      | 171                                  | 236          |
| Money market and savings                                     | 705                                  | 824          |
| Certificates of deposit \$100,000 or more                    | 2,070                                | 1,926        |
| Other time                                                   | 2,397                                | 2,382        |
| Interest on short-term borrowings                            | 366                                  | 246          |
| Interest on long-term debt                                   | 184                                  | 371          |
| Total interest expense                                       | 5,893                                | 5,985        |
| <b>NET INTEREST INCOME</b>                                   | <b>10,030</b>                        | <b>9,905</b> |
| <b>PROVISION FOR CREDIT LOSSES</b>                           | <b>462</b>                           | <b>242</b>   |
| <b>NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES</b> | <b>9,568</b>                         | <b>9,663</b> |
| <b>NONINTEREST INCOME</b>                                    |                                      |              |
| Service charges on deposit accounts                          | 871                                  | 689          |
| Other service charges and fees                               | 736                                  | 471          |
| Insurance agency commissions                                 | 3,467                                | 2,039        |
| Other noninterest income                                     | 428                                  | 449          |
| Total noninterest income                                     | 5,502                                | 3,648        |
| <b>NONINTEREST EXPENSE</b>                                   |                                      |              |
| Salaries and wages                                           | 4,607                                | 3,817        |
| Employee benefits                                            | 1,377                                | 1,116        |
| Occupancy expense                                            | 499                                  | 510          |
| Furniture and equipment expense                              | 286                                  | 322          |
| Data processing                                              | 470                                  | 432          |
| Directors' fees                                              | 165                                  | 163          |
| Amortization of other intangible assets                      | 129                                  | 83           |
| Other noninterest expenses                                   | 2,058                                | 1,448        |
| Total noninterest expense                                    | 9,591                                | 7,891        |
| <b>INCOME BEFORE INCOME TAXES</b>                            | <b>5,479</b>                         | <b>5,420</b> |
| Income tax expense                                           | 2,107                                | 2,017        |

|                                   |           |              |           |              |
|-----------------------------------|-----------|--------------|-----------|--------------|
| <b>NET INCOME</b>                 | <b>\$</b> | <b>3,372</b> | <b>\$</b> | <b>3,403</b> |
| Basic earnings per common share   | \$        | .40          | \$        | .41          |
| Diluted earnings per common share | \$        | .40          | \$        | .41          |
| Dividends paid per common share   | \$        | .16          | \$        | .16          |

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.  
 CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Unaudited)  
 For the Three-Month Periods Ended March 31, 2008 and 2007  
 (Dollars in thousands, except per share amounts)

|                                                                    | Common<br>Stock | Additional<br>Paid in<br>Capital | Retained<br>Earnings | Accumulated<br>other<br>Comprehensive<br>Income (Loss) | Total<br>Stockholders'<br>Equity |
|--------------------------------------------------------------------|-----------------|----------------------------------|----------------------|--------------------------------------------------------|----------------------------------|
| Balances, January 1, 2008                                          | \$ 84           | \$ 29,539                        | \$ 90,365            | \$ 247                                                 | \$ 120,235                       |
| Adjustment to initially apply EITF Issue<br>06-4                   | -               | -                                | (318)                | -                                                      | (318)                            |
| <b>Comprehensive income:</b>                                       |                 |                                  |                      |                                                        |                                  |
| Net income                                                         | -               | -                                | 3,372                | -                                                      | 3,372                            |
| Unrealized gains on available-for-sale<br>securities, net of taxes | -               | -                                | -                    | 714                                                    | 714                              |
| Total comprehensive income                                         |                 |                                  |                      |                                                        | 4,086                            |
| Shares issued for employee stock-based<br>awards                   | -               | 16                               | -                    | -                                                      | 16                               |
| Stock-based compensation expense                                   | -               | 23                               | -                    | -                                                      | 23                               |
| Cash dividends paid (\$0.16 per share)                             | -               | -                                | (1,343)              | -                                                      | (1,343)                          |
| <b>Balances, March 31, 2008</b>                                    | <b>\$ 84</b>    | <b>\$ 29,578</b>                 | <b>\$ 92,076</b>     | <b>\$ 961</b>                                          | <b>\$ 122,699</b>                |
| Balances, January 1, 2007                                          | \$ 84           | \$ 29,687                        | \$ 82,279            | (723)                                                  | \$ 111,327                       |
| <b>Comprehensive income:</b>                                       |                 |                                  |                      |                                                        |                                  |
| Net income                                                         | -               | -                                | 3,403                | -                                                      | 3,403                            |
| Unrealized gains on available-for-sale<br>securities, net of taxes | -               | -                                | -                    | 218                                                    | 218                              |
| Total comprehensive income                                         |                 |                                  |                      |                                                        | 3,621                            |
| Shares issued for employee stock-based<br>awards                   | -               | 24                               | -                    | -                                                      | 24                               |
| Stock-based compensation expense                                   | -               | 12                               | -                    | -                                                      | 12                               |
| Repurchase and retirement of 10,000<br>shares                      | -               | (261)                            | -                    | -                                                      | (261)                            |
| Cash dividends paid (\$0.16 per share)                             | -               | -                                | (1,341)              | -                                                      | (1,341)                          |
| <b>Balances, March 31, 2007</b>                                    | <b>\$ 84</b>    | <b>\$ 29,462</b>                 | <b>\$ 84,341</b>     | <b>(505)</b>                                           | <b>\$ 113,382</b>                |

See accompanying notes to Consolidated Financial Statements.





SHORE BANCSHARES, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)  
(Dollars in thousands)

|                                                                                   | For the Three Months Ended March 31, |                  |
|-----------------------------------------------------------------------------------|--------------------------------------|------------------|
|                                                                                   | 2008                                 | 2007             |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                                      |                  |
| Net income                                                                        | \$ 3,372                             | \$ 3,403         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                      |                  |
| Depreciation and amortization                                                     | 433                                  | 376              |
| Stock-based compensation expense                                                  | 23                                   | 12               |
| Discount accretion on debt securities                                             | (80)                                 | (33)             |
| Provision for credit losses                                                       | 462                                  | 242              |
| Loss on sale of other real estate owned                                           | 50                                   | -                |
| Net changes in:                                                                   |                                      |                  |
| Insurance premiums receivable                                                     | (771)                                | (265)            |
| Accrued interest receivable                                                       | (40)                                 | (191)            |
| Other assets                                                                      | (619)                                | (213)            |
| Accrued interest payable                                                          | (214)                                | 176              |
| Other liabilities                                                                 | 3,317                                | 2,003            |
| Net cash provided by operating activities                                         | 5,933                                | 5,510            |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                                      |                  |
| Proceeds from maturities and principal payments of securities available for sale  | 26,253                               | 6,003            |
| Purchases of securities available for sale                                        | (13,923)                             | (4,939)          |
| Proceeds from maturities and principal payments of securities held to maturity    | 690                                  | 3                |
| Purchases of securities held to maturity                                          | (802)                                | -                |
| Net (increase) decrease in loans                                                  | (32,458)                             | 2,218            |
| Purchases of premises and equipment                                               | (73)                                 | (207)            |
| Proceeds from sales of other real estate owned                                    | 264                                  | -                |
| Net cash (used in) provided by investing activities                               | (20,049)                             | 3,078            |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                                      |                  |
| Net increase (decrease) in demand, money market and savings deposits              | 12,530                               | (6,882)          |
| Net increase in certificates of deposit                                           | 30,492                               | 11,059           |
| Net (decrease) increase in short-term borrowings                                  | (4,982)                              | 4,291            |
| Proceeds from issuance of long-term debt                                          | 3,000                                | 2,000            |
| Proceeds from issuance of common stock                                            | 16                                   | 24               |
| Stock repurchased and retired                                                     | -                                    | (261)            |
| Dividends paid                                                                    | (1,343)                              | (1,341)          |
| Net cash provided by financing activities                                         | 39,713                               | 8,890            |
| <b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>                                  | <b>25,597</b>                        | <b>17,478</b>    |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>                           | <b>26,880</b>                        | <b>79,673</b>    |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>                                 | <b>\$ 52,477</b>                     | <b>\$ 97,151</b> |

Supplemental cash flows information:

|                                                 |    |              |    |       |
|-------------------------------------------------|----|--------------|----|-------|
| Interest paid                                   | \$ | <b>6,107</b> | \$ | 5,808 |
| Income taxes paid                               | \$ | <b>125</b>   | \$ | 35    |
| Transfers from loans to other real estate owned | \$ | <b>138</b>   | \$ | -     |

See accompanying notes to Consolidated Financial Statements.

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Shore Bancshares, Inc.  
Notes to Consolidated Financial Statements  
For the Three Months Ended March 31, 2008 and 2007  
(Unaudited)

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Shore Bancshares, Inc. (the "Company") and its subsidiaries with all significant intercompany transactions eliminated. The consolidated financial statements conform to accounting principles generally accepted in the United States of America and to prevailing practices within the banking industry. The accompanying interim financial statements are unaudited; however, in the opinion of management all adjustments necessary to present fairly the financial position at March 31, 2008, the results of operations for the three-month periods ended March 31, 2008 and 2007, changes in stockholders' equity for the three-month periods ended March 31, 2008 and 2007, and cash flows for the three-month periods ended March 31, 2008 and 2007, have been included. All such adjustments are of a normal recurring nature. The amounts as of December 31, 2007 were derived from audited financial statements. The results of operations for the three-month period ended March 31, 2008 are not necessarily indicative of the results to be expected for any other interim period or for the full year. This Quarterly Report on Form 10-Q should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

Note 2 – Earnings Per Share

Basic earnings per share are calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share are calculated by dividing net income by the weighted average number of shares outstanding during the period, adjusted for the dilutive effect of outstanding stock options and awards. The following table provides information relating to the calculation of earnings per share:

| (In thousands, except per share data)         | For the Three Months Ended March 31, |          |
|-----------------------------------------------|--------------------------------------|----------|
|                                               | <b>2008</b>                          | 2007     |
| Net Income                                    | \$ 3,372                             | \$ 3,403 |
| Weighted Average Shares Outstanding – Basic   | <b>8,391</b>                         | 8,382    |
| Dilutive effect of stock-based awards         | <b>9</b>                             | 14       |
| Weighted Average Shares Outstanding – Diluted | <b>8,400</b>                         | 8,396    |
| Earnings per common share – Basic             | \$ 0.40                              | \$ 0.41  |
| Earnings per common share – Diluted           | \$ 0.40                              | \$ 0.41  |

There were no antidilutive stock-based awards excluded from the calculation of earnings per share for the three months ended March 31, 2008 and 2007.

Note 3 – Significant Accounting Policy

Under the provisions of Statements of Financial Accounting Standards (SFAS) Nos. 114 and 118, "Accounting by Creditors for Impairment of a Loan," a loan is considered impaired if it is probable that the Company will not collect all principal and interest payments according to the loan's contracted terms. The impairment of a loan is measured at the present value of expected future cash flows using the loan's effective interest rate, or at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Interest income generally is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on such loans are applied as a reduction of the loan's principal balance. Interest income on other nonaccrual loans is recognized only to the extent of interest payments received.

Information with respect to impaired loans and the related valuation allowance is shown below:

| (Dollars in thousands)                                              | March 31,<br>2008 | December 31,<br>2007 | March 31,<br>2007 |
|---------------------------------------------------------------------|-------------------|----------------------|-------------------|
| Impaired loans with a valuation allowance                           | \$ 3,387          | \$ 3,413             | \$ 3,797          |
| Impaired loans with no valuation allowance                          | 51                | 127                  | 177               |
| <b>Total impaired loans</b>                                         | <b>\$ 3,438</b>   | <b>\$ 3,540</b>      | <b>\$ 3,974</b>   |
| Allowance for credit losses applicable to impaired loans            | \$ 999            | \$ 819               | \$ 880            |
| Allowance for credit losses applicable to other than impaired loans | 6,927             | 6,732                | 5,626             |
| <b>Total allowance for credit losses</b>                            | <b>\$ 7,926</b>   | <b>\$ 7,551</b>      | <b>\$ 6,506</b>   |
| Average recorded investment in impaired loans                       | \$ 3,489          | \$ 3,958             | \$ 5,172          |

Gross interest income of \$68 thousand for the first quarter of 2008, \$404 thousand for fiscal year 2007 and \$194 thousand for the first quarter of 2007 would have been recorded if nonaccrual loans had been current and performing in accordance with their original terms. Interest actually recorded on such loans was \$1 thousand for the first quarter of 2008, \$142 thousand for fiscal year 2007 and \$133 thousand for the first quarter of 2007.

Impaired loans do not include groups of smaller balance homogenous loans such as residential mortgage and consumer installment loans that are evaluated collectively for impairment. Reserves for probable credit losses related to these loans are based upon historical loss ratios and are included in the allowance for credit losses.

#### Note 4 – Commitments

In the normal course of business, to meet the financial needs of its customers, the Company's bank subsidiaries are parties to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. At March 31, 2008, total commitments to extend credit were approximately \$242.6 million. Outstanding letters of credit were approximately \$18.4 million at March 31, 2008.

#### Note 5 - Stock-Based Compensation

At March 31, 2008, the Company had three equity compensation plans: (i) the Shore Bancshares, Inc. 1998 Stock Option Plan; (ii) the Shore Bancshares, Inc. Employee Stock Purchase Plan ("ESPP"); and (iii) the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan ("2006 Equity Plan"). The plans are described in detail in Note 13 to the audited financial statements contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2007. Stock-based awards granted to date are generally time-based, vesting on each anniversary of the grant date over a three to five year period of time and, in the case of stock options, expiring 10 years from the grant date. ESPP awards allow employees to purchase shares of common stock at 85% of the fair market value on the date of grant. ESPP grants are 100% vested at date of grant and have a 27-month term.

During the three-month periods ended March 31, 2008 and 2007, the Company recognized pre-tax stock-based compensation expense of \$23 thousand and \$12 thousand, respectively. Stock-based compensation expense is recognized ratably over the requisite service period for all awards and is based on the grant-date fair value. Unrecognized stock-based compensation expense related to nonvested share-based compensation arrangements was \$368 thousand as of March 31, 2008. The weighted-average period over which this unrecognized expense was expected to be recognized was 4.2 years.



The Company estimates the fair value of stock options using the Black-Scholes valuation model with weighted average assumptions for dividend yield, expected volatility, risk-free interest rate and expected lives (in years). The expected dividend yield is calculated by dividing the total expected annual dividend payout by the average stock price. The expected volatility is based on historical volatility of the underlying securities. The risk-free interest rate is based on the Federal Reserve Bank's constant maturities daily interest rate in effect at grant date. The expected life of the options represents the period of time that the Company expects the awards to be outstanding based on historical experience with similar awards. Stock-based compensation expense recognized in the consolidated statements of income in the first quarter of 2008 and 2007 reflects forfeitures as they occurred.

No options were granted during the quarters ended March 31, 2008 and 2007.

The following table summarizes stock option activity for the Company under all plans for the three months ended March 31, 2008:

|                                  | Number<br>of Shares | Weighted<br>Average<br>Exercise Price | Aggregate<br>Intrinsic<br>Value |
|----------------------------------|---------------------|---------------------------------------|---------------------------------|
| Outstanding at beginning of year | 33,797              | \$ 15.67                              |                                 |
| Granted                          | -                   | -                                     |                                 |
| Exercised                        | (1,331)             | 15.48                                 |                                 |
| Expired/Cancelled                | (82)                | 18.47                                 |                                 |
| Outstanding at end of period     | 32,384              | 15.67                                 | \$ 187,051                      |
| Exercisable at end of period     | 32,384              | \$ 15.67                              | \$ 187,051                      |

The following summarizes information about options outstanding at March 31, 2008:

| Options Outstanding |        | Options Outstanding and Exercisable |                                                     |
|---------------------|--------|-------------------------------------|-----------------------------------------------------|
| Exercise Price      | Number | Number                              | Weighted Average Remaining Contract Life (in years) |
| \$ 21.33            | 5,075  | 5,075                               | 0.8                                                 |
| 14.00               | 4,005  | 4,005                               | 1.8                                                 |
| 13.17               | 16,445 | 16,445                              | 4.0                                                 |
| 18.47               | 6,859  | 6,859                               | 0.1                                                 |
|                     | 32,384 | 32,384                              |                                                     |

The total intrinsic value of stock options exercised during the three-month periods ended March 31, 2008 and 2007 was approximately \$9 thousand and \$15 thousand, respectively. Cash received upon exercise of options during the three-month periods ended March 31, 2008 and 2007 was approximately \$16 thousand and \$24 thousand, respectively.

The following table summarizes restricted stock award activity for the Company under the 2006 Equity Plan for the three months ended March 31, 2008:

|                              | Number<br>of Shares | Weighted Average Grant<br>Date Fair Value |
|------------------------------|---------------------|-------------------------------------------|
| Nonvested at January 1, 2008 | 3,845               | \$ 25.31                                  |
| Granted                      | 13,783              | 21.93                                     |



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|                             |           |       |
|-----------------------------|-----------|-------|
| Vested                      | -         | -     |
| Cancelled                   | -         | -     |
| Nonvested at March 31, 2008 | 17,628 \$ | 22.67 |

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Note 6 – Segment Reporting

The Company operates two primary business segments: Community Banking and Insurance Products and Services. Through the Community Banking business, the Company provides services to consumers and small businesses on the Eastern Shore of Maryland and Delaware through its 17-branch network. Community banking activities include small business services, retail brokerage, and consumer banking products and services. Loan products available to consumers include mortgage, home equity, automobile, marine, and installment loans, credit cards and other secured and unsecured personal lines of credit. Small business lending includes commercial mortgages, real estate development loans, equipment and operating loans, as well as secured and unsecured lines of credit, credit cards, accounts receivable financing arrangements, and merchant card services.

Through the Insurance Products and Services business, the Company provides a full range of insurance products and services to businesses and consumers in the Company's market areas. Products include property and casualty, life, marine, individual health and long-term care insurance. Pension and profit sharing plans and retirement plans for executives and employees are available to suit the needs of individual businesses.

Selected financial information by line of business for the three months ended March 31, 2008 and 2007 is included in the following table:

| (Dollars in thousands)            | Community banking | Insurance products and services | Parent Company  | Total               |
|-----------------------------------|-------------------|---------------------------------|-----------------|---------------------|
| <b>2008</b>                       |                   |                                 |                 |                     |
| Interest income                   | \$ 15,906         | \$ 17                           | \$ -            | \$ 15,923           |
| Interest expense                  | (5,859)           | -                               | (34)            | (5,893)             |
| Provision for credit losses       | (462)             | -                               | -               | (462)               |
| Noninterest income                | 1,802             | 3,700                           | -               | 5,502               |
| Noninterest expense               | (5,141)           | (3,044)                         | (1,406)         | (9,591)             |
| Net intersegment income (expense) | (1,263)           | (90)                            | 1,353           | -                   |
| Income before taxes               | 4,983             | 583                             | (87)            | 5,479               |
| Income tax (expense) benefit      | (1,916)           | (224)                           | 33              | (2,107)             |
| Net income                        | \$ 3,067          | \$ 359                          | \$ (54)         | \$ 3,372            |
| <b>Total assets</b>               | <b>\$ 980,506</b> | <b>\$ 20,818</b>                | <b>\$ 2,512</b> | <b>\$ 1,003,836</b> |
| <b>2007</b>                       |                   |                                 |                 |                     |
| Interest income                   | \$ 15,890         | \$ -                            | \$ -            | \$ 15,890           |
| Interest expense                  | (5,985)           | -                               | -               | (5,985)             |
| Provision for credit losses       | (242)             | -                               | -               | (242)               |
| Noninterest income                | 1,593             | 2,055                           | -               | 3,648               |
| Noninterest expense               | (5,185)           | (1,373)                         | (1,333)         | (7,891)             |
| Net intersegment income (expense) | ( 1,186)          | (95)                            | 1,281           | -                   |
| Income before taxes               | 4,885             | 587                             | (52)            | 5,420               |
| Income tax (expense) benefit      | (1,818)           | (218)                           | 19              | (2,017)             |
| Net income                        | \$ 3,067          | \$ 369                          | \$ (33)         | \$ 3,403            |
| <b>Total assets</b>               | <b>\$ 947,392</b> | <b>\$ 9,972</b>                 | <b>\$ 2,986</b> | <b>\$ 960,350</b>   |

Note 7 – Fair Value Measurements

Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standards (“SFAS”) No. 157, “*Fair Value Measurements*.” SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. In this standard, the Financial Accounting Standards Board (“FASB”) clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, SFAS 157 establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy is as follows:

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Level 1 inputs – Unadjusted quoted prices in active markets for identical assets or liabilities that the entity has the ability to access at the measurement date.

Level 2 inputs – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs – Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

Available-for-sale securities is the only balance sheet category that the Company is required by generally accepted accounting principles to account for at fair value. The following table presents information about the Company's assets measured at fair value on a recurring basis as of March 31, 2008, and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value.

| (Dollars in thousands)        | Carrying Value (Fair Value) | Quoted Prices (Level 1) | Significant Other Observable Inputs (Level 2) | Trading Gains and (Losses) | Total Changes In Fair Values Included In Period Earnings |
|-------------------------------|-----------------------------|-------------------------|-----------------------------------------------|----------------------------|----------------------------------------------------------|
| Securities available for sale | \$ 86,056                   | -                       | \$ 86,056                                     | -                          | -                                                        |

Securities classified as available-for-sale are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

#### Note 8 – New Accounting Pronouncements

##### **Pronouncements adopted**

*SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88 106, and 132(R)." SFAS 158 requires an employer to recognize the overfunded or underfunded status of post-retirement defined benefit plans as an asset or a liability in its statement of financial position. The funded status is measured as the difference between plan assets at fair value and the benefit obligation (the projected benefit obligation for pension plans or the accumulated benefit obligation for other post-retirement benefit plans). An employer is also required to measure the funded status of a plan as of the date of its year-end statement of financial position with changes in the funded status recognized through comprehensive income. SFAS 158 also requires certain disclosures regarding the effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of gains or losses, prior service costs or credits, and the transition asset or obligation. The adoption of SFAS 158's requirement to recognize the funded status in the financial statements for fiscal years ending after December 15, 2006 did not have a significant impact on the Company's consolidated financial statements. SFAS 158's requirement to use the fiscal year-end date as the measurement date is effective for fiscal years ending after December 15, 2008, and did not have a significant impact on the Company's consolidated financial statements.*

*SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115." SFAS 159 permits entities to choose to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value option has been elected are reported in*

earnings at each subsequent reporting date. The fair value option (i) may be applied instrument by instrument, with certain exceptions, (ii) is irrevocable (unless a new election date occurs) and (iii) is applied only to entire instruments and not to portions of instruments. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. The Company adopted SFAS 159 on January 1, 2008 and has not elected the fair value option for any financial assets or liabilities at March 31, 2008.

The Emerging Issues Task Force ("EITF") of the FASB issued EITF Issue 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements," which was effective January 1, 2008. EITF 06-4 requires the recognition of a liability and related compensation costs for endorsement split-dollar life insurance policies that provide a benefit to an employee that extends to postretirement periods as defined in SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." The EITF reached a consensus that Bank Owned Life Insurance policies purchased for this purpose do not effectively settle the entity's obligation to the employee in this regard and thus the entity must record compensation cost and a related liability. Entities should recognize the effects of applying this Issue through either, (a) a change in accounting principle through a cumulative-effect adjustment to retained earnings or to other components of equity or net assets in the balance sheet as of the beginning of the year of adoption, or (b) a change in accounting principle through retrospective application to all prior periods. This Issue is effective for fiscal years beginning after December 15, 2007. The effects of the guidance have been applied as a change in accounting principle through a cumulative-effect adjustment to retained earnings of \$318,000.

EITF Issue 06-11, "Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards." EITF 06-11 requires that tax benefits generated by dividends paid during the vesting period on certain equity-classified share-based compensation awards be classified as additional paid-in capital and included in a pool of excess tax benefits available to absorb tax deficiencies from share-based payment awards. EITF 06-11 is effective for years beginning after December 15, 2007. The adoption of EITF 06-11 did not have a significant impact on the Company's consolidated financial position or results of operations.

**Pronouncements issued but not yet effective**

*SFAS No. 141R, "Business Combinations."* SFAS 141R's objective is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after December 31, 2008. The Company does not expect the implementation of SFAS 141R to have a material impact on its consolidated financial statements.

*SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements."* SFAS 160's objective is to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 shall be effective for fiscal years and interim periods within those fiscal years, beginning on or after December 15, 2008. The Company does not expect the implementation of SFAS 160 to have a material impact on its consolidated financial statements.

*SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133"*. SFAS 161 is intended to enhance the disclosures previously required for derivative instruments and hedging activities under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", to include how and why an entity uses derivative instruments, how derivative instruments and related hedge items are accounted for and their impact on an entity's financial positions, results of operations and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The Company does not expect the implementation of SFAS 161 to have a material impact on its consolidated financial statements.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

Unless the context clearly suggests otherwise, references to "the Company", "we", "our", and "us" in this report are to Shore Bancshares, Inc. and its consolidated subsidiaries.

**Forward-Looking Information**

Portions of this Quarterly Report on Form 10-Q contain forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Statements that are not historical in nature, including statements that include the words "anticipate", "estimate", "should", "expect", "believe", "intend", and similar expressions, are expressions of our confidence, policies, and strategies, the adequacy of capital levels, and liquidity and are not guarantees of future performance. Such forward-looking statements involve certain risks and uncertainties, including economic conditions, competition in the geographic and business areas in which we operate, inflation, fluctuations in interest rates, legislation, and governmental regulation. These risks and uncertainties are described in detail in the section of the periodic reports that Shore Bancshares, Inc. files with the Securities and Exchange Commission entitled "Risk Factors" (see Item 1A of Part II of this report). Actual results may differ materially from such forward-looking statements, and we assume no obligation to update forward-looking statements at any time except as required by law.

**Introduction**

The following discussion and analysis is intended as a review of significant factors affecting the financial condition and results of operations of Shore Bancshares, Inc. and its consolidated subsidiaries for the periods indicated. This

discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes presented in this report, as well as the audited consolidated financial statements and related notes included in the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2007.

Shore Bancshares, Inc. is the largest independent financial holding company located on the Eastern Shore of Maryland. It is the parent company of The Talbot Bank of Easton, Maryland located in Easton, Maryland (“Talbot Bank”), The Centreville National Bank of Maryland located in Centreville, Maryland (“Centreville National Bank”) and The Felton Bank, located in Felton, Delaware (“Felton Bank”) (collectively, the “Banks”). The Banks operate 17 full service branches in Kent, Queen Anne’s, Talbot, Caroline and Dorchester Counties in Maryland and Kent County, Delaware. The Company engages in the insurance business through three insurance producer firms, The Avon-Dixon Agency, LLC, Elliott Wilson Insurance, LLC and Jack Martin Associates, Inc.; a wholesale insurance company, TSGIA, Inc.; and two insurance premium finance companies, Mubell Finance, LLC and ESFS, Inc. (all of the foregoing are collectively referred to as the “Insurance Subsidiary”) and the mortgage broker business through Wye Mortgage Group, LLC, all of which are wholly-owned subsidiaries of Shore Bancshares, Inc.

The shares of common stock of Shore Bancshares, Inc. are listed on the Nasdaq Global Select Market under the symbol “SHBI”.

The Company maintains an Internet site at [www.shbi.net](http://www.shbi.net) on which it makes available free of charge its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to the foregoing as soon as reasonably practicable after these reports are electronically filed with, or furnished to, the Securities and Exchange Commission.

### **Critical Accounting Policies**

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The financial information contained within the financial statements is, to a significant extent, financial information contained that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability.

We believe that our most critical accounting policy relates to the allowance for credit losses. The allowance for credit losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on two basic principles of accounting: (i) SFAS No. 5, Accounting for Contingencies, which requires that losses be accrued when they are probable of occurring and estimable, and (ii) SFAS No. 114, Accounting by Creditors for Impairment of a Loan, which requires that losses be accrued based on the differences between the loan balance and the value of collateral, present value of future cash flows or values that are observable in the secondary market. Management uses many factors, including economic conditions and trends, the value and adequacy of collateral, the volume and mix of the loan portfolio, and our internal loan processes in determining the inherent loss that may be present in our loan portfolio. Actual losses could differ significantly from Management’s estimates. In addition, GAAP itself may change from one previously acceptable method to another. Although the economics of transactions would be the same, the timing of events that would impact the transactions could change.

Management has significant discretion in making the adjustments inherent in the determination of the provision and allowance for credit losses, including in connection with the valuation of collateral, the borrower’s prospects of repayment, and in establishing allowance factors on the formula allowance and unallocated allowance components of the allowance. The establishment of allowance factors is a continuing exercise, based on Management’s continuing assessment of the totality of all factors, including, but not limited to, delinquencies, loss history, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of Management, national and local economic trends, concentrations of credit, the quality of the loan review system and the effect of external factors such as competition and regulatory requirements, and their impact on the portfolio, and allowance factors may change from period to period, resulting in an increase or decrease in the amount of the provision or allowance, based upon the same volume and classification of loans. Changes in allowance factors will have a direct impact on the amount of the provision, and a corresponding effect on net income. Errors in Management’s perception and assessment of these



factors and their impact on the portfolio could result in the allowance not being adequate to cover losses in the portfolio, and may result in additional provisions or charge-offs.

Three basic components comprise our allowance for credit losses: (i) a specific allowance; (ii) a formula allowance; and (iii) a nonspecific allowance. Each component is determined based on estimates that can and do change when the actual events occur. The specific allowance is used to individually allocate an allowance to loans identified as impaired. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. When a loan is identified as impaired, a specific allowance is established based on our assessment of the loss that may be associated with the individual loan. The formula allowance is used to estimate the loss on internally risk rated loans, exclusive of those identified as impaired. Loans identified as special mention, substandard, doubtful and loss, as well as impaired, are segregated from performing loans. Remaining loans are then grouped by type (commercial, commercial real estate, construction, home equity or consumer). Each loan type is assigned an allowance factor based on Management's estimate of the risk, complexity and size of individual loans within a particular category. Classified loans are assigned higher allowance factors than non-rated loans due to Management's concerns regarding collectibility or Management's knowledge of particular elements regarding the borrower. Allowance factors grow with the worsening of the internal risk rating. The nonspecific formula is used to estimate the loss of non-classified loans stemming from more global factors such as delinquencies, loss history, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of Management, national and local economic trends, concentrations of credit, the quality of the loan review system and the effect of external factors such as competition and regulatory requirements. The nonspecific allowance captures losses that have impacted the portfolio but have yet to be recognized in either the formula or specific allowance.

## OVERVIEW

Net income for the first quarter of 2008 was \$3.372 million, or diluted earnings per share of \$0.40, compared to \$3.403 million, or diluted earnings per share of \$0.41, for the first quarter of 2007. For the fourth quarter of 2007, net income was \$3.340 million or \$0.40 per diluted share.

Annualized return on average assets was 1.38% for the three months ended March 31, 2008, compared to 1.43% for the same period in 2007. Annualized return on average stockholders' equity was 10.96% for the three-month period ended March 31, 2008, compared to 12.09% for the same period in 2007. For the fourth quarter of 2007, return on average assets was 1.40% and return on average equity was 11.78%.

## RESULTS OF OPERATIONS

### Net Interest Income

Net interest income for the three-month period ended March 31, 2008 was \$10.0 million, representing an increase of 1.3% when compared to the same period last year. Increased loan volume was the reason for the increase. The net interest margin remained relatively flat at 4.42% for the first quarter of 2008 when compared to the first quarter of 2007. Net interest income decreased 3.8% from the fourth quarter of 2007 primarily due to decreased rates. The net interest margin decreased 28 basis points from 4.70% for the fourth quarter of 2007. The 200 basis-point reduction in interest rates by the Federal Reserve in the first quarter of 2008 had a significant and immediate impact on the overall yield on earning assets.

Interest income was \$15.9 million for both the first quarters of 2008 and 2007. Average earning assets increased 3.1% during the first quarter of 2008 when compared to the same period in 2007, and yields earned decreased 15 basis points to 7.00%. Average loans increased 14.0% while the yield earned on loans decreased 44 basis points. Loans comprised 86.5% and 78.1% of total average earning assets for the quarters ended March 31, 2008 and 2007, respectively. Interest income decreased 3.2% when compared to the fourth quarter of 2007.

Interest expense decreased 1.5% for the three-month period ended March 31, 2008 when compared to the same period last year. Average interest bearing liabilities increased 3.0% while rates paid decreased 13 basis points to 3.17%. Declining average balances and lower rates paid on money market and savings deposits and long-term debt were the primary reasons for the decreased expense. Although lower rates were paid for certificates of deposit and short-term borrowings, interest expense increased for these two categories due to increased average balances. The average balance of interest bearing deposits increased by 2.6% for the three months ended March 31, 2008 when compared to the same period in 2007. The overall rate paid for interest bearing deposits decreased 8 basis points to 3.12%. For the three months ended March 31, 2008, the average balance of certificates of deposits \$100,000 or more increased by 13.5% when compared to the same period last year, and the average rate paid for those certificates of deposit decreased 24 basis points to 4.60%. Interest expense decreased 2.2% when compared to the fourth quarter of 2007.

**Analysis of Interest Rates and Interest Differentials.**

The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid through March 31, 2008 and 2007:

| (Dollars in thousands)                     | March 31, 2008  |                   |            | March 31, 2007  |                   |            |
|--------------------------------------------|-----------------|-------------------|------------|-----------------|-------------------|------------|
|                                            | Average Balance | Income(1)/Expense | Yield/Rate | Average Balance | Income(1)/Expense | Yield/Rate |
| <b>Earning assets</b>                      |                 |                   |            |                 |                   |            |
| Investment securities                      |                 |                   |            |                 |                   |            |
| Taxable                                    | \$ 91,556       | \$ 1,080          | 4.74%      | \$ 116,792      | \$ 1,284          | 4.40%      |
| Nontaxable                                 | 12,676          | 190               | 6.01       | 13,215          | 192               | 5.81       |
| Loans (2), (3)                             | 796,849         | 14,601            | 7.37       | 698,735         | 13,641            | 7.81       |
| Federal funds sold                         | 16,237          | 122               | 3.03       | 38,819          | 520               | 5.35       |
| Interest bearing deposits                  | 4,204           | 38                | 3.64       | 26,678          | 338               | 5.07       |
| Total earning assets                       | 921,522         | 16,031            | 7.00%      | 894,239         | 15,975            | 7.15%      |
| Cash and due from banks                    | 16,648          |                   |            | 17,226          |                   |            |
| Other assets                               | 55,013          |                   |            | 43,835          |                   |            |
| Allowance for credit losses                | (7,716)         |                   |            | (6,445)         |                   |            |
| Total assets                               | \$ 985,467      |                   |            | \$ 948,855      |                   |            |
| <b>Interest bearing liabilities</b>        |                 |                   |            |                 |                   |            |
| Demand deposits                            | \$ 115,215      | 171               | 0.60%      | \$ 111,248      | 236               | 0.85%      |
| Money market and savings deposits          | 175,363         | 705               | 1.62       | 185,017         | 824               | 1.78       |
| Certificates of deposit \$100,000 or more  | 180,826         | 2,070             | 4.60       | 159,281         | 1,926             | 4.84       |
| Other time deposits                        | 217,123         | 2,397             | 4.44       | 215,285         | 2,382             | 4.43       |
| Interest bearing deposits                  | 688,527         | 5,343             | 3.12       | 670,831         | 5,368             | 3.20       |
| Short-term borrowings                      | 43,354          | 366               | 3.40       | 27,180          | 246               | 3.62       |
| Long-term debt                             | 14,925          | 184               | 4.95       | 27,000          | 371               | 5.50       |
| Total interest bearing liabilities         | 746,806         | 5,893             | 3.17%      | 725,011         | 5,985             | 3.30%      |
| Noninterest bearing deposits               | 100,982         |                   |            | 102,915         |                   |            |
| Other liabilities                          | 13,940          |                   |            | 8,297           |                   |            |
| Stockholders' equity                       | 123,739         |                   |            | 112,632         |                   |            |
| Total liabilities and stockholders' equity | \$ 985,467      |                   |            | \$ 948,855      |                   |            |
| Net interest spread                        |                 | \$ 10,138         | 3.83%      |                 | \$ 9,990          | 3.85%      |
| Net interest margin                        |                 |                   | 4.42%      |                 |                   | 4.47%      |

(1) All amounts are reported on a tax equivalent basis computed using the statutory federal income tax rate of 35% exclusive of the alternative minimum tax rate and nondeductible interest expense.

(2) Average loan balances include nonaccrual loans.

(3) Interest income on loans includes amortized loan fees, net of costs, for each loan category and yield calculations are stated to include all.

**Noninterest Income**

Noninterest income for the first quarter of 2008 increased \$1.9 million when compared to the first quarter of 2007. The increase was primarily the result of the acquisition of two insurance agencies during the fourth quarter of 2007. Service charges on deposit accounts increased \$182 thousand, other service charges and fees increased \$265 thousand and insurance agency commissions increased \$1.4 million for the first quarter of 2008 when compared to the first quarter of 2007. Noninterest income increased \$787 thousand from the fourth quarter of 2007 primarily due to an

increase in insurance agency commissions.

**Noninterest Expense**

Noninterest expense for the first quarter of 2008 increased \$1.7 million when compared to the first quarter of 2007. The increase was primarily attributable to the operating expenses of the two insurance agencies acquired during the fourth quarter of 2007. Salaries and benefits increased \$1.1 million and other noninterest expenses increased \$610 thousand for the first quarter of 2008 when compared to the first quarter of 2007. Included in other noninterest expenses was \$611 thousand in commissions paid to unrelated insurance companies relating to wholesale insurance company activities. Noninterest expense increased \$289 thousand from the fourth quarter of 2007 primarily due to an increase in salaries and benefits partially offset by a decrease in other noninterest expenses.

### **Income Taxes**

The effective tax rate was 38.5% for the three months ended March 31, 2008 compared to 37.2% for the same period last year. Management believes that there have been no changes in tax laws or to our tax structure that are likely to have a material impact on our future effective tax rate.

## **ANALYSIS OF FINANCIAL CONDITION**

### **Loans**

Loans, net of unearned income, totaled \$808.6 million at March 31, 2008, an increase of \$32.2 million, or 4.2%, since December 31, 2007. Average loans, net of unearned income, were \$796.8 million for the three months ended March 31, 2008, an increase of \$98.1 million, or 14.0%, when compared to the same period last of year.

### **Allowance for Credit Losses**

We have established an allowance for credit losses, which is increased by provisions charged against earnings and recoveries of previously charged-off debts. The allowance is decreased by current period charge-offs of uncollectible debts. Management evaluates the adequacy of the allowance for credit losses on a quarterly basis and adjusts the provision for credit losses based upon this analysis. The evaluation of the adequacy of the allowance for credit losses is based on a risk rating system of individual loans, as well as on a collective evaluation of smaller balance homogenous loans based on factors such as past credit loss experience, local economic trends, nonperforming and problem loans, and other factors which may impact collectibility. A loan is placed on nonaccrual when it is specifically determined to be impaired and principal and interest is delinquent for 90 days or more. Please refer to the discussion above under the caption "Critical Accounting Policies" for an overview of the underlying methodology Management employs on a quarterly basis to maintain the allowance.

The provision for credit losses for the three-month periods ended March 31, 2008 and 2007 was \$462 thousand and \$242 thousand, respectively. The provision for credit losses for the fourth quarter of 2007 was \$465 thousand. The increased provision for the first quarter of 2008 when compared to the same period last year reflected the overall growth in the loan portfolio and current economic conditions. The overall credit quality of the portfolio remains strong as evidenced by loan delinquency and charge-off data at March 31, 2008. Management believes that we continue to maintain strong underwriting guidelines.

Our historical charge-off ratios remain lower than those of similarly sized institutions according to the most recent Bank Holding Company Performance Report prepared by the Federal Reserve Board. Net charge-offs were \$87 thousand for the three-month period ended March 31, 2008, compared to \$36 thousand for the same period last year and \$135 thousand for the fourth quarter of 2007. The allowance for credit losses as a percentage of average loans was 0.99% at March 31, 2008, compared to 0.93% at March 31, 2007. Loans past due 90 days and still accruing at March 31, 2008 were \$1.1 million compared to \$1.6 million at December 31, 2007. Nonperforming assets decreased to \$3.4 million at March 31, 2008 from \$3.7 million at December 31, 2007. Based on Management's quarterly evaluation of the adequacy of the allowance for credit losses, it believes that the allowance for credit losses and the related provision are adequate at March 31, 2008.

The following table presents a summary of the activity in the allowance for credit losses:

| (Dollars in thousands)                                                                  | For the Three Months Ended March 31, |            |
|-----------------------------------------------------------------------------------------|--------------------------------------|------------|
|                                                                                         | 2008                                 | 2007       |
| Allowance balance - beginning of period                                                 | \$ 7,551                             | \$ 6,300   |
| Charge-offs:                                                                            |                                      |            |
| Real estate                                                                             | (12)                                 | -          |
| Consumer                                                                                | (63)                                 | (79)       |
| Commercial and other                                                                    | (42)                                 | (16)       |
| Totals                                                                                  | (117)                                | (95)       |
| Recoveries:                                                                             |                                      |            |
| Real estate                                                                             | 8                                    | -          |
| Consumer                                                                                | 19                                   | 27         |
| Commercial and other                                                                    | 3                                    | 32         |
| Totals                                                                                  | 30                                   | 59         |
| Net charge-offs                                                                         | (87)                                 | (36)       |
| Provision for credit losses                                                             | 462                                  | 242        |
| Allowance balance - end of period                                                       | \$ 7,926                             | \$ 6,506   |
| Average loans outstanding during period                                                 | \$ 796,849                           | \$ 698,735 |
| Net charge-offs (annualized) as a percentage of average loans outstanding during period | 0.04%                                | 0.02%      |
| Allowance for credit losses at period end as a percentage of average loans              | 0.99%                                | 0.93%      |

Because most of our loans are secured by real estate, weaknesses in the local real estate market may have a material adverse effect on the performance of our loan portfolio and the value of the collateral securing that portfolio. Despite the weaknesses in the national economy and real estate market, Management believes that the local economy and real estate market remain relatively stable.

We have a concentration of commercial real estate loans. Commercial real estate loans, excluding construction and land development loans, at March 31, 2008 were approximately \$266.4 million, or 33.0% of total loans, compared to \$249.5 million, or 32.1% of total loans at December 31, 2007. Construction and land development loans at March 31, 2008 were \$166.6 million, or 20.6% of total loans, compared to \$155.5 million, or 20.0% of total loans at December 31, 2007. We do not engage in foreign or subprime lending activities.

### Nonperforming Assets

The following table summarizes our past due and nonperforming assets:

| (Dollars in thousands)                        | March 31,<br>2008 | December 31,<br>2007 |
|-----------------------------------------------|-------------------|----------------------|
| Nonperforming assets                          |                   |                      |
| Nonaccrual loans                              | \$ 3,438          | \$ 3,540             |
| Other real estate owned                       | -                 | 176                  |
| Total nonperforming assets                    | 3,438             | 3,716                |
| Loans 90 days past due and still accruing     | 1,098             | 1,606                |
| Total nonperforming assets and past due loans | \$ 4,536          | \$ 5,322             |

### Investment Securities

Investment securities totaled \$99.1 million at March 31, 2008, compared to \$110.0 million at December 31, 2007. The decreased balance reflects that a portion of maturing securities were used to fund loan growth. The average balance of investment securities was \$104.2 million for the three months ended March 31, 2008, compared to \$130.0 million for the same period in 2007. The tax equivalent yields on investment securities were 4.90% and 4.54% for the three-month periods ended March 31, 2008 and 2007, respectively.

**Deposits**

Total deposits at March 31, 2008 were \$808.9 million, compared to \$765.9 million at December 31, 2007. Certificates of deposit of \$100,000 or more increased \$27.0 million, or 16.7%, due primarily to increased deposits of a large municipal customer, and money market and savings deposits increased \$14.6 million, or 8.6%, since the end of 2007. Growth in other time and demand deposits have remained relatively flat since December 31, 2007.

**Short-term borrowings**

Short-term borrowings at March 31, 2008 and December 31, 2007 were \$42.7 million and \$47.7 million, respectively. Short-term borrowings consisted of securities sold under agreements to repurchase, overnight borrowings from correspondent banks and short-term advances from the Federal Home Loan Bank. Short-term advances are defined as those with original maturities of one year or less.

**Long-Term Debt**

At March 31, 2008 and December 31, 2007, the Company had the following long-term debt:

| (Dollars in thousands)                                                             | March 31,<br>2008 | December 31,<br>2007 |
|------------------------------------------------------------------------------------|-------------------|----------------------|
| Federal Home Loan Bank (FHLB) 5.69% Advance due June 2008                          | \$ 7,000          | \$ 7,000             |
| FHLB 4.17% Advance due November 2009                                               | 3,000             | 3,000                |
| FHLB 3.09% Advance due January 2010                                                | 3,000             | -                    |
| Acquisition related debt, 4.08% interest, equal annual installments for five years | 2,485             | 2,485                |
|                                                                                    | <b>\$ 15,485</b>  | <b>\$ 12,485</b>     |

**Liquidity and Capital Resources**

We derive liquidity through increased customer deposits, maturities in the investment portfolio, loan repayments and income from earning assets. To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets through arrangements with correspondent banks. Talbot Bank and Centreville National Bank are also members of the Federal Home Loan Bank of Atlanta and Felton Bank is a member of the Federal Home Loan Bank of Pittsburgh to which they have pledged collateral sufficient to permit additional borrowings of up to approximately \$74.3 million in the aggregate at March 31, 2008. Management is not aware of any trends or demands, commitments, events or uncertainties that are likely to materially affect our future ability to maintain liquidity at satisfactory levels.

Total stockholders' equity was \$122.7 million at March 31, 2008, an increase of 2.0% since December 31, 2007. Accumulated other comprehensive income, which consists solely of net unrealized gains or losses on investment securities available for sale, increased by \$714 thousand since the end of 2007, resulting in accumulated other comprehensive income of \$961 thousand at March 31, 2008.

Bank regulatory agencies have adopted various capital standards for financial institutions, including risk-based capital standards. The primary objectives of the risk-based capital framework are to provide a more consistent system for comparing capital positions of financial institutions and to take into account the different risks among financial institutions' assets and off-balance sheet items.

Risk-based capital standards have been supplemented with requirements for a minimum Tier 1 capital to average assets ratio (leverage ratio). In addition, regulatory agencies consider the published capital levels as minimum levels and may require a financial institution to maintain capital at higher levels.

A comparison of our capital ratios as of March 31, 2008 to the minimum regulatory requirements is presented below:

|                           | Actual | Minimum<br>Requirements |
|---------------------------|--------|-------------------------|
| Tier 1 risk-based capital | 11.88% | 4.00%                   |
| Total risk-based capital  | 12.88% | 8.00%                   |
| Leverage ratio            | 10.32% | 4.00%                   |

**Item 3. Quantitative and Qualitative Disclosures about Market Risk.**



Our primary market risk is to interest rate fluctuation and Management has procedures in place to evaluate and mitigate this risk. This risk and these procedures are discussed in Item 7 of Part II of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2007 under the caption "Market Risk Management". Management believes that there have been no material changes in our market risks, the procedures used to evaluate and mitigate these risks, or our actual and simulated sensitivity positions since December 31, 2007.

#### **Item 4. Controls and Procedures.**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934 with the SEC, such as this Quarterly Report, is recorded, processed, summarized and reported within the time periods specified in those rules and forms, and that such information is accumulated and communicated to Management, including the Chief Executive Officer (“CEO”) and the Principal Accounting Officer (“PAO”), as appropriate, to allow for timely decisions regarding required disclosure. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

An evaluation of the effectiveness of these disclosure controls as of March 31, 2008 was carried out under the supervision and with the participation of Management, including the CEO and the PAO. Based on that evaluation, the Company’s management, including the CEO and the PAO, has concluded that our disclosure controls and procedures are, in fact, effective at the reasonable assurance level.

During the first quarter of 2008, there was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II – OTHER INFORMATION**

#### **Item 1A. Risk Factors.**

The risks and uncertainties to which our financial condition and operations are subject are discussed in detail in Item 1A of Part I of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2007. Management does not believe that any material changes in our risk factors have occurred since they were last disclosed.

#### **Item 6. Exhibits.**

The exhibits filed or furnished with this quarterly report are shown on the Exhibit List that follows the signatures to this report, which list is incorporated herein by reference.

## **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.

SHORE BANCSHARES, INC.

Date: May 8, 2008

By:

/s/ W. Moorhead Vermilye  
W. Moorhead Vermilye  
President/Chief Executive Officer

Date: May 8, 2008

By:

/s/ Susan E. Leaverton  
Susan E. Leaverton, CPA  
Treasurer/Principal Accounting Officer

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**EXHIBIT INDEX**

| Exhibit<br>Number | Description                                                                                      |
|-------------------|--------------------------------------------------------------------------------------------------|
| 31.1              | Certifications of the CEO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).    |
| 31.2              | Certifications of the PAO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).    |
| 32.1              | Certification of the CEO pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith). |
| 32.2              | Certification of the PAO pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith). |

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